AeroGrow International, Inc.
Form 10-Q
August 11, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2016

OR

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

Commission File No. 001-33531

AEROGROW INTERNATIONAL, INC.
(Exact name of registrant as specified in its charter)

NEVADA	46-0510685
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

6075 Longbow Drive, Suite 200, Boulder, Colorado	80301
(Address of principal executive offices)	(Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No

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

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

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

Number of shares of issuer's common stock outstanding as of August 4, 2016: 8,574,372

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June 30, 2016

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PART I - FINANCIAL INFORMATION

Item 1. Condensed Financial Statements

AEROGROW INTERNATIONAL, INC.
CONDENSED BALANCE SHEETS

(in thousands, except share and per share data)	June 30, 2016 (Unaudited)	March 31, 2016 (Derived from Audited Statements)
ASSETS		
Current assets		
Cash	$ 463	$ 1,401
Restricted cash	15	15
Accounts receivable, net of allowance for doubtful accounts of $9 and $14 at June 30, 2016 and March 31, 2016, respectively	1,018	1,577
Other receivables	148	232
Inventory, net	2,692	3,149
Prepaid expenses and other	385	196
Total current assets	4,721	6,570
Property and equipment, net of accumulated depreciation of $3,746 and $3,652 at June 30, 2016 and March 31, 2016, respectively	533	620
Other assets		
Intangible assets, net	2	2
Deposits	106	156
Total assets	$ 5,362	$ 7,348
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 1,647	$ 1,733
Accrued expenses	800	964
Customer deposits	246	352
Deferred rent	-	1
Notes payable – related party	-	1,293
Derivative warrant liability	1,089	644
Debt associated with sale of intellectual property	149	160
Total current liabilities	3,931	5,147
Commitments and contingencies		
Stockholders' equity		
Preferred stock, $.001 par value, 20,000,000 shares authorized, 2,649,007 shares issued and outstanding at June 30, 2016 and March 31, 2016, respectively	3	3
Common stock, $.001 par value, 750,000,000 shares authorized, 7,696,010 and 6,536,518 shares issued and outstanding at June 30, 2016 and March 31, 2016, respectively	8	7
Additional paid-in capital	84,669	84,129
Stock dividend to be distributed	2,544	2,391
Accumulated deficit	(85,793)	(84,329)

Total stockholders' equity	1,431	2,201
Total liabilities and stockholders' equity	$ 5,362	$ 7,348

See accompanying notes to the condensed financial statements.

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

	Three Months ended June 30, 2016	2015
(in thousands, except per share data)		
Net revenue	$2,156	$1,569
Cost of revenue	1,312	1,088
Gross profit	844	481
Operating expenses		
Research and development	97	131
Sales and marketing	820	642
General and administrative	580	665
Total operating expenses	1,497	1,438
Loss from operations	(653)	(957)
Other income (expense), net		
Fair value changes in derivative warrant liability	(446)	(264)
Other (expense)	(28)	-
Total other income (expense) income, net	(474)	(264)
Net loss	$(1,127)	$(1,221)
Change in fair value of stock to be distributed for Scotts Miracle-Gro transactions	(449)	221
Net loss attributable to common stockholders	$(1,576)	$(1,000)
Net loss per share, basic and diluted	$(0.20)	$(0.15)
Weighted average number of common shares outstanding, basic and diluted	7,696	6,700

See accompanying notes to the condensed financial statements.

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

	Three Months Ended June 30, 2016	2015
(in thousands)		
Cash flows from operating activities:		
Net (loss)	$(1,127)	$(1,221)
Adjustments to reconcile net (loss) to cash provided (used) by operations:		
Issuance of common stock and options under equity compensation plans	60	74
Depreciation and amortization expense	94	81
Bad debt (recovery) expense	(6)	(2)
Fair value remeasurement of derivative warrant liability	446	264
Accretion of debt associated with sale of intellectual property	(11)	(12)
SMG intellectual property royalty and branding license	106	84
Change in operating assets and liabilities:		
Decrease in accounts receivable	564	450
Decrease in other receivable	84	74
Decrease in inventory	457	454
(Increase) in prepaid expense and other	(189)	(170)
Decrease in deposits	50	-
(Decrease) in accounts payable	(192)	(440)
(Decrease) in accrued expenses	(164)	(50)
Increase in accrued interest-related party	4	-
(Decrease) in customer deposits	(106)	(23)
(Decrease) in deferred rent	(1)	1
Net cash provided (used) by operating activities	69	(436)
Cash flows from investing activities:		
Purchases of equipment	(7)	(108)
Net cash (used) by investing activities	(7)	(108)
Cash flows from financing activities:		
Repayment of notes payable-related party	(1,000)	-
Net cash (used) by financing activities	(1,000)	-
Net (decrease) in cash	(938)	(544)
Cash, beginning of period	1,401	1,015
Cash, end of period	$463	$471

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

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	Three Months Ended June 30, (in thousands)	
	2016	2015
Cash paid during the year for:		
Interest	$-	$-
Income taxes	$-	$-
Supplemental disclosure of non-cash investing and financing activities:		
Common stock issued for interest on notes payable – related party	$297	$207
Change in fair value of SMG intellectual property royalty and branding license	$391	$68
Change in fair value of stock dividends accrued on convertible preferred stock	$194	$(54)

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

1. Description of the Business

AeroGrow International, Inc. (collectively, the “Company," “AeroGrow,” “we,” “our” or “us”) was formed as a Nevada corporation in March 2002. The Company’s principal business is developing, marketing, and distributing advanced indoor aeroponic garden systems designed and priced to appeal to the consumer gardening, cooking and small indoor appliance markets worldwide. The Company manufactures, distributes and markets nine different models of its AeroGarden systems in multiple colors, as well as over 40 varieties of seed pod kits and a full line of accessory products through multiple channels including retail distribution via brick and mortar, storefronts and online retail outlets, catalogue and direct-to-consumer sales primarily in the United States and Canada.

2. Liquidity and Basis of Presentation

Interim Financial Information

The unaudited interim financial statements of the Company included herein have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim reporting including the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. These condensed statements do not include all disclosures required by accounting principles generally accepted in the United States of America (“U.S. GAAP”) for annual audited financial statements and should be read in conjunction with the Company’s audited financial statements and related notes included in the Company’s Annual Report on Form 10-K for the year ended March 31, 2016, as filed with the SEC on June 15, 2016.

In the opinion of management, the accompanying unaudited interim financial statements reflect all adjustments, including normal recurring adjustments, necessary to present fairly the financial position of the Company at June 30, 2016, the results of operations for the three months ended June 30, 2016 and 2015, and the cash flows for the three months ended June 30, 2016 and 2015. The results of operations for the three months ended June 30, 2016 are not necessarily indicative of the expected results of operations for the full year or any future period. In this regard, the Company’s business is highly seasonal, with approximately 70.9% of revenues in the fiscal year ended March 31, 2016 (“Fiscal 2016”) occurring in the four consecutive calendar months from October through January. Furthermore, during the three-month period ended June 30, 2016, the Company has further expanded its distribution channel and invested in necessary overhead in anticipation of the peak sales season. The balance sheet as of March 31, 2016 is derived from the Company’s audited financial statements.

Sources of funding to meet prospective cash requirements include the Company’s existing cash balances, cash flow from operations, and borrowings under the Company’s debt arrangements. We may need to seek additional debt or equity capital; however, to provide a cash reserve against contingencies, address the seasonal nature of our working capital needs, and to enable us to invest further in trying to increase the scale of our business. There can be no assurance we will be able to raise this additional capital. See Note 9 for subsequent events.

Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. It is reasonably possible that a change in the Company's estimates could occur in the near term as additional or new information becomes available.

Net Income (Loss) per Share of Common Stock

The Company computes net income (loss) per share of common stock in accordance with Accounting Standards Codification ("ASC") 260. ASC 260 requires companies with complex capital structures to present basic and diluted earnings per share ("EPS"). Basic EPS is measured as the income or loss available to common stockholders divided by the weighted average shares of common stock outstanding for the period. Diluted EPS is similar to basic EPS, but presents the dilutive effect on a per share basis of common stock equivalents (e.g., convertible securities, options, and warrants) as if such securities had been converted into common stock at the beginning of the periods presented. Potential shares of common stock that have an anti-dilutive effect (i.e., those that increase income per share or decrease loss per share) are excluded from the calculation of diluted EPS. For the three months ended June 30, 2016 and 2015, the Company had 3.1 million (including preferred stock), and 3.1 million shares, respectively, of securities that could potentially dilute basic EPS in the future that were not included in the computation of diluted EPS because to do so would have been anti-dilutive for the periods presented.

As of June 30, 2016, stock options to purchase approximately 93,000 shares of common stock and warrants to purchase approximately 394,000 shares of common stock were outstanding, but were not included in the computation of diluted net income per share because the effect of including such shares would have been anti-dilutive in the periods presented.

Concentrations of Risk

ASC 825-10-50-20 requires disclosure of significant concentrations of credit risk regardless of the degree of such risk. Financial instruments with significant credit risk include cash deposits. The amount on deposit with one financial institution exceeded the $250,000 federally insured limit as of June 30, 2016. However, management believes that the financial institution is financially sound and the risk of loss is minimal.

Customers:
For the three months ended June 30, 2016 and 2015, one customer, Amazon.com, represented 35.8% and 38.5%, respectively, of the Company's net revenue.

Suppliers:
For the three months ended June 30, 2016, the Company purchased inventories and other inventory-related items from one supplier totaling $300,000, representing 35.0% of cost of revenue. For the three months ended June 30, 2015, the Company purchased inventories and other inventory-related items from one supplier totaling $344,000, representing 31.5% of cost of revenue.

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

Accounts Receivable:
As of June 30, 2016, the Company had two customers, Amazon.com and QVC, that represented 42.9% and 21.8% of the Company's outstanding accounts receivable, respectively. As of March 31, 2016, the Company had two customers, Amazon.com and QVC, which represented 35.3% and 22.1%, respectively, of outstanding accounts receivable. The Company believes that all receivables from these customers are collectible.

Fair Value of Financial Instruments

The Company follows the guidance in ASC 820, Fair Value Measurements and Disclosures ("ASC 820"), as it relates to the fair value of its financial assets and liabilities. ASC 820 provides for a standard definition of fair value to be used in new and existing pronouncements. This guidance requires disclosure of fair value information about certain financial instruments (insurance contracts, real estate, goodwill and taxes are excluded) for which it is practicable to estimate such values, whether or not these instruments are included in the balance sheet at fair value. The fair values presented for certain financial instruments are estimates, which, in many cases, may differ significantly from the amounts that could be realized upon immediate liquidation.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e., exit price) in an orderly transaction between market participants. ASC 820 also provides a hierarchy for determining fair value, which emphasizes the use of observable market data whenever available. The three broad levels defined by the hierarchy are as follows, with the highest priority given to Level 1 as these are the most reliable, and the lowest priority given to Level 3.

Level 1 – Quoted prices in active markets for identical assets.

Level 2 – Quoted prices for similar assets in active markets, quoted prices for identical or similar assets in markets that are not active, or other inputs that are observable or can be corroborated by observable market data, including model-derived valuations.

Level 3 – Unobservable inputs that are supported by little or no market activity.

The carrying value of financial instruments including cash, receivables and accounts payable and accrued expenses, approximates their fair value at June 30, 2016 and March 31, 2016 due to the relatively short-term nature of these instruments.

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The Company has three liabilities for which the carrying value is determined by Level 3 inputs: (1) Notes payable – related party; (2) sale of intellectual property liability; and (3) derivative warrant liability. As discussed below in Notes 3 and 4, each of these liabilities was incurred in conjunction with the Company's strategic alliance with Scotts Miracle-Gro. As of June 30, 2016 and March 31, 2016, the fair value of the Company's note payable-related party and sale of the intellectual property liability were estimated using the discounted cash flow method, which is based on expected future cash flows, discounted to present value using a discount rate of 15%. The Company also issued a derivative warrant that entitles, but does not obligate, Scotts Miracle-Gro to purchase a number of shares of common stock that, on a fully diluted basis, would constitute 80% of the Company's outstanding capital stock. The Company accounts for the warrant as a liability and measures the value of the warrant using the Monte Carlo simulation model as of the end of each quarterly reporting period until the warrant is exercised or expires. As of June 30, 2016 and March 31, 2016, the fair value of the warrant was $1.1 million and $644,000, respectively. As of June 30, 2016, the Company did not have any financial assets or liabilities that were measured at fair value on a recurring basis subsequent to initial recognition, except for the derivative warrant liability. The table below summarizes the fair value and carry value of each Level 3 category liability:

	June 30, 2016 (in thousands)		March 31, 2016 (in thousands)	
	Fair Value	Carry Value	Fair Value	Carry Value
Liabilities				
Notes payable-related party	$-	$-	$1,277	$1,293
Derivative warrant liability	1,089	1,089	644	644
Sale of intellectual property liability	111	149	117	160
Total	$1,200	$1,238	$2,038	$2,097

Accounts Receivable and Allowance for Doubtful Accounts

The Company sells its products to retailers and directly to consumers. Consumer transactions are primarily paid by credit card. Retailer sales terms vary by customer, but generally range from net 30 days to net 60 days. Accounts receivable are reported at net realizable value and net of the allowance for doubtful accounts. The Company uses the allowance method to account for uncollectible accounts receivable. The Company's allowance estimate is based on a review of the current status of trade accounts receivable, which resulted in an allowance of $9,000 and $14,000 at June 30, 2016 and March 31, 2016, respectively.

Other Receivables

In conjunction with the Company's processing of credit card transactions for its direct-to-consumer sales activities and as security with respect to the Company's performance for credit card refunds and charge backs, the Company is required to maintain a cash reserve with Litle and Company, the Company's credit card processor. This reserve is equal to 5% of the credit card sales processed during the previous six months. As of June 30, 2016 and March 31, 2016, the balance in this reserve account was $148,000 and $232,000, respectively.

Advertising and Production Costs

The Company expenses all production costs related to advertising, including print, television, and radio advertisements when the advertisement has been broadcast or otherwise distributed. In contrast, the Company records media and marketing costs related to its direct-to-consumer advertisements, inclusive of postage and printing costs incurred in conjunction with mailings of direct-response catalogues, and related direct-response advertising costs, in accordance with ASC 340-20 Capitalized Advertising Costs. As prescribed by ASC 340-20-25, direct-to-consumer advertising costs incurred are 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 the Company has continued to expand its retail distribution channel, the Company has expanded its advertising to include online gateway and portal advertising, as well as placement in third party catalogues.

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Advertising expense for the three months ended June 30, 2016 and June 30, 2015, were as follows:

	Three Months Ended June 30, (in thousands)	
	2016	2015
Direct-to-consumer	$79	$137
Retail	195	-
Other	$8	$13
Total advertising expense	$282	$150

As of June 30, 2016 and March 31, 2016, the Company deferred $4,000 and $24,000, respectively, related to such media and advertising costs which include the catalogue cost described above. The costs are included in the prepaid expenses and other line of the balance sheet.

Inventory

Inventories are valued at the lower of cost, determined on the basis of standard costing, which approximates the first-in, first-out method, or net realizable value. When the Company is the manufacturer, raw materials, labor and manufacturing overhead are included in inventory costs. 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. A majority of the Company's products are manufactured overseas and are recorded at standard cost, which includes product costs for purchased and manufactured products, and freight and transportation costs for inbound freight from manufacturers.

	June 30, 2016 (in thousands)	March 31, 2016 (in thousands)
Finished goods	$ 1,920	$ 2,372
Raw materials	772	777
	$ 2,692	$ 3,149

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 June 30, 2016 and March 31, 2016, the Company had reserved $285,000 for inventory obsolescence. The inventory values are shown net of these reserves.

Revenue Recognition

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

The Company records estimated reductions to revenue for customer and distributor programs and incentive offerings, including promotions, rebates, and other volume-based incentives. Certain incentive programs require the Company to estimate the number of customers who will actually redeem the incentive based on historical industry experience. As of June 30, 2016 and March 31, 2016, the Company had accrued $89,000 and $151,000, respectively, as its estimate for the foregoing deductions and allowances. These expenses are included in the accrued expenses line of the balance sheets.

Warranty and Return Reserves

The Company records warranty liabilities at the time of sale for the estimated costs that may be incurred under its basic warranty program. The specific warranty terms and conditions vary depending upon the product sold, but generally include technical support, repair parts, and labor for periods up to one year. Factors that affect the Company's warranty liability include the number of installed units currently under warranty, historical and anticipated rates of warranty claims on those units, and cost per claim to satisfy the Company's warranty obligation. Based upon the foregoing, the Company has recorded a provision for potential future warranty costs of $112,000 and $117,000 as of June 30, 2016 and March 31, 2016, respectively.

The Company reserves for known and potential returns from customers and associated refunds or credits related to such returns based upon historical experience. In certain cases, retailer customers are provided a fixed allowance, usually in the 1% to 2% range, to cover returned goods and this allowance is deducted from payments made to us by such customers. As of June 30, 2016 and March 31, 2016, the Company has recorded a reserve for customer returns of $48,000 and $197,000, respectively.

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Recently Issued Accounting Pronouncements

In February 2016, the FASB issued Accounting Standards Update (“ASU”) 2016-02, “Leases.” The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The adoption of this ASU is expected to result in all operating leases being capitalized in the Company’s financial statements.

In November 2015, the FASB issued ASU 2015-17, “Balance Sheet Classification of Deferred Taxes,” which requires that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position to simplify the presentation of deferred income taxes. The standard is effective prospectively for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017, with early adoption permitted. The Company has early adopted this ASU and had no material impact on our financial statements.

In August 2015, the FASB issued ASU 2015-14 which updated (to defer the effective date by one year) previously issued ASU 2014-09, "Revenue from Contracts with Customers," which amended revenue recognition guidance to clarify the principles for recognizing revenue from contracts with customers. The guidance requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. The guidance also requires expanded disclosures relating to the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Additionally, qualitative and quantitative disclosures are required about customer contracts, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. This accounting guidance is effective for the Company beginning in the first quarter of fiscal year 2018 using one of two prescribed retrospective methods. Early adoption is not permitted. We have not yet selected a transition method, nor have we determined the effect of the standard on our ongoing financial reporting.

In July 2015, the FASB issued ASU 2015-11, “Simplifying the Measurement of Inventory.” Under this ASU, inventory will be measured at the “lower of cost and net realizable value” and options that currently exist for “market value” will be eliminated. The ASU defines net realizable value as the “estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation.” No other changes were made to the current guidance on inventory measurement. ASU 2015-11 is effective for i