AeroGrow International, Inc.
Form 10-K
June 25, 2010

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

FORM 10-K

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

For the fiscal year ended March 31, 2010
or

o 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	46-0510685
(State or other jurisdiction of incorporation or organization)	(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:

Title of each class:	Name of each exchange on which registered:
Common Stock, par value $0.001 per share	OTC Bulletin Board

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

None

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

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 o No ý

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 ý No o

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 o No o

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. o .

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 o	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company ý

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

The aggregate market value of the voting common stock held by non-affiliates of the registrant as of September 30, 2009 was $1,341,498. 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 May 31, 2010 is 12,398,249.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of our definitive Information Statement on Schedule 14C for the Annual Meeting of Stockholders are incorporated herein by reference in Part III of this Annual Report on Form 10-K to the extent stated herein. The information statement is expected to be filed with the Securities and Exchange Commission within 120 days of the fiscal year ended December 31, 2009.

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AeroGrow International Inc.
Annual Report on Form 10-K
Year Ended March 31, 2010

This Annual Report on Form 10-K (“Annual Report”) for AeroGrow International, Inc. (“AeroGrow,” the “Company,” “we,” “our” or “us”), including the “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” contains forward-looking statements regarding future events and our future results that are based on current expectations, estimates, forecasts, and projections about the industry in which we operate and the beliefs and assumptions of our management. Words such as “expects,” “anticipates,” “targets,” “goals,” “projects,” “may,” “will,” “would, “intends,” “plans,” “believes,” “seeks,” “estimates,” variations of such words, and similar expressions are intended to identify such forward-looking statements. These forward looking statements may include, among others, statements concerning our expectations regarding our business, growth prospects, revenue trends, operating costs, working capital requirements, competition, results of operations and other statements of expectations, beliefs, future plans and strategies, anticipated events or trends, and similar expressions concerning matters that are not historical facts. These forward-looking statements are only predictions that are subject to risks, uncertainties, and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in this Report under the section entitled “Risk Factors” in Item 1A of Part I and elsewhere, and in other reports we file with the SEC, specifically the most recent reports on Form 10-Q. While forward-looking statements are based on reasonable expectations of our management at the time that they are made, you should not rely on them. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

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PART I

ITEM 1. BUSINESS

Our Business

AeroGrow is a developer, marketer, direct-seller, and wholesaler of advanced indoor garden systems designed for consumer use and priced to appeal to the gardening, cooking, small indoor appliance, healthy eating, and home and office décor markets. To date, we have launched multiple lines of proprietary indoor gardens, more than 50 corresponding proprietary seed kits, and various cooking, gardening and décor accessories, both nationally and internationally.

As of March 31, 2010, we had manufactured and shipped over 958,202 AeroGarden® garden units and 2,037,531 seed kits to consumer and retailers worldwide. We commenced initial marketing and distribution of our products in March 2006 and have expanded these marketing efforts to encompass direct-to-consumer sales channels which include direct television, internet, and our own in-house direct mail catalogue, retail distribution, including brick and mortar retailers, online retailers and home shopping networks, and international markets.

Our principal products are indoor gardens and proprietary seed kits that allow consumers, with or without gardening experience, the ability to grow vegetables such as tomatoes, chili peppers and salad greens, fresh herbs including cilantro, chives, basil, dill, oregano, and mint, and flowers such as petunias, snapdragons, pink geraniums and phlox. Consumers can also plant and grow their own seeds using our proprietary "grow anything" kits, or use their AeroGardens as seed starters for their outdoor gardens with our "garden starter" trays.

Our indoor gardens are designed to be simple, consistently successful, and affordable. We believe that our focus on the design and features of our indoor gardening products made them the first of their kind on the consumer market. This conclusion was reached on the basis of market research, and a review of potentially competitive products offered at all ranges of functionality and price.

We believe that our products allow almost anyone, from consumers who have no gardening experience to professional gardeners, to produce year-round harvests of a variety of herbs, vegetables, and flowers, regardless of experience, season, weather, or availability of natural light. We believe that our indoor gardening products' unique and attractive designs make them appropriate for use in almost any location, including kitchens, living areas, and offices.

Our indoor gardening units are sold through different channels matching customer needs and interests with the appropriate garden unit features and benefits at prices ranging from approximately $50 to $170 depending on the features and components, including size, design elements, light intensity and automated features.

Corporate History

AeroGrow International, Inc. ("AeroGrow") was formed as a Nevada corporation on March 25, 2002. AeroGrow merged with Wentworth I, Inc., a Delaware corporation on February 24, 2006, and AeroGrow was the surviving corporation.

After more than three years of initial research and product development, we began sales activities in March 2006. Since that time, we have expanded all aspects of our operations in order to take advantage of what we believe to be an attractive market opportunity. We have increased the depth and breadth of our distribution through multiple sales channels. We have developed direct sales channels including web sales, direct television sales, including infomercials and 60 and 120 second television commercials, and a direct mail catalogue business with approximately 3.7 million catalogues mailed in our fiscal year ended March 31, 2010 ("Fiscal 2010"). AeroGarden products are also sold through an estimated 1,290 retail storefronts in North America, and in nine countries internationally. We have expanded our product lines, and now offer more than 15 different indoor garden models, more than 50 seed kits, and various gardening and kitchen accessories.

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Hydroponics Industry - Background

Hydroponics is the science of growing plants using nutrients suspended in water instead of soil. Used commercially worldwide, hydroponics is considered an advanced and often preferred crop production method. Hydroponics is typically used inside greenhouses to give growers the ability to better regulate and control nutrient delivery, light, air, water, humidity, pests, and temperature. Hydroponic growers benefit by producing crops faster and with higher crop yields per acre than traditional soil-based growers.

Aeroponic technology is derived from hydroponics and occurs when plant roots are suspended in an air chamber and bathed with a nutrient solution. AeroGrow believes that the aeroponic technology used in our indoor gardening products is a technological advance over most hydroponic growing systems because plant roots are partially suspended in air and allowed direct access to oxygen, while being bathed in a highly oxygenated, nutrient rich solution. For these reasons, we believe the use of a well-designed and maintained aeroponic system can yield increases in growth rates and plant survival when compared to most hydroponic or dirt-based systems.

Until the development of our indoor gardening products, certain barriers prevented hydroponic or aeroponic technology from being incorporated into mainstream, mass-marketed consumer products, including:

- Consumers generally lack the specialized knowledge required to select, set up, operate, and maintain the various components for a typical hydroponic or aeroponic system, including growing trays, irrigation channels, growing media, nutrient reservoirs, and nutrient delivery systems consisting of electronic timers, pumps, motors, tubing, and nozzles;

- Consumers generally do not possess the specialized knowledge required to select, set up, operate, and maintain the varied indoor lighting systems that are necessary to grow plants indoors in the absence of adequate natural light;

- Consumers are often unable to properly mix and measure complex hydroponic nutrient formulas, which change depending on the plant variety and the stage of plant growth. In addition, consumers are unable to deal with the problem of nutrient spoilage; and

- Federally-mandated water quality reports show that the water in many large cities is not suitable for hydroponic or aeroponic growing and requires treatments in order to sustain growth.

Our research led us to believe that these complexities have been accepted in existing hydroponic market channels because hydroponic manufacturers have generally focused their product development and marketing efforts on satisfying the needs of the commercial greenhouse and dedicated hobbyist markets. These users are motivated to gain the specialized knowledge, equipment and experience currently required to successfully grow plants with these products. Our research indicated that the hydroponic growing equipment currently available in these markets is bulky, expensive and comprised of many, often unintegrated, parts.

We believe that the complexities of currently available commercial hydroponic products fail to address the needs and wants of the mass consumer market, leaving that market unserved. We further believe that our trade secrets, patented and patent-pending inventions, and companion technologies have simplified and improved hydroponic and aeroponic technologies and have enabled us to create an indoor aeroponic gardening system appropriate for the mass consumer market.

Our Proprietary Technology

We spent seven years innovating, simplifying, and integrating our proprietary technologies and inventions into a family of “plug and grow” indoor gardening products and related seed kits specifically designed and priced for the mass consumer market. We have used this technology platform to develop more than 15 different models of indoor gardens, each with different features and technology groupings, priced from approximately $50 to $170. We have filed 18 patent applications in the United States and internationally to protect our inventions, and six patents have been issued (three in the United States and three internationally). Following is a description of our proprietary technologies and inventions that are used in our indoor garden system and seed kits.

Rainforest Nutrient Delivery System. Our “rainforest” nutrient delivery system combines our patent-pending technologies with features from several hydroponic and aeroponic methodologies into a proprietary system that leaves plant roots suspended in an air gap. Plant roots take oxygen directly out of the air and, in testing of aeroponic systems by multiple different sources, including lettuce studies by NASA Small Business Innovation Research, plants grow faster as a result.

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Advanced Growing System. Our Advanced Growing System (“AGS”) is available on several of our indoor gardens and combines features from our rainforest delivery system with new technologies that deliver increased nutrient oxygenation, faster, healthier root growth, decreased needs for consumer maintenance, and increased product reliability. With AGS, plant roots are suspended in air in a 100% humid aeroponic chamber and then grow into a continuously oxygenated nutrient bath.

Pre-Seeded Bio-Grow Seed Pods. Our proprietary bio-grow seed pods include pre-implanted, specially selected seeds, a growing medium, removable bio-dome covers, and a grow basket.

Microprocessor-Based Control Panel and Nutrient Cycle Delivery System. Microprocessor-based control panels can include automated grow lights to ensure that plants receive proper lighting can feature nutrient and water reminder systems that alert consumers to add water and nutrients when needed. In addition, several systems allow consumers to select from multiple plant types (for example, lettuce, herbs, tomatoes, or flowers) and the system then automatically adjusts and optimizes the nutrient, water and lighting cycles based on the plant variety selected. In addition, some systems take into account stage of growth of the specific plants when optimizing these factors.

Custom Nutrients and Automatic pH Adjustment. We have developed nutrient solutions designed specifically to deliver the proper nutrients to plants, while offering consumers a user-friendly application methodology. Plant specific nutrients are included with each seed kit, and consumers simply add them when instructed by the microprocessor-based nutrient reminder. The pre-measured and mixed nutrients eliminate the need for measuring and mixing multi-part nutrient formulas and storing various nutrients in separate containers. Also formulated into the nutrients is a proprietary buffer that automatically adjusts tap water from around the country to the right pH ranges for plant growth. Without this adjustment, tap water from many areas in the country will severely limit, or inhibit, plant growth in most aeroponic and hydroponic systems.

Integrated and Automated Lighting System. Hydroponic systems typically do not incorporate built-in lighting systems. Our indoor gardening products include built-in adjustable grow lights with ballast, reflector hood, grow bulbs and an electronic timer. Our integrated lighting systems include high-output compact fluorescent light bulbs that deliver a spectrum and intensity of light designed to optimize plant growth without natural light. In addition, our lighting system is fully automated and controlled by our microprocessor-based control panel described above. Variations in lighting are a differentiator in our product lines, and we have several gardens on the market with “twice the light and twice the height” of our initial gardens, allowing consumers to grow larger plants such as full-sized tomatoes in our indoor gardens, and deliver higher yields.

New Technologies in Development. We are continually engaged in developing incremental improvements in lights, nutrients, oxygenation, seed variety selection, and style and design innovation that are introduced to products on an ongoing basis.

Markets

Based on our sales experience to date and our existing channels of distribution, and supplemented by our own formal and informal market research consisting of individual consumer interviews, focus groups, blog monitoring, customer modeling, and Internet survey responses, we believe that our indoor gardening products appeal to a broad spectrum of consumers across multiple areas of interest. We believe that our products appeal to at least four major market segments:

Gardener Market. The 2010 National Gardening Survey conducted by the National Gardening Association states that gardening is America’s number one hobby with more than 81 million households active in gardening. Based upon this survey, there were estimated to be 36 million households participating in food gardening and 13 million households participating in fresh herb gardening. We believe that our indoor gardening products and related products offer both expert and novice gardeners several major benefits not readily available through traditional gardening methods, including:

- the ability to grow fresh herbs, lettuces, vegetables, tomatoes, and flowers year-round, regardless of indoor light levels or seasonal weather conditions,

- the ability to easily start plants indoors during colder months and then transplant them outdoors at the onset of the outdoor growing season,

- the ability to use stem cuttings to propagate multiple reproductions of the desired plants in our indoor gardening products, and

- the ease of growing in our indoor gardens, in contrast to the toil associated with traditional gardening, including preparing the soil, planting, thinning, weeding, watering, and removing pests.

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“Want-to-be” Gardener Market. We believe that many people have an interest in gardening but lack the knowledge, confidence, available space, equipment, or time to garden. We have observed the following barriers that often prevent people from gardening:

- gardening requires an ongoing time commitment,
- apartment, high-rise, and condominium dwellers often lack the land needed for a traditional garden,
- gardening requires physical work, which can be a significant barrier to people with limited mobility or health issues,
- buying the necessary equipment to garden can be expensive, and
- gardening requires knowledge and expertise.

We believe that our indoor gardening products overcome many of these barriers and provide a simple, convenient way for many current non-gardeners to begin to garden.

Cooking and Healthy Eating Market. Many Americans enjoy cooking as a hobby. Consumers in this market include:

- people interested in cooking who would appreciate the convenience and satisfaction of having a readily available supply of fresh-cut herbs to flavor soups, salads, and other dishes,
- people who prefer the distinctive texture and taste of freshly picked, vine-ripened tomatoes, basil, lettuces, and other vegetables over days-old supermarket produce, and
- people interested in healthy, pesticide-free foods for themselves and their families, reflecting both the rapidly growing interest in naturally and organically grown foods and the increasing number of people who, for health or weight concerns, include salads and fresh vegetables as part of their families’ diets.

We believe that our indoor gardening products are embraced in this market by people who understand the value of having an ongoing supply of fresh herbs and fresh produce throughout the year.

Home and Office Décor Market. Flowers are frequently used to brighten homes and offices around the world. It is difficult to readily grow flowers indoors due to a lack of sufficient light and growing knowledge. As a result, people often use cut flowers, which are expensive, short-lived, and require ongoing maintenance. Our indoor gardening products enable colorful and fragrant flowers to be easily grown indoors year-round. Flowers grown with our indoor gardening products will last for months with minimal care and maintenance. Flowers can be grown in a wide variety of indoor locations, including kitchen and bathroom countertops, living rooms, bedrooms, family rooms, offices, work stations, waiting rooms, and lobbies.

Products

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AeroGarden Indoor Gardens. We currently offer more than 15 different indoor garden models priced from approximately \$50 to \$170 and differentiated based on size, design, light intensity, degree of automation, inclusion of Adaptive Growth Technology or Advanced Growing Systems, height potential of light hoods, and inclusions of plant support systems.

Currently, our AeroGarden product line is divided into four main categories:

1. AeroGarden 3 Series – The AeroGarden 3 series features the Advanced Growing System, grow lights, a smaller footprint, and an attractive, stylish design that makes it suitable for use as a decorative feature throughout the home or office. AeroGarden 3's fit easily on kitchen counters, night stands, and end tables. Some models include upgraded trim and new finish designs such as the "Ladybug" garden targeted at all-family usage. Retail prices range from \$50 to \$60.

2. AeroGarden 6 Series – The AeroGarden 6 series features the Advanced Growing System, grow lights, greater output than the AeroGarden 3 series, and a space-saving configuration with a 30% smaller footprint relative to our AeroGarden 7 and AeroGarden Extra series, to fit more easily on countertops and in corners for apartments, condos, and smaller kitchens. Retail prices range from \$80 to \$100.

3. AeroGarden 7 Classic Series – Our original products which feature the rainforest nutrient delivery system, automated lights, and reminder systems. Retail prices range from \$100 to \$120.

4. AeroGarden Extra Series – Aerogarden 7 with extended lamp arms and greater light output for growing larger vegetables. Some models also include stainless steel trim. Retail prices range from \$150 to \$170.

AeroGarden Seed Kits. We currently offer more than 50 seed kits for use in our indoor gardening products. These seed kits include pre-seeded bio-grow seed pods and a three-to-six-month supply of nutrients, including our proprietary formula for adjusting water quality. Our seed kits retail at prices ranging from \$9.99 to \$24.99, and include:

- Vegetable Gardens: cherry tomato, chili pepper, salsa garden.

- Herb Gardens: gourmet herbs, Italian herbs, pesto basil.

- Flower Gardens: cascading petunias, English cottage, scented blooms, mountain meadow.

- Salad Gardens: salad greens, romaine lettuce.

Our seed kits are sold to consumers for use with our indoor gardening products. Individual seed kits are grown by consumers for three to six months and then new seed kits may be purchased for replanting.

AeroGarden Seed-Starting Kits. Developed for more experienced gardeners, our line of Seed Starting Trays and Master Gardener Kits are designed to allow consumers to plant and grow their own seeds in the AeroGarden. With our Seed Starter Trays, consumers can start up to 66 seedlings in our indoor gardens for transplant into their outdoor gardens when weather allows. With the Master Gardener Kit, consumers can grow their own seeds to maturity in the AeroGarden, or transplant seeds outdoors when weather allows.

Other Accessories. To complement and expand the functionality of our indoor gardening products, we have developed a variety of accessory products including cookbooks and cooking accessories. We also offer multiple wall brackets and other shelving and support systems, which can hold multiple indoor gardens at the same time. We also offer the Herb ‘n Serve, a battery-operated herb blender and salad dressing maker, the Herb ‘n Save and Herb ‘n Ice accessories which are easy-to-use fresh herb storage devices, and many other accessory items.

Future Products. Our core technology platform can be leveraged by bundling different components into new products with a wide variety of features and price points that then can be sold through a variety of direct and retail channels for use in different settings around the home or office. Examples include a desk garden series, a professional system for larger plants and vegetables, patio and deck gardens, home décor and air freshening gardens, and additional seed kits and accessories.

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Integrated Marketing and Sales Channel Strategy

We consider our products to be an entirely new product category. A primary objective since launch has been to maximize the exposure of the product and educate consumers on the benefits of indoor gardening through an integrated marketing and distribution strategy. We launched with a nationwide public relations campaign during the first quarter of 2006, and have since received extensive media exposure, with multiple features on national talk shows as well local television coverage, local and national print articles and blog and Internet pieces. We combined the public relations launch with a retail and direct strategy focusing on high visibility partners and media, including product sales through retailers, national cataloguers, home shopping channels, direct television commercials, our own in-house direct response catalogue, internet sales, and inbound and outbound telemarketing.

Shift in Channel Strategy. During Fiscal 2010 we determined that broad distribution through the retail channel was not appropriate for a company at our stage of development because of relatively low profit margins, high capital requirements, and the operational requirements of our retailer customers. As a consequence, we terminated our relationships with certain retailers and re-focused our efforts on building our direct-to-consumer business. As of March 31, 2010, our products were being offered in approximately 1,290 storefronts in North America. During Fiscal 2011, we expect to further reduce the number of storefronts carrying our products as we continue to focus our efforts on building relationships with only those retailers, both traditional and non-traditional, that have historically proven to be good business partners for AeroGrow.

Direct Sales. In the fall of 2006 we launched an infomercial advertising campaign, which began with 30 minute programming and has since been supplemented with 60-second and 120-second television commercials. We have since created new 60-second and 120-second commercials highlighting our new products. Overall spending on TV advertising has decreased as a percentage of the overall marketing budget, as we have been cash constrained and therefore focused our spending on the most efficient media channels.

In June 2007, we produced and began mailing our own in-house, direct mail product catalogue, which tested successfully with a mailing of approximately 60,000 catalogues. In Fiscal 2010 we mailed approximately 3.7 million catalogues. With our catalogue sales we focus on remarketing to current customers and also prospecting for new customers using database marketing techniques.

We established our first consumer product website in the fall of 2006 and in late 2007 supplemented this with search engine advertising, banner advertising, email campaigns and web affiliate programs. In the fall of 2008 we took on in-house management of many of these programs from third-party providers and have seen resulting increases in efficiency. A key focus of our web and catalogue marketing is to maximize the lifetime value of AeroGrow customers through repeat sales of our seed kits, light bulbs and accessories.

During Fiscal 2010, direct-to-consumer sales represented 57.5% of our total net sales.

Retail Sales. Initial shipments to retailers commenced in March 2006. Over the next several years, we rapidly grew our retail distribution and as of March 31, 2009 our products were being sold through approximately 7,500 stores in North America. In Fiscal 2010, we reduced our sales to retailers as discussed above, and as of March 31, 2010 our products were being sold through approximately 1,290 stores in North America. During Fiscal 2010, sales to retailers represented 40.1% of our total net sales. Approximately 69% of our total sales to retailers represented sales to Canadian Tire Corporation, Amazon, Bed Bath & Beyond and QVC. Canadian Tire Corporation represented 35% of our total retail sales for the fiscal year ended March 31, 2010.

International Sales. We began testing international sales opportunities in the UK and Japan in late 2007, and have since expanded internationally into Australia, South Korea, Mexico, France and several other countries. During Fiscal

2010, international sales represented 2.4% of our total sales. International efforts in the fiscal year ending March 31, 2011 (“Fiscal 2011”) are expected to focus primarily on supporting distribution in existing markets. Material incremental expansion into new countries in Fiscal 2011 is not anticipated, and will be pursued in future years as and when resources allow.

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Competition

Aeroponic and hydroponic technologies have historically been limited to ardent hobbyists and commercial growing facilities. We believe that we are the first company to develop and offer a simple dirt-free indoor growing system for the mass consumer market.

Typical hydroponic manufacturers offer a range of equipment and accessories through distributors or small independent “hydro-shops” in a trade-oriented manner similar to plumbing or electrical suppliers. Purchasers typically mix and match equipment from various suppliers in an “a la carte” fashion to individually customize a large system that they then assemble on their premises. We believe that these products are substantially more expensive than our products.

We believe that our simplified and complete indoor gardening products and current and planned methods of distribution offer significant benefits from these traditional hydroponic industry practices. To date, we have discovered a kitchen design firm that has tried to introduce an indoor growing system into the market, to what appears to be very limited success. In our in-house laboratory tests, these systems have performed at levels far below our own systems in terms of germination success, longevity, speed-of-growth and overall yields.

However, we recognize that a large market exists for products like ours and that there are other companies that are better funded and have greater experience in producing hydroponic products in commercial markets, or that have been more successful in manufacturing or selling consumer product or soil-based gardening products.

Manufacturing

We source our AeroGarden products and accessory items from contract manufacturing companies that manufacture products using tooling we own, in accordance with our specifications, and subject to our intellectual property rights. We assemble and package our seed kits in our facilities in Indianapolis, Indiana.

We have three Chinese manufacturers of our garden products. Each is capable of manufacturing multiple garden models. We believe the existing production capacity of these manufacturers is more than sufficient to meet our garden requirements for the short-to-medium term. In addition, capacity expansion is available in a reasonable period of time with a nominal tooling investment. We also have multiple, dual-sourced manufacturers of our many component parts and accessories.

In July 2008 we opened a company-owned distribution center in Indianapolis, Indiana. We also produce and assemble our seed kits in this facility. Indoor gardening products are shipped from China either to our primary fulfillment center in Indianapolis, or to third-party fulfillment centers in North America, as well as to third party distribution facilities in countries outside the North America.

Product Returns and Warranties

To date, product returns have been within our expectations for both retail and direct-to-consumer sales. At retail, we generally use a “destroy in field” methodology as the cost of shipping a used product back to us often does not justify the value of the recovered unit. Some customers are obligated to ship products to our facility in order to receive credit for returned goods. In certain cases, customers are provided a fixed allowance, usually in the 1% to 2% range, to cover returned goods, which allowance is deducted from payments made by such customers. To our knowledge, our retailers are satisfied with these arrangements. Our manufacturers will provide us with replacement parts at no charge for products that are deemed defective due to materials or manufacturing complications. We record warranty liabilities at the time of sale for the estimated costs that may be incurred under our 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 our 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 our warranty obligation.

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Intellectual Property

Our success and ability to compete are substantially dependent upon our internally developed technology and expertise. While we rely on patent, copyright, trade secret, and trademark law to protect our technology, we also believe that factors such as the technological and creative skills of our personnel, new product developments, frequent product enhancements, and reliable product maintenance are essential to establishing and maintaining a technology leadership position. There can be no assurance that others will not develop technologies that are similar or superior to our technology.

As of March 31, 2010, we have filed 14 patent applications in the United States and four patent applications internationally to protect our inventions, and of these, three United States and three international patents have been issued. We believe that the technology covered by our patent applications does not infringe on issued patents owned by others. We believe that if we fail to receive patents for any one of these patent applications, our operations will not be materially adversely affected. We believe that failure to obtain patents, however, will make it easier for competitors to bring competitive products to market. If competitive products perform better or are marketed by companies with greater financial and distribution resources than us, these competitive products may adversely affect our operations. In addition to the patents being sought, we maintain critical information about our products as trade secrets. The inventions under the patent applications have not been granted patents, and there can be no assurance that patents will be granted.

In addition, we have filed: (i) 34 trademark applications in the United States, 32 of which have registered and two of which have been allowed; and (ii) five trademark applications designating 32 countries, four of which have registered in 27 countries. We intend to prosecute to protect our products and brand equity.

Each of our employees, independent contractors, interns, and consultants has executed assignment of rights to intellectual property agreements and nondisclosure agreements. The assignment of application rights to intellectual property agreements grant us the right to own inventions and related patents which may be granted in the United States and throughout the world. The nondisclosure agreements generally provide that these people will not disclose our confidential information to any other person without our prior written consent. We have also obtained, both domestically and internationally, domain names for AeroGrow.com, AeroGarden.com, AeroGarden.net, AeroGarden.tv, AeroGarden.biz, and Getthegarden.com, among others.

Our success will depend upon our ability to obtain necessary intellectual property rights and protect our intellectual property rights. We cannot be certain that patents will be issued on the patent applications that we have filed, or that we will be able to obtain the necessary intellectual property rights, or that other parties will not contest our intellectual property rights.

Governmental Regulation and Certification

We believe that we are complying with United States regulations concerning the shipping and labeling of seeds and nutrients. Currently, the components for the indoor garden system are UL and/or ETL certified. These certifications confirm that the products have been tested and conform to a recognized level of fire and other safety standards for consumers. Such independent third party certification is required for sales of products through many major retailers.

We believe that our costs of compliance with environmental laws will not be material.

Personnel

As of March 31, 2010, AeroGrow employed 46 employees with 40 full-time and 6 part-time. In addition, we contract the services of part-time and project consultants on an "as needed" basis. We believe that our employee relations are good. Our outsourced business includes, but is not limited to, manufacturing, some telemarketing, infomercial production, and some fulfillment and shipping. Additional employees and/or consultants may be hired in the future as our operations grow.

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ITEM 1A. RISK FACTORS

Our business, future performance and forward-looking statements are affected by general industry and market conditions and growth rates, general U.S. and non-U.S. economic and political conditions (including the global economy), competition, interest rate and currency exchange rate fluctuations and other events. The following items are representative of the risks, uncertainties and other conditions that may impact our business, future performance and the forward-looking statements that we make in this report or that we may make in the future.

Risks Related to our Business, Products and Markets

We may need additional capital to fund our future operations and we may not be able to obtain the amount of capital required, particularly when the credit and capital markets are volatile.

During Fiscal 2010, we issued an aggregate of $6,685,486 of Series A Convertible Preferred stock and incurred $1,080,000 of bridge financing to help address our immediate short-term liquidity needs, fund prior operating losses and provide capital to support business operations. In addition, during June 2009 we converted certain accounts payable totaling approximately $1.4 million to long-term debt, amended our working capital financing agreement and negotiated concessions with certain of our accounts payable creditors with regard to payment timing and amounts due. (See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation – Liquidity and Capital Resources, and Note 3– Current and Long Term Debt – Long Term Debt and Note 10 – Stockholders' Equity in the accompanying Notes to Financial Statements for additional details.)

In May and June 2010, we issued $6,800,000 in three-year subordinated secured convertible notes to help address our liquidity requirements, refinance certain obligations and provide funding for future operations.

We may require additional capital to support our business, cover operational expenses, and finance planned growth. It is possible that none of our outstanding warrants and options will be exercised and we will therefore not receive additional capital from these sources. We may need to issue equity, debt, or securities convertible into equity, which are likely to rank senior to our common stock and to dilute the current stock ownership in AeroGrow. If we are unable to raise additional capital, or cannot raise capital on acceptable terms, we may not have sufficient capital to operate our business as planned and would have to modify our business plan or curtail some or all of our operations.

Because we have a limited operating history, we may not be able to successfully manage our business or achieve profitability.

We have a limited operating history upon which to base an evaluation of our prospects and the potential value of our common stock. Since commencing operations in 2002, we have not achieved profitability in any fiscal year. We are confronted with the risks inherent in an early stage company, including difficulties and delays in connection with the production and sales of our indoor garden systems, reliance on a small number of products and manufacturers, operational difficulties, and difficulty in estimating future sales, production requirements and costs, and administrative costs. If we cannot successfully manage our business, we may not be able to generate future profits and may not be able to support our operations. We are likely to incur additional expenses and losses in the further implementation of our business plan. We may not be able to improve operations and therefore may never become profitable.

We have incurred substantial losses since inception and may never achieve profitability.

Since we commenced operations in 2002, and through March 31, 2010, we incurred substantial losses, including a net loss of $6,331,205 for the twelve month period ended March 31, 2010. As of March 31, 2010, our losses have resulted in an accumulated deficit of $56,272,803. The future success of our business will depend on our ability to profitably expand sales of our AeroGarden indoor garden systems, seed kits and accessory products to consumers, and develop new product extensions and applications.

We are subject to many of the risks common to developing enterprises, including undercapitalization, cash shortages, limitations with respect to financial and other resources, and insufficient scale to be self-sustaining. There is no assurance that we will ever attain profitability.

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A worsening of the United States economy could materially adversely affect our business.

The success of our business operations depends significantly on consumer confidence and spending, which deteriorated during the recent worldwide economic downturn. A continuation or re-occurrence of the economic downturn, and the consequent impact on consumer spending, could adversely impact our revenue, ability to market our products, build customer loyalty, or otherwise implement our business strategy. If the current economic situation persists, or deteriorates significantly, our business could be negatively impacted.

Our sales to retailer customers are highly concentrated in a small number of retailers in the United States and Canada, including traditional "brick and mortar" retailers, online retailers, and television shopping channels. The loss of one or more of these customers could have a material adverse impact on our business.

In the fiscal years ended March 31, 2010, and March 31, 2009, approximately 40.1% and 60.9%, respectively, of our net sales were to retailer customers. Of these sales, approximately 69% represented sales to our top four retailer customers. The loss of one or more of our key retailer customers, or a significant decline in orders from one or more of these retailers could materially affect our sales of indoor garden systems, seed kits and accessories, and therefore have a material adverse impact on our business and our financial results.

We have recently shifted the focus of our business strategy toward the direct-to-consumer sales channels. Failure to successfully develop our position in these channels could have an adverse impact on our future results of operations.

On January 15, 2010, we announced a strategic shift to increase our focus on the direct-to-consumer business channels. We intend to dedicate a larger proportion of our capital and human resources to develop these channels. Successfully growing these channels will require that we invest in revenue-generating media to attract new customers, effectively target our marketing messages to consumers, and develop ongoing relationships with consumers through excellence in our fulfillment, shipping and customer service operations. There can be no assurances given that we will be successful in achieving these requirements, or that we can do so on a timely basis. In the event we do not succeed in developing the direct-to-consumer channels as we intend, there could be a material adverse impact on our future results of operations.

A significant portion of our sales are to retailers, many of which have been adversely impacted by the deterioration in economic conditions and the consequent impact on consumer spending.

In the fiscal years ended March 31, 2010, and March 31, 2009, approximately 40.1% and 60.9%, respectively, of our net sales were to retailer customers. Our business plan anticipates continued sales through this distribution channel, albeit at lower levels than in prior years. Uncertainty about the current and future global economic conditions may cause consumers and retailers to defer purchases, attempt to return inventory, or cancel purchase orders for our products in response to tighter credit, decreased cash availability and declining consumer confidence. In the event that certain retailers are adversely impacted by the current economic downturn, re-structure their business operations to reduce costs and capital investment, or choose to reduce the breadth of their product offering, our sales could be adversely affected.

Our future depends on the success of our indoor garden systems, seed kits and accessory products. We do not know if our indoor garden systems, seed kits and accessory products will generate consumer acceptance on a broader scale.

We have introduced our indoor garden systems and seed kits as new products to consumer markets unfamiliar with their use and benefits. Although we believe that we have penetrated only a small portion of the potential market for our products, we cannot be certain that our products will generate widespread consumer adoption. If consumers do not purchase our products in sufficient numbers, we will not be profitable.

If we are unable to recruit, train and retain key personnel necessary to operate our business, our ability to successfully manage our business and develop and market our products may be harmed.

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To maintain our business position, we will need to attract, retain, and motivate highly skilled design, development, management, accounting, sales, merchandising, marketing, and customer service personnel. Competition for many of these types of personnel can be intense, depending on general economic conditions, alternative employment options, and job location. As a result, we may be unable to successfully attract or retain qualified personnel. Additionally, any of our officers or employees can terminate their employment with us at any time. The loss of any key employee, or our inability to attract or retain other qualified employees, could harm our business and results of operations.

As a result of the economic downturn, decline in consumer spending and the consequent impact on the sales of our products, we restructured our operations and implemented a substantial workforce reduction. These actions could adversely impact the morale and performance of our remaining employees and our ability to hire new personnel.

Our business was adversely impacted by the deterioration in the global economy and the consequent impact on our various channels of distribution. We restructured our business operations in order to re-size our overhead costs and streamline our distribution, fulfillment, and manufacturing operations. This resulted in a substantial decrease in the number of our full-time employees. These restructuring actions and headcount reductions could have unintended impacts on our remaining employees, could lead to a decline in employee morale, and could lead to a loss of additional personnel over and above the level desired by the Company. In the event of such employee attrition, we may not be able to replace the lost personnel on a timely basis, or with individuals having the same level of skills. In either case, our operations and our financial performance could be adversely impacted.

Our marketing strategies may not be successful, which would adversely affect our future revenue and profitability.

Our future revenue and profitability depend on the successful marketing of our indoor garden systems. We cannot give assurance that consumers will continue to be interested in purchasing our products. We use direct consumer marketing, including television commercials, infomercials, catalogue, magazine and newspaper advertising, and the Internet. In addition, we collaborate with our retailer customers to market our products to consumers. If our marketing strategies fail to attract an adequate number of customers, our product sales will not produce future revenue sufficient to meet our operating expenses or fund our future operations.

Our current or future manufacturers could fail to fulfill our orders for indoor garden systems, which would disrupt our business, increase our costs, and could potentially cause us to lose our market.

We currently depend on three contract manufacturers in China to produce our indoor garden systems. These manufacturers could fail to produce the indoor garden system to our specifications or in a workmanlike manner and may not deliver the systems on a timely basis. Our manufacturers must also obtain inventories of the necessary parts and tools for production. We own the tools and dies used by our manufacturers. Our manufacturers operate in China and may be subject to business risks that fall outside our control, including but not limited to, political, currency, and regulatory risks, each of which may affect the manufacturer’s ability to fulfill our orders for indoor garden systems. In addition, weather or natural disasters in China could disrupt our supply of product. Any change in manufacturers could disrupt our ability to fulfill orders for indoor garden systems. Any change in manufacturers could disrupt our business due to delays in finding a new manufacturer, providing specifications, and testing initial production.

Our revenue and level of business activity are highly seasonal, requiring us to staff our operations, incur overhead and marketing costs, purchase and manufacture inventory, and incur other operating costs in advance of having firm customer orders for our products. A material variance in actual orders relative to anticipated orders could have an adverse impact on our business.

For the fiscal year ended March 31, 2010, approximately 56% of our total net sales occurred during four calendar months (September – December). We must estimate sales in advance of these peak months and operate our business during the balance of the year in such a way as to insure that we can meet the demand for our products during the peak months. This requires us to incur significant operating, marketing, and overhead expenses, and to utilize cash and other capital resources to invest in inventory in advance of having certainty as to the ultimate level of demand for our product during the peak months. Significant variations in actual demand for our products during the peak months relative to our forecast could result in our sales being limited by lack of product, our not achieving a sufficient level of sales to cover expenses incurred throughout the balance of the year, or in our having excess inventory to liquidate at potentially lower margins. In any of these cases, there could be a material adverse impact on our financial performance.

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We are highly reliant upon a single company-operated distribution and seed kit manufacturing facility. Any material disruption to the operation of this facility could adversely affect our business.

In July 2008 we opened a company-operated distribution and fulfillment center in Indianapolis, Indiana to supplement our existing third-party logistics providers. Since then, our facility in Indianapolis has become our primary distribution and fulfillment center for the United States and Canada, with the majority of our shipment volume handled through this facility in our fiscal year ended March 31, 2010. In February 2009 we re-located our seed kit manufacturing operations to the facility in Indianapolis from its previous location in Longmont, Colorado. We now manufacture all of our seed kits in the Indianapolis facility. Any material disruption to the operation of this facility, whether caused by internal or external factors, could have a material adverse impact on our business and financial performance.

We rely on third party providers in our manufacturing, warehouse, distribution, order processing, and fulfillment operations. If these parties are unwilling to continue providing services to us, or are unable to adequately perform such services for us on a cost effective basis, our business could be materially harmed.

We engage third parties to perform certain critical functions supporting our business operations. Any disruption in our relationship with any of our vendors could cause significant disruption to our business and we may not be able to locate another party that can provide comparable services in a timely manner or on acceptable commercial terms. In addition, no assurance can be made that these relationships will be adequate to support our business as we follow our business plan.

Our intellectual property and proprietary rights give us only limited protection, and can be expensive to defend.

Our ability to produce and sell indoor garden systems exclusively depends in part on securing patent protection for the components of our systems, maintaining various trademarks, and protecting our operational trade secrets. To protect our proprietary technology, we rely on a combination of patents pending (and if granted, patents), trade secrets, and non-disclosure agreements, each of which affords only limited protection. We own the rights to 18 United States and international patent applications, three of which have been issued in the United States and three of which have issued internationally. However, the remaining patent applications may not result in issued patents and even issued patents may be challenged. We are selling our indoor garden systems prior to receiving issued patents relating to our patent applications. All of our intellectual property rights may be challenged, invalidated, or circumvented. Claims for infringement may be asserted or prosecuted against us in the future and we may not be able to protect our patents, if any more are obtained, and intellectual property rights against others. Our former employees or consultants may violate their non-disclosure agreements, leading to a loss of proprietary intellectual property. We could also incur substantial costs to assert our intellectual property or proprietary rights against others.

We may face significant competition, and if we are unable to compete effectively, our sales may be adversely affected.

We believe that our complete indoor garden systems offer significant benefits over traditional hydroponic industry products. There are companies in a variety of related markets including but not limited to, consumer electronics, commercial hydroponics, gardening wholesale, and soil-based gardening that are larger, better funded, have more recognizable brand names, and have experience in our channels of distribution. These companies could potentially decide to develop products to compete with our products. These companies could use hydroponic technologies, and could achieve better consumer acceptance. The success of any competing products may adversely impact us.

Increases in energy prices, resulting from general economic conditions, or other factors, may raise our cost of goods sold and adversely affect our business, results of operations and financial condition.

Energy costs, especially gasoline and fuel costs, are significant expenses in the delivery of our products. Increased costs resulting from general economic conditions, acts of nature, or other factors, may result in declining margins and operating results if market conditions prevent us from passing these increased costs on to our customers through timely price increases on our products.

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Our current or future manufacturers are located in China and therefore our product costs may be subject to fluctuations in the value of the dollar against the Chinese currency.

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

If our indoor garden systems fail to perform properly, our business could suffer with increased costs and reduced income.

We have sold more than 958,000 AeroGardens since our inception and have provided a limited warranty with each garden sold. In addition, our indoor garden systems are "guaranteed to grow." We therefore may be required to replace or repair products or refund the purchase price to consumers. Failure of our products to meet expectations could damage our reputation, decrease sales, increase costs related to returns and repairs, delay market acceptance of our products, result in unpaid accounts receivable, and divert our resources to remedy the malfunctions. The occurrence of any of these events would have an adverse impact on our results of operations.

From time to time, we may be subject to litigation that, if decided adversely to us, could have a material adverse impact on our financial condition.

From time to time, we are a party to various litigation matters, in most cases involving ordinary and routine claims incidental to our business. We cannot estimate with certainty our ultimate legal and financial liability with respect to any such pending litigation matters. However, we believe, based on our examination of such matters, that our ultimate liability, if any, will not have a material adverse effect on our financial position, results of operations or cash flows.

In connection with the Linens 'N Things ("LNT") bankruptcy proceedings, a Complaint to Avoid and Recover Preferential Transfers was filed by LNT in the United States Bankruptcy Court for the District of Delaware on April 20, 2009 (the "Complaint"). The Complaint alleges that, pursuant to Sections 547 and 550 of the United States Bankruptcy Code, we are required to return to LNT approximately $623,000 in "preferential" transfers allegedly made to AeroGrow during the 90-day period preceding the filing of the LNT bankruptcy cases. The Complaint also alleges that AeroGrow is required to pay to LNT approximately $44,000 on account of credits allegedly earned but not redeemed by LNT prior to the filing of the LNT bankruptcy cases. We negotiated a settlement of all claims with LNT, executed a settlement agreement, and are now awaiting final approval of the settlement by the bankruptcy court. We do not anticipate there will be any material change to the terms of the executed settlement agreement, and the cost to us of the settlement is less than the amount previously accrued in our balance sheet and consolidated statement of operations in anticipation of the cost of defending, or settling, this matter.

Risks Related to the Market for our Securities

The market price of our shares may fluctuate greatly. Investors in AeroGrow bear the risk that they will not recover their investment.

Effective as of May 4, 2009, our common stock ceased to be listed on The Nasdaq Stock Market and is now traded on the OTC Bulletin Board. Currently, trading in our common stock is limited, and the price per share is likely to be influenced by the price at which and the amount of shares the selling security holders are attempting to sell at any time. This could have the effect of limiting the trading price or lowering the market price to the selling security holders' offering prices. Common stock such as ours may be subject to the activities of persons engaged in short selling securities, which generally has the effect of driving the price down. In addition, the common stock of emerging growth companies is typically subject to high price and volume volatility. Therefore, the price of our common stock has fluctuated, and may continue to fluctuate, widely. A full and stable trading market for our common stock may never develop and, as a result, stockholders may not be able to sell their shares at the time they elect, if at all.

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There may be substantial sales of our common stock by existing security holders which could cause the price of our stock to fall.

Future sales of substantial amounts of our common stock in the public market or the perception that such sales might occur, could cause the market price of our common stock to decline and could impair the value of an investment in our common stock and our ability to raise equity capital in the future.

Sales of our common stock by security holders, or even the appearance that such holders may make such sales, may limit the market for our common stock or depress any trading market volume and price before other investors are able to sell the common stock. Moreover, a number of shareholders have held their investment for a substantial period of time and may desire to sell their shares, which could drive down the price of our common stock.

We can issue debt securities and shares of preferred stock without stockholder approval, which could adversely affect the rights of common stockholders.

Our Articles of Incorporation allow our Board of Directors to approve the terms and conditions of debt securities and preferred stock for issuance by the Company, including but not limited to voting rights, conversion privileges and liquidation preferences, without the approval of common stockholders. The rights of the holders of our common stock may be adversely impacted as a result of the rights that could potentially be granted to holders of debt securities or preferred stock that we may issue in the future. In addition, there could be an impact on the price of our common stock because of the potential impact on the rights of common shareholders resulting from future issuances of debt or preferred stock.

Our outstanding warrants, options and additional future obligations to issue our securities to various parties, may dilute the value of an investment in AeroGrow and may adversely affect our ability to raise additional capital.

As of March 31, 2010, we were committed to issue up to 68,191,852 additional shares of common stock under the terms of outstanding warrants, options and other arrangements as detailed in Note 5 – Equity Compensation Plans and Note 9 – Stockholders' Equity in the accompanying Notes to Financial Statements.

In addition, during Fiscal 2010 we issued an aggregate of 7,586 shares of Series A Convertible Preferred stock giving the holders the right to convert their preferred shares into a total of 37,930,000 common shares of AeroGrow. The preferred shareholders also received 4,164 warrants to purchase additional preferred shares that could be converted into 20,820,000 shares of AeroGrow common stock. Furthermore, during the fiscal year ended March 31, 2010, we incurred $1,080,000 in bridge financing in which we also issued warrants to purchase an additional 1,080,000 shares of AeroGrow common stock. In addition, during May and June 2010, we issued $6,800,000 in secured subordinated convertible notes that can convert to 68,000,000 shares of common stock, and issued 68,000,000 warrants to purchase shares of common stock. See Management's Discussion and Analysis of Financial Condition – Liquidity and Capital Resources and Note 9 – Stockholders' Equity in the accompanying Notes to Financial Statements).

For the length of time the warrants, options and preferred shares are outstanding, the holders will have an opportunity to profit from a rise in the market price of our common stock without assuming all the risks of common share ownership. This may adversely affect the terms upon which we can obtain additional capital. The holders of such derivative securities would likely exercise or convert them at a time when we would be able to obtain equity capital on terms more favorable than the exercise or conversion prices provided by the notes, warrants or options.

Further, future sales of substantial amounts of these shares, or the perception that such sales might occur, could cause the market price of our common stock to decline and could impair the value of an investment in our common stock and our ability to raise equity capital in the future.

During Fiscal 2010, we issued an aggregate of $6,685,486 Series A Convertible Preferred securities. During May and June 2010 we issued $6,800,000 of subordinated secured convertible notes. The terms and conditions of these securities could significantly impact the price of our common shares, and could adversely impact our ability to raise additional equity capital.

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The holders of our Series A Convertible Preferred shares (the "Preferred Shareholders") have the right to convert each of their shares and warrants into 5,000 common shares of AeroGrow. In addition, the Preferred Shareholders have the right to vote their shares on an as-converted basis on all matters voted on by common shareholders. The Preferred Shareholders also have the right to elect three Directors of AeroGrow, voting as a separate class. As a result of these rights, the Preferred Shareholders have effective control over AeroGrow and its governance. In addition, the Preferred Shareholders possess certain rights that give them preferences relative to common shareholders in the event of a sale or liquidation of the Company. It is possible that the Preferred Shareholders could take actions that could adversely impact the value of investments in common shares of the Company. In addition, the control position of the Preferred Shareholders, as well as other anti-dilution rights held by the Preferred Shareholders, could adversely impact our ability to raise capital in the future. The holders of our subordinated secured convertible notes have the right to convert the notes at a conversion price of $0.10 per share of our common stock at any time during the three-year life of the notes. (For more detail on the Series A Convertible Preferred securities and the subordinated secured convertible notes, see Item 7 - Management's Discussion and Analysis of Financial Condition – Liquidity and Capital Resources and Note 9 – Stockholders' Equity in the accompanying Notes to Financial Statements.)

If an exemption from registration on which we have relied for any of our past offerings of common stock or warrants is challenged legally, our principals may have to spend time defending claims, and we would then risk paying expenses for defense, rescission, and/or regulatory sanctions.

To raise working capital, we offered common stock and warrants in private transactions that we believed to be exempt from registration under the Securities Act and state securities laws. In 2004 we conducted a state-registered offering in Colorado of common stock and warrants, intended to be exempt from registration under the Securities Act as an intrastate offering. However, because we are incorporated in Nevada, the offering did not satisfy all of the requirements for an intrastate offering. This could result in investors or regulators asserting that the Colorado offering and/or private offerings subsequent to the Colorado offering (if the private offerings were integrated with the Colorado offering) violated the Securities Act. There can be no assurance that investors or regulators will not be successful in asserting a claim that these transactions should not be integrated. In the event that one or more investors seeks rescission, with resulting return of investment funds and interest at a market rate, or that state or federal regulators seeks sanctions against us or our principals, we would spend time and financial resources to pay expenses for defense, rescission awards, or regulatory sanctions. The use of funds would reduce the capital available to operate our business. No assurance can be given regarding the outcome of any such actions.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. DESCRIPTION OF PROPERTY

We lease a 21,012 square foot office space in, Boulder, Colorado, with a current monthly rent of $18,385. 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.

We also rent warehouse and manufacturing space in Indianapolis, Indiana. The Indianapolis facility houses our distribution and fulfillment operations and our seed kit manufacturing operations. We currently lease 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 expires on February 28, 2011.

While our facilities appear adequate for the foreseeable future, we may add space to meet future growth as needed. Upon expiration of our current leases, we believe that we will be able to either renew our existing leases or arrange new leases in nearby locations on acceptable terms. We believe that these properties are adequately covered by insurance.

ITEM 3. LEGAL PROCEEDINGS

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In connection with the Linens 'N Things ("LNT") bankruptcy proceedings, a Complaint to Avoid and Recover Preferential Transfers was filed by LNT in the United States Bankruptcy Court for the District of Delaware on April 20, 2009 (the "Complaint"). The Complaint alleges that, pursuant to Sections 547 and 550 of the United States Bankruptcy Code, we are required to return to LNT approximately $623,000 in "preferential" transfers allegedly made to AeroGrow during the 90-day period preceding the filing of the LNT bankruptcy cases. The Complaint also alleges that AeroGrow is required to pay to LNT approximately $44,000 on account of credits allegedly earned but not redeemed by LNT prior to the filing of the LNT bankruptcy cases. We negotiated a settlement of all claims with LNT, executed a settlement agreement, and are now awaiting final approval of the settlement by the bankruptcy court. We do not anticipate there will be any material change to the terms of the executed settlement agreement, and the cost to us of the settlement is less than the amount previously accrued in our balance sheet and consolidated statement of operations in anticipation of the cost of defending, or settling, this matter.

From time to time, we are also a party to various other litigation matters, in most cases involving ordinary and routine claims incidental to our business. We cannot estimate with certainty our ultimate legal and financial liability with respect to any such pending litigation matters. However, we believe, based on our examination of such matters, that our ultimate liability, if any, will not have a material adverse effect on our financial position, results of operations or cash flows.

ITEM 4. RESERVED

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

Our common stock has been listed on the OTC Bulletin Board (the "OTCBB") since June 9, 2009 under the symbol AERO. In the past, our common stock was listed on the Pink Sheets Electronic OTC Market from May 4, 2009 through June 9, 2009, on the NASDAQ Capital Market from June 13, 2007, to May 1, 2009, and on the OTCBB from January 8, 2007 to June 12, 2007.

Price Range of Common Stock

The following table sets forth, for the periods indicated, the high and low daily closing prices of our common stock for the two most recently completed fiscal years while trading on the markets noted above.

	Fiscal Year Ended 3/31/10		Fiscal Year Ended 3/31/09	
	High	Low	High	Low
1st Quarter - Ended June 30	$0.24	$0.12	$3.75	$1.81
2nd Quarter - Ended Sept 30	$0.18	$0.07	$3.22	$1.27
3rd Quarter - Ended Dec 31	$0.22	$0.12	$2.94	$0.19
4th Quarter - Ended Mar 31	$0.20	$0.12	$0.40	$0.08

Holders

As of May 31, 2010, we had approximately 492 holders of record of our common stock.

Dividends

We have never declared or paid cash dividends on our common stock. We currently intend to retain all available funds and any future earnings for use in the operation of our business and do not anticipate paying any cash dividends in the foreseeable future. Any future determination to declare cash dividends will be made at the discretion of our board of directors, subject to compliance with covenants under any existing financing agreements, which may restrict or limit our ability to declare or pay dividends, and will depend on our financial condition, results of operations, capital requirements, general business conditions, and other factors that our board of directors may deem relevant.

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Equity Compensation Plan Information

The equity compensation plan information called for by Item 201(d) of Regulation S-K is set forth in Item 12 of Part III of this Annual Report under the heading “Equity Compensation Plan Information.”

Company Stock Performance

The following graph compares the cumulative total stockholder return data for our stock for the period beginning April 1, 2008 and ending on March 31, 2010 to the cumulative return over such period of (i) The Russell 2000 Index (RUT) and (ii) the Russell Microcap Index (IWC). The graph assumes $100 was invested on March 31, 2008 in our Common Stock and in each of the comparative indices. Note that the historical stock price performance on the following graph is not necessarily indicative of future stock price performance.

ITEM 6. SELECTED FINANCIAL DATA

Consolidated Statements of Operations Data

	Fiscal Years ended March 31,		
	2010	2009	2008
Revenues	$17,251,347	$37,449,868	$38,356,676
Cost of revenue	11,846,399	23,710,787	22,975,385
Research and development	424,741	2,146,493	2,605,112
Sales and marketing	6,104,742	13,772,822	16,084,353
General and administrative	5,112,647	7,043,391	6,084,728
Total operating expenses	23,488,529	46,673,493	47,749,578
Loss from operations	(6,237,182)	(9,223,625)	(9,392,902)
Other (income) expense	94,023	1,089,889	443,019
Net loss	$(6,331,205)	$(10,313,514)	$(9,835,921)
Net loss per share, basic and diluted	$(0.50)	$(0.82)	$(0.84)
Weighted average number of common shares outstanding, basic and diluted	12,564,140	12,519,999	11,662,891
Consolidated Balance Sheet Data		March 31,	
	2010	2009	2008
Cash and cash equivalents	$249,582	$332,698	$1,559,792
Total assets	$6,843,780	$14,609,190	$11,919,629
Total liabilities	$10,170,710	$18,840,815	$7,511,078
Total stockholders’ equity (deficit)	$(3,326,930)	$(4,231,625)	$4,408,551

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Annual Report on Form 10-K ("Annual Report"), including the "Management's Discussion and Analysis of Financial Condition and Results of Operations," contains forward-looking statements regarding future events and our future results that are based on current expectations, estimates, forecasts, and projections about the industry in which we operate and the beliefs and assumptions of our management. Words such as "expects," "anticipates," "targets," "goals," "projects," "may," "will," "would," "could," "intends," "plans," "believes," "seeks," "estimates," variations of such word expressions are intended to identify such forward-looking statements. These forward looking statements may include, among others, statements concerning our expectations regarding our business, growth prospects, revenue trends, operating costs, working capital requirements, competition, results of operations and other statements of expectations, beliefs, future plans and strategies, anticipated events or trends, and similar expressions concerning matters that are not historical facts. These forward-looking statements are only predictions that are subject to risks, uncertainties, and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in this Report under the section entitled "Risk Factors" in Item 1A of Part I and elsewhere, and in other reports we file with the SEC, specifically the most recent reports on Form 10-Q. While forward-looking statements are based on reasonable expectations of our management at the time that they are made, you should not rely on them. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

Executive Overview

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

However, during the fiscal year ended March 31, 2010 ("Fiscal 2010"), we scaled back our operations as a result of the general economic downturn and the resulting decline in consumer confidence and spending. We also determined that broad distribution through retail channels was not appropriate for a company at our stage of development because of relatively low profit margins, high capital requirements, and the operational requirements of our retailer customers. As of March 31, 2010, our products were offered in approximately 1,290 storefronts in North America, as compared to approximately 7,500 stores as of March 31, 2009. Although we expect to further reduce the number of retailer storefronts carrying our products during the next fiscal year, we plan to maintain relationships with retailers, both traditional and non-traditional, that have historically proven to be good business partners for AeroGrow. In this regard, we plan to continue selling through our largest retailer customers, including three customers that comprised approximately 59% of our retailer sales during Fiscal 2010.

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

During Fiscal 2010 we began the process of re-capitalizing the Company by issuing approximately $6.7 million in convertible preferred shares. In addition, we negotiated deferred payment arrangements with certain vendors, negotiated reduced balances with certain vendors, and reduced the amount of our interest-bearing debt and our accounts payable obligations. Nonetheless, we continued to face cash and liquidity constraints during Fiscal 2010 that were, at times, severe, and that had a material impact on our ability to operate our business. Subsequent to the end of Fiscal 2010, in May and June 2010, we issued $6,800,000 in convertible secured subordinated debt to supplement our internal cash sources and to address our liquidity constraints. As a result, we believe that we have sufficient liquidity to execute our business plans for the fiscal year ending March 31, 2011.

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Our Critical Accounting Policies

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, 2010	March 31, 2009
Finished goods	$ 2,515,451	$ 6,799,996
Raw materials	978,281	1,550,139
	$ 3,493,732	$ 8,350,135

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, 2010, the Company had reserved $670,134 for inventory obsolescence and as of March 31, 2009 the Company had reserved $335,705.

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. Accordingly, the Company did not record $1,354 and $0 of revenue as of March 31, 2010 and March 31, 2009, respectively, related to the unpaid balance due for orders shipped in conjunction with the Company's direct sales to consumers because the consumer has 36 days to evaluate the product, and is required to pay only the shipping and handling costs for such products before making the required installment payments after the expiration of the 36-day trial period. The Company offers the 36-day trial period intermittently. The Company also, as of March 31, 2010 and March 31, 2009, did not record $561 and $0, respectively, of product costs associated with the foregoing revenue in as much as the customer is required to return the product and the Company is therefore able to recover these costs through resale of the goods. The liability for sales returns is estimated based upon historical experience of return levels.

Additionally, the Company did not record $339,041 and $46,131 of revenue as of March 31, 2010 and March 31, 2009, respectively, related to the wholesale sales value of inventory held by its retail shopping channel customers as these sales are contingent upon the shopping channels selling the goods. Deferred payments for these goods are charged to Customer Deposits. The Company also deferred, as of March 31, 2010 and March 31, 2009, recognition of $243,456, and $21,336 of product and freight costs associated with these sales, which have been included in inventory.

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, 2010 and March 31, 2009, the Company had accrued $80,119 and $431,148 respectively, as its estimate for the foregoing deductions and allowances. In addition, for the fiscal year ended March 31, 2010 and March 31, 2009, the Company had accrued $66,000 and $1,393,198 for possible returns or price markdowns associated with several large retailer accounts along with $21,207 and $30,310 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. The manufacturers of the Company's products provide replacement parts for any defective components free of charge up to 2% of the total units purchased. Based upon the foregoing, the Company has recorded as of March 31, 2010 and March 31, 2009 a provision for potential future warranty costs of $55,842 and $69,587, respectively.

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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, 2010 and March 31, 2009, the Company has recorded a reserve for customer returns of $47,398 and $101,743, 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.

Stock Based Compensation
The Financial Accounting Standards Board ("FASB") issued ASC 710-10-15 (prior authoritative guidance: FASB Statement No. 123R, Share-Based Payment). The Securities and Exchange Commission ("SEC") provided for a phase-in implementation process, which required adoption of the new accounting standard no later than January 1, 2006. ASC 710-10-15 requires accounting for stock options using a fair-value-based method as described in such statement and recognizing the resulting compensation expense in the Company's financial statements. Prior to January 1, 2006, the Company accounted for employee stock options using the intrinsic value method under APB No. 25, "Accounting for Stock Issued to Employees" and related Interpretations, which generally results in no employee stock option expense. The Company uses the Black-Scholes option valuation model to estimate the fair value of stock option awards issued under ASC 710-10-15. In addition, the Company uses the "simplified" method for determining the expected term of its "plain vanilla" stock options as permitted. For the years ended March 31, 2010, March 31, 2009, March 31, 2008, equity compensation in the form of stock options and grants of restricted stock totaled $452,393, $723,406, and $710,899, respectively, and is included in the accompanying Statements of Operations in the following categories:

		Years ended	
	March 31, 2010	March 31, 2009	March 31, 2008
General and administrative	$319,673	$457,592	$225,730
Research and development	6,644	121,952	300,702
Sales and marketing	126,076	143,862	184,467
Total	$452,393	$723,406	$710,899

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 the Statement of Position, ASC 340-20-25 (prior authoritative guidance: 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, 2010 and March 31, 2009, the Company had deferred $19,058 and $346,130, respectively, related to such media costs. Advertising expenses for the years ended March 31, 2010, March 31, 2009 and March 31, 2008 were $2,299,431, $5,101,910 and $6,955,555, 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.

Deferred Debt Issuance Costs

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

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New Accounting Pronouncements

In January 2010, the FASB issued a new accounting standard which updates and clarifies some existing disclosure requirements about fair value measurements codified within ASC 820, Fair Value Measurements and Disclosures. The majority of the provisions of this update are effective for interim and annual reporting periods beginning after December 15, 2009. The adoption of these provisions did not have a material impact on our financial statements.

In October 2009, the FASB issued a new accounting standard which provides guidance for arrangements with multiple deliverables. Specifically, the new standard requires an entity to allocate arrangement consideration at the inception of an arrangement to all of its deliverables based on their relative selling prices. In addition, the new standard eliminates the use of the residual method of allocation and requires the relative-selling-price method in all circumstances in which an entity recognizes revenue for an arrangement with multiple deliverables. In October 2009, the FASB also issued a new accounting standard which changes revenue recognition for tangible products containing software and hardware elements. Specifically, if certain requirements are met, revenue arrangements that contain tangible products with software elements that are essential to the functionality of the products are scoped out of the existing software revenue recognition accounting guidance and will be accounted for under the multiple-element arrangements revenue recognition guidance discussed above. We do not expect the adoption will have a material impact on our financial statements. This guidance is effective prospectively for revenue entered into or materially modified in fiscal years beginning after June 15, 2010.

In August 2009, the FASB issued a new accounting standard which provides additional guidance on the measurement of liabilities at fair value. Specifically, when a quoted price in an active market for the identical liability is not available, the new standard requires that the fair value of a liability be measured using one or more of the valuation techniques that should maximize the use of relevant observable inputs and minimize the use of unobservable inputs. In addition, an entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of a liability. Adoption did not have a material impact on our financial statements.

In June 2009, the FASB issued ASC 105, Generally Accepted Accounting Principles (prior authoritative guidance: SFAS No. 168, The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles). ASC 105 establishes the FASB ASC as the single source of authoritative nongovernmental U.S. GAAP, except for SEC rules and interpretive releases, which are sources of authoritative GAAP for SEC registrants. The standard is effective for interim and annual periods ending after September 15, 2009. The Company adopted the provisions of the standard on September 30, 2009, which did not have a material impact on our financial statements other than references to accounting standards in our accounting principles disclosure where modified.

In May 2009, the FASB issued ASC 855, Subsequent Events (prior authoritative guidance: SFAS No. 165, Subsequent Events). ASC 855 establishes general accounting standards and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date. This Statement is effective for interim and annual periods ending after June 15, 2009, and as such, adopted this standard in the first quarter of our fiscal year ending March 31, 2010. The adoption of ASC 855 did not have a material effect on our financial position, results of operations or cash flows. We have performed an evaluation of subsequent events through the date of our filing of this Form 10-K.

In April 2009, the FASB issued ASC 825-10-65, Financial Instruments (prior authoritative guidance: Financial Staff Position ("FSP") No. FAS 107-1 and Accounting Principles Board ("APB") Opinion No. 28-1, Interim Disclosures about Fair Value of Financial Instruments). ASC 825-10-65 requires disclosures about fair values of financial instruments for interim reporting periods as well as in annual financial statements. ASC 825-10-65 enhances consistency in financial reporting by increasing the frequency of fair value disclosures and is effective for interim and annual period ending after June 15, 2009, and is to be applied prospectively. The adoption of ASC 825-10-65 did not have a material impact on our financial statements.

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In October 2008, the FASB issued ASC 820-10-35-15A (prior authoritative guidance: FSP No. FAS 157-3, Determining the Fair Value of a Financial Asset in a Market that is Not Active), which clarifies the application of ASC 820 when the market for a financial asset is inactive. Specifically, ASC 820-10-35-15A clarifies how (1) the internal assumptions should be considered in measuring fair value when observable data are not present, (2) observable market information from an inactive market should be taken into account, and (3) the use of broker quotes or pricing services should be considered in assessing the relevance of observable and unobservable data to measure fair value. The guidance in ASC 820-10-35-15A was effective immediately. The adoption of ASC 820-10-35-15A did not have a material effect on our financial statements.

In May 2008, the FASB issued ASC 944-20 (prior authoritative guidance: SFAS No. 163, Accounting for Financial Guarantee Insurance Contracts-an interpretation of FASB Statement No. 60). Diversity exists in practice in accounting for financial guarantee insurance contracts by insurance enterprises under FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises. This results in inconsistencies in the recognition and measurement of claim liabilities. This Statement requires that an insurance enterprise recognize a claim liability prior to an event of default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation. This Statement requires expanded disclosures about financial guarantee insurance contracts. The accounting and disclosure requirements of the Statement will improve the quality of information provided to users of financial statements. ASC 944-20 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The adoption of ASC 944-20 did not have a material impact on our financial position.

In March 2008, the FASB issued ASC 815-10-50 (prior authoritative guidance: SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities—An Amendment of FASB Statement No. 133). ASC 815-10-50 establishes the disclosure requirements for derivative instruments and for hedging activities with the intent to provide financial statement users with an enhanced understanding of the entity's use of derivative instruments, the accounting of derivative instruments, and related hedged items under ASC 815-10-50 and its related interpretations, and the effects of these instruments on the entity's financial position, financial performance, and cash flows. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2008. The adoption of ASC 815-10-50 did not have a material impact on our financial position disclosures.

In December 2007, the FASB issued ASC 805 (prior authoritative guidance: SFAS No. 141(R), Business Combinations), which amends SFAS No. 141, and provides revised guidance for recognizing and measuring identifiable assets and goodwill acquired, liabilities assumed, and any non-controlling interest in the acquiree. It also provides disclosure requirements to enable users of the financial statements to evaluate the nature and financial effects of the business combination. ASC 805 is effective for fiscal years beginning on or after January 1, 2009, and is to be applied prospectively. The adoption of ASC 805 did not have a material impact on our financial position.

In December 2007, the FASB issued ASC 810-10 (prior authoritative guidance: SFAS No. 160, Non-controlling Interests in Consolidated Financial Statements – an amendment of ARB No. 51), which establishes accounting and reporting standards pertaining to ownership interests in subsidiaries held by parties other than the parent, the amount of net income attributable to the parent and to the non-controlling interest, changes in a parent's ownership interest, and the valuation of any retained non-controlling equity investment when a subsidiary is deconsolidated. ASC 810-10 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the non-controlling owners. ASC 810-10 is effective for fiscal years beginning on or after January 1, 2009. The adoption of ASC 810-10 did not have a material impact on our financial position.

In February 2007, the FASB issued ASC 825-10 (prior authoritative guidance: SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement 157). The Company adopted ASC 825-10 beginning April 1, 2008. The adoption of ASC 825-10 did not have a material effect on our financial position.

Inflation and Seasonality

We do not currently expect inflation to have a significant effect on our operations. Because our indoor garden systems are designed for an indoor gardening experience, we experience slower sales in the United States during the late spring and summer months when our consumers may tend to garden outdoors. In addition, we have experienced increased sales during the holiday season in the fourth calendar quarter (the third quarter of our fiscal year). We sell to our international distributors in US Dollars thereby minimizing effects from currency fluctuations. We purchase our gardens and other accessory products from Chinese manufacturers, and these purchases are denominated in US Dollars. However, over time, the cost of the products we procure from China may be affected by changes in the value of the US Dollar relative to the Chinese currency.

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Results of Operations

The following table sets forth, as a percentage of sales, our financial results for the last three fiscal years:

	Fiscal Years Ended March 31,					
	2010		2009		2008	
Revenue						
Product sales- retail	40.1	%	60.9	%	62. 4	%
Product sales- direct-to-consumer	57.5	%	32.9	%	35.7	%
Product sales- international	2.4	%	6.2	%	1.9	%
Total sales	100.0	%	100.0	%	100.0	%
Operating expenses						
Cost of revenue	68.7	%	63.3	%	59.9	%
Research and development	2.5	%	5.7	%	6.8	%
Sales and marketing	35.4	%	36.8	%	41.9	%
General and administrative	29.6	%	18.8	%	15.9	%
Total operating expenses	136.3	%	124.6	%	124.5	%
Loss from Operations	-36.3	%	-24.6	%	-24.5	%
Total other (income)/expense, net	0.4	%	2.9	%	1.1	%
Net Loss	-36.7	%	-27.5	%	-25.6	%

Fiscal Years Ended March 31, 2010 and March 31, 2009

Summary Overview

For the fiscal year ended March 31, 2010 (“Fiscal 2010”), our net sales totaled $17,251,347, a decrease of 53.9% from the fiscal year ended March 31, 2009 (“Fiscal 2009”).

Our sales to retailer customers declined by 69.7% to $6,923,619, representing 78.7% of the overall sales decrease we experienced during Fiscal 2010. The reduction in sales to retailers reflected a combination of factors, included our decision to de-emphasize sales to retailers because of the higher risk and lower margins associated with these sales. In addition, during Fiscal 2010, retailers generally took a more cautious approach to inventory decisions, resulting in fewer and smaller orders than in previous years. As a result of our strategic decision to reduce our exposure to the retail channel, and, in some case, inventory actions by certain retailers, we reduced the number of retail store doors carrying our products, to an estimated 1,290 at March 31, 2010, from approximately 7,500 a year earlier.

Our direct-to-consumer sales also declined, by 19.4% to $9,921,278, despite a 78.9% year-over-year increase in the efficiency of our marketing efforts during Fiscal 2010, as measured by dollars of direct-to-consumer sales per dollar of advertising expense. However, we reduced our revenue-generating advertising spending by 54.9% during Fiscal 2010, more than offsetting the increase in marketing efficiency, because of our cash constraints, and our decision to implement a more targeted marketing program during the year in light of the difficult macroeconomic environment. Sales to international distributors also fell, by 82.5% to $406,450 in Fiscal 2010 as we did not promote international sales, and our distributors’ inventory levels in existing markets were sufficient to meet most of our international consumer demand, thereby limiting re-orders.

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Our gross margin for the fiscal year ended March 31, 2010 was 31.3%, down from 36.7% in the prior year. The reduction in gross margin reflected a number of factors including severe operational inefficiencies caused by our cash constraints during Fiscal 2010, a higher inventory reserve established during Fiscal 2010, and the impact of fixed facility costs on a lower level of revenue during the year.

Operating expenses other than cost of revenue for the fiscal year ended March 31, 2010 totaled $11,642,130, 49.3% or $11,320,576 lower than the prior fiscal year. This decrease reflected the combined impacts of lower headcount and cost reduction initiatives executed throughout the year. Sales and marketing costs were reduced by 55.7%, including a $2,802,479, or 54.9% reduction in advertising spending caused in large part by the cash constraints we experienced throughout Fiscal 2010, as well as by planned reductions we implemented in reaction to the impact of the global economic recession on consumer spending. General and administrative expense totaled $5,112,647 during Fiscal 2010, representing a $1,930,744, or 27.4% reduction relative to the prior fiscal year. The lower general and administrative expense primarily reflected the impact of headcount reductions, lower legal and accounting costs, lower facility costs, and reductions in corporate and governance expenses, partially offset by a higher allowance for bad debts associated with the termination of our relationships with certain retailers. Research and development costs also declined year-over-year, by $1,721,752, or 80.2%, to $424,741 in Fiscal 2010. The reduction in research and development expense primarily reflected the impact of lower headcount relative to the prior fiscal year.

Our loss from operations totaled $