

AeroGrow International, Inc.  
Form 10-Q  
November 10, 2010

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

\_\_\_\_\_  
FORM 10-Q  
\_\_\_\_\_

(MARK ONE)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended September 30, 2010

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 001-33531

AEROGROW INTERNATIONAL, INC.  
(Exact Name of Registrant as specified in its charter)

NEVADA  
(State or other jurisdiction  
of incorporation or organization)

46-0510685  
(IRS Employer  
Identification Number)

6075 Longbow Drive, Suite 200, Boulder, Colorado  
(Address of principal executive offices)

80301  
(Zip Code)

(303) 444-7755  
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  ( Do not check if smaller reporting company)  Smaller reporting company x

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

Yes  No

Number of shares of issuer's common stock outstanding as of November 8, 2010: 12,650,605

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Table of Contents

AeroGrow International, Inc.  
TABLE OF CONTENTS  
FORM 10-Q REPORT  
September 30, 2010

PART I Financial Information

|         |  |    |
|---------|--|----|
| Item 1. | <u>Financial Statements</u>  | 3  |
|         | <u>Condensed Balance Sheets as of September 30, 2010 (Unaudited) and March 31, 2010</u>  | 3  |
|         | <u>Condensed Statements of Operations for the Three and Six Months Ended September 30, 2010 and September 30, 2009 (Unaudited)</u> | 4  |
|         | <u>Condensed Statements of Cash Flows for the Six Months Ended September 30, 2010 and September 30, 2009 (Unaudited)</u>           | 5  |
|         | <u>Notes to the Condensed Financial Statements (Unaudited)</u>   | 7  |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                                       | 20 |
| Item 3. | <u>Quantitative and Qualitative Disclosures about Market Risk</u>  | 38 |
| Item 4. | <u>Controls and Procedures</u>   | 39 |

PART II Other Information

|          |  |    |
|----------|--|----|
| Item 1.  | <u>Legal Proceedings</u>   | 40 |
| Item 1A. | <u>Risk Factors</u>  | 40 |
| Item 2.  | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 40 |
| Item 3.  | <u>Defaults Upon Senior Securities</u>                             | 41 |
| Item 4.  | <u>Reserved</u>  | 41 |
| Item 5.  | <u>Other Information</u>   | 41 |
| Item 6.  | <u>Exhibits</u>  | 42 |
|          | <u>Signatures</u>  | 43 |

---

Table of Contents

## Item 1. Condensed Financial Statements

AEROGROW INTERNATIONAL, INC.  
CONDENSED BALANCE SHEETS

|   | September<br>30, 2010 | March 31,<br>2010<br>(Derived<br>from Audited<br>Statements) |
|---|-----------------------|--|
| ASSETS  | (Unaudited)           |  |
| Current assets  |                       |  |
| Cash  | \$629,178             | \$249,582  |
| Restricted cash   | 87,904                | 443,862  |
| Accounts receivable, net of allowance for doubtful accounts of<br>\$85,416 and \$87,207 at September 30, 2010 and March 31, 2010, respectively                                      | 360,411               | 478,113  |
| Other receivables   | 104,108               | 259,831  |
| Inventory   | 4,245,458             | 3,493,732  |
| Prepaid expenses and other  | 552,994               | 338,095  |
| Total current assets  | \$5,980,053           | \$5,263,215  |
| Property and equipment, net of accumulated depreciation of<br>\$2,875,420 and \$2,486,377 at September 30, 2010 and March 31, 2010,<br>respectively                                 | 672,731               | 1,002,530  |
| Other assets  |                       |  |
| Intangible assets, net of \$16,468 and \$6,854 of accumulated<br>amortization at September 30, 2010 and March 31, 2010, respectively  | 270,053               | 275,599  |
| Deposits  | 217,840               | 240,145  |
| Deferred debt issuance costs, net of accumulated amortization<br>of \$244,316 and \$486,791 at September 30, 2010 and March 31,<br>2010, respectively                               | 1,867,280             | 62,291   |
| Total other assets  | \$2,355,173           | \$578,035  |
| Total Assets  | \$9,007,957           | \$6,843,780  |
| LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)  |                       |  |
| Current liabilities   |                       |  |
| Current portion – long term debt – related party  | \$143,743             | \$911,275  |
| Current portion – long term debt  | 1,914,636             | 3,053,984  |
| Accounts payable  | 1,974,605             | 3,354,703  |
| Accrued expenses  | 2,006,646             | 1,449,977  |
| Customer deposits   | 13,223                | 339,041  |
| Deferred rent   | 32,519                | 40,773   |
| Total current liabilities   | \$6,085,372           | \$9,149,753  |
| Long term debt  | 1,407,070             | 1,020,957  |
| Long term debt – related party  | 136,926               | -  |
| Stockholders' equity  |                       |  |
| Preferred stock, \$.001 par value, 20,000,000 shares authorized and<br>7,586 shares issued and outstanding at September 30, 2010 and March 31, 2010                                 | 8                     | 8  |
| Common stock, \$.001 par value, 500,000,000 shares authorized,<br>12,650,605 and 12,398,249 shares issued and outstanding at<br>September 30, 2010 and March 31, 2010, respectively | 12,650                | 12,398   |
| Additional paid-in capital  | 61,497,338            | 52,933,467   |

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|  |              |                |
|--|--------------|----------------|
| Accumulated (deficit)                                | (60,131,407) | (56,272,803)   |
| Total Stockholders' Equity (Deficit)                 | \$1,378,589  | \$(3,326,930 ) |
| Total Liabilities and Stockholders' Equity (Deficit) | \$9,007,957  | \$6,843,780    |

See accompanying notes to the condensed financial statements.

Table of Contents

AEROGROW INTERNATIONAL, INC.  
CONDENSED STATEMENTS OF OPERATIONS  
(Unaudited)

|   | Three Months ended<br>September 30, |                 | Six Months ended<br>September 30, |                 |
|---|-------------------------------------|-----------------|-----------------------------------|-----------------|
|   | 2010                                | 2009            | 2010                              | 2009            |
| Revenue   |                                     |                 |                                   |                 |
| Product sales   | \$ 1,379,617                        | \$ 3,285,949    | \$ 3,197,636                      | \$ 6,265,642    |
| Operating expenses  |                                     |                 |                                   |                 |
| Cost of revenue   | 1,038,812                           | 2,270,556       | 2,360,515                         | 4,140,361       |
| Research and development  | 52,745                              | 173,354         | 89,760                            | 292,552         |
| Sales and marketing   | 593,309                             | 1,248,102       | 1,410,287                         | 2,407,898       |
| General and administrative  | 812,300                             | 1,299,598       | 1,708,483                         | 2,753,806       |
| Total operating expenses  | \$ 2,497,166                        | \$ 4,991,610    | \$ 5,569,045                      | \$ 9,594,617    |
| Profit (loss) from operations   | (1,117,549 )                        | (1,705,661 )    | (2,371,409 )                      | (3,328,975 )    |
| Other (income) expense, net   |                                     |                 |                                   |                 |
| Interest (income)   | (1,900 )                            | (61 )           | (8,530 )                          | (141 )          |
| Interest expense  | 933,400                             | 239,940         | 1,451,500                         | 485,990         |
| Interest expense – related party  | 94,490                              | -               | 155,749                           | -               |
| Other (income)  | (13,986 )                           | (180,286 )      | (111,525 )                        | (987,838 )      |
| Total other (income) expense, net   | 1,012,004                           | 59,593          | 1,487,194                         | (501,989 )      |
| Net income (loss)   | \$ (2,129,553 )                     | \$ (1,765,254 ) | \$ (3,858,603 )                   | \$ (2,826,986 ) |
| Net income (loss) per share, basic  | \$(0.17 )                           | \$(0.14 )       | \$(0.31 )                         | \$(0.22 )       |
| Net income (loss) per share, diluted  | \$(0.17 )                           | \$(0.14 )       | \$(0.31 )                         | \$(0.22 )       |
| Weighted average number of common shares<br>outstanding used to calculated basic net<br>income (loss) per share | 12,566,486                          | 12,422,249      | 12,566,486                        | 12,729,125      |
| Effect of dilutive securities:  |                                     |                 |                                   |                 |
| Equity based compensation   | -                                   | -               | -                                 | -               |
| Weighted average number of common shares<br>outstanding used to calculated diluted net<br>income per share      | 12,566,486                          | 12,422,249      | 12,566,486                        | 12,729,125      |

See accompanying notes to the condensed financial statements.

Table of Contents

AEROGROW INTERNATIONAL, INC.  
CONDENSED STATEMENTS OF CASH FLOWS  
(Unaudited)

|   | Six months ended<br>September 30, |               |
|---|-----------------------------------|---------------|
|   | 2010                              | 2009          |
| Cash flows from operating activities:   |                                   |               |
| Net (loss)  | \$(3,858,603)                     | \$(2,826,986) |
| Adjustments to reconcile net (loss) to cash (used) by operations:                     |                                   |               |
| Issuance of common stock and options under equity compensation plans                  | 39,887                            | 338,919       |
| Issuance of common stock not under equity compensation plans                          | 24,983                            | --            |
| Issuance of warrants related to debt  | --                                | 15,000        |
| Depreciation and amortization expense   | 398,656                           | 435,987       |
| Allowance for bad debt  | (1,781 )                          | (787,347 )    |
| Amortization of debt issuance costs   | 306,254                           | 101,236       |
| Gain on forgiveness of accounts payable   | --                                | (807,310 )    |
| Amortization of convertible debentures, beneficial conversion feature                 | 362,633                           | --            |
| Amortization of convertible debentures, beneficial conversion feature - related party | 51,399                            | --            |
| Interest expense from warrants issued with convertible debentures                     | 343,570                           | --            |
| Interest expense from warrants issued with convertible debentures – related party     | 49,527                            | --            |
| Change in assets and liabilities:   |                                   |               |
| Decrease in accounts receivable   | 119,482                           | 621,218       |
| Decrease in other receivable  | 155,723                           | 292,598       |
| (Increase) decrease in inventory  | (751,726 )                        | 596,319       |
| (Increase) decrease in other current assets   | (214,899 )                        | 59,098        |
| (Increase) decrease in deposits   | 22,306                            | (80,000 )     |
| (Decrease) in accounts payable  | (1,330,096)                       | (650,025 )    |
| Increase (decrease) in accrued expenses   | 556,669                           | (843,754 )    |
| Increase in accrued interest  | 155,958                           | 19,589        |
| Increase (decrease) in accrued interest-related party                                 | 15,754                            | (30,652 )     |
| Increase (decrease) in customer deposits  | (325,818 )                        | 213,141       |
| (Decrease) in deferred rent   | (8,254 )                          | (8,255 )      |
| Net cash (used) by operating activities   | \$(3,888,376)                     | \$(3,341,224) |
| Cash flows from investing activities:   |                                   |               |
| (Increase) decrease in restricted cash  | 355,958                           | (110 )        |
| Purchases of equipment  | (59,243 )                         | (2,607 )      |
| Patent expenses   | (4,069 )                          | (27,030 )     |
| Net cash provided (used) by investing activities                                      | \$292,646                         | \$(29,747 )   |
| Cash flows from financing activities:   |                                   |               |
| (Increase) in prepaid debt issuance costs   | (593,626 )                        | (62,500 )     |
| Proceeds from long term debt borrowings   | 2,060,425                         | 5,623,317     |
| Proceeds from long term debt borrowings-related party                                 | --                                | 225,000       |
| Repayments of long term debt borrowings   | (2,123,950)                       | (6,435,093)   |
| Repayments of long term debt borrowings-related party                                 | (1,127,989)                       | --            |
| Proceeds from the issuance of convertible debt  | 5,485,000                         | --            |
| Proceeds from the issuance of convertible debt-related party                          | 300,000                           | --            |

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|   |             |             |
|---|-------------|-------------|
| Proceeds from the exercise of stock options   | 252         | 20          |
| Proceeds from the issuance of preferred stock | --          | 3,801,000   |
| Principal payments on capital leases          | (24,786 )   | (66,580 )   |
| Net cash provided by financing activities     | \$3,975,326 | \$3,085,164 |
| Net increase (decrease) in cash               | 379,596     | (285,807 )  |
| Cash, beginning of period                     | 249,582     | 332,698     |
| Cash, end of period                           | \$629,178   | \$46,891    |

See supplemental disclosures below and the accompanying notes to the condensed financial statements.



Table of Contents

|  | Six Months Ended<br>September 30, |              |
|--|-----------------------------------|--------------|
|  | 2010                              | 2009         |
| Interest paid  | \$ 137,303                        | \$ 293,765   |
| Income taxes paid  | \$-                               | \$-          |
| Supplemental disclosure of non-cash investing and financing activities:          |                                   |              |
| Conversion of related party debt to equity                                       | \$-                               | \$ 1,200,000 |
| Conversion of accounts payable to equity   | \$-                               | \$ 1,043,000 |
| Increase of notes receivable for equity  | \$-                               | \$ 139,000   |
| Increase of notes receivable, related party for equity                           | \$-                               | \$ 762,000   |
| Decrease of notes receivable, related party for equity as debt payment           | \$-                               | \$ 50,000    |
| Modification of accrued expenses to equity                                       | \$-                               | \$ 89,000    |
| Modification of accounts payable to long term debt                               | \$-                               | \$ 1,386,040 |
| Modification of debt to convertible debt   | \$ 475,000                        | \$-          |
| Modification of related party debt to related party convertible debt             | \$ 656,406                        | \$-          |
| Modification of accrued interest to convertible debt                             | \$ 33,757                         | \$-          |
| Modification of related party accrued interest to related party convertible debt | \$ 19,847                         | \$-          |
| Modification of accounts payable to convertible debt                             | \$ 50,000                         | \$-          |
| Conversion of convertible note to common stock                                   | \$ 25,236                         | \$-          |
| Warrants issued to placement agent as a cost of debt issuance                    | \$ 1,518,600                      | \$-          |

Table of Contents

AEROGROW INTERNATIONAL INC.  
NOTES TO THE CONDENSED FINANCIAL STATEMENTS  
(Unaudited)

1. Description of the Business

AeroGrow International, Inc. (the “Company”) was incorporated in the State of Nevada on March 25, 2002. We are in the business of developing, marketing, and distributing advanced indoor aeroponic and hydroponic garden systems. After several years of initial research and product development, we began sales activities in March 2006. Since that time we have expanded all aspects of our operations in order to take advantage of what we believe to be an attractive market opportunity. We currently offer more than 15 different indoor garden models, more than 50 seed kits, and various gardening and kitchen accessories. Although our business is focused on the United States and Canada, our products are available in nine other countries.

During the fiscal year ended March 31, 2010 (“Fiscal 2010”), and continuing through September 30, 2010, we have scaled back our operations as a result of the general economic downturn and the resulting decline in consumer confidence and spending. We also determined that broad distribution through retail channels was not appropriate for a company at our stage of development because of relatively low profit margins, high capital requirements, and the operational requirements of our retailer customers. As of September 30, 2010, our products were offered in approximately 850 storefronts in North America, as compared to approximately 3,600 stores as of September 30, 2009. Although we expect to further reduce the number of retailer storefronts carrying our products during the fiscal year ending March 31, 2011, we plan to maintain relationships with retailers, both traditional and non-traditional, that have historically proven to be good business partners for AeroGrow. In this regard, we plan to continue selling through our largest retailer customers, including three customers that comprised approximately 59% of our retailer sales during Fiscal 2010.

In Fiscal 2010 we re-focused our efforts towards building our direct-to-consumer business, which carries higher margin opportunity. To position our business for the future, we have increased the depth and breadth of our direct sales distribution channels to include a direct mail catalogue business with approximately 3.7 million catalogues mailed in Fiscal 2010, web sales, infomercials, and 60 and 120 second television commercials. Our products are also sold through television home shopping channels and by online retailers. In Fiscal 2010, approximately 57.5% of our total sales were to direct customers.

2. Liquidity and Basis of Presentation

Interim Financial Information

The unaudited interim financial statements of the Company included herein have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim reporting including the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. These condensed statements do not include all disclosures required by accounting principles generally accepted in the United States of America (“U.S. GAAP”) for annual audited financial statements and should be read in conjunction with the Company’s audited consolidated financial statements and related notes included in the Company’s Annual Report on Form 10-K for the year ended March 31, 2010, as filed with the SEC on June 25, 2010.

In the opinion of management, the accompanying unaudited interim financial statements reflect all adjustments, including normal recurring accruals, necessary to present fairly the financial position of the Company at September 30, 2010, the results of operations for the three and six months ended September 30, 2010 and 2009, and the cash flows for the six months ended September 30, 2010 and 2009. The results of operations for the three and six months ended September 30, 2010, are not necessarily indicative of the expected results of operations for the full year or any

future period. The balance sheet as of March 31, 2010, is derived from the Company's audited financial statements.

The Company has incurred net losses since its inception, including a net loss for the six months ended September 30, 2010 of \$3,858,603. Sources of funding to meet prospective cash requirements include the Company's existing cash balances, cash flow from operations, and borrowings under the Company's debt arrangements.

## Table of Contents

During Fiscal 2010 we began the process of re-capitalizing the Company by issuing approximately \$6.7 million in convertible preferred shares. In addition, we negotiated deferred payment arrangements with certain vendors, negotiated reduced balances with certain vendors, and reduced the amount of our interest-bearing debt and our accounts payable obligations. Nonetheless, we continued to face cash and liquidity constraints during Fiscal 2010 that were, at times, severe, and that had a material impact on our ability to operate our business. In May, June and September 2010, we issued an aggregate of \$7.02 million in convertible secured subordinated debt to supplement our internal cash sources and to address our liquidity constraints.

Because of the seasonality of our business and our working capital requirements, our liquidity position is at its low point during the summer and fall months. To address the seasonality of our liquidity requirements for the current fiscal year, we recently closed on \$1.5 million in 9-month convertible notes secured by a portion of our prospective credit card receipts. With these facilities in place, we believe we have sufficient liquidity to support our operations through the balance of our current fiscal year. Subsequent to that time period, in order to continue to meet our liquidity requirements we will need to secure additional capital, either in the form of seasonal working capital borrowings, or longer-term debt or equity capital, or reduce our scale of operations. There can be no assurance that the Company will have access to sufficient capital, from our existing financing sources or from other sources, to enable us to meet our short-term cash requirements. In the event the Company takes actions to reduce its scale of operations, there can be no assurance that such actions will be sufficient, or on a timely basis, to allow the Company to meet its liquidity requirements.

The Company's liquidity projections are predicated on a variety of assumptions including, but not limited to: the timing and seasonality of working capital needs, revenue and expenses, cash flow from operations, access to sufficient funding, the levels of customer and consumer demand, the impact of cost reduction programs, and the state of the general economic environment in which the Company operates. In the event these assumptions prove to be inaccurate, there could be material adverse changes to the Company's liquidity position, and there can be no assurance given that the Company would be able to successfully support its operations in such circumstances.

## Significant Accounting Policies

### Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. It is reasonably possible that a change in the Company's estimates with regard to return reserves, inventory obsolescence and the allowance for bad debts will occur in the near term.

### Net Income (Loss) per Share of Common Stock

The Company computes net income (loss) per share of common stock in accordance with ASC 260 (prior authoritative guidance: Statement of Financial Accounting Standards ("SFAS") No. 128, Earnings per Share, and SEC Staff Accounting Bulletin No. 98). ASC 260 requires companies with complex capital structures to present basic and diluted Earnings per Share ("EPS"). Basic EPS is measured as the income or loss available to common stock shareholders divided by the weighted average shares of common stock outstanding for the period. Diluted EPS is similar to basic EPS but presents the dilutive effect on a per share basis of potential common stock (e.g., convertible securities, options, and warrants) as if they had been converted at the beginning of the periods presented. Potential shares of common stock that have an anti-dilutive effect (i.e., those that increase income per share or decrease loss per share) are excluded from the calculation of diluted EPS.

## Reclassifications

Certain prior year amounts have been reclassified to conform to current year presentation.

## Table of Contents

### Concentrations of Risk

ASC 825-10-50-20 (prior authoritative guidance: SFAS No.105, Disclosure of Information About Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk), requires disclosure of significant concentrations of credit risk regardless of the degree of such risk. Financial instruments with significant credit risk include cash. The amount on deposit with a financial institution exceeded the \$250,000 federally insured limit as of September 30, 2010. However, management believes that the financial institution is financially sound and the risk of loss is minimal.

### Customers:

The Company maintains a credit insurance policy on many of its trade accounts receivables. For the three months ended September 30, 2010, the Company had one customer, Canadian Tire Corporation, who represented 16.3% of the Company's net product sales. For the three months ended September 30, 2009, the Company had two customers who represented 26.2% and 12.3% of the Company's net product sales. For the six months ended September 30, 2010, the Company had one customer, Canadian Tire Corporation, who represented 8.4% of net product sales. For the six months ended September 30, 2009, the Company had two customers who represented 13.3% and 10.8% of net product sales.

### Suppliers:

For the three months ended September 30, 2010, the Company purchased inventories and other inventory-related items from three suppliers totaling \$237,067, \$174,834, and \$131,411, representing 22.8%, 16.8% and 12.7% of cost of sales, respectively. For the three months ended September 30, 2009, the Company purchased inventories and other inventory-related items from three suppliers totaling \$1,037,865, \$303,764, and \$196,457, representing 45.7%, 13.4%, and 8.7% of cost of sales, respectively. For the six months ended September 30, 2010, the Company purchased inventories and other inventory-related items from three suppliers totaling \$341,310, \$272,869, and \$200,973, representing 14.5%, 11.6%, and 8.5% of cost of sales, respectively. For the six months ended September 30, 2009, the Company purchased inventories and other inventory-related items from three suppliers totaling \$1,058,191, \$526,545, and \$330,641, representing 25.6%, 12.7%, and 8.0% of cost of sales, respectively. Although the Company believes alternate sources of manufacturing could be obtained, loss of any of these suppliers could have an adverse impact on operations.

The Company's primary contract manufacturers are located in China. As a result, the Company may be subject to political, currency, regulatory and weather/natural disaster risks. Although the Company believes alternate sources of manufacturing could be obtained, these risks could have an adverse impact on operations.

### Accounts Receivable:

As of September 30, 2010, the Company had one customer, Canadian Tire Corporation who represented 60% of outstanding accounts receivable. Management believes all receivable from this customer are collectible. As of September 30, 2010, the Company also had two customers who represented 9%, and 7% of outstanding accounts receivables. As of March 31, 2010, the Company had two customers who represented 23% and 20% of outstanding accounts receivables.

### Fair Value of Financial Instruments

ASC 820-10-55 (prior authoritative guidance: FSP 157-2/Statement 157, Fair Value Measurements) defines fair value as the price that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (also referred to as an exit price). ASC 820-10-55 also establishes a three-level fair value hierarchy for classifying financial instruments that is based on whether the inputs to the valuation techniques used to measure fair value are observable or unobservable. The three levels of the ASC 820-10-55 fair value hierarchy are described below:

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- Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2: Observable market-based inputs, other than quoted prices in active markets for identical assets or liabilities.
- Level 3: Unobservable inputs.

As of September 30, 2010 and March 31, 2010, the carrying amounts of cash and cash equivalents, accounts receivable, and accounts payable approximated fair value because of the relatively short maturities of these instruments. The carrying amount of debt approximated fair value as of September 30, 2010 and March 31, 2010, based upon the terms and conditions currently available to the Company in comparison to the terms and conditions of the existing debt.

Table of Contents

## Accounts Receivable and Allowance for Doubtful Accounts

The Company sells its products to retailers and consumers. Consumer transactions are paid primarily by credit card. Retailer sales terms vary by customer, but generally range from net 30 days to net 60 days. Accounts receivable are reported at net realizable value and net of the allowance for doubtful accounts. The Company uses the allowance method to account for uncollectible accounts receivable. The Company also maintains a credit insurance policy which insures against losses from most retailer accounts. The Company's allowance estimate is based on a review of the current status of trade accounts receivable, which resulted in an allowance of \$85,416 and \$87,207 at September 30, 2010 and March 31, 2010, respectively.

## Other Receivables

In conjunction with the Company's processing of credit card transactions for its direct-to-consumer sales activities and as security with respect to the Company's performance for required credit card refunds and charge backs, the Company is required to maintain a cash reserve with Litle and Company, the Company's credit card processor. This reserve is equal to 5% of the credit card sales processed during the previous six months. As of September 30, 2010 and March 31, 2010, the balance in this reserve account was \$104,108 and \$259,831, respectively.

## Advertising and Production Costs

The Company expenses all production costs related to advertising, including print, television, and radio advertisements when the advertisement has been broadcast or otherwise distributed. The Company records media costs related to its direct-to-consumer advertisements, inclusive of postage and printing costs incurred in conjunction with mailings of direct-response catalogues, and related direct-response advertising costs, in accordance with ASC 340-20-25 (prior authoritative guidance: Statement of Position, "No. SOP 93-7" Reporting on Advertising Costs). In accordance with ASC 340-20-25, direct response advertising costs incurred are reported as assets and are amortized over the estimated period of the benefits, based on the proportion of current period revenue from the advertisement to probable future revenue. As of September 30, 2010 and September 30, 2009, the Company had deferred \$4,556 and \$49,698, respectively, related to such media costs. Advertising expenses for the three and six months ended September 30, 2010 were \$123,437 and \$350,502, respectively, and for the three and six months ended and September 30, 2009 were \$196,587 and \$649,169, respectively.

## Inventory

Inventories are valued at the lower of cost, determined by the first-in, first-out method, or market. Included in inventory costs where the Company is the manufacturer are raw materials, labor, and manufacturing overhead. The Company records the raw materials at delivered cost. Standard labor and manufacturing overhead costs are applied to the finished goods based on normal production capacity as prescribed under ASC 330 (prior authoritative guidance: Accounting Research Bulletin ("ARB") No. 43, Chapter 4, Inventory Pricing). A majority of the Company's products are manufactured overseas and are recorded at cost.

|                | September<br>30,<br>2010 | March 31,<br>2010 |
|----------------|--------------------------|-------------------|
| Finished goods | \$ 3,373,482             | \$2,515,451       |
| Raw materials  | 871,976                  | 978,281           |
|                | \$ 4,245,458             | \$3,493,732       |

The Company determines an inventory obsolescence reserve based on management's historical experience and establishes reserves against inventory according to the age of the product. As of September 30, 2010 and March 31, 2010, the Company had reserved \$81,451 and \$670,134, respectively, for inventory obsolescence.





## Table of Contents

### Revenue Recognition

The Company recognizes revenue from product sales, net of estimated returns, when persuasive evidence of a sale exists: that is, a product is shipped under an agreement with a customer; risk of loss and title has passed to the customer; the fee is fixed or determinable; and collection of the resulting receivable is reasonably assured.

The Company records estimated reductions to revenue for customer and distributor programs and incentive offerings, including promotions, rebates, and other volume-based incentives. Certain incentive programs require the Company to estimate based on industry experience the number of customers who will actually redeem the incentive. At September 30, 2010 and September 30, 2009, the Company had accrued \$72,970 and \$370,468 respectively, as its estimate for the foregoing deductions and allowances.

### Warranty and Return Reserves

The Company records warranty liabilities at the time of sale for the estimated costs that may be incurred under its basic warranty program. The specific warranty terms and conditions vary depending upon the product sold but generally include technical support, repair parts, and labor for periods up to one year. Factors that affect the Company's warranty liability include the number of installed units currently under warranty, historical and anticipated rates of warranty claims on those units, and cost per claim to satisfy the Company's warranty obligation. Based upon the foregoing, the Company has recorded as of September 30, 2010 and March 31, 2010 a provision for potential future warranty costs of \$57,408 and \$55,842, respectively.

The Company reserves for known and potential returns from customers and associated refunds or credits related to such returns based upon historical experience. In certain cases, customers are provided a fixed allowance, usually in the 1% to 2% range, to cover returned goods from which this allowance is deducted from payments from such customers. As of September 30, 2010 and March 31, 2010, the Company has recorded a reserve for customer returns of \$18,687 and \$47,398, respectively.

### 3. Capital Lease Obligations

As of September 30, 2010, the Company had capitalized lease obligations for factory equipment due November 2010 of \$6,672 at 12% interest per annum. This lease obligation is collateralized by related assets with a net book value of \$44,194 as of September 30, 2010. In addition, recorded in deposits is a security deposit of \$48,180 which will be released upon the Company achieving certain financial requirements. The leases also required \$4,529 in prepaid rents.

### 4. Long Term Debt and Current Portion – Long Term Debt

#### First National Loan

On May 19, 2008, the Company and Jack J. Walker, then one of the Company's directors and now the Company's Chairman and CEO, acting as co-borrowers, entered into a Business Loan Agreement with First National Bank for a loan to the Company in a principal amount of up to \$1,000,000 (the "FNB Loan"). The FNB Loan had an initial maturity date of May 19, 2009, which was extended by various agreements between the Company and FNB.

Principal payments totaling \$408,439 were made by Mr. Walker against the FNB Loan during the loan term. The first \$150,000 of payments made by Mr. Walker was recorded by the Company as an offset to a \$150,000 receivable due from Mr. Walker. The remaining \$258,439 was recorded by the Company as promissory notes due to Mr. Walker, which carried an interest rate of 20% per annum. On May 7, 2010, the Company paid \$50,000 in principal and \$4,603 in interest to Mr. Walker. On June 24, 2010, Mr. Walker converted \$206,406 of principal and accrued interest on the promissory notes into three year convertible promissory notes (the "Subordinated Secured Convertible Notes") issued by the Company, as further described below under the caption "Subordinated Secured Convertible Notes." On June 28,

2010, the Company paid \$17,109 in remaining principal and interest to Mr. Walker.

## Table of Contents

On May 24, 2010, the Company paid the remaining balance on the FNB Loan of \$511,647, including accrued interest, and the FNB Loan was terminated.

### Revolving Credit Facility

On June 23, 2008, the Company entered into a Loan and Security Agreement with FCC, LLC d/b/a First Capital (“FCC”) for a revolving credit facility (the “Revolving Credit Facility”) to fund working capital requirements. The Revolving Credit Facility had an initial termination date of June 23, 2010. As collateral for the Revolving Credit Facility, the Company granted FCC a first priority security interest over all of the Company’s assets, including, but not limited to, accounts receivable, inventory, and equipment. From time to time, Jack J. Walker, then one of the Company’s directors and now the Company’s Chairman and CEO, provided guarantees of up to a maximum of \$1.5 million of the Company’s obligations under the Revolving Credit Facility. Through the term of the Revolving Credit Facility, the Company, FCC and Mr. Walker, as guarantor, entered into various agreements to amend the terms of the Revolving Credit Facility.

On May 3, 2010, the Company, FCC, and Jack J. Walker, as guarantor, executed a Forbearance Agreement and Fifth Amendment (the “Fifth Amendment”) effective as of April 30, 2010. Under the Fifth Amendment, FCC agreed to forbear from exercising its rights and remedies with regard to the Company’s non-compliance with financial covenants until May 21, 2010, if no other defaults occur. The Fifth Amendment enabled the Company to borrow up to \$600,000 more than would otherwise be permitted by the applicable borrowing base calculation under the Revolving Credit Facility until the earlier of (i) the Company closing on a sale of subordinated secured convertible promissory notes, or (ii) the termination date of the forbearance period. In addition, the Fifth Amendment set the maximum borrowing under the Revolving Credit Facility at \$2,000,000 until such time as the Company closed on a sale of subordinated secured convertible promissory notes, at which time the maximum borrowing amount was required to be reduced to \$1,000,000. The Fifth Amendment provided for a continuation of the \$500 per day forbearance fee set forth in the Fourth Amendment, with such fees related to both the Fourth Amendment and Fifth Amendment to be payable on the earlier of (i) May 21, 2010 or (ii) the date on which loans under the Revolving Credit Facility were repaid in full.

On May 24, 2010, the Company paid \$673,600 to FCC to repay, in full, amounts due under the Revolving Credit Facility, and the Revolving Credit Facility was terminated.

During Fiscal 2011, Mr. Walker was paid a fee of \$25,000 for guaranteeing the Company’s obligations under the Revolving Credit Facility.

### Main Power Promissory Note

On June 30, 2009, the Company entered into a Letter Agreement (“Letter Agreement”) with Main Power Electrical Factory, Ltd. (“Main Power”) and executed a Promissory Note. Pursuant to the terms of the Letter Agreement, Main Power agreed to release the Company from \$1,386,041 of existing accounts payable obligations owed by the Company to Main Power in return for the Company executing the Promissory Note for the same amount. In addition, the Letter Agreement included other provisions relating to the terms and conditions under which AeroGrow must purchase AeroGarden products from Main Power. The Promissory Note has a final maturity of June 30, 2011, and carries an interest rate of 8% per annum, with interest accrued and added to the principal amount of the Promissory Note for the first year. During the second year of the Promissory Note, interest is due and payable quarterly. Principal payments of \$150,000 are due and payable monthly beginning January 31, 2011, with a final payment of all principal and accrued but unpaid interest due on June 30, 2011. As of September 30, 2010, the outstanding balance under the Promissory Note totaled \$1,510,425, including accrued interest.

### Bridge Financing

On August 28 through September 1, 2009, the Company entered into bridge financing arrangements totaling \$500,000 (the "Bridge Loans") with six lenders who were directors or officers, or who had greater than a 10% beneficial ownership in the Company. The Bridge Loans were unsecured, subordinated to loans made to the Company by FCC, and accrued interest at 15% per annum. The Company issued 500,000 warrants to purchase common shares of the Company to the Lenders. Each of the warrants has a five-year term and an exercise price of \$0.25 per common share.

## Table of Contents

On May 6, 2010, \$430,466 of the Bridge Loans, inclusive of accrued interest, was converted into the Subordinated Secured Convertible Notes issued by the Company, as further described below. In addition, on May 6, 2010, \$25,000 of the Bridge Loans was extended to a new maturity date of February 1, 2011. On June 24, 2010, an additional \$43,594 of the Bridge Loans, inclusive of accrued interest, was converted into the Subordinated Secured Convertible Notes issued by the Company, as described below under the caption “Subordinated Secured Convertible Notes. As of September 30, 2010, \$55,610 in Bridge Loans were outstanding, including accrued interest.

Between October 30 and November 9, 2009, the Company entered into additional bridge financing arrangements totaling \$580,000 (the “Additional Bridge Loans”) with five lenders. Directors, officers, and shareholders with greater than a 10% beneficial ownership in the Company extended \$400,000 of the Additional Bridge Loans. The remaining \$180,000 in Additional Bridge Loans was guaranteed by Jack J. Walker, then one of the Company’s directors and now the Company’s Chairman and CEO. The Additional Bridge Loans were unsecured, subordinated to loans made to the Company by FCC, and accrued interest at 20% per annum. The Company issued 580,000 warrants to purchase common shares of the Company to the Additional Lenders. Each of the warrants has a five-year term and an exercise price of \$0.25 per common share.

On May 6, 2010, \$504,534 of the Additional Bridge Loans, inclusive of accrued interest, was converted into the Subordinated Secured Convertible Notes issued by the Company, as described below under the caption “Subordinated Secured Convertible Notes.” Of this amount, \$379,534 was converted by directors, officers, and shareholders with greater than a 10% beneficial ownership in the Company. In addition, on May 6, 2010, \$50,000 of the Additional Bridge Loans was extended to a new maturity date of February 1, 2011. On June 1, 2010, a payment of principal and interest totaling \$74,390 was made against the Additional Bridge Loans. As of September 30, 2010, \$64,164 in Additional Bridge Loans were outstanding, including accrued interest.

### First Western Trust Credit Facilities

On May 21, 2010, the Company and First Western Trust Bank (“FWTB”) executed a business loan agreement and related promissory note (the “FWTB Line of Credit”). The FWTB Line of Credit provides for loans by FWTB to the Company of up to a maximum of \$2 million at any given time, subject to the Company maintaining an equivalent amount of cash on deposit in a restricted account at FWTB. Loans under the FWTB Line of Credit bear interest at a fixed rate of 2.0% per annum. In addition, the Company paid FWTB an origination fee of \$2,500. The terms and conditions of the FWTB Line of Credit include limitations on the Company incurring additional debt and paying dividends on the Company’s stock without the consent of FWTB. In the event of a default under the FWTB Line of Credit, FWTB has the option to declare any loans outstanding immediately due and payable. During the quarter ended September 30, 2010 there were no borrowing under the FWTB line of credit. As of September 30, 2010 there were no loans outstanding under the FWTB Line of Credit. On October 22, 2010 the FWTB Line of Credit was terminated.

On May 21, 2010, the Company, FWTB and Jack J. Walker, the Company’s Chairman and CEO, as guarantor, executed a business loan agreement and related promissory note (the “FWTB Term Loan”) for a four-year loan in an initial principal amount of \$1 million. The FWTB Term Loan is secured by a lien on the Company’s assets. In addition, Mr. Walker provided a guaranty of all Company obligations relating to the FWTB Term Loan. The Company paid Mr. Walker \$50,000 as compensation for guaranteeing the FWTB Term Loan. The FWTB Term Loan bears interest at a fixed rate of 7.25% per annum and the Company paid a \$12,500 origination fee to FWTB. The Company will make equal monthly payments of principal/interest over the four-year term of the FWTB Term Loan, which has a final maturity date of May 21, 2014. The terms and conditions of the FWTB Term Loan include limitations on the Company incurring additional debt and paying dividends on the Company’s stock without the consent of FWTB. In the event of a default under the FWTB Term Loan, FWTB has the option to declare the loan immediately due and payable. As of September 30, 2010, there was \$928,768 outstanding under the FWTB Term

Loan, including accrued interest.

13

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Table of Contents

Subordinated Secured Convertible Notes

Beginning in March 2010, the Company began a private offering of units comprising an aggregate of up to \$8.4 million of 8% Senior Secured Convertible Notes and warrants to purchase 84,000,000 shares of the Company's common stock (the "Warrants"). The Company intends to use the proceeds from the private offering to invest in advertising and marketing programs to support its direct-to-consumer business, provide general working capital, pay commissions and expenses related to the private offering, and repay certain outstanding obligations. The issuance of the Units (as defined below) the Additional Units (as defined below), and the Final Units (as defined below) was conducted in reliance upon exemptions from registration requirements under the Securities Act, including, without limitation, those under Rule 506 of Regulation D (as promulgated under the Securities Act). The Units, Additional Units, and Final Units were offered and sold only to investors who are "accredited investors," as defined in Rule 501 of Regulation D under the Securities Act. Because the units have not been registered under the Securities Act, investors will not be able to sell their Subordinated Secured Convertible Notes (or the shares of the Company's common stock issuable upon conversion of the Subordinated Secured Convertible Notes or conversion of the Warrants) in the United States absent an effective registration statement or an applicable exemption from registration.

On May 6, 2010, the Company closed on the private sale of units (the "Units") comprising an aggregate of \$4,200,000 in 8% Subordinated Secured Convertible Notes and an aggregate of 42,000,000 Warrants. The Units were sold at a price equal to the face value of the Subordinated Secured Convertible Notes. Consideration for the Units sold comprised \$3,265,000 in cash and \$935,000 from the conversion of existing obligations of the Company into the Subordinated Secured Convertible Notes.

On June 24, 2010, the Company closed on the private sale of additional units (the "Additional Units") comprising an aggregate of \$2,600,000 in 8% Subordinated Secured Convertible Notes and an aggregate of 26,000,000 Warrants. The Additional Units were sold at a price equal to the face value of the Subordinated Secured Convertible Notes. The Company also received a commitment to purchase an additional \$200,000 face value of Subordinated Secured Convertible Notes under the same terms and conditions as the Additional Units. Consideration for the Additional Units sold comprised \$2,300,000 in cash and \$300,000 from the conversion of existing obligations of the Company into the Subordinated Secured Convertible Notes.

On September 17, 2010, the Company closed on the private sale of units (the "Final Units") comprising an aggregate of \$220,000 in 8% Subordinated Secured Convertible Notes and an aggregate of 2,200,000 Warrants. The Final Units were sold at a price equal to the face value of the Subordinated Secured Convertible Notes. Consideration for the Final Units comprised \$220,000 in cash.

On September 17, 2010, the Company and GVC Capital LLC, the Company's placement agent, terminated the private offering.

The Subordinated Secured Convertible Notes bear interest at 8% per year, payable quarterly in cash, additional Subordinated Secured Convertible Notes, or in registered common stock of the Company, at the option of the Company, and mature on May 6, 2013. The Subordinated Secured Convertible Notes can be converted into shares of the Company's common stock at any time, initially at a conversion price of \$0.10 per share (the "Conversion Price"). The Subordinated Secured Convertible Notes will automatically convert into shares of the Company's common stock in the event (i) there is an effective registration statement registering the resale under the Securities Act of 1933 ("Securities Act") of the underlying stock ("Conversion Shares") or the Conversion Shares are eligible to be resold without restriction or limitation under Rule 144 under the Securities Act, and (ii) the closing bid price of the Company's common stock as quoted on the OTC Bulletin Board or other principal trading market is at least \$0.25 per share for 20 out of 30 consecutive trading days with an average daily trading volume of at least one million shares. The Subordinated Secured Convertible Notes are secured by a subordinated lien on all assets of the Company.



Each Warrant entitles the holder to purchase one share of the Company's common stock at a price of \$0.20 per share, and contains customary anti-dilution rights (for stock splits, stock dividends and sales of substantially all the Company's assets) and piggyback registration rights. The Warrants expire May 6, 2015.

## Table of Contents

In accordance with applicable accounting guidance, the Company recorded a \$6,980,400 debt discount on the Subordinated Secured Convertible Notes because the combined value of the Warrants and the beneficial conversion feature (resulting because the market price of the Company's shares on the date of issuance was greater than the Conversion Price of the Subordinated Secured Convertible Notes) exceeded the amount of Subordinated Secured Convertible Notes issued. The amortization of the \$6,980,400 debt discount will be reported as additional interest expense and increases in long-term debt over the three-year term of the Subordinated Secured Convertible Notes.

During the quarter ended June 30, 2010, \$25,000 of the Subordinated Secured Convertible Notes was converted into common stock. The remaining unamortized debt discount of \$24,018 related to the amount converted was charged to interest expense during the quarter. Amortization of the debt discount on the Subordinated Secured Convertible Notes amounted to \$582,198 and \$807,129 for the three and six months ended September 30, 2010, respectively. As of September 30, 2010, the remaining unamortized discount on the Subordinated Secured Convertible Notes was \$6,149,253.

The Company paid \$509,119 in placement agent fees and expenses in connection with the issuance of the Subordinated Secured Convertible Notes. This amount was recognized as deferred financing costs on the Company's balance sheet. These costs will be amortized to expense over the three-year term of the Subordinated Secured Convertible Notes. In addition, the Company granted warrants to purchase the Company's common stock to the placement agent for its Subordinated Secured Convertible Notes (the "Placement Agent Warrants"). The Company granted 7,020,000 Placement Agent Warrants with an exercise price of \$0.10 per common share and 7,020,000 Placement Agent Warrants with an exercise price of \$0.20 per common share. The Placement Agent Warrants have a five year term expiring May 6, 2015 and contain a cashless exercise provision. The value of the Placement Agent Warrants has been recognized as \$1,518,600 in deferred financing cost on the Company's balance sheet, which will be amortized to expense over the three-year term of the Subordinated Convertible Notes. For the three and six months ended September 30, 2010, the amortized deferred financing costs relating to the Subordinated Convertible Notes totaled \$170,671 and \$233,128.

### 5. Equity Compensation Plans

For the three months ended September 30, 2010, the Company granted zero options to purchase the Company's common stock under the Company's 2005 Equity Compensation Plan (the "2005 Plan"). For the three months ended September 30, 2009, the Company granted 1,619,973 options to purchase the Company's common stock at an exercise price ranging from \$0.12 to \$0.13 per share under the 2005 Plan.

For the six months ended September 30, 2010, the Company granted 200,000 options to purchase the Company's common stock at an exercise price of \$0.14 per share under the 2005 Plan. For the six months ended September 30, 2009, the Company granted 1,619,973 options to purchase the Company's common stock at exercise prices ranging from \$0.12 to \$0.13 per share under the 2005 Plan.

During the three months ended September 30, 2010, there were 2,594 options that either were cancelled or expired and zero shares of common stock issued upon exercise of outstanding stock options under the 2005 Plan. During the three months ended September 30, 2009, there were 1,237,898 options that either were cancelled or expired and zero shares issued upon exercise of outstanding stock options under the 2005 Plan.

During the six months ended September 30, 2010 there were 96,830 options that either were cancelled or expired and zero shares exercised. During the six months ended September 30, 2009, there were 1,291,711 options that either were cancelled or expired and 4,075 shares issued upon exercise of outstanding stock options under the 2005 Plan.

As of September 30, 2010, the Company had granted options for 367,851 shares of the Company's common stock that are unvested that will result in \$29,929 of compensation expense in future periods if fully vested.

Table of Contents

Information regarding all stock options outstanding under the 2005 Plan as of September 30, 2010 is as follows:

| Exercise price range  | OPTIONS OUTSTANDING |   |                                 |                           | OPTIONS EXERCISABLE |   |                                 |                           |
|-----------------------|---------------------|---|---------------------------------|---------------------------|---------------------|---|---------------------------------|---------------------------|
|                       | Options             | Weighted-average Remaining Contractual Life (years) | Weighted-average Exercise Price | Aggregate Intrinsic Value | Options             | Weighted-average Remaining Contractual Life (years) | Weighted-average Exercise Price | Aggregate Intrinsic Value |
| Over \$0.00 to \$0.50 | 2,824,869           | 3.01  | \$ 0.15                         |                           | 2,457,018           | 2.84  | \$ 0.15                         |                           |
| Over \$0.50 to \$2.50 | -                   | -   | \$ -                            |                           | -                   | -   | \$ -                            |                           |
| Over \$2.50 to \$5.00 | -                   | -   | \$ -                            |                           | -                   | -   | \$ -                            |                           |
| Over \$5.00 to \$5.50 | 421,763             | 0.51  | \$ 5.00                         |                           | 421,763             | 0.51  | \$ 5.00                         |                           |
| Over \$5.50           | 25,000              | 1.47  | \$ 5.90                         |                           | 25,000              | 1.47  | \$ 5.90                         |                           |
|                       | 3,271,632           | 2.67  | \$ 0.82                         | \$ 1,330                  | 2,903,781           | 2.49  | \$ 0.90                         | \$ 43,455                 |

The aggregate intrinsic value in the preceding table represents the difference between the Company's closing stock price and the exercise price of each in-the-money option on the last trading day of the period presented, which was September 30, 2010.

On July 28, 2010, the Company filed a definitive Information Statement pursuant to Section 14(c) of the Securities Exchange Act of 1934 (the "Information Statement"). Among other items, the Information Statement provided notice to shareholders that the holders of 54.6% of its outstanding voting stock had approved an amendment to the 2005 Plan to authorize the issuance of an additional 10,000,000 shares under the 2005 Plan. This action became effective on August 25, 2010, 20 days after the initial mailing of the Information Statement to the Company's stockholders.

## 6. Income Taxes

In September 2006, the FASB issued ASC 740 (prior authoritative guidance: FASB issued FASB Interpretation ("FIN") No. 48, Accounting for Uncertainty in Income Taxes and SFAS No. 109, Accounting for Income Taxes). ASC 740 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. This interpretation defines the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. The Company adopted ASC 740 on April 1, 2007. As a result of the implementation, the Company recognized no material adjustment in the liability of unrecognized income tax benefits. At the adoption date, the Company had no unrecognized tax benefits, which would affect the Company's effective tax rate. It is possible that the Company's unrecognized tax benefit could change; however, the Company does not expect any such change to be material.

Deferred income taxes are recognized for the tax consequences in future years of differences between the tax basis of assets and liabilities and their financial reporting amounts at the end of each period, based on enacted laws and statutory rates applicable to the periods in which the differences are expected to affect taxable income. Any liability for actual taxes to taxing authorities is recorded as income tax liability. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is established against such assets where management is unable to conclude more likely than not that such asset will be realized. As of September 30, 2010 and March 31, 2010, the Company recognized a valuation allowance equal to 100% of the net deferred tax asset balance.



Table of Contents

## 7. Related Party Transactions

See Note 4. Long Term Debt and Current Portion – Long Term Debt for disclosure of related party transactions.

## 8. Stockholders' Equity

As noted above in Note 4 “Long Term Debt and Current Portion – Long Term Debt”, on May 6, 2010, the Company closed on the private sale of Units comprising an aggregate of \$4,200,000 in 8% Subordinated Secured Convertible Notes and an aggregate of 42,000,000 Warrants. The Units were sold at a price equal to the face value of the Subordinated Secured Convertible Notes. Consideration for the Units sold comprised \$3,265,000 in cash and \$935,000 from the conversion of existing obligations of the Company into the Subordinated Secured Convertible Notes.

As noted above in Note 4 “Long Term Debt and Current Portion – Long term Debt”, on June 24, 2010, the Company closed on the private sale of Additional Units comprising an aggregate of \$2,600,000 in 8% Subordinated Secured Convertible Notes and an aggregate of 26,000,000 Warrants. The Additional Units were sold at a price equal to the face value of the Subordinated Secured Convertible Notes. Consideration for the Additional Units sold comprised \$2,300,000 in cash and \$300,000 from the conversion of existing obligations of the Company into the Subordinated Secured Convertible Notes.

As noted above in Note 4 “Long Term Debt and Current Portion-Long term Debt”, on September 17, 2010, the Company closed on the private sale of Final Units comprising an aggregate of \$220,000 in 8% Subordinated Secured Convertible Notes and an aggregate of 2,200,000 Warrants. The Final Units were sold at a price equal to the face value of the Subordinated Secured Convertible Notes. Consideration for the Final Units sold comprised \$220,000.

Each Warrant issued as part of the Units, Additional Units, or Final Units entitles the holder to purchase one share of the Company's common stock at a price of \$0.20 per share, and contains customary anti-dilution rights (for stock splits, stock dividends and sales of substantially all the Company's assets) and piggyback registration rights. The Warrants expire May 6, 2015.

The Company granted warrants to purchase the Company's common stock to the placement agent for its Subordinated Secured Convertible Notes (the “Placement Agent Warrants”). The Company granted 7,020,000 Placement Agent Warrants with an exercise price of \$0.10 per common share and 7,020,000 Placement Agent Warrants with an exercise price of \$0.20 per common share. The Placement Agent Warrants have a five year term expiring May 6, 2015 and contain a cashless exercise provision. The value of the Placement Agent Warrants has been recognized as \$1,518,600 in deferred financing cost on the Company's balance sheet, which will be amortized to expense over the three-year term of the Subordinated Convertible Notes. For the three and six months ended September 30, 2010, the amortized deferred financing costs relating to the Subordinated Convertible Notes totaled \$170,671 and \$233,128.

A summary of the Company's warrant activity for the period from April 1, 2010 through September 30, 2010 is presented below:

|                               | Warrants<br>Outstanding | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value |
|-------------------------------|-------------------------|--|---------------------------------|
| Outstanding, April 1,<br>2010 | 6,273,390               | \$ 4.88                                  | -                               |
| Granted                       | 84,240,000              | 0.19                                     |                                 |

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|                         |            |         |         |  |
|-------------------------|------------|---------|---------|--|
| Exercised               | -          | -       |         |  |
| Expired                 | -          | -       |         |  |
| O u t s t a n d i n g , |            |         |         |  |
| September 30, 2010      | 90,513,390 | \$ 0.52 | \$ 0.00 |  |

Table of Contents

As of September 30, 2010, the Company had the following outstanding warrants to purchase its common stock:

| Warrants Outstanding | Weighted Average Exercise Price | Remaining Life (Yrs) |
|----------------------|---------------------------------|----------------------|
| 7,020,000            | \$ 0.10                         | 4.66                 |
| 77,220,000           | \$ 0.20                         | 4.66                 |
| 1,320,000            | \$ 0.25                         | 4.06                 |
| 3,200                | \$ 0.66                         | 0.05                 |
| 325,000              | \$ 1.00                         | 3.38                 |
| 132,639              | \$ 2.00                         | 0.82                 |
| 16,000               | \$ 2.07                         | 2.75                 |
| 450,000              | \$ 5.00                         | 0.05                 |
| 505,796              | \$ 6.00                         | 0.55                 |
| 1,937,299            | \$ 6.25                         | 0.41                 |
| 50,000               | \$ 6.96                         | 1.84                 |
| 746,956              | \$ 7.50                         | 1.45                 |
| 720,000              | \$ 8.00                         | 3.93                 |
| 66,500               | \$ 8.25                         | 3.93                 |
| 90,513,390           | \$ 0.52                         | 4.47                 |

A summary of the Company's preferred stock warrant activity for the period from April 1, 2010, through September 30, 2010, is presented below:

|                                 | Warrants Outstanding | Weighted Average Exercise Price |
|---------------------------------|----------------------|---------------------------------|
| Outstanding, April 1, 2010      | 4,164                | \$ 1,250                        |
| Granted                         | --                   | \$ --                           |
| Exercised                       | --                   | \$ --                           |
| Expired                         | --                   | \$ --                           |
| Outstanding, September 30, 2010 | 4,164                | \$ 1,250                        |

The warrants granted expire five years from issuance.



Table of Contents

9. Subsequent Events

Credit Card Receipts-Backed Notes

On October 28, 2010 and November 5, 2010, the Company closed on the private sale of \$1.5 million in 15% secured convertible promissory notes backed by a portion of the Company's prospective credit card receipts, (the "Credit Card Notes") and 5,000,000 warrants to purchase the Company's common stock (the "Credit Card Warrants") (collectively, the "Credit Card Offering"). Consideration for the Credit Card Offering comprised \$1.5 million in cash. Net cash proceeds to the Company after deducting a 2% sales commission (1% on company-referred investors) paid to GVC Capital LLC, the Company's placement agent, totaled \$1,474,500. In addition, the Company will pay a 3% deferred sales commission (2% on company-referred investors) to the placement agent concurrently with the repayment of principal of the Credit Card Notes.

The Company intends to use the proceeds from the Credit Card Offering to invest in advertising and marketing programs to support its direct-to-consumer business, provide general working capital, pay commissions and expenses related to the private offering, and repay certain outstanding obligations. The issuance of the Credit Card Offering was conducted in reliance upon exemptions from registration requirements under the Securities Act of 1933 (the "Securities Act"), including, without limitation, those under Rule 506 of Regulation D (as promulgated under the Securities Act). The Credit Card Offering was offered and sold only to six (6) investors who are, or the Company reasonably believed are, "accredited investors," as defined in Rule 501(a) of Regulation D under the Securities Act. Because the Credit Card Offering has not been registered under the Securities Act, the securities sold in the Offering, including the Credit Card Notes, Credit Card Warrants and shares of common stock underlying the Credit Card Notes and Warrants are "restricted securities" within the meaning of Rule 144 under the Securities Act, and investors will not be able to sell their Credit Card Notes (or the shares of the Company's common stock issuable upon conversion of the Credit Card Notes or exercise of the Credit Card Warrants) in the United States absent an effective registration statement or an applicable exemption from registration.

The Credit Card Notes bear interest at 15% per annum, have a final maturity of July 28, 2011, and can be converted at any time into common shares of the Company at a conversion price of \$0.18 per share. 20% of the Company's daily credit card receipts will be held in escrow with First Western Trust Bank under an Escrow and Account Control Agreement to fund bi-weekly payments of principal and interest to the investors in the Credit Card Offering.

Each Credit Card Warrant entitles the holder to purchase one share of the Company's common stock at a price of \$0.20 per share, and contains customary anti-dilution rights (for stock splits, stock dividends and sales of substantially all the Company's assets) and piggyback registration rights. The Warrants expire October 28, 2015.

The obligation of the Company to repay the Notes is severally guaranteed by Jack J. Walker, the Company's Chairman and CEO (up to \$500,000), J. Michael Wolfe, Chief Operating Officer (up to \$200,000) and H. MacGregor Clarke, Chief Financial Officer (up to \$100,000). The guarantors have executed a Contribution Agreement between and among themselves to enforce the limited several guaranties; and the Company has executed an Indemnity Agreement to hold harmless the guarantors from any future liability under the guaranties.

For nominal consideration, the Company sold a total of 1,333,333 warrants to purchase the Company's common stock to the placement agent. 833,333 of the placement agent warrants have an exercise price of \$0.18 per share of common stock. 500,000 of the placement agent warrants have an exercise price of \$0.20 per share of common stock. The placement agent warrants have a five-year term and contain a cashless exercise provision.

On November 5, 2010 the Company and the placement agent terminated the private offering.

Revised Vendor Payment Agreement

On November 5, 2010, the Company entered into a revised payment agreement with a vendor. The vendor had previously discounted the amount owed by \$105,591 in order to accelerate payment terms. Because the Company fell behind in the agreed accelerated payments, the vendor is now requiring the original amount due to be paid in full. This is an event that provided evidence about a condition that did not exist at the date of the balance sheet but arose subsequent to that date. The \$105,591 will be accounted for as an adjustment to other (income) and expense in the quarter ending December 31, 2010.

## Table of Contents

### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The discussion contained herein is for the three and six months ended September 30, 2010 and September 30, 2009. The following discussion should be read in conjunction with the financial statements of AeroGrow International, Inc. (the "Company," "we," or "our") and the notes to the financial statements included elsewhere in this Quarterly Report on Form 10-Q for the period ended September 30, 2010 (this "Quarterly Report"). The following discussion contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), including statements that include words such as "anticipates," "expects," "intends," "plans," "believes," "may," "will," or similar expressions that are intended to identify forward-looking statements. In addition, any statements that refer to expectations, projections, or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. Such statements include, but are not limited to, statements regarding our intent, belief, or current expectations regarding our strategies, plans, and objectives, our product release schedules, our ability to design, develop, manufacture, and market products, the ability of our products to achieve or maintain commercial acceptance, and our ability to obtain financing necessary to fund our future operations. Such statements are not guarantees of future performance and are subject to risks, uncertainties, and assumptions that are difficult to predict. Therefore, the Company's actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. Factors that could cause or contribute to the differences are discussed in this Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations and in Item 1A. "Risk Factors" of our Annual Report on Form 10-K for the year ended March 31, 2010. Except as required by applicable law or regulation, we undertake no obligation to revise or update any forward-looking statements contained in this Quarterly Report. The information contained in this Quarterly Report is not a complete description of our business or the risks associated with an investment in our common stock. Each reader should carefully review and consider the various disclosures made by the Company in this Quarterly Report and in our other filings with the SEC.

#### Overview

AeroGrow International, Inc. (the "Company") was incorporated in the State of Nevada on March 25, 2002. We are in the business of developing, marketing, and distributing advanced indoor aeroponic and hydroponic garden systems. After several years of initial research and product development, we began sales activities in March 2006. Since that time we have expanded all aspects of our operations in order to take advantage of what we believe to be an attractive market opportunity. We currently offer more than 15 different indoor garden models, more than 50 seed kits, and various gardening and kitchen accessories. Although our business is focused on the United States and Canada, our products are available in nine other countries.

During the fiscal year ended March 31, 2010 ("Fiscal 2010"), and continuing through September 30, 2010, we scaled back our operations as a result of the general economic downturn and the resulting decline in consumer confidence and spending. We also determined that broad distribution through retail channels was not appropriate for a company at our stage of development because of relatively low profit margins, high capital requirements, and the operational requirements of our retailer customers. As of September 30, 2010, our products were offered in approximately 850 storefronts in North America, as compared to approximately 3,600 stores as of September 30, 2009. Although we expect to further reduce the number of retailer storefronts carrying our products during the fiscal year ending March 31, 2011, we plan to maintain relationships with retailers, both traditional and non-traditional, that have historically proven to be good business partners for AeroGrow. In this regard, we plan to continue selling through our largest retailer customers, including three customers that comprised approximately 59% of our retailer sales during Fiscal 2010.

In Fiscal 2010, we re-focused our efforts towards building our direct-to-consumer business, which carries higher margin opportunity. To position our business for the future, we have increased the depth and breadth of our direct

sales distribution channels to include a direct mail catalogue business with approximately 3.7 million catalogues mailed in Fiscal 2010, web sales, infomercials, and 60 and 120 second television commercials. Our products are also sold through television home shopping channels and by online retailers. In Fiscal 2010, approximately 57.5% of our total sales were to direct customers.

Table of Contents

Results of Operations

Three Months Ended September 30, 2010 and September 30, 2009

Summary Overview

For the three months ended September 30, 2010, sales totaled \$1,379,617, a \$1,906,332, or 58.0% decrease from the same period in the prior year. \$1,544,408, or 81.0%, of the overall decline in revenue resulted from an 84.3% reduction in sales to retailers, a result of our strategic decision to reduce our exposure to the retail channel because of its low margins and high capital requirements. Our direct-to-consumer sales also declined, by 22.1% from the prior year, reflecting the combined impact of a 37.2% reduction in the amount of revenue-generating media spending, the impact of inventory stock outs during the period which were caused by cash constraints earlier in the fiscal year and long lead times on products procured from China, and lower average pricing on sales of our products resulting from our shift to an “everyday low pricing” sales model. Despite these issues, the effectiveness of our direct-to-consumer advertising continued to improve, and increased 24.0% year-over-year as we generated \$8.68 of direct-to-consumer revenue for every dollar of revenue-generating media spent in the 2010 period, as compared to \$7.00 of direct-to-consumer revenue per media dollar in 2009. The strategic shift away from sales to retailers, combined with the impact of inventory stock outs, was reflected in lower sales of AeroGardens, which declined by 78.2% from the prior year. Recurring revenue from seed kit and accessories declined slightly, by 7.8%, as these sales were not as affected as AeroGardens by the reduced retail presence or by the inventory stocking issues. Seed kit and accessory sales represented 63.0% percent of total revenue for the three months ended September 30, 2010, up from 28.7% in the prior year period.

Gross margin for the three months ended September 30, 2010 was 24.7%, as compared to 30.9% for the year earlier period. The decrease in percentage margin reflected a variety of factors during the current year period, including lower average pricing on sales of our products, operational inefficiencies caused by cash and inventory constraints, and fixed manufacturing and distribution facility costs spread over a lower revenue base. Operating expenses other than cost of revenue decreased \$1,262,700, or 46.4%, from the prior year reflecting cost saving initiatives, reductions in media spending, and staffing reductions.

Our loss from operations totaled \$1,117,549 for the three months ended September 30, 2010, as compared to a loss of \$1,705,661 in the prior year period. The decreased loss reflected the significant decrease in operating expenses other than cost of revenue, partially offset by the impact of lower sales and gross margin.

Other income and expense for the three months ended September 30, 2010 totaled to a net other expense of \$1,012,004, as compared to net other expense of \$59,593 in the prior year period. The net other expense in the current year period included \$760,900 in non-cash expense related to the combined effect of the amortization of deferred financing costs (principally the value of warrants granted to a placement agent) and a debt discount, on convertible notes we issued during the current fiscal year. These notes were considered to have been issued at a discount because they had a conversion price lower than the market price of our stock at the time of issuance, and because the notes were issued with warrants to purchase our common stock. The resulting discount is being amortized to expense over the three-year life of the notes, as are the related financing costs. The prior year net other expense amount included \$180,286 in gains related to accounts payable balance reduction agreements negotiated with certain vendors.

The year-over-year increase in other expense more than offset the reduction in the operating loss, and, as a result, the net loss for the three months ended September 30, 2010 increased to \$2,129,553 from a net loss of \$1,765,254 in the same period a year earlier.



Table of Contents

The following table sets forth, as a percentage of sales, our financial results for the three months ended September 30, 2010 and the three months ended September 30, 2009:

|  | Three Months Ended<br>September 30, |         |
|--|-------------------------------------|---------|
|  | 2010                                | 2009    |
| Revenue                                    |                                     |         |
| Product sales – retail, net                | 20.8%                               | 55.8%   |
| Product sales – direct to<br>consumer, net | 77.7%                               | 41.8%   |
| Product sales – international              | 1.5%                                | 2.4%    |
| Total sales                                | 100.0%                              | 100.0%  |
| Operating expenses                         |                                     |         |
| Cost of revenue                            | 75.3%                               | 69.1%   |
| Research and development                   | 3.8%                                | 5.3%    |
| Sales and marketing                        | 43.0%                               | 38.0%   |
| General and administrative                 | 58.9%                               | 41.2%   |
| Total operating expenses                   | 181.0%                              | 151.9%  |
| Profit/(loss) from operations              | -81.0 %                             | -51.9 % |

## Revenue

For the three months ended September 30, 2010, revenue totaled \$1,379,617 a year-over-year decrease of 58.0% or \$1,906,332 from the three months ended September 30, 2009.

|                         | Three Months Ended September<br>30, |              |
|-------------------------|-------------------------------------|--------------|
|                         | 2010                                | 2009         |
| Product Revenue         |                                     |              |
| Retail, net             | \$ 287,373                          | \$ 1,831,781 |
| Direct to consumer, net | 1,071,606                           | 1,375,141    |
| International           | 20,638                              | 79,027       |
| Total                   | \$ 1,379,617                        | \$ 3,285,949 |

Sales to retailer customers for the three months ended September 30, 2010 totaled \$287,373, down \$1,544,408 or 84.3%, from the same period a year earlier. The decline principally reflected our strategic decision to reduce our exposure to the retail channel because of the low margins and high capital requirements associated with sales into this channel. As a result of this decision we discontinued our relationships with a number of retailers that had previously carried our products. As of September 30, 2010, our products were carried in approximately 850 traditional “brick and mortar” storefronts in the United States and Canada, as compared to approximately 3,600 as of September 30, 2009. Because of the impact of non-“brick and mortar” retailers, including online retailers and television shopping channels which do not have storefronts, on our retail sales, we do not believe “sales per store” is a meaningful metric for assessing our retail business.

Table of Contents

Direct-to-consumer sales for the three months ended September 30, 2010 totaled \$1,071,606, down \$303,535 or 22.1%, from the prior year period. The decrease reflected a combination of factors, including a 37.2% year-over-year reduction in the amount of revenue-generating media spent during the period and lower average pricing on the sales of our products that resulted from our shift to an “everyday low pricing” sales model. In addition, cash constraints experienced during the first half of the fiscal year combined with long lead times on China-sourced product, impacted available inventory during the quarter ended September 30, 2010, resulting in stock-outs that had a significant negative impact on revenue during the current year period, and contributed to the year-over-year decline in revenue. Despite the reduction in media spending, lower average pricing, and the inventory issues, there was a 24.0% increase in media effectiveness as direct-to-consumer sales per dollar of advertising expense totaled \$8.68 in the quarter ended September 30, 2010, as compared to \$7.00 per dollar of advertising expense in the prior year period.

International sales for the three months ended September 30, 2010 totaled \$20,638, down \$58,389 from the same period in the prior fiscal year. During the current year period sales to international distributors were constrained by a lack of available inventory, and a dispute with a third party warehouse in Europe that impacted our ability to fulfill orders from customers in Western Europe.

Our products consist of AeroGardens and seed kits and accessories. A summary of the sales of these two product categories for the three months ended September 30, 2010 and September 30, 2009 is as follows:

|                           | Three Months Ended September |              |
|---------------------------|------------------------------|--------------|
|                           | 30,                          |              |
|                           | 2010                         | 2009         |
| Product Revenue           |                              |              |
| AeroGardens               | \$ 510,458                   | \$ 2,343,439 |
| Seed kits and accessories | 869,159                      | 942,510      |
| Total                     | \$ 1,379,617                 | \$ 3,285,949 |
| % of Total Revenue        |                              |              |
| AeroGardens               | 37.0%                        | 71.3%        |
| Seed kits and accessories | 63.0%                        | 28.7%        |
| Total                     | 100.0%                       | 100.0%       |

AeroGarden sales declined \$1,832,981 or 78.2%, from the year earlier period, principally reflecting the impact of our decision to reduce sales into the retail channel. In addition, inventory stock-out issues constrained our direct-to-consumer sales of AeroGardens during the current year quarter. Sales of seed kits and accessories, which represent a recurring revenue stream that is generated by the 971,305 AeroGardens we have sold to-date, declined \$73,351, or 7.8%. Our sales of seed kits and accessories occur primarily in the direct-to-consumer channel, given the decline in our retail presence, and were not as adversely affected as AeroGarden sales by inventory stocking issues. For the three months ended September 30, 2010, sales of seed kits and accessories represented 63.0% of total revenue, as compared to 28.7% in the prior year period.



Table of Contents

## Cost of Revenue

Cost of revenue for the three months ended September 30, 2010 totaled \$1,038,812, a decrease of \$1,231,744, or 54.2%, from the three months ended September 30, 2009. Cost of revenue includes product costs for purchased and manufactured products, freight costs for inbound freight from manufacturers and outbound freight to customers, costs related to warehousing and the shipping of products to customers, credit card processing fees for direct sales, and duties and customs applicable to products imported. The dollar amount of cost of revenue decreased primarily because of the decline in revenue discussed above. As a percent of total revenue, these costs represented 75.3% of revenue as compared to 69.1% for the quarter ended September 30, 2009. The increase in costs as a percent of revenue reflected the impact of lower average selling prices for our products in the current year, as well as changes in channel, customer, and product mix. Finally, the increase reflected inefficiencies in our manufacturing and fulfillment operations necessitated by cash and inventory constraints we faced during the current year period, as well as the impact of fixed facility costs at our Indianapolis manufacturing and distribution facility on a lower revenue base.

## Gross Margin

Our gross margin varies based upon the factors impacting net revenue and cost of revenue as discussed above, as well as the mix of our revenue that comes from the retail, direct-to-consumer, and international channels. In a direct-to-consumer sale, we recognize as revenue the full consumer purchase price for the product; in retail and international sales, by comparison, we recognize as revenue the wholesale price for the product which we charge to the retailer or international distributor. Media costs associated with direct sales are included in sales and marketing expenses. For international sales, margins are structured based on the distributor purchasing products by letter of credit or cash in advance terms with the distributor bearing all of the marketing and distribution costs within their territory. As a result, international sales generally have lower margins than domestic retail sales. The gross margin for the quarter ended September 30, 2010 was 24.7% as compared to 30.9% for the quarter ended September 30, 2009.

## Sales and Marketing

Sales and marketing costs for the three months ended September 30, 2010 totaled \$593,309, as compared to \$1,248,102 for the three months ended September 30, 2009, a decrease of 52.5% or \$654,793. Sales and marketing costs include all costs associated with the marketing, sales, operations, customer support, and sales order processing for our products, and consist of the following:

|                   | Three Months Ended<br>September 30, |              |
|-------------------|-------------------------------------|--------------|
|                   | 2010                                | 2009         |
| Advertising       | \$ 123,437                          | \$ 196,587   |
| Personnel         | 311,147                             | 619,970      |
| Sales commissions | 13,993                              | 89,534       |
| Trade Shows       | -                                   | 37,698       |
| Other             | 144,732                             | 304,313      |
|                   | \$ 593,309                          | \$ 1,248,102 |

Advertising expense is principally comprised of the costs of developing and airing our infomercials and short-form television commercials, the costs of development, production, printing, and postage for our catalogues, and mailing and web media costs for search and affiliate web marketing programs. Each of these are key components of our integrated marketing strategy because they help build awareness of, and consumer demand for, our products for all our channels of distribution, in addition to generating direct-to-consumer sales. Advertising expense totaled \$123,437 for the quarter ended September 30, 2010, a year-over-year decrease of 37.2%, or \$73,150, principally reflecting a 58.4% reduction in the number of catalogues mailed.



## Table of Contents

Sales and marketing personnel costs include salaries, payroll taxes, employee benefits and other payroll costs for our sales, operations, customer service, graphics and marketing departments. For the three months ended September 30, 2010, personnel costs for sales and marketing were \$311,147, down from \$619,970 for the three months ended September 30, 2009, a decrease of 49.8%. The decrease principally reflects staff reductions undertaken throughout the prior fiscal year.

Sales commissions, ranging from 2.5% to 7% of net cash collections from our retailer customers, are paid to sales representative organizations that assist us in developing and maintaining our relationships with retailers. These commissions totaled \$13,393 during the quarter ended September 30, 2010, down 84.4% from the prior year. The year-over-year decline in sales commissions resulted from the combined effects of the decline in sales to retailers during the quarter ended September 30, 2010, as discussed above, and the termination of our agreements with the majority of our sales representative organizations, reflecting our strategic decision to de-emphasize the retail channel.

Trade show expense and other marketing expense decreased year-over-year because of our reduced activity in the retail channel, and lower inventory storage fees during the three months ended September 30, 2010 for use of third party warehouses.

### General and Administrative

General and administrative costs for the three months ended September 30, 2010 totaled \$812,300, as compared to \$1,299,598 for the three months ended September 30, 2009, a decrease of 37.5%, or \$487,298. The decrease reflected a \$304,394 reduction in personnel costs, primarily resulting from a year-over-year decline in management headcount. Also, there were reductions across a variety of expense categories, including legal costs which declined \$60,723 because of prior year legal fees related to our issuance of preferred stock and other financing-related legal costs.

### Research and Development

Research and development costs for the quarter ended September 30, 2010 totaled \$52,745, a decrease of 69.6% from the quarter ended September 30, 2009. The lower cost principally reflected lower headcount related to staffing reductions and a reduction in new product development activities.

### Operating Loss

Our loss from operations for the three months ended September 30, 2010 was \$1,117,549, as compared to a loss of \$1,705,661 for the three months ended September 30, 2009. The lower loss resulted from reductions in non-cost of sales operating expenses, partially offset by the impact of lower revenue and gross margin.

### Other Income and Expense

Other income and expense for the quarter ended September 30, 2010 totaled to a net other expense of \$1,012,004, as compared to net other expense of \$59,593 in the prior year period, which included \$180,286 in gains related to negotiated discounts on accounts payable obligations. The net other expense in the current year period included \$760,900 in non-cash expense related to: (i) the amortization of deferred financing costs, and (ii) the amortization of a calculated debt discount. Each of these charges related to convertible notes issued during the current fiscal year. These notes were considered to have been issued at a discount because they had a conversion price lower than the market price of our stock at the time of issuance, and because the notes were issued with warrants to purchase our common stock. The resulting discount will be amortized to expense over the three-year life of the notes, as will the related financing costs.

Table of Contents

Net Loss

For the three months ended September 30, 2010 the net loss totaled \$2,129,553 as compared to a net loss of \$1,765,254 for the three months ended September 30, 2009. The year-over-year increase in the net loss reflects the reduced operating loss, which was more than offset by the impact of the non-cash interest expense related to the convertible notes issued during the current fiscal year.

Six Months Ended September 30, 2010 and September 30, 2009

Summary Overview

For the six months ended September 30, 2010, sales totaled \$3,197,636 which was 49.0% lower than in the prior year period. The reduction in sales primarily reflected our strategic decision, taken in early 2010, to reduce our sales to retailers because of the relatively low margin and high capital requirements associated with servicing this channel. As a consequence, sales to retailers declined 82.3% year-over-year, and represented 72.4% of our total sales decline. Sales into the direct-to-consumer channel also declined, by 22.7%, as a consequence of a 46.0% year-over-year reduction in the amount of advertising expense, lower average selling prices for our products, as well as the impact of inventory shortages we experienced during the current year period. Each of these factors reflected cash constraints we faced, particularly in the first quarter of Fiscal 2011.

The gross margin for the six months ended September 30, 2010 was 26.2% as compared to 33.9% for the year earlier period. The decline in margin reflected a number of factors, including lower average selling prices during the current year period resulting from our shift to an “everyday low pricing” sales model, inefficiencies in our operations related to cash and inventory shortages, and the impact of fixed costs in our manufacturing and fulfillment facility on a lower revenue base. Operating expenses other than cost of revenue were reduced \$2,245,726, or 41.2%, from the prior year reflecting cost saving initiatives, staffing reductions, and reduced spending on advertising and promotion.

The loss from operations totaled \$2,371,409 for the six months ended September 30, 2010, as compared to \$3,328,975 in the prior year. The decreased loss reflected the significant reduction in operating expenses other than cost of revenue, which was partially offset by the impact of the decline in revenue and gross margin.

Other expense for the six months ended September 30, 2010 totaled \$1,487,194 as compared to other income of \$501,989 in the prior year. The current year expense included the impact of \$1,138,384 in non-cash interest expense related to the amortization of debt discount and deferred financing costs related to our issuance of \$7,020,000 in convertible notes in Fiscal 2011. The prior year income amount included \$987,838 in gains that were recognized to reflect discounts negotiated on certain accounts payable balances.

The net loss for the six months ended September 30, 2010 was \$3,858,603 as compared to a \$2,826,986 net loss in the same period a year earlier. The net loss increased year-over-year as the \$957,566 reduction in the operating loss was more than offset by the impact of more than \$1.1 million in non-cash financing charges and the comparison to the prior year that included the almost \$1 million in gains related to the negotiated accounts payable discounts.

Table of Contents

The following table sets forth, as a percentage of sales, our financial results for the six months ended September 30, 2010 and the six months ended September 30, 2009:

|  | Six Months Ended<br>September 30, |         |
|--|-----------------------------------|---------|
|  | 2010                              | 2009    |
| Revenue                                    |                                   |         |
| Product sales - retail, net                | 15.0 %                            | 43.1%   |
| Product sales - direct to<br>consumer, net | 81.9 %                            | 54.0%   |
| Product sales – international, net         | 3.1 %                             | 2.9%    |
| Total sales                                | 100.00 %                          | 100.00% |
| Operating expenses                         |                                   |         |
| Cost of revenue                            | 73.9 %                            | 66.0%   |
| Research and development                   | 2.8 %                             | 4.7%    |
| Sales and marketing                        | 44.1 %                            | 38.4%   |
| General and administrative                 | 53.4 %                            | 44.0%   |
| Total operating expenses                   | 174.2 %                           | 153.1%  |
| Profit/(loss) from operations              | (74.2)%                           | (53.1)% |

## Revenue

For the six months ended September 30, 2010 and September 30, 2009, revenue totaled \$3,197,636 and \$6,265,642 respectively, a year-over-year decrease of 49.0% or \$3,068,006.

|                         | Six Months Ended<br>September 30, |              |
|-------------------------|-----------------------------------|--------------|
|                         | 2010                              | 2009         |
| Product Revenue         |                                   |              |
| Retail, net             | \$ 478,951                        | \$ 2,700,044 |
| Direct to consumer, net | 2,618,541                         | 3,385,384    |
| International, net      | 100,144                           | 180,214      |
| Total                   | \$ 3,197,636                      | \$ 6,265,642 |

Table of Contents

The year-over-year decrease in revenue principally reflected sales to retailer customers, which declined by 82.3%, or \$2,221,093, representing 72.4% of the total sales decline. The decline in sales to retailers was caused by our strategic decision in early 2010 to reduce our exposure to the retail channel because of the relatively low margins and high capital requirements of servicing this channel. As a result, the number of retailers carrying our products was reduced, to an estimated 850 at September 30, 2010, from an estimated 3,600 a year earlier.

Direct-to-consumer sales also decreased year-over-year, by 22.7%, to \$2,618,541. The decline reflected a 46.0% year-over-year reduction in the amount of revenue-generating media spent, lower average selling prices for our products resulting from our shift to an “everyday low pricing” sales model, and inventory stock-out issues resulting from our cash constraints early in the fiscal year, which caused delays in procuring long lead time products, particularly AeroGardens, from Chinese manufacturers. Despite these issues, overall there was a 43.3% increase in media effectiveness as direct-to-consumer sales per dollar of advertising expense totaled \$7.47 for the six months ended September 30, 2010, as compared to \$5.21 in the prior year period.

A summary of the sales of AeroGardens and seed kits and accessories for the six months ended September 30, 2010 and September 30, 2009 is as follows:

|                           | Six Months Ended<br>September 30, |              |
|---------------------------|-----------------------------------|--------------|
|                           | 2010                              | 2009         |
| Product Revenue           |                                   |              |
| AeroGardens               | \$ 1,619,450                      | \$ 3,927,747 |
| Seed kits and accessories | 1,578,186                         | 2,337,895    |
| Total                     | \$ 3,197,636                      | \$ 6,265,642 |
| % of Total Revenue        |                                   |              |
| AeroGardens               | 50.6%                             | 62.7%        |
| Seed kits and accessories | 49.4%                             | 37.3%        |
| Total                     | 100.0%                            | 100.0%       |

AeroGarden sales decreased \$2,308,297, or 58.8% year-over-year, principally reflecting the decline in sales to retailer customers, as well as the decline in revenue-generating media spending. Seed kit and accessory sales also declined, by \$759,709, or 32.5%.

**Cost of Revenue**

Cost of revenue for the six months ended September 30, 2010 totaled \$2,360,510, a year-over-year decrease of \$1,779,846, or 43.0%. The decline principally resulted from the decrease in sales during the period. As a percent of total revenue, these costs totaled 73.8% for the six months ended September 30, 2010, as compared to 66.1% in the year earlier period. The increase in costs as a percent of revenue primarily reflects the impact of lower average selling prices for our products during the current year period, inefficiencies in our operations caused by cash and inventory shortages, and the impact of higher fixed facility costs on a lower revenue base.

Table of Contents

## Gross Margin

The lower pricing, inefficiencies in our operations and fixed cost de-leveraging caused our gross margin for the six months ended September 30, 2010 to decline to 26.2%, from 33.9 % for the prior year period.

## Sales and Marketing

Sales and marketing costs for the six months ended September 30, 2010 totaled \$1,410,286, as compared to \$2,407,898 for the six months ended September 30, 2009, a decrease of \$997,612, or 41.4%. The breakdown of sales and marketing costs for both time periods is presented in the table below:

|                   | Six Months Ended<br>September 30, |              |
|-------------------|-----------------------------------|--------------|
|                   | 2010                              | 2009         |
| Advertising       | \$ 350,502                        | \$ 649,169   |
| Personnel         | 696,431                           | 1,233,078    |
| Sales commissions | 19,401                            | 140,107      |
| Trade shows       | -                                 | 31,108       |
| All other         | 343,952                           | 354,436      |
|                   | \$ 1,410,286                      | \$ 2,407,898 |

Advertising expense totaled \$350,502 for the six months ended September 30, 2010, a decrease of 46.0% from the same period a year earlier, principally reflecting a 56.2% decline in the number of catalogues mailed. Cash constraints, particularly in the first quarter of the fiscal year, impacted the amount of advertising we were able to spend during the current year period.

For the six months ended September 30, 2010, personnel costs for sales and marketing totaled \$696,431, a year-over-year decrease of \$536,647, or 43.5%. The decrease principally reflected headcount reduction in sales, marketing, and operations personnel.

Sales commissions decreased by \$120,706, or 86.2%, to \$19,401, reflecting our strategic shift away from the retail channel and the consequent decline in sales to retailers during the six months ended September 30, 2010, as discussed above.

## General and Administrative

General and administrative costs for the six months ended September 30, 2010 totaled \$1,708,483 as compared to \$2,753,806 for the six months ended September 30, 2009, a decrease of 38.0%. The decrease reflected the impact of lower headcount, as well as spending reductions in all areas, including legal expense, and administration, and facility and office-related expenses.

## Table of Contents

### Research and Development

Research and development costs for the six months ended September 30, 2010 totaled \$89,760 as compared to \$292,552 for the six months ended September 30, 2009, a decrease of 69.3%. The reduced cost principally reflected lower employee expense resulting from staffing reductions.

### Operating Loss

The loss from operations for the six months ended September 30, 2010 totaled \$2,371,409, and was \$957,566 lower than the operating loss of \$3,328,975 for the six months ended September 30, 2009, as the reductions in operating expenses other than cost of sales more than offset the impact of lower revenue and gross margin during the current year period.

### Other Income and Expense

Other expense for the six months ended September 30, 2010 totaled \$1,487,194, as compared to other income of \$501,989 for the six months ended September 30, 2009. The net other expense in the current year period included \$1,138,384 in non-cash expense related to: (i) the amortization of deferred financing costs, and (ii) the amortization of a calculated debt discount. Each of these charges related to convertible notes issued during the current fiscal year. These notes were considered to have been issued at a discount because they had a conversion price lower than the market price of our stock at the time of issuance, and because the notes were issued with warrants to purchase our common stock. The resulting discount will be amortized to expense over the three-year life of the notes, as will the related financing costs. The prior year income amount included the impact of \$987,838 in gains recorded as a result of negotiated reductions in accounts payable amounts owed to certain vendors.

### Net Loss

The net loss for the six months ended September 30, 2010 increased to \$3,858,603 from \$2,826,986 in the prior year, because the \$957,566 reduction in the operating loss was offset by the impact of the more than \$1.1 million in non-cash interest expense charges related to the convertible note issue in the current year, and the comparison to the prior year that included almost \$1 million in gains related to the negotiated discounts on accounts payable obligations.

### Liquidity and Capital Resources

After adjusting the net loss for non-cash items and changes in assets and liabilities, the net cash used by operating activities totaled \$3,888,376 for the six months ended September 30, 2010 as compared to \$3,341,224 in the prior year.

Non-cash items, comprising depreciation, amortization, bad debt allowances, issuances of common stock and options, change in allowances for bad debt, and interest expense from warrants issued with convertible debentures, totaled to a net cash gain of \$1,575,130 for the six months ended September 30, 2010.

Changes in current assets contributed a net cash usage of \$669,113 during the six months ended September 30, 2010, principally from an increase in inventory. As of September 30, 2010, the inventory balance was \$4,245,458, representing approximately 154 days of sales activity, and 368 days of sales activity, at the average daily rate of product cost expensed during the twelve months and three months ended September 30, 2010, respectively. The days in inventory calculation based on the three months of sales activity is greatly impacted by the seasonality of our sales, which are at the lowest seasonal level during the summer months. Net accounts receivable totaled \$360,411 as of September 30, 2010, representing approximately 28 days of net retail sales activity, and 113 days of net retail sales activity, at the average daily rate of sales recognized during the twelve months and three months ended September 30, 2010, respectively. The days of receivables calculation based on the three months of sales activity is impacted by the timing of sales to retailers which, in the three months ended September 30, 2010, were concentrated in the last several weeks of the period.





## Table of Contents

Current operating liabilities decreased \$935,787 during the six months ended September 30, 2010, principally because of reductions in accounts payable totaling \$1,330,096. Accounts payable as of September 30, 2010 totaled \$1,974,605, representing approximately 37 days of daily expense activity, and 71 days of daily expense activity, at the average daily rate of expenses incurred during the twelve months and three months ended September 30, 2010, respectively.

Financing activity, including the issuance of convertible debt, the impact of the conversions of various short-term obligations to convertible debt, as well as the net reduction in other debt obligations, provided net cash of \$3,975,326 during the six months ended September 30, 2010, as compared to \$3,085,164 in the prior year.

As of September 30, 2010, we had a cash balance of \$717,082, of which \$87,904 was restricted as collateral for our corporate credit card program. This compares to a cash balance of \$693,444 as of March 31, 2010, of which \$443,862 was restricted as collateral for the credit card program and letter of credit obligations.

We use, or have used, a variety of debt funding sources to meet our liquidity requirements:

### First National Loan

On May 19, 2008, the Company and Jack J. Walker, then one of the Company's directors and now the Company's Chairman and CEO, acting as co-borrowers, entered into a Business Loan Agreement with First National Bank for a loan to the Company in a principal amount of up to \$1,000,000 (the "FNB Loan"). The FNB Loan had an initial maturity date of May 19, 2009, which was extended by various agreements between the Company and FNB.

Principal payments totaling \$408,439 were made by Mr. Walker against the FNB Loan during the loan term. The first \$150,000 of payments made by Mr. Walker was recorded by the Company as an offset to a \$150,000 receivable due from Mr. Walker. The remaining \$258,439 was recorded by the Company as promissory notes due to Mr. Walker, which carried an interest rate of 20% per annum. On May 7, 2010, the Company paid \$50,000 in principal and \$4,603 in interest to Mr. Walker. On June 24, 2010, Mr. Walker converted \$206,406 of principal and accrued interest on the promissory notes into three year convertible promissory notes (the "Subordinated Secured Convertible Notes") issued by the Company, as further described below under the caption "Subordinated Secured Convertible Notes." On June 28, 2010, the Company paid \$17,109 in remaining principal and interest to Mr. Walker.

On May 24, 2010, the Company paid the remaining balance on the FNB Loan of \$511,647, including accrued interest, and the FNB Loan was terminated.

### Revolving Credit Facility

On June 23, 2008, the Company entered into a Loan and Security Agreement with FCC, LLC d/b/a First Capital ("FCC") for a revolving credit facility (the "Revolving Credit Facility") to fund working capital requirements. The Revolving Credit Facility had an initial termination date of June 23, 2010. As collateral for the Revolving Credit Facility, the Company granted FCC a first priority security interest over all of the Company's assets, including, but not limited to, accounts receivable, inventory, and equipment. From time to time, Jack J. Walker, then one of the Company's directors and now the Company's Chairman and CEO, provided guarantees of up to a maximum of \$1.5 million of the Company's obligations under the Revolving Credit Facility. Through the term of the Revolving Credit Facility, the Company, FCC and Mr. Walker, as guarantor, entered into various agreements to amend the terms of the Revolving Credit Facility.



## Table of Contents

On May 3, 2010, the Company, FCC, and Jack J. Walker, as guarantor, executed a Forbearance Agreement and Fifth Amendment (the "Fifth Amendment") effective as of April 30, 2010. Under the Fifth Amendment, FCC agreed to forbear from exercising its rights and remedies with regard to the Company's non-compliance with financial covenants until May 21, 2010, if no other defaults occur. The Fifth Amendment enabled the Company to borrow up to \$600,000 more than would otherwise be permitted by the applicable borrowing base calculation under the Revolving Credit Facility until the earlier of (i) the Company closing on a sale of subordinated secured convertible promissory notes, or (ii) the termination date of the forbearance period. In addition, the Fifth Amendment set the maximum borrowing under the Revolving Credit Facility at \$2,000,000 until such time as the Company closed on a sale of subordinated secured convertible promissory notes, at which time the maximum borrowing amount was required to be reduced to \$1,000,000. The Fifth Amendment provided for a continuation of the \$500 per day forbearance fee set forth in the Fourth Amendment, with such fees related to both the Fourth Amendment and Fifth Amendment to be payable on the earlier of (i) May 21, 2010 or (ii) the date on which loans under the Revolving Credit Facility were repaid in full.

On May 24, 2010, the Company paid \$673,600 to FCC to repay, in full, amounts due under the Revolving Credit Facility, and the Revolving Credit Facility was terminated.

During Fiscal 2011, Mr. Walker was paid a fee of \$25,000 for guaranteeing the Company's obligations under the Revolving Credit Facility.

### Main Power Promissory Note

On June 30, 2009, the Company entered into a Letter Agreement ("Letter Agreement") with Main Power Electrical Factory, Ltd. ("Main Power") and executed a Promissory Note. Pursuant to the terms of the Letter Agreement, Main Power agreed to release the Company from \$1,386,041 of existing accounts payable obligations owed by the Company to Main Power in return for the Company executing the Promissory Note for the same amount. In addition, the Letter Agreement included other provisions relating to the terms and conditions under which AeroGrow must purchase AeroGarden products from Main Power. The Promissory Note has a final maturity of June 30, 2011, and carries an interest rate of 8% per annum, with interest accrued and added to the principal amount of the Promissory Note for the first year. During the second year of the Promissory Note, interest is due and payable quarterly. Principal payments of \$150,000 are due and payable monthly beginning January 31, 2011, with a final payment of all principal and accrued but unpaid interest due on June 30, 2011. As of September 30, 2010, the outstanding balance under the Promissory Note totaled \$1,510,425, including accrued interest.

### Bridge Financing

On August 28 through September 1, 2009, the Company entered into bridge financing arrangements totaling \$500,000 (the "Bridge Loans") with six lenders who were directors or officers, or who had greater than a 10% beneficial ownership in the Company. The Bridge Loans were unsecured, subordinated to loans made to the Company by FCC, and accrued interest at 15% per annum. The Company issued 500,000 warrants to purchase common shares of the Company to the Lenders. Each of the warrants has a five-year term and an exercise price of \$0.25 per common share.

On May 6, 2010, \$430,466 of the Bridge Loans, inclusive of accrued interest, was converted into the Subordinated Secured Convertible Notes issued by the Company, as further described below. In addition, on May 6, 2010, \$25,000 of the Bridge Loans was extended to a new maturity date of February 1, 2011. On June 24, 2010, an additional \$43,594 of the Bridge Loans, inclusive of accrued interest, was converted into the Subordinated Secured Convertible Notes issued by the Company, as described below under the caption "Subordinated Secured Convertible Notes. As of September 30, 2010, \$55,610 in Bridge Loans were outstanding, including accrued interest.

Between October 30 and November 9, 2009, the Company entered into additional bridge financing arrangements totaling \$580,000 (the “Additional Bridge Loans”) with five lenders. Directors, officers, and shareholders with greater than a 10% beneficial ownership in the Company extended \$400,000 of the Additional Bridge Loans. The remaining \$180,000 in Additional Bridge Loans was guaranteed by Jack J. Walker, then one of the Company’s directors and now the Company’s Chairman and CEO. The Additional Bridge Loans were unsecured, subordinated to loans made to the Company by FCC, and accrued interest at 20% per annum. The Company issued 580,000 warrants to purchase common shares of the Company to the Additional Lenders. Each of the warrants has a five-year term and an exercise price of \$0.25 per common share.

## Table of Contents

On May 6, 2010, \$504,534 of the Additional Bridge Loans, inclusive of accrued interest, was converted into the Subordinated Secured Convertible Notes issued by the Company, as described below under the caption “Subordinated Secured Convertible Notes.” Of this amount, \$379,534 was converted by directors, officers, and shareholders with greater than a 10% beneficial ownership in the Company. In addition, on May 6, 2010, \$50,000 of the Additional Bridge Loans was extended to a new maturity date of February 1, 2011. On June 1, 2010, a payment of principal and interest totaling \$74,390 was made against the Additional Bridge Loans. As of September 30, 2010, \$64,164 in Additional Bridge Loans were outstanding, including accrued interest.

### First Western Trust Credit Facilities

On May 21, 2010, the Company and First Western Trust Bank (“FWTB”) executed a business loan agreement and related promissory note (the “FWTB Line of Credit”). The FWTB Line of Credit provides for loans by FWTB to the Company of up to a maximum of \$2 million at any given time, subject to the Company maintaining an equivalent amount of cash on deposit in a restricted account at FWTB. Loans under the FWTB Line of Credit bear interest at a fixed rate of 2.0% per annum. In addition, the Company paid FWTB an origination fee of \$2,500. The terms and conditions of the FWTB Line of Credit include limitations on the Company incurring additional debt and paying dividends on the Company’s stock without the consent of FWTB. In the event of a default under the FWTB Line of Credit, FWTB has the option to declare any loans outstanding immediately due and payable. During the quarter ended September 30, 2010 there were no borrowing under the FWTB line of credit. As of September 30, 2010 there were no loans outstanding under the FWTB Line of Credit. On October 22, 2010 the FWTB Line of Credit was terminated.

On May 21, 2010, the Company, FWTB and Jack J. Walker, the Company’s Chairman and CEO, as guarantor, executed a business loan agreement and related promissory note (the “FWTB Term Loan”) for a four-year loan in an initial principal amount of \$1 million. The FWTB Term Loan is secured by a lien on the Company’s assets. In addition, Mr. Walker provided a guaranty of all Company obligations relating to the FWTB Term Loan. The Company paid Mr. Walker \$50,000 as compensation for guaranteeing the FWTB Term Loan. The FWTB Term Loan bears interest at a fixed rate of 7.25% per annum and the Company paid a \$12,500 origination fee to FWTB. The Company will make equal monthly payments of principal/interest over the four-year term of the FWTB Term Loan, which has a final maturity date of May 21, 2014. The terms and conditions of the FWTB Term Loan include limitations on the Company incurring additional debt and paying dividends on the Company’s stock without the consent of FWTB. In the event of a default under the FWTB Term Loan, FWTB has the option to declare the loan immediately due and payable. As of September 30, 2010, there was \$928,768 outstanding under the FWTB Term Loan, including accrued interest.

### Subordinated Secured Convertible Notes

Beginning in March 2010, the Company began a private offering of units comprising an aggregate of up to \$8.4 million of 8% Senior Secured Convertible Notes and warrants to purchase 84,000,000 shares of the Company’s common stock (the “Warrants”). The Company intends to use the proceeds from the private offering to invest in advertising and marketing programs to support its direct-to-consumer business, provide general working capital, pay commissions and expenses related to the private offering, and repay certain outstanding obligations. The issuance of the Units (as defined below), the Additional Units (as defined below), and the Final Units (as defined below) was conducted in reliance upon exemptions from registration requirements under the Securities Act, including, without limitation, those under Rule 506 of Regulation D (as promulgated under the Securities Act). The Units, Additional Units, and Final Units were offered and sold only to investors who are “accredited investors,” as defined in Rule 501 of Regulation D under the Securities Act. Because the units have not been registered under the Securities Act, investors will not be able to sell their Subordinated Secured Convertible Notes (or the shares of the Company’s common stock issuable upon conversion of the Subordinated Secured Convertible Notes or conversion of the Warrants) in the United

States absent an effective registration statement or an applicable exemption from registration.

Table of Contents

On May 6, 2010, the Company closed on the private sale of units (the “Units”) comprising an aggregate of \$4,200,000 in 8% Subordinated Secured Convertible Notes and an aggregate of 42,000,000 Warrants. The Units were sold at a price equal to the face value of the Subordinated Secured Convertible Notes. Consideration for the Units sold comprised \$3,265,000 in cash and \$935,000 from the conversion of existing obligations of the Company into the Subordinated Secured Convertible Notes.

On June 24, 2010, the Company closed on the private sale of additional units (the “Additional Units”) comprising an aggregate of \$2,600,000 in 8% Subordinated Secured Convertible Notes and an aggregate of 26,000,000 Warrants. The Additional Units were sold at a price equal to the face value of the Subordinated Secured Convertible Notes. The Company also received a commitment to purchase an additional \$200,000 face value of Subordinated Secured Convertible Notes under the same terms and conditions as the Additional Units. Consideration for the Additional Units sold comprised \$2,300,000 in cash and \$300,000 from the conversion of existing obligations of the Company into the Subordinated Secured Convertible Notes.

On September 17, 2010, the Company closed on the private sale of units (the “Final Units”) comprising an aggregate of \$220,000 in 8% Subordinated Secured Convertible Notes and an aggregate of 2,200,000 Warrants. The Final Units were sold at a price equal to the face value of the Subordinated Secured Convertible Notes. Consideration for the Final Units comprised \$220,000 in cash.

On September 17, 2010, the Company and GVC Capital LLC, the Company’s placement agent, terminated the private offering.

The Subordinated Secured Convertible Notes bear interest at 8% per year, payable quarterly in cash, additional Subordinated Secured Convertible Notes, or in registered common stock of the Company, at the option of the Company, and mature on May 6, 2013. The Subordinated Secured Convertible Notes can be converted into shares of the Company’s common stock at any time, initially at a conversion price of \$0.10 per share (the “Conversion Price”). The Subordinated Secured Convertible Notes will automatically convert into shares of the Company’s common stock in the event (i) there is an effective registration statement registering the resale under the Securities Act of 1933 (“Securities Act”) of the underlying stock (“Conversion Shares”) or the Conversion Shares are eligible to be resold without restriction or limitation under Rule 144 under the Securities Act, and (ii) the closing bid price of the Company’s common stock as quoted on the OTC Bulletin Board or other principal trading market is at least \$0.25 per share for 20 out of 30 consecutive trading days with an average daily trading volume of at least one million shares. The Subordinated Secured Convertible Notes are secured by a subordinated lien on all assets of the Company.

Each Warrant entitles the holder to purchase one share of the Company’s common stock at a price of \$0.20 per share, and contains customary anti-dilution rights (for stock splits, stock dividends and sales of substantially all the Company’s assets) and piggyback registration rights. The Warrants expire May 6, 2015.

In accordance with applicable accounting guidance, the Company recorded a \$6,980,400 debt discount on the Subordinated Secured Convertible Notes because the combined value of the Warrants and the beneficial conversion feature (resulting because the market price of the Company’s shares on the date of issuance was greater than the Conversion Price of the Subordinated Secured Convertible Notes) exceeded the amount of Subordinated Secured Convertible Notes issued. The amortization of the \$6,980,400 debt discount will be reported as additional interest expense and increases in long-term debt over the three-year term of the Subordinated Secured Convertible Notes.

During the quarter ended June 30, 2010, \$25,000 of the Subordinated Secured Convertible Notes was converted into common stock. The remaining unamortized debt discount of \$24,018 related to the amount converted was charged to interest expense during that quarter. Amortization of the debt discount on the Subordinated Secured Convertible Notes amounted to \$582,198 and \$807,129 for the three and six months ended September 30, 2010, respectively. As



of September 30, 2010, the remaining unamortized discount on the Subordinated Secured Convertible Notes was \$6,149,253.

## Table of Contents

The Company paid \$509,119 in placement agent fees and expenses in connection with the issuance of the Subordinated Secured Convertible Notes. This amount was recognized as deferred financing costs on the Company's balance sheet. These costs will be amortized to expense over the three-year term of the Subordinated Secured Convertible Notes. In addition, the Company granted warrants to purchase the Company's common stock to the placement agent for its Subordinated Secured Convertible Notes (the "Placement Agent Warrants"). The Company granted 7,020,000 Placement Agent Warrants with an exercise price of \$0.10 per common share and 7,020,000 Placement Agent Warrants with an exercise price of \$0.20 per common share. The Placement Agent Warrants have a five year term expiring May 6, 2015 and contain a cashless exercise provision. The value of the Placement Agent Warrants has been recognized as \$1,518,600 in deferred financing cost on the Company's balance sheet, which will be amortized to expense over the three-year term of the Subordinated Convertible Notes. For the three and six months ended September 30, 2010, the amortized deferred financing costs relating to the Subordinated Convertible Notes totaled \$170,671 and \$233,128.

### Credit Card Receipts-Backed Notes

On October 28, 2010 and November 5, 2010, the Company closed on the private sale of \$1.5 million in 15% secured convertible promissory notes backed by a portion of the Company's prospective credit card receipts, (the "Credit Card Notes") and 5,000,000 warrants to purchase the Company's common stock (the "Credit Card Warrants") (collectively, the "Credit Card Offering"). Consideration for the Credit Card Offering comprised \$1.5 million in cash. Net cash proceeds to the Company after deducting a 2% sales commission (1% on company-referred investors) paid to GVC Capital LLC, the Company's placement agent, totaled \$1,474,500. In addition, the Company will pay a 3% deferred sales commission (2% on company-referred investors) to the placement agent concurrently with the repayment of principal of the Credit Card Notes.

The Company intends to use the proceeds from the Credit Card Offering to invest in advertising and marketing programs to support its direct-to-consumer business, provide general working capital, pay commissions and expenses related to the private offering, and repay certain outstanding obligations. The issuance of the Credit Card Offering was conducted in reliance upon exemptions from registration requirements under the Securities Act of 1933 (the "Securities Act"), including, without limitation, those under Rule 506 of Regulation D (as promulgated under the Securities Act). The Credit Card Offering was offered and sold only to six (6) investors who are, or the Company reasonably believed are, "accredited investors," as defined in Rule 501(a) of Regulation D under the Securities Act. Because the Credit Card Offering has not been registered under the Securities Act, the securities sold in the Offering, including the Credit Card Notes, Credit Card Warrants and shares of common stock underlying the Credit Card Notes and Warrants are "restricted securities" within the meaning of Rule 144 under the Securities Act, and investors will not be able to sell their Credit Card Notes (or the shares of the Company's common stock issuable upon conversion of the Credit Card Notes or exercise of the Credit Card Warrants) in the United States absent an effective registration statement or an applicable exemption from registration.

The Credit Card Notes bear interest at 15% per annum, have a final maturity of July 28, 2011, and can be converted at any time into common shares of the Company at a conversion price of \$0.18 per share. 20% of the Company's daily credit card receipts will be held in escrow with First Western Trust Bank under an Escrow and Account Control Agreement to fund bi-weekly payments of principal and interest to the investors in the Credit Card Offering.

Each Credit Card Warrant entitles the holder to purchase one share of the Company's common stock at a price of \$0.20 per share, and contains customary anti-dilution rights (for stock splits, stock dividends and sales of substantially all the Company's assets) and piggyback registration rights. The Warrants expire October 28, 2015.

The obligation of the Company to repay the Notes is severally guaranteed by Jack J. Walker, the Company's Chairman and CEO (up to \$500,000), J. Michael Wolfe, Chief Operating Officer (up to \$200,000) and H. MacGregor Clarke,

Chief Financial Officer (up to \$100,000). The guarantors have executed a Contribution Agreement between and among themselves to enforce the limited several guaranties; and the Company has executed an Indemnity Agreement to hold harmless the guarantors from any future liability under the guaranties.

For nominal consideration, the Company sold a total of 1,333,333 warrants to purchase the Company's common stock to the placement agent. 833,333 of the placement agent warrants have an exercise price of \$0.18 per share of common stock. 500,000 of the placement agent warrants have an exercise price of \$0.20 per share of common stock. The placement agent warrants have a five-year term and contain a cashless exercise provision.

Table of Contents

On November 5, 2010 the Company and the placement agent terminated the private offering.

Cash Requirements

The Company generally requires cash to:

- fund our operations and working capital requirements,
- develop and execute our product development and market introduction plans,
- execute our sales and marketing plans,
- fund research and development efforts, and
- pay for debt obligations as they come due.

We expect to fund these and other cash requirements with cash provided by operations, the debt facilities described above, and with existing cash. In addition, we are attempting to secure a new source of short-term funding to support our seasonal working capital requirements for our next fiscal year, and we may raise new long-term debt or equity capital depending on market conditions. At this time, based on a variety of assumptions including, but not limited to, our anticipated operating cash flow, the level of customer and consumer demand, our access to funding, the impact of cost reduction programs, and the state of the general economic environment in which we operate, we believe we have sufficient liquidity to support our operations through the balance of our current fiscal year. Subsequent to that time period, in order to continue to meet our liquidity requirements we will need to secure additional capital, either in the form of seasonal working capital borrowings, or longer-term debt or equity capital, or reduce our scale of operations. There can be no assurance that the Company will have access to sufficient capital, from our existing financing sources or from other sources, to enable us to meet our short-term cash requirements. In the event the Company takes actions to reduce its scale of operations, there can be no assurance that such actions will be sufficient, or on a timely basis, to allow the Company to meet its liquidity requirements.

We cannot predict with certainty the cash requirements for our operations as market conditions, competitive pressures, regulatory requirements, credit and capital markets, and customer requirements can change rapidly. If the assumptions regarding these and other factors do not prove to be accurate in all material respects, there could be a material adverse impact on our operations and liquidity position, and on our ability to support the operating requirements of our business.

At this time, we do not expect to enter into additional capital leases to finance major purchases. In addition, we do not currently have any binding commitments with third parties to obtain any material amount of equity or debt financing other than the financing arrangements described in this report.

## Table of Contents

### Assessment of Future Liquidity and Results of Operations

#### Liquidity

To assess our ability to fund ongoing operating requirements, we developed assumptions regarding our business plan, projected operating cash flow, anticipated capital expenditures, and availability under our various existing credit facilities. Critical sources of funding, and key assumptions and areas of uncertainty include:

- our cash of \$717,082 (\$87,904 of which was restricted as collateral for letters of credit and other corporate obligations) as of September 30, 2010,
- our cash of \$909,461 (\$91,573 of which is restricted as collateral for letters of credit and other corporate obligations) as of November 8, 2010,
- continued support of, and extensions of credit by, our suppliers and lenders,
- our historical pattern of increased sales between September and March, and lower sales volume from April through August,
- the level of spending necessary to support our planned initiatives, and
- our sales to consumers, retailers, and international distributors, and the resulting cash flow from operations, which will depend in great measure on the success of our direct-to-consumer initiatives.

#### Results of Operations

There are several factors that could affect our future results of operations. These factors include, but are not limited to, the following:

- the effectiveness of our consumer-focused marketing efforts in generating both direct-to-consumer sales, and sales to consumers by our retailer customers,
- uncertainty regarding the impact of macroeconomic conditions on consumer spending,
- uncertainty regarding the capital markets and on our access to sufficient capital to support our current and projected scale of operations,
- the seasonality of our business, in which we have historically experienced higher sales volume during the fall and winter months (September through March), and
- a timely, uninterrupted supply of product from our third-party manufacturing suppliers in China.

During Fiscal 2010, we took a number of actions to address our liquidity issues. Specifically, we re-focused our efforts on building our direct-to-consumer business, which we believe carries higher margin opportunities than our retailer business. We also reduced the number of retailers that carry our products in order to focus on those retailers that have proven to be the best and most profitable business partners. We issued approximately \$6.7 million of convertible preferred stock to re-capitalize the Company, restructured the amounts and payment timing of certain of our accounts payable, and reduced the amount of interest-bearing debt outstanding. Furthermore, during Fiscal 2011, we have issued \$7,020,000 in Subordinated Secured Convertible Notes and \$1.5 million in Credit Card Notes (as described above).

## Table of Contents

Based on the assumptions and contingencies presented above, and on the sources of capital described above, we believe we have sufficient liquidity to support our operations through the balance of our current fiscal year. Subsequent to that time period, in order to continue to meet our liquidity requirements we will need to secure additional capital, either in the form of seasonal working capital borrowings, or longer-term debt or equity capital, or reduce our scale of operations. There can be no assurance that the Company will have access to sufficient capital, from our existing financing sources or from other sources, to enable us to meet our short-term cash requirements. In the event the Company takes actions to reduce its scale of operations, there can be no assurance that such actions will be sufficient, or on a timely basis, to allow the Company to meet its liquidity requirements.

### Off-Balance Sheet Arrangements

We have certain current commitments under capital leases and have not entered into any contracts for financial derivative such as futures, swaps, and options. We do not believe that these arrangements are material to our current or future financial condition, results of operations, liquidity, capital resources or capital expenditures.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

#### Interest Rate Risk

Our interest income is most sensitive to fluctuations in the general level of U.S. interest rates. As such, changes in U.S. interest rates affect the interest earned on our cash, cash equivalents, and short-term investments, and the value of those investments. Due to the short-term nature of our cash equivalents and investments, we have concluded that a change in interest rates does not pose a material market risk to us with respect to our interest income. Our debt carries fixed interest rates and therefore changes in the general level of market interest rates will not impact our interest expense during the terms of our existing debt arrangements.

#### Foreign Currency Exchange Risk

We transact business in primarily in U.S. currency. Although we purchase our products in U.S. dollars, the prices charged by our China factories are predicated upon their cost for components, labor and overhead. Therefore, changes in the valuation of the U.S. dollar in relation to the Chinese currency may cause our manufacturers to raise prices of our products which could reduce our profit margins.

In future periods, it is possible that we could be exposed to fluctuations in foreign currency exchange rates on accounts receivable from sales and net monetary assets denominated in foreign currencies and liabilities. To date, however, virtually all of our transactions have been denominated in U.S. dollars.

Table of Contents

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

Disclosure controls and procedures are designed to ensure that information required to be disclosed in the reports filed or submitted by the Company under the Exchange Act, is recorded, processed, summarized, and reported, within the time periods specified in the rules and forms of the SEC. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports filed under the Exchange Act is accumulated and communicated to the Company's management, including its principal executive and financial officer, as appropriate, to allow timely decisions regarding required disclosure.

The Company carried out an evaluation, under the supervision and with the participation of its management, including its principal executive officer and principal financial officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based upon and as of the date of that evaluation, the Company's principal executive officer and financial officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports the Company files and submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

(b) Changes in Internal Controls

There were no changes in the Company's internal controls or in other factors that could have significantly affected those controls during the three months ended September 30, 2010.

Table of Contents

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

None

Item 1A. Risk Factors

Our operations and financial results are subject to various risks and uncertainties that could adversely affect our business, results of operations, financial condition, future results, and the trading price of our common stock. In addition to the other information set forth in this Quarterly Report, you should carefully consider the factors described in “Part I. Item 1A. Risk Factors” of our Annual Report on Form 10-K for the year ended March 31, 2010, which could materially affect our business, results of operations, financial condition, future results, and the trading price of our common stock.

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

Subordinated Secured Convertible Notes

Beginning in March 2010, the Company began a private offering of units comprising an aggregate of up to \$8.4 million of 8% Subordinated Secured Convertible Notes and warrants to purchase 84,000,000 shares of the Company’s common stock (the “Warrants”). The Company expects the private offering to remain open through September 30, 2010. The Company intends to use the proceeds from the private offering to invest in advertising and marketing programs to support its direct-to-consumer business, provide general working capital, pay commissions and expenses related to the private offering, and repay certain outstanding obligations. The issuance of the Units (as defined below), the Additional Units (as defined below), and the Final Units (as defined below) was conducted in reliance upon exemptions from registration requirements under the Securities Act, including, without limitation, those under Rule 506 of Regulation D (as promulgated under the Securities Act). The Units, Additional Units, and Final Units were offered and sold only to investors who are “accredited investors,” as defined in Rule 501 of Regulation D under the Securities Act. Because the units have not been registered under the Securities Act, investors will not be able to sell their Subordinated Secured Convertible Notes (or the shares of the Company’s common stock issuable upon conversion of the Subordinated Secured Convertible Notes or conversion of the Warrants) in the United States absent an effective registration statement or an applicable exemption from registration.

On May 6, 2010, the Company closed on the private sale of units (the “Units”) comprising an aggregate of \$4,200,000 in 8% Subordinated Secured Convertible Notes and an aggregate of 42,000,000 Warrants. The Units were sold at a price equal to the face value of the Subordinated Secured Convertible Notes. Consideration for the Units sold comprised \$3,265,000 in cash and \$935,000 from the conversion of existing obligations of the Company into the Subordinated Secured Convertible Notes.

On June 24, 2010, the Company closed on the private sale of units (the “Additional Units”) comprising an aggregate of \$2,600,000 in 8% Subordinated Secured Convertible Notes and an aggregate of 26,000,000 Warrants. The Company also received a commitment to purchase an additional \$200,000 face value of Subordinated Secured Convertible Notes under the same terms and conditions as the Additional Units. The Additional Units were sold at a price equal to the face value of the Subordinated Secured Convertible Notes. Consideration for the Additional Units sold comprised \$2,300,000 in cash and \$300,000 from the conversion of existing obligations of the Company into the Notes.

On September 17, 2010, the Company closed on the private sale of units (the “Final Units”) comprising an aggregate of \$220,000 in 8% Subordinated Secured Convertible Notes and an aggregate of 2,200,000 Warrants. The Final Units were sold at a price equal to the face value of the Subordinated Secured Convertible Notes. Consideration for the Final Units comprised \$220,000 in cash.





Table of Contents

On September 17, 2010, the Company and GVC Capital LLC, the Company's placement agent, terminated the private offering.

The Subordinated Secured Convertible Notes bear interest at 8% per year, payable quarterly in cash, additional Subordinated Secured Convertible Notes, or in registered common stock of the Company, at the option of the Company, and mature on May 6, 2013. The Subordinated Secured Convertible Notes can be converted into shares of the Company's common stock at any time, initially at a conversion price of \$0.10 per share. The Subordinated Secured Convertible Notes will automatically convert into shares of the Company's common stock in the event (i) there is an effective registration statement registering the resale under the Securities Act of 1933 ("Securities Act") of the underlying stock ("Conversion Shares") or the Conversion Shares are eligible to be resold without restriction or limitation under Rule 144 under the Securities Act, and (ii) the closing bid price of the Company's common stock as quoted on the OTC Bulletin Board or other principal trading market is at least \$0.25 per share for 20 out of 30 consecutive trading days with an average daily trading volume of at least one million shares. The Subordinated Secured Convertible Notes are secured by a subordinated lien on all assets of the Company.

Each Warrant entitles the holder to purchase one share of the Company's common stock at a price of \$0.20 per share, and contains customary anti-dilution rights (for stock splits, stock dividends and sales of substantially all the Company's assets) and piggyback registration rights. The Warrants expire May 6, 2015.

In addition, the Company granted warrants to purchase the Company's common stock to the placement agent for its Subordinated Secured Convertible Notes (the "Placement Agent Warrants"). The Company granted 7,020,000 Placement Agent Warrants with an exercise price of \$0.10 per common share and 7,020,000 Placement Agent Warrants with an exercise price of \$0.20 per common share. The Placement Agent Warrants have a five year term and contain a cashless exercise provision.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Reserved

Not applicable.

Item 5. Other Information

Refer to the disclosure under the caption "Credit Card Receipts – Backed Notes" in Part I. Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Quarterly Report of Form 10-Q.

Table of Contents

Item 6. Exhibits

| Exhibit Number | Description  |
|----------------|--|
| 3.1            | Articles of Incorporation of the Company (incorporated by reference to Exhibit 3.1 of our Current Report on Form 8-K/A-2, filed November 16, 2006).  |
| 3.2            | Certificate of Amendment to Articles of Incorporation, dated June 25, 2002 (incorporated by reference to Exhibit 3.2 of our Current Report on Form 8-K/A-2, filed November 16, 2006).  |
| 3.3            | Certificate of Amendment to Articles of Incorporation, dated November 3, 2002 (incorporated by reference to Exhibit 3.3 of our Current Report on Form 8-K/A-2, filed November 16, 2006).   |
| 3.4            | Certificate of Change to Articles of Incorporation, dated January 31, 2005 (incorporated by reference to Exhibit 3.4 of our Current Report on Form 8-K/A-2, filed November 16, 2006).  |
| 3.5            | Certificate of Amendment to Articles of Incorporation, dated July 27, 2005 (incorporated by reference to Exhibit 3.5 of our Current Report on Form 8-K/A-2, filed November 16, 2006).  |
| 3.6            | Certificate of Amendment to Articles of Incorporation, dated February 24, 2006 (incorporated by reference to Exhibit 3.6 of our Current Report on Form 8-K/A-2, filed November 16, 2006).  |
| 3.7            | Certificate of Amendment to Articles of Incorporation, certified May 3, 2010 (incorporated by reference to Exhibit 3.7 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2010, filed August 12, 2010).   |
| 3.8            | Amended and Restated Bylaws (incorporated by reference to Exhibit 3.1 of our Current Report on Form 8-K, filed September 26, 2008).  |
| 3.9            | Amendment to Bylaws (incorporated by reference to Exhibit 3.9 of our Form 10-K for the fiscal year ended March 31, 2009, filed on July 6, 2009).   |
| 3.10           | Certificate of Designations of Series A Convertible Preferred Stock (incorporated by reference to Exhibit 3.7 of our Annual Report on Form 10-K for the fiscal year ended March 31, 2009, filed July 6, 2009).   |
| 3.11           | Certificate of Amendment to Series A Convertible Preferred Stock Certificate of Designations, certified June 21, 2010 (incorporated by reference to Exhibit 3.11 of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2010, filed August 12, 2010). |
| 10.1           | Form of 15% Secured Convertible Promissory Note or "Credit Card Note" (incorporated by reference to Exhibit 4.1 of our Current Report on Form 8-K, filed October 28, 2010).  |
| 10.2           | Form of Credit Card Warrant (incorporated by reference to Exhibit 4.2 of our Current Report on Form 8-K, filed October 28, 2010).  |
| 10.3           | Guaranty Agreement by Jack J. Walker, J. Michael Wolfe and H. MacGregor Clarke, dated October 21, 2010 (incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K, filed October 28, 2010).  |
| 10.4           | Contribution Agreement by Jack J. Walker, J. Michael Wolfe and H. MacGregor Clarke, dated October 25, 2010 (incorporated by reference to Exhibit 10.2 of our Current Report on Form 8-K, filed October 28, 2010).  |
| 10.5           | Indemnity Agreement by Jack J. Walker, J. Michael Wolfe and H. MacGregor Clarke, dated October 25, 2010 (incorporated by reference to Exhibit 10.3 of our  |

- Current Report on Form 8-K, filed October 28, 2010).
- 10.6 Escrow and Account Control Agreement dated October 21, 2010 (incorporated by reference to Exhibit 10.4 of our Current Report on Form 8-K, filed October 28, 2010).
- 10.9 2005 Equity Compensation Plan, as amended and restated (incorporated by reference to Appendix A of our Definitive Information Statement on Schedule 14C, filed July 28, 2010).
- 10.10\* Form of Indemnification Agreement.
- 31.1\* Certifications of the Chief Executive Officer Under Section 302 of the Sarbanes-Oxley Act.
- 31.2\* Certifications of the Chief Financial Officer Under Section 302 of the Sarbanes-Oxley Act.
- 32.1\* Certifications of the Chief Executive Officer Under Section 906 of the Sarbanes-Oxley Act.
- 32.2\* Certifications of the Chief Financial Officer Under Section 906 of the Sarbanes-Oxley Act.

\* Filed Herewith

Table of Contents

SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934 the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

AeroGrow International Inc.

Date: November 10, 2010

/s/Jack J. Walker  
By: Jack J. Walker  
Its: Chairman and Chief Executive Officer  
(Principal Executive Officer) and Director

Date: November 10, 2010

/s/H. MacGregor Clarke  
By: H. MacGregor Clarke  
Its: Chief Financial Officer (Principal Financial  
Officer)

Date: : November 10, 2010

/s/Grey H. Gibbs  
By: Grey H. Gibbs  
Its: Controller (Principal Accounting Officer)

Table of Contents