

AeroGrow International, Inc.
Form 10-K/A
August 22, 2011

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

FORM 10-K/A
Amendment No.1

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended March 31, 2011
or
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

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

6075 Longbow Drive, Suite 200
Boulder, Colorado 80301

(303) 444-7755

(Address, including zip code and telephone number, including area code, of registrant's of principal executive office)

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Title of each class:
Common Stock, par value \$0.001 per share

Name of each exchange on which registered:
OTC Bulletin Board

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

Indicate by check mark whether the registrant has submitted electronically 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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to the Form 10-K.

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 definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

| | | | |
|-------------------------|---|---|--|
| Large accelerated filer | Accelerated filer <input type="radio"/> | Non-accelerated filer <input type="radio"/> | Smaller reporting company <input checked="" type="radio"/> |
| <input type="radio"/> | | (Do not check if a smaller reporting company) | |

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

The aggregate market value of the voting common stock held by non-affiliates of the registrant as of September 30, 2010 was \$1,101,721, the last day of the Company's most recent second quarter. For the purpose of the foregoing calculation only, all directors and executive officers of the registrant and owners of more than 5% of the registrant's common stock are assumed to be affiliates of the registrant. This determination of affiliate status is not necessarily conclusive for any other purpose.

The number of shares of the registrant's common stock outstanding as of July 29, 2011 is 19,244,160.

DOCUMENTS INCORPORATED BY REFERENCE

None

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AeroGrow International Inc.
Form 10-K/A
Amendment No. 1
For the Fiscal Year Ended March 31, 2011

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EXPLANATORY NOTE

AeroGrow International, Inc. (the “Company”) is filing this Amendment on Form 10-K/A to the Company’s Report on Form 10-K for the fiscal year ended March 31, 2011, originally filed on August 15, 2011 (the “Report”). This Form 10-K/A is being filed solely for the purpose of revising the audit opinion letter to include the name of the Company’s public auditors, which was inadvertently omitted from the Report due to a clerical error.

Except as described above, no other amendments are being made to the Report. This Form 10-K/A does not reflect events occurring after the August 15, 2011 filing of the Company’s Report or modify or update the disclosures contained in the Report in any way other than as required to reflect the amendment discussed above.

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PART II

ITEM 8. FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Audit Committee, Board of Directors and Stockholders
AeroGrow International, Inc.
Boulder, Colorado

We have audited the accompanying balance sheets of AeroGrow International, Inc. (“the Company”) as of March 31, 2011 and 2010, and the related statements of operations, changes in stockholders’ equity (deficit) and cash flows for the years then ended. The Company’s management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of AeroGrow International, Inc. as of March 31, 2011 and 2010, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1, the Company does not currently have sufficient liquidity to meet its anticipated working capital, debt service and other liquidity needs in the near term. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1 to the financial statements. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Eide Bailly LLP

Fargo, North Dakota
August 15, 2011

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AEROGROW INTERNATIONAL, INC.

BALANCE SHEETS

| | March 31, 2011 | March 31, 2010 |
|---|-------------------|-------------------|
| ASSETS | | |
| Current assets | | |
| Cash and cash equivalents | \$355,781 | \$249,582 |
| Restricted cash | 162,837 | 443,862 |
| Accounts receivable, net of allowance for doubtful accounts of \$17,791 and \$87,207 at March 31, 2011 and March 31, 2010, respectively | 290,997 | 478,113 |
| Other receivables | 260,692 | 259,831 |
| Inventory, net | 2,547,570 | 3,493,732 |
| Prepaid expenses and other | 335,854 | 338,095 |
| Total current assets | 3,953,731 | 5,263,215 |
| Property and equipment, net of accumulated depreciation of \$2,525,853 and \$2,486,377 at March 31, 2011 and March 31, 2010, respectively | 359,962 | 1,002,530 |
| Other assets | | |
| Intangible assets, net of \$24,834 and \$6,854 of accumulated amortization at March 31, 2011 and March 31, 2010, respectively | 273,081 | 275,599 |
| Deposits | 159,631 | 240,145 |
| Deferred debt issuance costs, net of accumulated amortization of \$737,531 and \$486,791 at March 31, 2011 and March 31, 2010, respectively | 1,488,491 | 62,291 |
| Total other assets | 1,921,203 | 578,035 |
| Total Assets | \$6,234,896 | \$6,843,780 |
| LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT) | | |
| Current liabilities | | |
| Accounts payable | \$1,506,841 | \$3,354,703 |
| Notes payable | 350,798 | - |
| Notes payable – Related party | 211,321 | - |
| Current portion - long term debt – Related Party | 13,947 | 911,275 |
| Current portion – long term debt | 1,168,160 | 3,053,984 |
| Accrued expenses | 614,234 | 1,449,977 |
| Customer deposits | 122,377 | 339,041 |
| Deferred rent | 22,513 | 40,773 |
| Total current liabilities | 4,010,191 | 9,149,753 |
| Long-term debt | 3,716,229 | 1,020,957 |
| Long-term debt-related party | 359,751 | - |
| Stockholders' equity (deficit) | | |
| Preferred stock, \$.001 par value, 20,000,000 shares authorized, 7,576 and 7,586 issued and outstanding at March 31, 2011 and March 31, 2010, respectively | 8 | 8 |
| Common stock, \$.001 par value, 500,000,000 shares authorized, 19,244,160 and 12,398,249 shares issued and outstanding at March 31, 2011 and March 31, 2010, respectively | 19,244 | 12,398 |
| Additional paid-in capital | 62,324,016 | 52,933,467 |
| Accumulated (deficit) | (64,194,543) | (56,272,803) |

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| | | |
|--|--------------|--------------|
| Total Stockholders' Equity (Deficit) | (1,851,275) | (3,326,930) |
| Total Liabilities and Stockholders' Equity (Deficit) | \$6,234,896 | \$6,843,780 |

See accompanying notes to the financial statements

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STATEMENTS OF OPERATIONS

| | Years ended March 31, | | |
|---|-----------------------|----------------|-----------------|
| | 2011 | 2010 | 2009 |
| Revenue | | | |
| Product sales, net | \$ 11,313,212 | \$ 17,251,347 | \$ 37,449,868 |
| Operating expenses | | | |
| Cost of revenue | 7,928,687 | 11,846,399 | 23,710,787 |
| Research and development | 187,178 | 424,741 | 2,146,493 |
| Sales and marketing | 3,760,290 | 6,104,742 | 13,772,822 |
| General and administrative | 3,116,446 | 5,112,647 | 7,043,391 |
| Total operating expenses | 14,992,601 | 23,488,529 | 46,673,493 |
| (Loss) from operations | (3,679,389) | (6,237,182) | (9,223,625) |
| Other (income) expense, net | | | |
| Interest (income) | (8,582) | (8,537) | (6,285) |
| Interest expense | 3,787,684 | 931,468 | 796,070 |
| Interest expense – related party | 415,109 | 117,382 | 195,961 |
| Other (income) expense, net | 48,140 | (946,290) | 104,143 |
| Total other (income) expense, net | 4,242,351 | 94,023 | 1,089,889 |
| Net (loss) | \$(7,921,740) | \$(6,331,205) | \$(10,313,514) |
| Net (loss) per share, basic and diluted | \$(0.56) | \$(0.50) | \$(0.82) |
| Weighted average number of common shares outstanding, basic and diluted | 14,240,761 | 12,564,140 | 12,519,999 |

See accompanying notes to the financial statements

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AEROGROW INTERNATIONAL, INC.
STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)

| | Common Stock | | Preferred Stock | | Additional Paid-in Capital | Accumulated (Deficit) | Total |
|--|--------------|--------|-----------------|--------|----------------------------------|--------------------------|--------------|
| | Shares | Amount | Shares | Amount | | | |
| Balances, April 1, 2008 | 12,076,717 | 12,076 | - | - | 44,024,559 | (39,628,084) | 4,408,551 |
| Common stock issued for services | 22,605 | 23 | - | - | 46,769 | - | 46,792 |
| Exercise of common stock warrants at \$.66 | 213,276 | 213 | - | - | 140,549 | - | 140,762 |
| Exercise of common stock warrants at \$.75 | 976,703 | 977 | - | - | 731,550 | - | 732,527 |
| Exercise of common stock warrants at \$2.50 | 10,000 | 10 | - | - | 24,990 | - | 25,000 |
| Exercise of stock options | 43,576 | 44 | - | - | 51,599 | - | 51,643 |
| Stock options issued under equity compensation plans | - | - | - | - | 676,614 | - | 676,614 |
| Net (loss) | - | - | - | - | - | (10,313,514) | (10,313,514) |
| Balances, March 31, 2009 | 13,342,877 | 13,343 | - | - | 45,696,630 | (49,941,598) | (4,231,625) |
| Preferred Stock issued in private placements | - | - | 7,586 | 8 | 6,685,478 | - | 6,685,486 |
| Exercise of stock options | 4,075 | 4 | - | - | 16 | - | 20 |
| Repurchase and Retirement of Common Stock | (948,703) | (949) | - | - | - | - | (949) |
| Warrants issued in accordance with debt | - | - | - | - | 38,200 | - | 38,200 |
| Stock options issued under | - | - | - | - | 513,143 | - | 513,143 |

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| | | | | | | | | |
|---|------------|-----------|-------|------|---------------|-----------------|-----------------|--|
| equity compensation plans | | | | | | | | |
| Net (loss) | - | - | - | - | - | (6,331,205) | (6,331,205) | |
| Balances, March 31, 2010 | 12,398,249 | \$ 12,398 | 7,586 | \$ 8 | \$ 52,933,467 | \$ (56,272,803) | \$ (3,326,930) | |
| Common stock issued upon conversion of convertible debt | 6,045,911 | 6,046 | - | - | 598,545 | - | 604,591 | |
| Conversion of preferred stock to common stock | 100,000 | 100 | (10) | - | (100) | - | - | |
| Common stock issued to consultants | 700,000 | 700 | - | - | 34,300 | - | 35,000 | |
| Warrants issued to consultants | - | - | - | - | 1,548,600 | - | 1,548,600 | |
| Stock options issued under equity compensation plans | - | - | - | - | 138,804 | - | 138,804 | |
| Convertible debt discount | - | - | - | - | 7,070,400 | - | 7,070,400 | |
| Net (loss) | - | - | - | - | - | (7,921,740) | (7,921,740) | |
| Balances, March 31, 2011 | 19,244,160 | \$ 19,244 | 7,576 | \$ 8 | \$ 62,324,016 | \$ (64,194,543) | \$ (1,851,275) | |

See accompanying notes to the financial statements

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STATEMENTS OF CASH FLOWS

| | Years Ended March 31, | | |
|---|-----------------------|----------------|-----------------|
| | 2011 | 2010 | 2009 |
| Cash flows from operating activities: | | | |
| Net (loss) | \$(7,921,740) | \$(6,331,205) | \$(10,313,514) |
| Adjustments to reconcile net (loss) to cash and cash equivalents provided (used) by operations: | | | |
| Issuance of common stock and options under equity compensation plans | 138,804 | 452,393 | 723,406 |
| Issuance of common stock and options under equity compensation associated with severance agreements | - | 60,750 | - |
| Issuance of common stock not under equity compensation plans | 35,000 | - | - |
| Issuance of warrants related to debt | - | 38,200 | - |
| Issuance of warrants for services | - | - | - |
| Depreciation and amortization expense | 698,432 | 840,315 | 844,427 |
| Loss on disposal of fixed assets | 73,438 | - | - |
| Allowance for bad debt | (69,407) | (1,336,311) | 911,798 |
| Amortization of debt issuance costs | 800,451 | 242,854 | 191,437 |
| Amortization of debt issuance costs – related party | - | - | 52,500 |
| Gain on forgiveness of accounts payable | - | (807,310) | - |
| Loss from revision of vendor payment agreement | 105,591 | - | - |
| Amortization of convertible debentures, beneficial conversion feature | 1,134,140 | - | - |
| Amortization of convertible debentures, beneficial conversion, feature -related party | 157,002 | - | - |
| Interest expense from warrants issued with convertible debentures | 1,040,149 | - | - |
| Interest expense from warrants issued with convertible debentures – related party | 135,823 | - | - |
| Change in assets and liabilities: | | | |
| (Increase) decrease in accounts receivable | 256,523 | 3,136,250 | (777,749) |
| (Increase) decrease in other receivable | (861) | 72,228 | 90,471 |
| (Increase) decrease in inventory | 946,162 | 4,856,403 | (3,661,691) |
| Decrease in other current assets | 2,241 | 227,359 | 196,559 |
| (Increase) decrease in deposits | 80,514 | (129,369) | (9,612) |
| Increase (decrease) in accounts payable | (1,903,453) | (1,747,506) | 5,315,193 |
| (Decrease) in accrued expenses | (174,297) | (868,693) | (133,355) |
| Increase in accrued interest – related party | 39,025 | 14,465 | 19,418 |
| Increase in accrued interest | 408,473 | 10,878 | 35,528 |
| Increase (decrease) in customer deposits | (216,664) | 92,313 | 14,528 |
| (Decrease) in deferred rent | (18,260) | (16,510) | (7,754) |
| Net cash and cash equivalents provided (used) by operating activities | (4,252,914) | (1,192,496) | (6,508,410) |
| Cash flows from investing activities: | | | |
| (Increase) decrease in restricted cash | 281,025 | (5,531) | (351,655) |
| Purchases of equipment | (111,322) | (71,139) | (796,067) |
| Patent expenses | (15,463) | (47,347) | (161,410) |
| | 154,240 | (124,017) | (1,309,132) |

Net cash and cash equivalents provided (used) by investing activities

| Cash flows from financing activities: | | | |
|---|--------------|---------------|---------------|
| (Decrease) in amount due to factor | - | - | (1,480,150) |
| Proceeds from long term debt borrowings | 6,554,677 | 13,981,196 | 27,034,153 |
| Proceeds from long term debt borrowings – related party | 300,000 | 863,439 | 1,213,953 |
| Repayment of long term borrowings | (2,349,266) | (17,851,462) | (20,552,850) |
| Repayment of long term borrowings – related party | (169,485) | - | - |
| Proceeds from notes payable | 1,050,000 | - | - |
| Proceeds from notes payable – related party | 450,000 | - | - |
| Repayments of notes payable | (687,723) | - | - |
| Repayments of notes payable – related party | (233,820) | - | - |
| Proceeds from issuance of common stock, net | - | - | - |
| Proceeds from exercise and issuance of warrants | - | - | 898,289 |
| Proceeds from the exercise of stock options, net | - | 20 | 51,643 |
| Proceeds from issuance of preferred stock, net | - | 4,441,537 | - |
| Principal payments on capital leases | (31,459) | (97,914) | (128,927) |
| (Increase) decrease in debt issuance costs | (678,051) | (103,419) | (393,163) |
| (Increase) in debt issuance costs-related party | - | - | (52,500) |
| Net cash provided by financing activities | 4,204,873 | 1,233,397 | 6,590,448 |
| Net increase (decrease) in cash | 106,199 | (83,116) | (1,227,094) |
| Cash and cash equivalents, beginning of period | 249,582 | 332,698 | 1,559,792 |
| Cash and cash equivalents, end of period | \$355,781 | \$249,582 | \$332,698 |

See supplemental disclosures on the following page and the accompanying notes to the financial statements

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| | Years Ended March 31, | | |
|--|-----------------------|-------------|-------------|
| | 2011 | 2010 | 2009 |
| Interest paid | \$371,368 | \$2,285,146 | \$1,041,228 |
| 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 | \$- | \$150,000 | \$- |
| Modification of accrued expenses to equity | \$- | \$89,000 | \$- |
| Modification of accounts payable to long-term debt | \$- | \$1,386,040 | \$- |
| Common stock returned upon issuance of preferred shares | \$- | \$949 | \$- |
| Modification of accrued interest to long term debt | \$350,871 | \$- | \$- |
| Modification of related party accrued interest to long term debt - related party | \$72,107 | \$- | \$- |
| Modification of accounts payable to long-term debt related party | \$50,000 | \$- | \$- |
| Conversion of long term debt to common stock | \$592,989 | \$- | \$- |
| Conversion of accrued interest to common stock | \$11,602 | \$- | \$- |
| Warrants issue to placement agent as a cost of debt issuance | \$1,548,600 | \$- | \$- |
| Modification of accrued expenses and accounts payable to debt | \$661,446 | \$- | \$- |
| Reclassification of related party debt to long term debt | \$37,548 | \$- | \$- |
| Common stock issued upon conversion of preferred shares | \$700 | \$- | \$- |

See accompanying notes to the financial statements

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AEROGROW INTERNATIONAL, INC.
NOTES TO FINANCIAL STATEMENTS

Note 1 – Description of the Business and Summary of Significant Accounting Policies

Organization and Description of the Business

AeroGrow International, Inc. ("the Company") was incorporated in the State of Nevada on March 25, 2002. On January 12, 2006, the Company and Wentworth I, Inc., a Delaware corporation ("Wentworth"), entered into an Agreement and Plan of Merger (the "Merger Agreement") which was consummated on February 24, 2006. Under the Merger Agreement, Wentworth merged with and into the Company, and the Company was the surviving corporation ("Merger"). The Merger, for accounting and financial reporting purposes, has been accounted for as an acquisition of Wentworth by the Company. As such, the Company was the accounting acquirer in the Merger, and the historical financial statements of the Company will be the financial statements for the Company following the Merger.

The Company's principal business is developing, marketing, and distributing advanced indoor aeroponic garden systems designed and priced to appeal to the consumer gardening, cooking and small indoor appliance markets worldwide. The Company's principal activities from its formation through March 2006, consisted of product research and development, market research, business planning, and raising the capital necessary to fund these activities. In December 2005, the Company commenced pilot production of its AeroGarden system and, in March 2006, began shipping these systems to retail and catalogue customers. The Company manufactures, distributes and markets more than 15 different models of its AeroGarden systems in multiple colors, as well as over 50 varieties of seed kits and a full line of accessory products through multiple channels including retail, catalogue and direct-to-consumer sales in the United States as well as selected countries in Europe, Asia and Australia.

Liquidity, Ability to Continue as a Going Concern, and Basis of Presentation

As shown in the accompanying financial statements, we have incurred net losses of \$7,921,740 and \$6,331,205 for the years ended March 31, 2011 and 2010, and have an accumulated deficit of \$64,194,543 and total debt obligations of \$10,423,491 (including our convertible notes at face value) as of March 31, 2011. These conditions raise substantial doubt as to our ability to continue as a going concern. The consolidated financial statements contained herein do not include any adjustments relating to the recoverability and classification of recorded asset amounts or amounts and classification of liabilities that might be necessary should we be unable to continue in existence.

Our ability to continue as a going concern is dependent upon our ability to generate sufficient cash flows to meet our obligations on a timely basis, to obtain additional capital as may be required, and ultimately to attain profitable operations. We believe we will need to raise new capital to meet our cash requirements for the next twelve months. Management is in the process of attempting to raise the additional capital required to support our operations; however, there can be no assurances we will be able to raise the capital we need to meet our cash requirements, or in sufficient amounts or during the timeframe necessary to support our operating needs. In such an event we would reduce the scale of our operations and take such actions as are available to us to reduce our cash requirements. However, there can be no assurances given that such actions would be successful or that we would be able to continue operations in the absence of new capital.

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 regards to return reserves, inventory obsolescence and the allowance for bad debts will occur in the near term.

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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. For the years ended March 31, 2011, March 31, 2010 and March 31, 2009, the Company had 245,921,563, 68,191,852 and 8,434,815, respectively, of securities that could potentially dilute basic EPS in the future that were not included in the computation of diluted EPS because to do so would have been anti-dilutive for the periods presented.

Reclassifications

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

Cash and Cash Equivalents

The Company considers all highly liquid investments with an original maturity of three months or less when purchased to be cash equivalents. There were no cash equivalents at March 31, 2011 and March 31, 2010.

Restricted Cash

The Company has secured activity related to its corporate credit card purchase account with a restricted money market account. In addition, as discussed in Note 2– Notes Payable and Long Term Debt, 20% of the Company’s daily credit card receipts are held in a restricted escrow account in accordance with the Credit Card Receipts-Backed Notes. The balances in this account as of March 31, 2011 and March 31, 2010 were \$162,837 and \$443,862, respectively.

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 March 31, 2011. However, management believes that the financial institution is financially sound and the risk of loss is minimal.

Customers:

For the year ended March 31, 2011, the Company had one customer who represented 12% of the Company’s net product sales. For the year ended March 31, 2010, the Company had two customers who represented 14% and 7% of the Company’s net product sales, respectively. For the year ended March 31, 2009, the Company had one customer who represented 10% of the Company’s net product sales.

Suppliers:

For the year ended March 31, 2011, the Company purchased inventories and other inventory related items from three suppliers totaling \$855,203, \$790,372 and \$693,272, representing 12%, 11% and 10% of cost of sales, respectively. For the year ended March 31, 2010, the Company purchased inventory and other inventory related items from one supplier totaling \$1,495,163, representing 13% of cost of sales. For the year ended March 31, 2009, the Company purchased inventories and other inventory related items from three suppliers totaling \$8,862,484, \$3,857,284 and \$3,345,734, representing 37%, 16% and 14% of cost of sales, respectively.

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 and any potential loss of supply could have an adverse impact on operations.

Account Receivables:

As of the year ended March 31, 2011, the Company had three customers who represented 19%, 19%, and 11% of outstanding accounts receivables, respectively. Management believes that all receivables from these customers are collectible. As of the year ended March 31, 2010, the Company had two customers who represented 23% and 20% of outstanding accounts receivables.

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Fair Value of Financial Instruments

The carrying value of financial instruments including cash, receivables, accounts payable and accrued expenses, approximates their fair value at March 31, 2011 and March 31, 2010 due to the relatively short-term nature of these instruments. In February 2008, the FASB issued ASC 820-10-55 (prior authoritative guidance: FSP 157-2/Statement 157, Fair Value Measurements). ASC 820-10-55 delayed the effective date for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). On April 1, 2008 the Company adopted the portion of ASC 820-10-55 that was not delayed as it applies to non-financial assets and liabilities. As a result of the delay, ASC 820-10-55 was applied to the Company's non-financial assets and liabilities effective on April 1, 2009. ASC 820-10-55 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:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities.

1:

Level 2: Observable market-based inputs, other than quoted prices in active markets for

2: identical assets or liabilities.

Level 3: Unobservable inputs.

3:

The carrying value of debt approximated fair value at March 31, 2010 due to the relative short-term nature of when the debt was entered into compared to the fiscal year end. As of March 31, 2011, the fair value of the Company's debt using Level 3 inputs was estimated using the discounted cash flow method, which is based on the future expected cash flows, discounted to their present values, using a discount rate of 18%.

| | March 31, 2011 | | March 31, 2010 | |
|-------------------------|----------------|--------------|----------------|--------------|
| | Fair Value | Carry Value | Fair Value | Carry Value |
| Liabilities | | | | |
| Notes Payable | \$ 558,077 | \$ 580,621 | \$ - | \$ - |
| Notes Payable discount | - | (18,502) | - | - |
| Long-term debt | 7,000,700 | 9,842,870 | 4,986,216 | 4,986,216 |
| Long-term debt discount | - | (4,584,783) | - | - |
| Total | \$ 7,558,777 | \$ 5,820,206 | \$ 4,986,216 | \$ 4,986,216 |

As of March 31, 2011 and March 31, 2010, the Company did not have any financial assets or liabilities that were measured at fair value on a recurring basis subsequent to initial recognition.

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Property and Equipment

Property and equipment are stated at cost. Depreciation for financial accounting purposes is computed using the straight-line method over the estimated lives of the respective assets. Office equipment and computer hardware are depreciated over five years. Tooling is depreciated over three years. Leasehold improvements are being amortized over the life of the lease.

Property and equipment consist of the following as of:

| | March 31, 2011 | March 31, 2010 |
|-------------------------------------|-------------------|-------------------|
| Manufacturing equipment and tooling | \$ 1,985,405 | \$ 2,096,708 |
| Computer equipment and software | 404,159 | 800,073 |
| Leasehold improvements | 111,759 | 128,631 |
| Other equipment | 384,492 | 463,495 |
| | 2,885,815 | 3,488,907 |
| Less: accumulated depreciation | (2,525,853) | (2,486,377) |
| Property and equipment, net | \$ 359,962 | \$ 1,002,530 |

Depreciation expense for the years ended March 31, 2011, March 31, 2010, and March 31, 2009 was \$680,452, \$836,977 and \$858,145, respectively.

Intangible Assets

Intangible assets, to date, have consisted of the direct costs incurred for application fees and legal expenses associated with patents and trademarks on the Company's products. The Company periodically reviews the recoverability from future operations using undiscounted cash flows. To the extent carrying values exceed fair values, an impairment loss will be evaluated for possible recording. The Company amortizes its patent and trademark costs on a straight line basis over their estimated useful life of 17 years.

Intangible assets consist of the following:

| | March 31, 2011 | March 31, 2010 |
|--------------------------------|-------------------|-------------------|
| Patents | \$ 253,435 | \$ 236,422 |
| Trademarks | 44,480 | 46,031 |
| | 297,915 | 282,453 |
| Less: accumulated amortization | (24,834) | (6,854) |
| Intangible assets, net | \$ 273,081 | \$ 275,599 |

Amortization expense for the years ended March 31, 2011, March 31, 2010 and March 31, 2009, was \$17,981, \$3,338 and \$61,656, 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.

| | March 31, 2011 | March 31, 2010 |
|----------------|-------------------|-------------------|
| Finished goods | \$ 1,351,245 | \$ 2,515,451 |
| Raw materials | 1,196,325 | 978,281 |
| | \$ 2,547,570 | \$ 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 March 31, 2011, the Company had reserved \$848,794 for inventory obsolescence and as of March 31, 2010, the Company had reserved \$670,134 for inventory obsolescence.

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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 are generally 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 writes-off uncollectible accounts when occurred and the allowance is based upon historical level of write-offs associated with all customers plus any specifically identified uncollectible receivables. The Company's allowance estimate resulted in an allowance of \$17,791 and \$87,207 at March 31, 2011 and March 31, 2010, respectively.

Other Receivables

In conjunction with the Company's processing of credit card transactions and 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 March 31, 2011 and March 31, 2010, the balance in this reserve account was \$260,692 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 should be reported as assets and should be 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 March 31, 2011 and March 31, 2010, the Company had deferred \$3,386 and \$19,058, respectively, related to such media costs. Advertising expenses for the years ended March 31, 2011, March 31, 2010 and March 31, 2009 were \$1,542,939, \$2,299,431 and \$5,101,910, respectively.

Research and Development

Research, development, and engineering costs are expensed as incurred, in accordance with ASC 730-10-25 (prior authoritative guidance: SFAS No. 2 Accounting for Research and Development Costs). Research, development, and engineering expenses primarily include payroll and headcount related costs, contractor fees, infrastructure costs, and administrative expenses directly related to research and development support.

Stock Based Compensation

The Company accounts for share-based payments in accordance with ASC 710-10-55 (prior authoritative guidance: FASB Statement 123(R) Shared-Based Payment). The Company uses the Black-Scholes option valuation model to estimate the fair value of stock option awards issued under ASC 710-10-55. For the years ended March 31, 2011, March 31, 2010, March 31, 2009, equity compensation in the form of stock options and grants of restricted stock totaled \$138,804, \$452,393, and \$723,406, respectively, and is included in the accompanying Statements of Operations in the following categories:

Years ended

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| | March 31, 2011 | March 31, 2010 | March 31, 2009 |
|----------------------------|-------------------|-------------------|-------------------|
| General and administrative | \$ 69,295 | \$ 319,673 | \$ 457,592 |
| Research and development | - | 6,644 | 121,952 |
| Sales and marketing | 69,509 | 126,076 | 143,862 |
| Total | \$ 138,804 | \$ 452,393 | \$ 723,406 |

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Income Taxes

ASC 740-10 (prior authoritative guidance: FASB Interpretation No. (“FIN”) 48, Accounting for Uncertainty in Income Taxes) clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements. ASC 740-10 defines the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. The Company adopted ASC 740-10 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 reasonably 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. For the years ended March 31, 2011 and March 31, 2010, the Company recognized a valuation allowance equal to 100% of the net deferred tax asset balance.

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 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 March 31, 2011 and March 31, 2010, the Company had accrued \$23,889 and \$80,119 respectively, as its estimate for the foregoing deductions and allowances. In addition, for the fiscal year ended March 31, 2011 and March 31, 2010, the Company had accrued \$0 and \$66,000 for possible returns or price markdowns associated with several large retailer accounts along with \$17,791 and \$21,207 of general allowance for potential returns. These accruals were recorded as bad debt expense, and an increase in allowance for bad debt, which reduced net trade receivables relating to retailers.

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 March 31, 2011 and March 31, 2010 a provision for potential future warranty costs of \$22,105 and \$55,842, respectively.

The Company reserves for known and potential returns 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 retailers. As of March 31, 2011 and March 31, 2010, the Company has recorded a reserve for customer returns of \$44,315 and \$47,398,

respectively.

Shipping and Handling Costs

Shipping and handling costs associated with inbound freight are recorded in cost of revenue. Shipping and handling costs associated with freight out to customers are also included in cost of revenue. Shipping and handling charges paid by customers are included in product sales.

Deferred Rent

In July 2006, the Company entered into a facility lease with a term through January 2012, for its corporate offices in Boulder, Colorado. At March 31, 2011 and March 31, 2010, the Company had recorded deferred rent related to this agreement in the amount of \$22,513 and \$40,773, respectively, based on the difference between rent expense recorded and the rent payment obligation.

Deferred Debt Issuance Costs

The Company capitalizes debt issuance costs that are directly attributable to realizing the proceeds of the debt issued and it is amortized over the contractual life of the debt.

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Segments of an Enterprise and Related Information

ASC 280 (previous authoritative guidance: SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information) replaces the industry segment approach under previously issued pronouncements with the management approach. The management approach designates the internal organization that is used by management for allocating resources and assessing performance as the source of the Company's reportable segments. ASC 280 also requires disclosures about products and services, geographic areas and major customers. At present, the Company only operates in one segment.

New Accounting Pronouncements

In May 2011, the FASB issued ASU No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs or ASU 2011-04, which changes the wording used to describe the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements in order to improve consistency in the application and description of fair value between U.S. GAAP and International Financial Reporting Standards ("IFRS"). ASU 2011-04 clarifies how the concepts of highest and best use and valuation premise in a fair value measurement are relevant only when measuring the fair value of nonfinancial assets and are not relevant when measuring the fair value of financial assets or of liabilities. In addition, the guidance expanded the disclosures for the unobservable inputs for Level 3 fair value measurements, requiring quantitative information to be disclosed related to (1) the valuation processes used, (2) the sensitivity of the fair value measurement to changes in unobservable inputs and the interrelationships between those unobservable inputs, and (3) use of a nonfinancial asset in a way that differs from the asset's highest and best use. The revised guidance is effective for interim and annual periods beginning after December 15, 2011 and early application by public entities is prohibited. The Company is currently evaluating the potential impact of adopting this guidance on its consolidated financial position and results of operations.

Note 2 – Notes Payable and Long Term Debt

We relied upon a variety of debt funding sources to help 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, 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.

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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, the Company’s Chairman, 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 in full, amounts due under the Revolving Credit Facility, and the Revolving Credit Facility was terminated.

During Fiscal 2011 and Fiscal 2010, Mr. Walker was paid a fee of \$25,000 for each year 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 obligations owed by the Company to Main Power in return for the execution of 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 original Promissory Note had a final maturity of June 30, 2011, carried an interest rate of 8% per annum and called for principal payments of \$150,000 monthly beginning January 31, 2011, with a final payment of all principal and accrued but unpaid interest due on June 30, 2011.

Effective as of December 31, 2010, AeroGrow and Main Power entered into an agreement to amend various obligations owed by AeroGrow to Main Power. As part of the amendments, AeroGrow issued a new promissory note (the “Revised Main Power Note”) in the amount of \$2,162,046. The Revised Main Power Note retired and replaced the original Promissory Note, and also retired and replaced certain obligations totaling \$661,446 relating to raw material and finished goods inventory purchased and/or manufactured by Main Power on behalf of AeroGrow. The Revised Main Power Note has a final maturity of May 31, 2013, and carries an interest rate of 8% per annum. Interest and principal amounts are payable monthly, with total scheduled principal amortization of \$625,000 during calendar year 2011, \$1,075,000 during calendar year 2012, with the balance paid during calendar year 2013. As of March 31, 2011,

the outstanding balance under the Revised Main Power Note, including accrued interest, totaled \$2,103,600. Subsequent to the end of Fiscal 2011, AeroGrow fell behind on the scheduled payments because of its cash constraints and reached an informal arrangement with Main Power to defer payments for an unspecified period of time.

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Bridge Financing

On August 28 through September 1, 2009, the Company entered into bridge financing arrangements totaling \$500,000 (the "Bridge Loans") with nine 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. On October 28, 2010, a payment of principal and interest totaling \$28,092 was made against the Bridge Loans. On January 19, 2011, the Company paid the remaining balance on the Bridge Loans of \$28,945, including accrued interest, and the Bridge Loans were terminated.

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, the Company's Chairman. 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. On October 28, 2010, an interest payment \$5,464 was made against the Additional Bridge Loans. On February 11, 2011, a payment of principal and interest totaling \$25,000 was made against the Additional Bridge Loans. As of March 31, 2011, \$38,837 in Additional Bridge Loans were outstanding and past due, 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 Fiscal 2011 there were no borrowings 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, 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 March 31, 2011, there was \$816,151 outstanding under the FWTB Term Loan, including accrued interest.

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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 used 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.

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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 Fiscal 2011, \$604,591 of the Subordinated Secured Convertible Notes and accrued interest was converted into common stock. The remaining unamortized debt discount of \$452,922 related to the amount converted was charged to interest expense during the quarters in which the conversions took place. Amortization of the debt discount on the Subordinated Secured Convertible Notes amounted to \$1,942,695 for the fiscal year ended March 31, 2011. As of March 31, 2011, the remaining unamortized discount on the Subordinated Secured Convertible Notes was \$4,584,783.

The Company paid \$534,263 in placement agent fees and related 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 Fiscal 2011, the amortized deferred financing costs relating to the Subordinated Convertible Notes totaled \$629,894.

As of October 31, 2010, the Company issued new Subordinated Secured Convertible Notes to pay interest accrued through that date (the "Interest Notes"). A total of \$228,763 in Interest Notes, including \$30,942 in related party interest notes, was issued. The Interest Notes have the same terms and conditions as the Subordinated Secured Convertible Notes.

As of January 31, 2011, the Company issued new Subordinated Secured Convertible Notes to pay interest accrued through that date (the "Additional Interest Notes"). A total of \$140,622 in Additional Interest Notes, which includes \$21,318 in related party interest notes, were issued. The Additional Interest Notes have the same terms and conditions as the Subordinated Secured Convertible Notes and Interest Notes. As of March 31, 2011, the outstanding balance under the Subordinated Secured Convertible note, including accrued interest totaled \$2,299,500.

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Notes Payable - 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, including \$450,000 in 15% related party 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 used 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 to six (6) investors who 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 certain of the Credit Card 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.

In accordance with applicable accounting guidance, the Company recorded a \$90,000 debt discount on the Credit Card Offering. The amortization of the \$90,000 debt discount will be reported as additional interest expense and increases in notes payable over the estimated payoff period of the Credit Card Notes.

Amortization of the debt discount on the Credit Card Notes amounted to \$71,498 for the fiscal year ended March 31, 2011. As of March 31, 2011, the remaining unamortized discount on the Credit Card Notes was \$18,502.

The Company incurred \$80,659 in paid and deferred placement agent fees and related expenses in connection with the issuance of the Credit Card Notes. This amount was recognized as deferred financing costs on the Company's balance

sheet. These costs will be amortized to interest expense over the estimated payoff period of the Credit Card Notes. In addition, for nominal consideration, the Company sold a total of 1,333,333 warrants to purchase the Company's common stock to the placement agent (the "Placement Agent Warrants"). 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. The value of the Placement Agent Warrants has been recognized as \$30,000 in deferred financing cost on the Company's balance sheet, which will be amortized to interest expense over the estimated payoff period of the Credit Card Notes. For the fiscal year ended March 31, 2011, the total amortized deferred financing costs relating to the Credit Card Offering totaled \$87,258.

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

As of March 31, 2011, \$580,621 in Credit Card Notes was outstanding, including accrued interest.

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Debt Payment Obligations

The timing of the Company's estimated contractual obligations, including accrued interest and excluding unamortized discounts, as of March 31, 2011 is as follows:

| | Fiscals Years Ended March 31 | | | | |
|----------------|------------------------------|--------------|--------------|--------------|-----------|
| | Total Amounts | 2012 | 2013 | 2014 | 2015 |
| Notes payable | \$ 580,621 | \$ 580,621 | \$ - | \$ - | \$ - |
| Long-term debt | 9,842,870 | 1,093,653 | 1,380,343 | 7,321,086 | 47,788 |
| Total | \$ 10,423,491 | \$ 1,674,274 | \$ 1,380,343 | \$ 7,321,086 | \$ 47,788 |

The amounts do not include the discounts related to the value of embedded warrants, the beneficial conversion feature and the related loan origination fees.

Note 3 – Equity Compensation Plans

In 2003, the Company's Board of Directors approved a Stock Option Plan (the "2003 Plan") pursuant to which nonqualified stock options were reserved for issuance to eligible employees, consultants and directors of the Company. The 2003 Plan was administered by the Board of Directors, which had the authority to select the individuals to whom awards were to be granted, the number of shares of common stock to be covered by each award, the vesting schedule of stock options, and all other terms and conditions of each award. The Company has granted nonqualified stock options to purchase shares of common stock to certain employees at exercise prices ranging from \$0.01 to \$5.00 per share. In August 2005, the 2003 Plan was merged into the 2005 Equity Compensation Plan and it no longer separately exists. However, options issued and outstanding under the 2003 Plan continue to be governed by the original grant agreements but are administered under the 2005 Equity Compensation Plan.

In August 2005, the Company's Board of Directors approved the 2005 Equity Compensation Plan (the 2005 Plan) pursuant to which both qualified and nonqualified stock options as well as restricted shares of common stock are reserved for issuance to eligible employees, consultants and directors of the Company. A total of 13,505,000 shares of our common stock may be granted under the 2005 Plan as the original 1,505,000 was increased by 2,000,000 shares on October 1, 2008 and 10,000,000 shares on July 25, 2010.

The 2005 Plan is administered by the Company's compensation committee which has the authority to select the individuals to whom awards are to be granted, the number of shares of common stock to be covered by each award, the vesting schedule of stock options, and all other terms and conditions of each award. The Company has granted qualified stock options to purchase shares of common stock to certain employees at exercise prices ranging from \$0.01 to \$6.00 per share.

The Company accounts for share-based payments in accordance with ASC 710-10-55 (prior authoritative guidance: FASB Statement FASB 123(R) Share-Based Payments). In addition to recognizing compensation expense related to restricted stock and performance units, ASC 710-10-55 also requires recognition of compensation expense related to the estimated fair value of stock options. The Company uses the modified-prospective-transition method. Under that transition method, compensation expense recognized subsequent to adoption includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the values estimated in accordance with the provisions of ASC 710-10-55, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair values estimated in accordance with the provisions of ASC

710-10-55. Consistent with the modified-prospective-transition method, the Company's results of operations for prior periods have not been adjusted to reflect the adoption of ASC 710-10-55.

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For the years ended March 31, 2011, March 31, 2010 and March 31, 2009, respectively, the Company granted 8,890,000, 1,744,973, and 1,781,701 options to purchase the Company's common stock at exercise prices ranging from \$0.07 to \$2.96 per share under the 2005 Plan as follows:

| | Years ended March 31, | | |
|-------------|-----------------------|-----------|-----------|
| | 2011 | 2010 | 2009 |
| Employees | 8,890,000 | 1,441,573 | 1,641,591 |
| Consultants | - | 400 | 13,110 |
| Directors | - | 303,000 | 127,000 |
| | 8,890,000 | 1,744,973 | 1,781,701 |

In November 2007, the Board of Directors of the Company approved a resolution authorizing that an increase of 1.0 million shares in the 2005 Plan be submitted as a matter to be voted on by the shareholders of the Company at the next annual shareholders meeting and that all grants of options in excess of the 1,505,000 shares allowable pursuant to the current 2005 Plan be issued subject to such shareholder approval. On July 23, 2008, the Board of Directors approved a revised resolution that increased the number of shares to be added to the 2005 Plan by 2,000,000. Included in the options granted for the year ended March 31, 2008 were 221,063 options which exceeded the 1,505,000 shares eligible to be issued under the 2005 Plan. On October 1, 2008, the shareholders of the Company approved the increase of 2,000,000 shares for the 2005 Plan.

In March 2007, in as much as the Company's stock had begun trading in the public market but trading history was limited, the Company reviewed the assumptions utilized for the volatility rate, researching companies within the consumer products category with comparable market capitalizations, comparable per share prices and with a minimum of five years of trading history, the length of time the options are exercisable. Accordingly, for the options granted for the period January 1, 2007 through December 31, 2007, the Company used the following weighted average assumptions: no dividend yield; expected volatility rate of 50.3%; risk free interest rate of 5%; and average lives of 3 years resulting in a value of \$2.28 per option granted based upon a market value of \$5.90 per share on the date of grant. The foregoing assumptions were re-evaluated in March 2008 using the same comparison companies for the options granted for the period January 1, 2008 through October 19, 2009, the Company used the following weighted average assumptions: no dividend yield; expected volatility rate of 61.0%; risk free interest rate of 5%; and average lives of 3 years resulting in values of \$.18 to \$2.61 per option granted based upon market values on the date of grant. For the options granted in January 2010, the Company used the following weighted average assumptions: no dividend yield; expected volatility rate of 103.0%; risk free interest rate of 5%; and average lives of 3 years resulting in values of \$.09 and \$.11 per option granted based upon market values on the date of grant. Accordingly, for the options granted on June 23, 2010, December 8, 2010, and January 14, 2011, the Company used the following weighted average assumptions: no dividend yield; expected volatility rates of 122.24%, 122.57% and 121.05%, respectively; risk free interest rates of 1.0%, 1.0% and 1.0%, respectively; and average lives of 3 years resulting in values of \$0.10, \$0.06 and \$0.05, respectively, based on the market values on the date of grant. As a result of recognizing compensation expense for stock options pursuant to the provisions of ASC 710-10-55, the net loss for the years ended March 31, 2011, March 31, 2010 and the March 31, 2009, was increased by \$138,804, \$513,143 and \$676,614, respectively.

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A summary of option activity in the 2005 Plan is as follows:

| | Options | Exercise price | | Weighted-Average |
|----------------------------|--------------|----------------|---------|------------------|
| | | Low | High | |
| Balances at April 1, 2008 | | | | |
| Granted | 1,553,951 | \$ 0.01 | \$ 5.90 | \$ 4.46 |
| Exercised | 1,781,701 | \$ 0.18 | \$ 2.96 | \$ 1.07 |
| Forfeited | (43,576) | \$ 0.50 | \$ 2.95 | \$ 0.60 |
| | (273,003) | \$ 0.01 | \$ 5.90 | \$ 2.52 |
| Balances at March 31, 2009 | | | | |
| Granted | 3,019,073 | \$ 0.01 | \$ 5.90 | \$ 2.77 |
| Exercised | 1,744,973 | \$ 0.07 | \$ 0.13 | \$ 0.09 |
| Forfeited | (4,075) | \$ 0.01 | \$ 0.01 | \$ 0.01 |
| | (1,591,509) | \$ 0.21 | \$ 5.90 | \$ 3.65 |
| Balances at March 31, 2010 | | | | |
| Granted | 3,168,462 | \$ 0.18 | \$ 5.90 | \$ 0.83 |
| Exercised | 8,890,000 | \$ 0.07 | \$ 0.14 | \$ 0.08 |
| Forfeited | - | - | - | - |
| | (938,706) | \$ 0.12 | \$ 5.00 | \$ 2.27 |
| Balances at March 31, 2011 | | | | |
| | 11,119,756 | \$ 0.07 | \$ 5.90 | \$ 0.12 |

Information regarding all stock options outstanding under the 2005 Plan as of March 31, 2011 is as follows:

| Exercise price range | OPTIONS OUTSTANDING | | | | OPTIONS EXERCISABLE | | | |
|-----------------------|---------------------|--|---------------------------------|---------------------------|---------------------|--|---------------------------------|---------------------------|
| | Options | Weighted-average Remaining Contract Life (years) | Weighted-average Exercise Price | Aggregate Intrinsic Value | Options | Weighted-average Remaining Contract Life (years) | Weighted-average Exercise Price | Aggregate Intrinsic Value |
| Over \$0.00 to \$0.50 | 11,075,425 | 4.31 | \$0.09 | | 3,649,610 | 3.55 | \$0.12 | |
| Over \$0.50 to \$2.50 | - | - | \$- | | - | - | \$- | |
| Over \$2.50 to \$5.00 | - | - | \$- | | - | - | \$- | |
| Over \$5.00 to \$5.50 | 19,331 | 0.58 | \$5.00 | | 19,331 | 0.58 | \$5.00 | |
| Over \$5.50 | 25,000 | 0.97 | \$5.90 | | 25,000 | 0.97 | \$5.90 | |
| | 11,119,756 | 4.30 | \$0.12 | \$ - | 3,693,941 | 3.51 | \$0.19 | \$ - |

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.

At March 31, 2011 the Company has granted options for 7,425,815 shares of the Company's common stock that are unvested that will result in \$441,707 of compensation expense over the next 21 months.

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Note 4 – Income Taxes

The Company accounts for income taxes in accordance with ASC 740, Income Taxes (formerly Statement of Financial Accounting Standard No., 109, Accounting for Income Taxes). Under the provisions of ASC 740, a deferred tax asset or liability (net of a valuation allowance) is provided in the financial statements by applying the provisions of applicable laws to measure the deferred tax consequences of temporary differences that will result in taxable or deductible amounts in future years as a result of events recognized in the financial statements in the current or preceding years.

Income tax provision consisted of the following:

Income tax provision consisted of the following:

| | 2011 | 2010 |
|----------------------|----------|----------|
| Current: | | |
| Federal | \$ - | \$ - |
| Foreign | | |
| State | 2,056 | 1,586 |
| | 2,056 | 1,586 |
| Deferred: | | |
| Federal | - | - |
| Foreign | - | - |
| State | - | - |
| | - | - |
| Income Tax Provision | \$ 2,056 | \$ 1,586 |

Reconciliation of effective tax rate:

| | 2011 | | 2010 | |
|-------------------------------------|--------|---|--------|---|
| Federal taxes at statutory rate | 34.00 | % | 34.00 | % |
| State taxes, net of federal benefit | 3.56 | % | 2.98 | % |
| Permanent items | -0.68 | % | -1.88 | % |
| Change in Effective Tax Rate | 3.00 | % | 0.00 | % |
| Other Adjustments | 0.91 | % | -1.26 | % |
| Valuation Allowance | -40.82 | % | -33.87 | % |
| Effective income tax rate | -0.03 | % | -0.03 | % |

| | 2011 | 2010 |
|------------------------------|---------------|---------------|
| Deferred tax assets: | | |
| Net Operating Loss | \$ 19,041,350 | \$ 16,115,294 |
| R & D Credit carryforwards | 609,807 | 622,739 |
| Intangibles and Fixed Assets | 166,354 | 85,159 |
| Accrued Compensation | 77,431 | 280,344 |
| Allowance for Bad Debt | 31,998 | 32,426 |
| Reserve for Customer Returns | 16,676 | 17,626 |
| Warranty Reserve | 8,318 | 20,766 |
| Other Accrued Liabilities | - | - |
| Prepaid Expenses | - | - |

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| | | |
|--|--------------|--------------|
| SFAS 123R | 1,545,249 | 1,526,407 |
| Charitable Contributions | 6,760 | 4,778 |
| Other | 109,483 | - |
| Gross deferred tax assets | 21,613,426 | 18,705,539 |
| Deferred tax liabilities: | | |
| Other | (3,662) | - |
| Prepaid Expenses | (67,659) | (80,461) |
| Gross deferred tax liabilities | (71,321) | (80,461) |
| Net deferred tax assets before valuation allowance | 21,542,105 | 18,625,078 |
| Valuation Allowance | (21,542,105) | (18,625,078) |
| Deferred Tax Assets (Liabilities), Net | \$ - | \$ - |

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The Tax Reform Act of 1986 contains provisions that limit the utilization of net operating loss and tax credit carryforwards if there has been a change of ownership as described in Section 382 of the Internal Revenue Code. The Company has not prepared an analysis to determine if a change of ownership has occurred. Such a change of ownership may limit the Company's utilization of its net operating losses.

At March 31, 2011 approximately \$51.1 million of net operating loss carryforwards for federal income tax purposes were available to offset future taxable income through the year 2030. As of March 31, 2011 approximately \$546 thousand of the net operating loss carry-forwards are attributable to stock options, the benefit of which will be credited to additional paid-in capital if realized. The ultimate realization of these assets is dependent upon the generation of future taxable income sufficient to offset the related deductions and loss carryforwards within the applicable carryforward period. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is not more likely than not that the Company will realize the benefits of these deductible differences at March 31, 2011.

ASC 740 provides detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in the financial statements. Tax positions must meet a "more-likely-than-not" recognition threshold before a benefit is recognized in the financial statements. As of March 31, 2011, the Company has not recorded a liability for uncertain tax positions. Included in net deferred tax assets is \$610 thousand of research credits. While the company believes that the credit calculations are correct, it is possible that upon an examination by taxing authorities, the research credits available to offset future taxable income may be reduced in whole or in part. However, as the company is not currently recognizing a benefit for the research credits, there is no impact to the financial statements pursuant to ASC 740. There have been no income tax related interest or penalties assessed or recorded and if interest and penalties were to be assessed, the Company would charge interest and penalties to income tax expense. It is not anticipated that unrecognized tax benefits would significantly increase or decrease within 12 months of the reporting date. The Company files income tax returns in the U.S. and various state jurisdictions and there are open statutes of limitations for taxing authorities to audit the Company's tax returns from years ended March 31, 2007 through the current period.

Note 5 – Related Party Transactions

See Note 2 to our consolidated financial statements for discussion related to debt transactions involving our officers, directors and 5% or greater shareholders.

Note 6 – Commitments and Contingencies

We lease a 21,012 square foot office space in, Boulder, Colorado, with a current monthly rent of \$19,261. We also pay our proportionate share of building taxes, insurance and operating expenses. The initial term continues until January 31, 2012, unless modified under specified circumstances. The agreement contains other standard office lease provisions.

During Fiscal 2011, the Company also rented a warehouse and manufacturing space in Indianapolis, Indiana. The Indianapolis facility houses our distribution and fulfillment operations and our seed kit manufacturing operations. The lease was for approximately 90,400 square feet of space in this facility at a monthly rental rate of \$16,950 with no additional operating expenses. The initial term of the lease expired on February 28, 2011. After the initial term expired, the Company rented this facility on a month-to-month basis at a monthly rental rate of \$20,717 with no additional operating expenses. The Company moved completely out of the facility in May 2011.

Future cash payments under such operating lease for the remaining years of the leases are as follows:

| Year Ended | Rent |
|----------------|---------|
| March 31, 2012 | 366,115 |
| \$366,115 | |

Rent expense for the years ended March 31, 2011, March 31, 2010 and March 31, 2009, was \$503,731 \$543,676, and \$807,702, respectively.

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Note 7 – Stockholders' Equity

In September 2007, the Company completed a private offering in which it sold an aggregate of 800,000 shares of common stock and warrants to purchase 800,000 shares of common stock at an exercise price of \$8.00 per share in the form of units consisting of one share of common stock and one warrant per unit, (the "September 2007 Offering"). The units were sold at a per unit price of \$6.25. Upon closing of offering, the Company received gross proceeds of \$5,000,000, less a placement agent fee in the amount of \$400,000 and approximately \$170,000 in other expenses related to the offering. In addition, the Company issued warrants to purchase 80,000 shares of common stock at an exercise price of \$8.25 per share to the placement agent of this offering.

During the year ended March 31, 2008, the Company received proceeds, net of \$5,000 in expenses, of \$987,500 from the exercise of warrants to purchase 174,750 shares of the Company's common stock at prices ranging from \$2.50 to \$6.25 per share.

On August 1, 2007, the Company entered into an agreement with an investor relations firm that included a grant of a five year warrant to purchase 50,000 shares of the Company's common stock at an exercise price of \$6.96, the closing market price as of the date of the agreement. The warrants vested monthly over a one year period. The Company used the following weighted average assumptions for valuation of the warrants issued: no dividend yield; expected volatility rate of 50.3%; risk free interest rate of 6%; and average lives of three years, resulting in a total value of \$138,023 that was recognized monthly over the twelve month period.

Between November 17, 2008 and November 21, 2008, the Company agreed to reduce the per share exercise prices of certain of its outstanding warrants to purchase shares of its common stock from original exercise prices ranging from \$5.00 to \$8.25 to reduced exercise prices ranging from \$0.66 to \$0.75 in connection with an agreement by the holders of such warrants to immediately exercise such warrants. In connection with such warrant exercises, the Company received \$873,289 in cash proceeds and issued 1,189,979 shares of its common stock.

In connection with the warrant repricing and exercise of such warrants, the Company issued replacement warrants to such warrant holders (the "Replacement Warrants"), permitting the holder to purchase one share of the Company's common stock for every two shares that were purchased pursuant to the exercise of such repriced warrants at an exercise price of \$2.00 per share. In total, Replacement Warrants representing the right to purchase 594,990 shares of Company's common stock were issued, and the Replacement Warrants have termination dates ranging from September 13, 2010 to September 4, 2014.

As noted above in Note 2 "Notes Payable and 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. The Subordinated Secured Convertible Notes can be converted at the option of the holders into the Company's common stock at a conversion price of \$0.10 per share. Under certain circumstances, the Company can force conversion of the Subordinated Secured Convertible Notes.

As noted above in Note 2 "Notes Payable and 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. The Subordinated Secured Convertible Notes can be converted at the option of the holders into common stock

of AeroGrow at a conversion price of \$0.10 per share. Under certain circumstances, the Company can force conversion of the Subordinated Secured Convertible Notes.

As noted above in Note 2 “Notes Payable and 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. The Subordinated Secured Convertible Notes can be converted at the option of the holders into common stock of AeroGrow at a conversion price of \$0.10 per share. Under certain circumstances, the Company can force conversion of the Subordinated Secured Convertible Notes.

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 costs on the Company's balance sheet, which will be amortized to expense over the three-year term of the Subordinated Convertible Notes. For Fiscal 2011, the amortized deferred financing costs relating to the Subordinated Convertible Notes Placement Agent Warrants totaled \$463,113.

As noted above in Note 2 “Notes Payable and Long Term Debt”, on October 28, 2010 and November 5, 2010, the Company closed on the private sale of \$1.5 million in 15% Credit Card Notes and an aggregate of 5,000,000 Warrants. Consideration for the Credit Card Offering comprised \$1.5 million in cash. The Credit Card Notes can be converted at the option of the holders into common stock of AeroGrow at a conversion price of \$0.18 per share.

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 Credit Card Warrants expire October 28, 2015.

The Company granted warrants to purchase the Company's common stock to the placement agent for its Credit Card Notes (the “Credit Card Note Placement Agent Warrants”). The Company granted 833,333 Credit Card Note Placement Agent Warrants with an exercise price of \$0.18 per common share and 500,000 Credit Card Note Placement Agent Warrants with an exercise price of \$0.20 per common share. The Credit Card Note Placement Agent Warrants have a five year term expiring October 28, 2015 and contain a cashless exercise provision. The value of the Credit Card Note Placement Agent Warrants has been recognized as \$30,000 in deferred financing cost on the Company's balance sheet, which will be amortized to interest expense over the estimated payoff period of the Credit Card Notes. For Fiscal 2011, the total amortized deferred financing costs relating to the Credit Card Note Placement Agent Warrants totaled \$23,656.

The shares of common stock issued upon exercise of the repriced warrants and the issuance of the Replacement Warrants were done in reliance on Section 4(2) of the Securities Act of 1933, as amended, and Rule 506 promulgated thereunder.

The Company's Articles of Incorporation authorize the issuance of 20,000,000 shares of preferred stock with \$.001 par value. As of March 31, 2011, 7,586 of preferred stock have been issued, 10 shares have been converted to common stock, as well as 4,164 warrants for preferred stock with a strike price of \$1,250.

A summary of the Company's warrant activity for the period from April 1, 2008 through March 31, 2011 is presented below:

| | Warrants Outstanding | Weighted Average Exercise Price | Aggregate Intrinsic Value |
|-----------------------------|-------------------------|------------------------------------|---------------------------------|
| Outstanding, April 1, 2008 | 5,694,736 | 6.66 | |
| Granted | 935,991 | 1.65 | |
| Exercised | (1,199,979) | .75 | |
| Expired | (15,006) | 2.50 | |
| Outstanding, March 31, 2009 | 5,415,742 | 5.76 | |
| Granted | 1,320,000 | .25 | |
| Exercised | - | - | |
| Expired | (462,352) | 2.00 | |
| Outstanding, March 31, 2010 | 6,273,390 | 4.88 | |
| Granted | 90,573,333 | .19 | |
| Exercised | - | - | |
| Expired | (2,846,795) | 5.90 | |
| Outstanding, March 31, 2011 | 93,999,928 | \$.33 | \$ - |

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As of March 31, 2011, the Company had the following outstanding warrants to purchase its common stock:

| Warrants Outstanding | Weighted Average Exercise Price | Weighted Average Remaining Life (Yrs) |
|----------------------|---------------------------------|---------------------------------------|
| 7,020,000 | \$ 0.10 | 4.16 |
| 833,333 | \$ 0.18 | 4.58 |
| 82,720,000 | \$ 0.20 | 4.19 |
| 1,320,000 | \$ 0.25 | 3.56 |
| 325,000 | \$ 1.00 | 2.88 |
| 54,139 | \$ 2.00 | 1.00 |
| 16,000 | \$ 2.07 | 2.25 |
| 128,000 | \$ 6.00 | 1.00 |
| 50,000 | \$ 6.96 | 1.34 |
| 746,956 | \$ 7.50 | 0.95 |
| 720,000 | \$ 8.00 | 3.43 |
| 66,500 | \$ 8.25 | 3.43 |
| 93,999,928 | \$ 0.33 | 4.14 |

The Series A and Additional Series A Shares (the “Preferred Shares”) carry certain rights, preferences, and designations, including the right to convert each Preferred Share into 5,000 shares of the Company’s common stock. Each Preferred Share has an original issue price of \$1,000. The holders of the Preferred Shares are entitled to receive cumulative dividends in preference to any dividend on the Company’s common stock at the rate of 8% of the original issue price per annum, and are entitled to participate pro rata in any dividends paid on the Company’s common stock on an as-if-converted basis. In the event of a sale, liquidation, or other winding up of the Company, the holders of the Preferred Shares are entitled to receive in preference to the holders of the Company’s common stock a per share amount equal to the greater of (i) 1.5 times the original issue price, plus any accrued but unpaid dividends or (ii) the amount that the holder of a Preferred Share would otherwise receive in such event on an as-converted to common stock basis. The holders of the Preferred Shares vote along with holders of the Company’s common stock on an as-if-converted basis. Each Preferred Share shall have a number of votes equal to the number of shares of the Company’s common stock then issuable upon conversion of such Preferred Share. In addition, the holders of the Preferred Shares are entitled to elect three members of the Company’s Board of Directors by an affirmative vote or consent of the holders of at least a majority of the outstanding Preferred Shares, voting together as a single class. The Preferred Shares also carry certain other rights, including the right to block certain actions of the Company unless such actions are approved by a vote of the holders of the Preferred Shares voting together as a single class, anti-dilution provisions (the “Initial Anti-Dilution Provisions”), and other rights and preferences commonly associated with preferred shares.

The issuance of the Preferred Shares was conducted in reliance upon exemptions from registration 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 Preferred Shares were offered and sold only to investors who are “accredited investors,” as defined in Rule 501 under the Securities Act.

On March 4, 2010, the anti-dilution provisions of the Preferred Shares were amended such that the effective conversion price of the Preferred Shares would be adjusted to the price at which new equity or equity-related instruments were issued, if these instruments were issued at prices below the effective conversion price of the Preferred Shares. Effective as of March 5, 2010, holders of 7,186 Preferred Shares agreed to waive the anti-dilution adjustments related to the issuance of the Subordinated Secured Convertible Notes on 75% of their shares. These holders also agreed to receive an adjustment related to the issuance of the Subordinated Secured Convertible Notes

equal to that provided by the Initial Anti-Dilution Provisions on the 25% balance of their Preferred Shares.

Note 8 – Subsequent Events

On April 12, 2011, the Company entered into a Distribution and Licensing Agreement with AG Worldwide, LLC and Cyrano Partners, LLC (“Cyrano”) pursuant to which AG Worldwide began sales of AeroGrow products into the network marketing sales channel. Also on April 12, 2011, the Company entered into a Transaction Agreement with Cyrano to form a joint venture to pursue the network marketing sales channel, subject to the achievement of certain conditions precedent, including an obligation on the part of Cyrano to raise the capital necessary to fund the joint venture. Cyrano was unable to satisfy the funding condition precedent and, effective as of August 5, 2011, the Distribution and Licensing Agreement and the Transaction Agreement were terminated.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

INDEX TO EXHIBITS

31.1* Chief Executive Officer Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2* Chief Financial Officer Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1* Chief Executive Officer Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2* Chief Financial Officer Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Filed herewith

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SIGNATURES

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

AEROGROW INTERNATIONAL, INC.,
A NEVADA CORPORATION

Date: August 22, 2011

By: /s/ Jack J. Walker
Jack J. Walker
Chairman of the Board

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