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upon exercise of non-qualified stock options by a former employee upon payment of the exercise price of $3,375.

The total unrecognized compensation expense for unvested non-qualified stock options, RSUs and stock bonus awards at June 30, 2018 was $1,103,770, which will be recognized over approximately 2.0 years. This unrecognized compensation expense does not include the potential future compensation expense related to non-qualified stock options and RSUs which are subject to vesting based on the achievement of $18,000,000 in revenue for 2018 and $25,000,000 in revenue for 2019 (the "Performance-based Awards"). As of June 30, 2018 and the grant date, the Company has determined that the likelihood of performance levels being obtained is remote; therefore, no expense was recognized. The unrecognized compensation expense with respect to these Performance-based Awards at June 30, 2018 was $1,251,973.

Non-Qualified Stock Options

The Company uses the Black-Scholes Model to determine the fair value of options granted. Option-pricing models require the input of highly subjective assumptions, particularly for the expected stock price volatility and the expected term of options. Changes in the subjective input assumptions can materially affect the fair value estimate. The expected stock price volatility assumptions are based on the historical volatility of the Company's common stock over periods that are similar to the expected terms of grants and other relevant factors. The Company derives the expected term based on an average of the contract term and the vesting period taking into consideration the vesting schedules and future employee behavior with regard to option exercise. The risk-free interest rate is based on U.S. Treasury yields for a maturity approximating the expected term calculated at the date of grant. The Company has never paid any cash dividends on its common stock and the Company has no intention to pay a dividend at this time; therefore, the Company assumes that no dividends will be paid over the expected terms of option awards.

The Company determines the assumptions used in the valuation of option awards as of the date of grant. Differences in the expected stock price volatility, expected term or risk-free interest rate may necessitate distinct valuation assumptions at those grant dates. As such, the Company may use different assumptions for options granted throughout the year. During the six months ended June 30, 2018, the valuation assumptions used to determine the fair value of each option award on the date of grant were: expected stock price volatility 118.90%; expected term in years 7.5 and risk-free interest rate 2.77%.

Surna Inc.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

A summary of the non-qualified stock options granted to employees under the 2017 Equity Plan as of June 30, 2018, and changes during the six months then ended, are presented in the table below:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding, December 31, 2017	10,235,000	$ 0.121	8.7	$1,218,375
Granted	1,000,000	$ 0.283		
Exercised	(25,000)	$ 0.135		
Forfeited	(1,116,666)	$ 0.122		
Expired	(33,334)	0.135		
Outstanding, June 30, 2018	10,060,000	$ 0.137	8.3	$333,800
Exercisable, June 30, 2018	1,826,674	$ 0.124	3.9	$83,884
Outstanding vested and expected to vest, June 30, 2018	2,760,000	$ 0.127	5.7	$120,050
Performance options based on 2018 and 2019 revenue thresholds - uncertain vesting as of June 30, 2018	7,300,000	$ 0.141	9.2	$213,750

A summary of non-vested non-qualified stock options granted to employees under the 2017 Equity Plan as of June 30, 2018, and any changes during the six months then ended, are presented in the table below:

	Number of Options	Weighted Average Grant-Date Fair Value	Aggregate Intrinsic Value
Nonvested, December 31, 2017	8,349,992	$ 0.107	$1,000,499
Granted	1,000,000	$ 0.257	
Vested	-	-	
Forfeited	(1,116,666)	$ 0.109	

Expired	-	-	
Nonvested, June 30, 2018	8,233,326	$ 0.125	$249,916

During the six months ended June 30, 2018, the Company recorded $27,978 as compensation expense related to vested options issued to employees, net of forfeitures. As of June 30, 2018, total unrecognized share-based compensation related to unvested options was $970,611, of which $54,338 was related to time-based vesting and $916,273 was related to performance-based vesting.

As of June 30, 2018, the Company had granted non-qualified options to purchase 10,250,000 shares which were performance-based, of which 1,950,000 were forfeited due to the failure to satisfy the 2017 revenue and bookings performance thresholds and 1,000,000 were forfeited due to employee terminations. Of the remaining non-qualified options to purchase 7,300,000 shares which are performance-based, the Company has determined that the likelihood of the 2018 and 2019 performance thresholds being satisfied is remote as of the date of grant and June 30, 2018; therefore, no expense was recognized. As of June 30, 2018, the performance-based non-qualified stock options include: (i) 2,950,000 options that vest if the Company achieves 2018 revenue of $18,000,000, and (ii) 4,350,000 options that vest if the Company achieves 2019 revenue of $25,000,000.

Surna Inc.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

A summary of the non-qualified stock options granted to the directors under the 2017 Equity Plan as of June 30, 2018, and changes during the six months then ended, are presented in the table below:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)
Outstanding, December 31, 2017	900,000	$ 0.135	9.6	$ 94,500
Granted	-	-		
Exercised	-	-		
Forfeited/Cancelled	-	-		
Expired	-	-		
Outstanding, June 30, 2018	900,000	$ 0.135	9.1	$ 31,500
Exerciseable, June 30, 2018	900,000	$ 0.135	9.1	$ 31,500
Outstanding vested, June 30, 2018	900,000	$ 0.135	9.1	$ 31,500

A summary of non-vested non-qualified stock options granted to directors under the 2017 Equity Plan as of June 30, 2018, and any changes during the six months then ended, are presented in the table below:

	Number of Options	Weighted Average Grant-Date Fair Value	Aggregate Intrinsic Value
Nonvested, December 31, 2017	450,000	$ 0.123	$ 52,470
Granted	-	-	
Vested	(450,000)	$ 0.123	
Forfeited	-	-	
Expired	-	-	
Nonvested, June 30, 2018	-	-	$ -

During the six months ended June 30, 2018, the Company recorded $12,205 as compensation expense related to vested options issued to directors. As of June 30, 2018, total unrecognized share-based compensation related to unvested options was $0.

Restricted Stock Units

A summary of the RSUs awarded to employees, directors and consultants under the 2017 Equity Plan as June 30, 2018, and changes during the six months then ended, are presented in the table below:

	Number of Units	Weighted Average Grant-Date Fair Value	Aggregate Intrinsic Value
Outstanding, December 31, 2017	13,800,000	$ 0.122	$3,312,000
Granted	5,000,000	$ 0.188	
Vested and settled with share issuance[1]	(5,050,000)	$ 0.141	
Forfeited	-	-	
Outstanding, June 30, 2018	13,750,000	$ 0.139	$2,337,500
Expected to vest as of June 30, 2018	10,750,000	$ 0.146	$1,827,500
2018/2019 Performance Units - uncertain vesting	3,000,000	$ 0.112	$510,000

[1]Includes 1,000,000 RSUs which were vested and to be settled with issued shares as of June 30, 2018.

Surna Inc.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

During the six months ended June 30, 2018, the Company recorded $796,874 as compensation expense related to vested RSUs issued to employees, directors and consultants. As of June 30, 2018, total unrecognized share-based compensation related to unvested RSUs was $1,080,982, of which $745,282 was related to time-based vesting and $335,700 was related to performance-based vesting. The total intrinsic value of RSUs vested and settled or to be settled with share issuance was $1,577,100 for the six months ended June 30, 2018, based on the closing price of the Company’s stock on the vesting date.

As of June 30, 2018, the Company had granted 3,000,000 RSUs to the CEO which were performance-based. The Company has determined that the likelihood of the performance thresholds being satisfied is remote as of the date of grant and June 30, 2018; therefore, no expense was recognized. As of June 30, 2018, the performance-based RSUs include: (i) 1,500,000 RSUs that vest if the Company achieves 2018 revenue of $18,000,000, and (ii) 1,500,000 options that vest if the Company achieves 2019 revenue of $25,000,000.

Incentive Stock Bonus Awards

Incentive stock bonuses awarded pursuant to certain employment agreements are treated as vesting over each award’s service period based on the fair value of the award at the time of grant. Even though the awards are subject to Board approval, the awards are treated as vesting over each service period based on the employee performance standards for such awards included in the employment agreements. Since the awards are denominated in shares of common stock, the fair value of the vested award is charged to additional paid-in capital. In the event the Board does not approve these incentive stock bonus awards or the employee terminates employment, the Company would reverse any previously recognized compensation costs related to these awards.

A summary of the incentive stock bonus awards granted to employees under the 2017 Equity Plan as June 30, 2018, and changes during the six months then ended, are presented in the table below:

	Number of Shares	Weighted Average	Aggregate Intrinsic

		Grant-Date Fair Value	Value
Unvested, December 31, 2017	7,040,000	$ 0.113	$1,689,600
Awarded	-	-	
Vested	(1,560,000)	$ 0.112	
Forfeited	(200,000)	$ 0.121	
Unvested, June 30, 2018	5,280,000	$ 0.113	$897,600

During the six months ended June 30, 2018, the Company recorded $277,566 as compensation expense related to vested stock bonus awards issued to employees, net of forfeitures related to employee terminations. As of June 30, 2018, total unrecognized share-based compensation related to unvested stock bonus awards was $304,150.

Note 11 – Income Taxes

As of December 31, 2017, the Company has U.S. federal and state net operating losses (“NOLs”) of approximately $10,848,000, which will expire, if not utilized, in the years 2034 through 2037. Pursuant to Section 382 of the Internal Revenue Code of 1986, as amended, use of the Company’s NOLs carryforwards may be limited in the event of cumulative changes in ownership of more than 50% within a three-year period.

The Company must assess the likelihood that its net deferred tax assets (including NOLs) will be recovered from future taxable income, and to the extent the Company believes that recovery is not likely, the Company establishes a valuation allowance. Management’s judgment is required in determining the Company’s provision for income taxes, deferred tax assets and liabilities, and any valuation allowance recorded against the net deferred tax assets. The Company recorded a full valuation allowance as of December 31, 2017 and June 30, 2018. Based on the available evidence, the Company believes it is more likely than not that it will not be able to utilize its net deferred tax assets (including NOLs) in the foreseeable future.

Surna Inc.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Note 12 – Subsequent Events

The Company has evaluated all subsequent events through August 14, 2018, the date the financial statements were available to be issued. The following events occurred after June 30, 2018.

Appointment of Chief Financial Officer

On July 9, 2018, the Board appointed a new Chief Financial Officer ("CFO") and Treasurer, which positions had been previously vacant. In connection with this appointment, the Company and the new CFO entered into an employment agreement that will continue until June 30, 2020. Under the employment agreement, the new CFO is eligible to receive an aggregate of 4,000,000 shares of the Company's common stock, as determined by the Board in its sole discretion, as follows: (i) for the six-month period ended December 31, 2018, the new CFO will be eligible to receive a special bonus of 1,000,000 shares of the Company's common stock, provided the Board has determined that his performance has been average or better for such period, and (ii) for each of the six-month periods ended June 30, 2019, December 31, 2019 and June 30, 2020, the new CFO will be eligible to receive a special bonus of 1,000,000 shares of the Company's common stock, provided the Board has determined that he has achieved certain benchmarks and milestones as mutually agreed to by him and the Board in advance of each such period.

Equity-related Transactions

On July 13, 2018, the Company issued 1,000,000 shares to Brandy Keen in settlement of RSUs that vested on June 30, 2018. See Note 6.

On August 2, 2018, the Board approved the following:

The issuance of 105,634 shares of common stock to independent directors in lieu of cash director fees of $15,000 related to the second quarter of 2018;

The issuance of 560,000 shares pursuant to special incentive stock bonuses earned by an employee for the six-month period ended June 30, 2018, subject to the remittance of required withholding taxes by the recipient; and

The grant to a new employee of 120,000 RSUs that vest on the six-month anniversary of employment.

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

The following discussion should be read in conjunction with our unaudited condensed consolidated financial statements and related notes included elsewhere in this Quarterly Report, which include additional information about our accounting policies, practices, and the transactions underlying our financial results, as well as with our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the SEC. In addition to historical information, the following discussion and other parts of this Quarterly Report contain forward-looking information that involves risks and uncertainties. Our actual results could differ materially from those anticipated by such forward-looking information due to the factors discussed under "Cautionary Statements and Projections" appearing elsewhere herein and the risks and uncertainties described or identified in "Item 1A – Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2017, as updated from time to time in the Company's filings with the SEC, and Part II, Item 1A of this Quarterly Report entitled "Risk Factors."

Non-GAAP Financial Measures

To supplement our financial results on U.S. generally accepted accounting principles ("GAAP") basis, we use the non-GAAP measures including net bookings and backlog, as well as other significant non-cash expenses such as stock-based compensation and certain debt-related expenses. We believe these non-GAAP measures are helpful in understanding our past performance and are intended to aid in evaluating our potential future results. The presentation of these non-GAAP measures should be considered in addition to our GAAP results and are not intended to be considered in isolation or as a substitute for financial information prepared or presented in accordance with GAAP. We believe these non-GAAP financial measures reflect an additional way to view aspects of our operations that, when viewed with our GAAP results, provide a more complete understanding of factors and trends affecting our business.

Overview

We design, engineer and manufacture application-specific environmental control and air sanitation systems for commercial, state- and provincial-regulated indoor cannabis cultivation facilities in the U.S. and Canada. Our engineering and technical team provides energy and water efficient solutions that allow growers to meet the unique demands of a cannabis cultivation environment through precise temperature, humidity, and process controls and to satisfy the evolving code and regulatory requirements being imposed at the state and local levels.

Headquartered in Boulder, Colorado, we leverage our experience in this space in order to bring value-added climate control solutions to our customers that help improve their overall crop quality and yield as well as optimize the resource efficiency of their controlled environment (i.e., indoor and greenhouses) cultivation facilities. We have been involved in consulting, equipment sales and/or full-scale design for over 700 grow facilities since 2006 making us a trusted resource for indoor environmental design and control management for the cannabis industry.

Our customers have included small cultivation operations to licensed commercial facilities ranging from several thousand to more than 100,000 square feet. We have sold our equipment and systems throughout the U.S. and Canada as well as internationally in South Africa, Switzerland and the United Kingdom. Our revenue stream is derived primarily from supplying mechanical engineering services and climate and environmental control equipment to commercial indoor cannabis grow facilities in North America. We also sell equipment to smaller cultivators who can purchase either directly from us, or from our authorized wholesalers or retailers. Though our customers do, we neither produce nor sell cannabis.

Shares of our common stock are traded on the OTCMarkets under the ticker symbol “SRNA.”

Cannabis Market

The demand for our climate control and air sanitation systems, including system design and engineering, proprietary equipment, and third-party manufactured equipment, is primarily influenced by the construction of new cannabis cultivation facilities in the U.S. and Canada. Due to continued uncertainty of the cannabis industry following the U.S. Justice Department’s announcement of its opposition to legalized cannabis in early 2017, and the January 4, 2018 rescission of the Cole Memo, we believe there may be an interim decrease in the development and financing of new cannabis cultivation facilities. However, this possible market effect is expected to be mitigated by California’s legalization of recreational cannabis use, and Canada’s recent federal legalization of cannabis.

Recent and anticipated regulatory changes involving medicinal and/or recreational cannabis use in various jurisdictions, such as California and Canada, tend to be a leading indicator for the granting of licenses for new facility construction. As more new cultivation facilities become licensed, we in turn have an expanded set of potential customers that might buy our climate control systems.

For 2018, we are pursuing customers seeking to build larger indoor cannabis cultivation facilities in all regulated markets, with special focus in California and Canada. In Canada, medicinal use of cannabis is federally legal, and the Canadian federal government recently legalized recreational use effective October 2018. On June 26, 2018, Oklahoma voters approved a medical cannabis ballot initiative. We also believe that Michigan will offer opportunities in 2018 as the state attempts to move to a recreational use regulated market, with the second-largest medical cannabis patient base in the U.S. In November 2018, voters in Michigan will consider an initiative legalizing and regulating recreational use of cannabis. Utah voters will also decide on a medical cannabis ballot measure in November 2018.

During the three months ended June 30, 2018, we entered into sales orders for 12 projects, each with a sales value over $100,000, which we refer to as commercial-scale projects. These commercial-scale projects represented aggregate net bookings of $4,145,000 for the three months ended June 30, 2018. For the six months ended June 30, 2018, we entered into sales orders for 23 commercial-scale projects with aggregate net bookings of $8,584,000. This compares to 21 commercial-scale projects representing aggregate net bookings of $6,749,000 for the year ended December 31, 2017. The California and Canadian markets each showed signs of strength for us through the first half of 2018, and we expect this trend to continue through the remainder of 2018. The following table sets forth our net bookings of commercial-scale projects for each cohort period presented (meaning, the commercial-scale contracts executed during each period for which we received an initial deposit, adjusted for any change orders or cancellations for that cohort group to date) by country/state.

	For the Six Months Ended **June 30, 2018**			For the Year Ended **December 31, 2017**		
	Number of New Commercial-Scale Projects	Total Commercial-Scale Project Net Bookings	Average Commercial-Scale Project Net Bookings	Number of New Commercial-Scale Projects	Total Commercial-Scale Project Net Bookings	Average Commercial-Scale Project Net Bookings
Canada	6	$ 2,125,613	$ 354,269	7	$ 3,302,917	$ 471,845
California	7	$ 2,063,184	$ 294,741	1	$ 262,336	$ 262,336
Colorado	-	$ -	$ -	3	$ 421,948	$ 140,649
Arizona	-	$ -	$ -	3	$ 785,547	$ 261,849
Oregon	1	$ 370,898	$ 370,898	2	$ 403,365	$ 201,682
Washington	3	$ 1,844,277	$ 614,759	1	$ 170,976	$ 170,976
Massachusetts	1	$ 594,748	$ 594,748	-	$ -	$ -
Ohio	1	$ 135,860	$ 135,860	-	$ -	$ -
Alaska	-	$ -	$ -	1	$ 297,500	$ 297,500

Rhode Island	-	$ -	$ -	1	$ 227,680	$ 227,680
Nevada	-	$ -	$ -	1	$ 556,950	$ 556,950
Texas	-	$ -	$ -	1	$ 319,557	$ 319,557
Michigan	3	$ 1,345,000	$ 448,333	-	$ -	$ -
New Mexico	1	$ 104,772	$ 104,772	-	$ -	$ -
Total	**23**	**$ 8,584,352**	**$ 373,233**	**21**	**$ 6,748,776**	**$ 321,370**

Project Life-Cycle and Backlog

The project life-cycle for our commercial projects continues to vary significantly. From the execution of the sales contract, to engineering services and equipment delivery, and all the way through installation and commissioning of the installed system, which we refer to as our project life-cycle, the project can take anywhere from four months to two years to complete. The longer the project life-cycle, the longer it takes for us to recognize revenue on booked sales orders. Since we do not install the climate control systems, our customers are required to use third-party installation contractors, which adds to the variability in the project life-cycle and our revenue recognition.

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The time it takes for our customer to complete a project, which corresponds to when we are able to recognize revenue, is driven by numerous factors including:

- the large number of first-time participants interested in the indoor cannabis cultivation business;
- the complexities and uncertainties involved in obtaining state and local licensure and permitting;
- local and state government delays in approving licenses and permits due to lack of staff or the large number of pending applications, especially in states where there is no cap on the number of cultivators;
- the customer’s need to obtain cultivation facility financing;
- the time needed, and coordination required, for our customers to acquire real estate and properly design and build the facility (to the stage when climate control systems can be installed);
- the large price tag and technical complexities of the climate control and air sanitation system;
- the availability of power; and
- delays that are typical in completing any construction project.

Because of the foregoing factors, there are risks that we may not realize the full contract value of these projects in a timely manner or at all. Completion of a customer’s cultivation facility project is dependent upon the customer’s ability to secure funding and real estate, obtain a license and then build their cultivation facility so they can take possession of the equipment.

Given the timing of the deliverables in our sales contracts, we can experience large variances in quarterly revenue. Our revenue recognition is dependent upon shipment of the equipment portions of our sales contracts, which, in many cases, may be delayed while our customers complete permitting, prepare their facilities for equipment installation or obtain project financing.

Industry uncertainty, project financing concerns, and the licensing and qualification of our prospective customers, which are out of our control, make it difficult for us to predict when we will recognize revenue. We continue to focus on increasing our sales contract backlog and quoting on larger (i.e., greater than $100,000) projects in an effort to increase revenue. We also will focus on leveraging our current market position and presence to build our pipeline in the California and Canadian markets, as well as other emerging U.S. markets. As our backlog has grown with increased bookings, we have been making investments in people, facilities and systems to prepare ourselves to meet our customers’ demand for timely delivery of a fully engineered, application-specific, climate control system.

The following table sets forth: (i) our beginning backlog (the remaining contract value of outstanding sales contracts for which we have received an initial deposit as of the previous period), (ii) our net bookings for the period (new sales contracts executed during the period for which we received an initial deposit, net of any adjustments including change orders during the period), (iii) our recognized revenue for the period, and (iv) our ending backlog for the period (the sum of the beginning backlog and net bookings, less recognized revenue).

	For the quarter ended				
	June 30, 2017	September 30, 2017	December 31, 2017	March 31, 2018	June 30, 2018
Backlog, beginning balance	$3,790,000	$3,933,000	$4,311,000	$4,456,000	$7,024,000
Net bookings, current period	$1,885,000	$1,944,000	$2,454,000	$4,623,000	$3,867,000
Recognized revenue, current period	$1,742,000	$1,566,000	$2,309,000	$2,055,000	$2,008,000
Backlog, ending balance	$3,933,000	$4,311,000	$4,456,000	$7,024,000	$8,883,000

During the three months ended June 30, 2018, (i) our net bookings were $3,867,000, a decrease of $756,000, or 16%, compared to the prior quarter, and (ii) our recognized revenue was $2,008,000, a decrease of $47,000, or 2%, compared to the prior quarter. We believe net bookings in any given cohort quarter are our best leading indicator of revenue that we may recognize in the ensuing two to eight quarters from that cohort.

As of June 30, 2018, our ending backlog was $8,883,000, an increase of $1,859,000, or 26%, compared to the prior quarter-end. About 53% of our June 30, 2018 ending backlog (down from 78% at March 31, 2018) is attributable to projects for which we have only received an initial deposit and, as a result, there are potential risks that the equipment portion of these projects will not be completed or will be delayed, which could occur if our customer is dissatisfied with the quality or timeliness of our engineering services or there is a delay or abandonment of the project due to the customer's inability to obtain project financing or licensing.

Backlog and net bookings may not be indicative of future operating results, and our customers may attempt to renegotiate or terminate their contracts for a number of reasons, including delays in or inability to obtain project financing or licensing. Accordingly, there can be no assurance that contracts included in backlog will actually generate revenues or when the actual revenues will be generated. Backlog and net bookings are considered non-GAAP financial measures, and therefore, they should be considered in addition to, rather than as a substitute for, recognized revenue and deferred revenue. Further, we can provide no assurance as to the profitability of our contracts reflected in backlog and net bookings.

Government Regulation

The use, possession, cultivation, and distribution of cannabis is prohibited by U.S. federal law. This includes medical and recreational cannabis. Although certain states have legalized medical and recreational cannabis, companies and individuals involved in the sector are still at risk of being prosecuted by federal authorities. Further, the landscape in the cannabis industry changes rapidly. This means that at any time the city, county, or state where cannabis is permitted can change the current laws and/or the federal government can supersede those laws and take prosecutorial action. Given the uncertain legal nature of the cannabis industry, it is imperative that investors understand that investments in the cannabis industry should be considered very high risk. A change in the current laws or enforcement policy can negatively affect the status and operation of our business, require additional fees, stricter operational guidelines and unanticipated shut-downs.

See the "*Risks Related to the Cannabis Industry*" set forth in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2017, which addresses various risks related to U.S. and foreign regulation and enforcement of cannabis laws and regulations and their potential impact on our business.

Results of Operations

Comparison of Three Months ended June 30, 2018 and 2017

Revenues and Cost of Goods Sold

Revenue for the three months ended June 30, 2018 was $2,008,000 compared to $1,742,000 for the three months ended June 30, 2017, an increase of $266,000, or 15%. Although our net bookings trended favorably and our backlog grew during 2018, revenue recognition continues to be impacted by our long and uncertain project life-cycle and delays faced by our customers in the construction of new cultivation facilities.

Cost of revenue increased by $155,000, or 12%, from $1,329,000 for the three months ended June 30, 2017 to $1,484,000 for the three months ended June 30, 2018.

The gross profit for the three months ended June 30, 2018 was $523,000 compared to $413,000 for the three months ended June 30, 2017. Gross profit margin increased by two percentage points from 24% for the three months ended June 30, 2017 to 26% for the three months ended June 30, 2018. This increase was due primarily to higher gross profit margin on our equipment sales, which were offset by lower gross profit margins on our engineering services and shipping and handling.

We experienced unfavorable trends in our fixed costs and favorable trends in our variable costs during the three months ended June 30, 2018. Our fixed costs (which include engineering, service, manufacturing and project management salaries and benefits and manufacturing overhead) totaled $437,000, or 22% of total revenue, for the three months ended June 30, 2018 as compared to $274,000, or 16% of total revenue, for the three months ended June 30, 2017. The increase of $163,000 was primarily due to an increase in salaries and benefits (including stock-based compensation) of $157,000. Our variable costs (which include the cost of equipment, outside engineering costs, shipping and handling, travel and warranty costs) totaled $1,047,000, or 52% of total revenue, in the three months ended June 30, 2018 as compared to $1,055,000, or 60% of total revenue, in the three months ended June 30, 2017.

We continue to focus on gross margin improvement through a combination of, among other things, more disciplined pricing using enhanced pricing software, better absorption of our fixed costs as we convert our increased bookings into revenue, and the implementation over time of lower-cost supplier alternatives.

Operating Expenses

Operating expenses increased by 21% from $1,610,000 for the three months ended June 30, 2017 to $1,941,000 for the three months ended June 30, 2018, an increase of $331,000. The operating expense increase consisted of: (i) an increase in selling, general and administrative expenses ("SG&A expenses") of $356,000, and (ii) an increase in advertising and marketing expenses of $14,000, offset by (iii) a decrease in product development expense of $39,000.

The increase in SG&A expenses for the three months ended June 30, 2018 compared to the three months ended June 30, 2017, was due primarily to: (i) an increase of $542,000 in stock-related compensation paid to employees, (ii) an increase of $73,000 in salaries and benefits, (iii) an increase of $235,000 in consulting fees (of which $193,000 were paid in stock), offset by (iv) a decrease $37,000 in accounting, legal and other professional fees, and (v) a decrease of $442,000 in stock-related compensation paid to our independent directors.

Operating Loss

We had an operating loss of $1,417,000 for the three months ended June 30, 2018, as compared to an operating loss of $1,197,000 for the three months ended June 30, 2017, an increase of $220,000, or 18%. The operating loss included $853,000 of non-cash, stock-based compensation expenses in the three months ended June 30, 2018 as compared to $262,000 for the three months ended June 30, 2017. Excluding these non-cash items, our operating loss decreased by $371,000.

Other Income

We had other income (net) of $123,000 for the three months ended June 30, 2017 compared to other income (net) of $16,000 for the three months ended June 30, 2018. The other income for the three months ended June 30, 2017 included the gain of $164,000 on the change in derivative liabilities associated with certain warrants.

Net Loss

Overall, we had a net loss of $1,401,000 for the three months ended June 30, 2018 as compared to a net loss of $1,073,000 for the three months ended June 30, 2017, an increase of $328,000, or 31%. The net loss included $853,000 of non-cash, stock-based compensation expenses in the three months ended June 30, 2018 as compared to non-cash, stock-based compensation expense of $262,000 and debt-related income (net) of $123,000 in the three months ended June 30, 2017.

Comparison of Six Months ended June 30, 2018 and 2017

Revenues and Cost of Goods Sold

Revenue for the six months ended June 30, 2018 was $4,062,000 compared to $3,335,000 for the six months ended June 30, 2017, an increase of $727,000, or 22%. Although our net bookings trended favorably and our backlog grew during 2018, revenue recognition continues to be impacted by an uncertain project life-cycle and delays faced by our customers in the construction of new cultivation facilities.

Cost of revenue increased by $663,000, or 27%, from $2,494,000 for the six months ended June 30, 2017 to $3,157,000 for the six months ended June 30, 2018.

The gross profit for the six months ended June 30, 2018 was $905,000 compared to $841,000 for the six months ended June 30, 2017. Gross profit margin decreased by three percentage points from 25% for the six months ended June 30, 2017 to 22% for the six months ended June 30, 2018. This decrease was due primarily to a one-time accommodation during the six months ended June 30, 2018 to a customer with whom we are working on several indoor grow facilities who we assisted in sourcing certain climate control equipment, which we did not normally sell, so the customer could complete this particular project in a timely manner. This equipment sale generated revenue of $413,000 at a gross profit margin of 2.5%.

We experienced unfavorable trends in our fixed and favorable trends in our variable costs during the six months ended June 30, 2018. Our fixed costs (which include engineering, service, manufacturing and project management salaries and benefits and manufacturing overhead) totaled $843,000, or 21% of total revenue, for the six months ended June 30, 2018 as compared to $568,000, or 17% of total revenue, for the six months ended June 30, 2017. The increase of $275,000 was primarily due to an increase in salaries and benefits of $180,000 and stock-based compensation of $79,000. Our variable costs (which include the cost of equipment, outside engineering costs, shipping and handling, travel and warranty costs) totaled $2,314,000, or 57% of total revenue, in the six months ended June 30, 2018 as compared to $1,925,000, or 58% of total revenue, in the six months ended June 30, 2017.

Operating Expenses

Operating expenses increased by 61% from $2,628,000 for the six months ended June 30, 2017 to $4,228,000 for the six months ended June 30, 2018, an increase of $1,600,000. The operating expense increase consisted of: (i) an increase in SG&A expenses of $1,539,000, and (ii) an increase in advertising and marketing expenses of $119,000, offset by (iii) a decrease in product development expense of $58,000.

The increase in SG&A expenses for the six months ended June 30, 2018 compared to the six months ended June 30, 2017, was due primarily to: (i) an increase of $997,000 in stock-related compensation paid to employees, (ii) an increase of $397,000 in salaries and benefits, (iii) an increase of $424,000 in consulting fees (of which $298,000 were paid in stock), (iv) an increase $67,000 in accounting, legal and other professional fees, offset by (v) a decrease of $516,000 in stock-related compensation paid to our independent directors.

The increase in marketing expenses were primarily for: (i) marketing salaries and benefits (including stock related-compensation) which increased by approximately $24,000, and (ii) advertising and marketing events which increased by $159,000.

Operating Loss

We had an operating loss of $3,322,000 for the six months ended June 30, 2018, as compared to an operating loss of $1,786,000 for the six months ended June 30, 2017, an increase of $1,536,000, or 86%. The operating loss included $1,493,000 of non-cash, stock-based compensation expenses in the six months ended June 30, 2018 as compared to $392,000 for the six months ended June 30, 2017. Excluding these non-cash items, our operating loss increased by $435,000.

Other Income (Expense)

We had other expense (net) of $288,000 for the six months ended June 30, 2017 compared to other income (net) of $38,000 for the six months ended June 30, 2018. The other income (net) during the six months ended June 30, 2018 included the gain of $21,000 on the change in derivative liabilities associated with certain warrants that were exercised on a cashless basis. The other expense (net) during the six months ended June 30, 2017 included the loss on extinguishment of debt of $415,000 due to the conversion of certain notes, the gain of $218,000 on the change in derivative liabilities associated with certain warrants, and other debt-related costs of $95,000.

Net Loss

Overall, we had a net loss of $3,284,000 for the six months ended June 30, 2018, as compared to a net loss of $2,074,000 for the six months ended June 30, 2017, an increase of $1,210,000, or 58%. The net loss included $1,493,000 of non-cash, stock-based compensation expenses in the six months ended June 30, 2018 as compared to non-cash, stock-based compensation expense of $392,000 and debt-related expenses (net) of $291,000 in the six months ended June 30, 2017.

Financial Condition, Liquidity and Capital Resources

Cash and Cash Equivalents

As of June 30, 2018, we had cash and cash equivalents of $1,629,000, compared to cash and cash equivalents of $2,468,000 as of December 31, 2017. The $839,000 decrease in cash and cash equivalents during the six months ended June 30, 2018 was primarily the result of: (i) cash used in our operating activities of $1,511,000, (ii) cash used in our investing activities of $144,000, which are primarily related to improvements made to our leased manufacturing facility, and (iii) cash provided by our financing activities of $816,000, which includes our private placement offering of $1,210,000, offset by our common share repurchase of $400,000.

Our cash is held in bank depository accounts in certain financial institutions. We currently have deposits in financial institutions that exceed the federally insured amount.

As of June 30, 2018, we had accounts receivable (net of allowance for doubtful accounts) of $230,000, inventory (net of excess and obsolete allowance) of $454,000, and prepaid expenses of $264,000. While we typically require advance payment before we commence engineering services or ship equipment to our customers, we have made exceptions requiring us to record accounts receivable, which carry a risk of non-collectability especially since most of our customers are funded on an as-needed basis to complete facility construction. As of June 30, 2018, we had no indebtedness, total accounts payable and accrued expenses of $1,253,000, and deferred revenue of $1,413,000. As of June 30, 2018, we had a working capital deficit of $63,000, compared to a working capital surplus of $308,000 as of December 31, 2017.

We have never declared or paid any cash dividends on our common stock. We currently intend to retain all available funds and any future earnings for use in the operation and expansion of our business and do not anticipate paying any cash dividends in the foreseeable future.

Summary of Cash Flows

The following summarizes our cash flows for the three months ended June 30, 2018 and 2017:

	For the Six Months Ended June 30,	
	2018	2017
Net cash used in operating activities	$(1,511,000)	$(1,980,000)
Net cash (used in) provided by investing activities	(144,000)	132,000
Net cash provided by financing activities	816,000	2,882,000
Net (decrease) increase in cash	$(839,000)	$1,034,000

Operating Activities

We have never reported net income. We incurred a net loss for the six months ended June 30, 2018 of $3,284,000 and have an accumulated deficit of $22,887,000 as of June 30, 2018.

Cash used in operations for the six months ended June 30, 2018 was $1,511,000 compared to cash used in operations of $1,980,000 for the six months ended June 30, 2017, a decrease of $469,000. The reduction in cash usage during the six months ended June 30, 2018 is primarily attributable to a decrease in cash used for working capital of $801,000 and an increase in non-cash charges of $878,000, offset by an increase in net loss of $1,210,000. During the six months ended June 30, 2018, the significant non-cash item was stock-related compensation of $1,493,000.

Investing Activities

Cash used in investing activities for the six months ended June 30, 2018 was $144,000 compared to cash provided by investing activities of $132,000 for the six months ended June 30, 2017. During the six months ended June 30, 2018, we had payments for property and equipment (including equipment held for lease) of $243,000, primarily related to leasehold improvements, offset by proceeds from the payment of the tenant improvement allowance on our building lease.

Financing Activities

Cash provided by financing activities for the six months ended June 30, 2018 was $816,000 compared to cash provided by financing activities of $2,882,000 for the six months ended June 30, 2017. During the six months ended June 30, 2018, we received $1,210,000 from a private placement of common stock and warrants and $18,000 from the exercise of options and warrants, which was offset by payment of $400,000 for the repurchase of common stock from a related party, $5,000 to purchase an option to purchase preferred stock held by a related party, and $7,000 on a note to a related party. During the six months ended June 30, 2017, we issued two unsecured promissory notes for aggregate proceeds of $500,000, which were converted into common stock in the third quarter of 2017, we made payments of $270,000 to extinguish the principal under our remaining convertible promissory notes, and we raised $2,685,000 in a private placement of common stock and warrants to investors.

Going Concern

Our condensed consolidated financial statements have been presented on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. Our independent registered public accounting firm included in its audit opinion on our financial statements for the year ended December 31, 2017 a statement that there is substantial doubt as to our ability to continue as a going concern. Our condensed consolidated financial statements have been prepared assuming that we will continue as a going concern. We have determined that our ability to continue as a going concern is dependent on raising additional capital to fund our operations and ultimately on generating future profitable operations. There can be no assurance that we will be able to raise sufficient additional capital or eventually have positive cash flow from operations to address all of our cash flow needs. If we are not able to find alternative sources of cash or generate positive cash flow from operations, our business and shareholders will be materially and adversely affected. The foregoing factors raise substantial doubt about our ability to continue as a going concern for a period of one year from the date our condensed consolidated financial statements are issued. Our condensed consolidated financial statements do not include any adjustment that might result from the outcome of this uncertainty.

Capital Raising

During the second quarter of 2018, we raised $1,210,000 in a private placement offering of investment units (the "Units"), at a price of $0.16 per Unit. Each Unit consisted of one share of common stock and one warrant for the purchase of one share of common stock. We issued a total of 7,562,500 Units in the offering, and no commissions or fees were paid. The proceeds from the offering will be used for working capital and general corporate purposes. In addition, we used $400,000 from the proceeds of the offering to repurchase shares of common stock from our co-founders, Stephen and Brandy Keen. Refer to Note 9 – *Non-compensatory Equity Transactions* of the Notes to Condensed Consolidated Financial Statements, included as part of this Quarterly Report for additional information on the private placement offering.

We believe our cash balances and cash flow from operations will be insufficient to fund our operations for the next 12 months. If we are unable to substantially increase revenues, reduce expenditures, or otherwise generate cash flows for operations, then we will need to raise additional funding to continue as a going concern.

If results of operations for 2018 do not meet management's expectations, or additional capital is not available, management believes it has the ability to reduce certain expenditures. The precise amount and timing of the funding needs cannot be determined accurately at this time, and will depend on a number of factors, including the market demand for our products and services, the quality of product development efforts, management of working capital, and continuation of normal payment terms and conditions for purchase of our products and services.

Based on management's estimate for our operational cash requirements, we may need to raise financing during the fourth quarter of 2018 or the first quarter of 2019 in order to continue our operations and achieve our growth targets. There can be no assurance that we will be able to raise debt or equity financing in sufficient amounts, when and if needed, on acceptable terms or at all.

If we are unable to generate sufficient cash flow from operations, make adjustments to our payment arrangements or raise sufficient additional capital through future debt and equity financings or strategic and collaborative ventures with potential partners, we will likely have to reduce the size and scope of our operations. Our officers and shareholders have not made any written or oral agreement to provide us additional financing. There can be no assurance that we will be able to continue to raise capital on terms and conditions that are deemed acceptable to us, or at all.

Inflation

In the opinion of management, inflation has not and will not have a material effect on our operations in the immediate future. Management will continue to monitor inflation and evaluate the possible future effects of inflation on our business and operations.

Contractual Payment Obligations

As of June 30, 2018, our contractual payment obligations consisted of a building lease. On January 2, 2018, the leased space was expanded to 18,600 square feet and the monthly rental rate increased to $18,979, which will continue through August 31, 2018. Beginning September 1, 2018, the monthly rent will increase by 3% each year through the end of the lease.

Refer to Note 8 – *Commitments and Contingencies* of the Notes to the Condensed Consolidated Financial Statements, included as part of this Quarterly Report for a discussion of commitments and contingencies.

Commitments and Contingencies

Refer to Note 8 – *Commitments and Contingencies* of the Notes to the Condensed Consolidated Financial Statements, included as part of this Quarterly Report for a discussion of commitments and contingencies.

Off-Balance Sheet Arrangements

We are required to disclose any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources that are material to investors. As of June 30, 2018, we had no off-balance sheet arrangements. During the three months ended June 30, 2018, we did not engage in any off-balance sheet financing activities other than those included in the "Contractual Payment Obligations" discussed above in Note 8 to our Condensed Consolidated Financial Statements.

Recent Developments

Refer to Note 12 - *Subsequent Events* of the Notes to Condensed Consolidated Financial Statements, included as part of this Quarterly Report for the more significant events occurring since June 30, 2018.

Critical Accounting Estimates

This discussion and analysis of our financial condition and results of operations is based upon our condensed consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America. Certain accounting policies are particularly important to the understanding of our financial position and results of operations and require the application of significant judgment by our management or can be materially affected by changes from period to period in economic factors or conditions that are outside of our control. As a result, they are subject to an inherent degree of uncertainty. In applying these policies, management uses their judgment to determine the appropriate assumptions to be used in the determination of certain estimates. Those estimates are based on our historical operations, our future business plans and projected financial results, the terms of existing contracts, observance of trends in the industry, information provided by our customers, and information available from other outside sources, as appropriate. Actual results could materially differ from those estimates. Key estimates include: valuation of derivative liabilities, valuation of intangible assets, valuation of equity-based compensation, valuation of deferred tax assets and liabilities, warranty accruals, inventory allowances, and legal contingencies.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are a smaller reporting company, as defined by Rule 12b-2 of the Exchange Act, therefore are not required to provide the information under this item.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Principal Financial and Accounting Officer, which positions were held by the same person as of June 30, 2018, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and Principal Financial and Accounting Officer concluded that as a result of material weakness in our internal control over financial reporting as described in Item 9A of our Annual Report on Form 10-K for the year ended December 31, 2017 filed with the SEC, our disclosure controls and procedures were not effective as of June 30, 2018.

We did not maintain effective controls over certain aspects of the financial reporting process because: (i) we lack a sufficient complement of personnel with a level of accounting expertise and an adequate supervisory review structure that is commensurate with our financial reporting requirements, (ii) there is inadequate segregation of duties due to the limitation on the number of our accounting personnel, and (iii) we have insufficient controls and processes in place to adequately verify the accuracy and completeness of spreadsheets that we use for a variety of purposes including revenue, taxes, stock-based compensation and other areas, and place significant reliance on, for our financial reporting.

We intend to take appropriate and reasonable steps to make the necessary improvements to remediate these deficiencies. We are committed to continuing to improve our financial organization including, without limitation, expanding our accounting staff and improving our systems and controls to reduce our reliance on the manual nature of our existing systems. However, due to our size and our financial resources, remediating the several identified weaknesses has not been possible and may not be economically feasible now or in the future.

Changes in Internal Control over Financial Reporting

There were no changes identified in connection with our internal control over financial reporting during the three months ended June 30, 2018, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

We are not presently a party to any material legal proceedings, nor are we aware of any pending or threatened litigation that would have a material adverse effect on our business, operating results, cash flows, or financial condition should such litigation be resolved unfavorably. We have and will continue to have commercial disputes arising in the ordinary course of our business.

Item 1A. Risk Factors

In addition to the information set forth in this Form 10-Q, you should also carefully review and consider the risk factors contained in our other reports and periodic filings with the SEC, including, without limitation, the risk factors and uncertainties contained under the caption "Item 1A—Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2017 that could materially and adversely affect our business, financial condition, and results of operations. The risk factors discussed in that Form 10-K do not identify all risks that we face because our business operations could also be affected by additional factors that are not presently known to us or that we currently consider to be immaterial to our operations. There have been no material changes in the significant factors that may affect our business and operations as described in "Item 1A—Risk Factors" of the Annual Report on 10-K for the year ended December 31, 2017.

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

During the second quarter of 2018, we completed a private placement offering of investment units (the "Units"), at a price of $0.16 per Unit, with certain accredited investors. Each Unit consisted of one share of common stock and one warrant for the purchase of one share of common stock. We issued a total of 7,562,500 Units for aggregate proceeds of $1,210,000, and no commissions or fees were paid. The proceeds from the offering will be used for working capital and general corporate purposes, after $400,000 from the proceeds was used to repurchase 3,125,000 shares of common stock from our co-founders, Stephen and Brandy Keen, at a purchase price of $0.128 per share. The offer and sale of the Units was made by in reliance upon an exemption from registration under Section 4(a)(2) of the Securities Act of 1933, as amended, and Rule 506 of Regulation D promulgated thereunder. No registration rights were provided for any of the securities issued in the offering or on exercise of the warrants. Refer to Note 9 – *Non-compensatory Equity Transactions* of the Notes to Condensed Consolidated Financial Statements, included as part of this Quarterly Report for additional information on the private placement offering.

During the three months ended June 30, 2018, we issued shares of our restricted common stock as follows:

- 459,246 shares upon the exercise of certain warrants by a former director on a cashless exercise basis;
- 100,000 shares to a consultant as compensation for services rendered; and
- 31,562 shares to certain employees under a sales incentive plan.

Item 3. Defaults upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

Regulation FD Disclosure.

Press Release Announcing Financial Results

On August 14, 2018, we issued a press release announcing our financial condition and results of operations for the three months ended June 30, 2018. The press release is attached hereto as Exhibit 99.1.

The foregoing information, including the exhibits related thereto, is furnished in response to Item 2.02 of Form 8-K and shall not be deemed "filed" for purposes of Section 18 of the Exchange Act, nor shall it be deemed incorporated by reference in any disclosure document of the Company, except as shall be expressly set forth by specific reference in such document.

Item 6. Exhibits

The documents listed in the Exhibit Index of this Form 10-Q are incorporated by reference or are filed with this Form 10-Q, in each case as indicated therein (numbered in accordance with Item 601 of Regulation S-K).

SIGNATURES

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

	SURNA INC. (the "Registrant")
Dated: August 14, 2018	By: */s/ Chris Bechtel* Chris Bechtel Chief Executive Officer and President (Principal Executive Officer)
Dated: August 14, 2018	By: */s/ Chris Bechtel* Chris Bechtel Principal Financial and Accounting Officer

EXHIBIT INDEX

Exhibit Number	Description of Exhibit
31.1 *	Certification of Principal Executive Officer, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2 *	Certification of Principal Financial and Accounting Officer, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1**	Certification of Principal Executive Officer, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2**	Certification of Principal Financial and Accounting, pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.1*	Press Release dated August 14, 2018, announcing financial condition and financial results
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Schema
101.CAL*	XBRL Taxonomy Calculation Linkbase
101.DEF*	XBRL Taxonomy Definition Linkbase
101.LAB*	XBRL Taxonomy Label Linkbase
101.PRE*	XBRL Taxonomy Presentation Linkbase

* Filed herewith.
** Furnished herewith.