

# GROWLIFE, INC.

## **FORM 10-Q** (Quarterly Report)

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Address	5400 CARILLON POINT KIRKLAND, WA, 98033
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Industry	Appliances, Tools & Housewares
Sector	Consumer Cyclical
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

**FORM 10-Q**

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-50385



**GrowLife, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**90-0821083**

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

**20301 Ventura Blvd., Suite 126, Woodland Hills, CA 91364**

(Address of principal executive offices and zip code)

**(800) 977-5255**

(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 to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Indicate by check mark 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

Smaller reporting company

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

As of November 14, 2013 there were 711,855,833 shares of the issuer's common stock, \$0.0001 par value per share, outstanding.

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## PART 1 - FINANCIAL INFORMATION

## ITEM 1. Financial Statements

GrowLife, Inc. and Subsidiaries (formerly Phototron Holdings, Inc.)  
Condensed Consolidated Balance Sheets

	September 30, 2013 <u>(Unaudited)</u>	December 31, 2012 <u></u>
<b>ASSETS</b>		
Current Assets		
Cash	\$ 190,686	\$ 36,602
Restricted cash	46,400	46,400
Accounts receivable, net	9,886	15,036
Inventory, net	879,322	357,976
Prepaid expenses	3,813	-
Other receivable	18,730	-
Deposits	64,965	15,990
Total current assets	<u>1,213,802</u>	<u>472,004</u>
Property and equipment, net	61,589	19,372
Intangibles, net	510,853	508,600
Goodwill	<u>1,294,998</u>	<u>279,515</u>
Total Assets	<u>\$ 3,081,242</u>	<u>\$ 1,279,491</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>		
Current liabilities		
Accounts payable	\$ 498,262	\$ 293,020
Accrued expenses	166,712	19,368
Credit line	26,177	-
Deferred revenue	18,644	33,638
Derivative liability	411,071	-
Notes payable and accrued interest	380,211	193,180
Total current liabilities	<u>1,501,077</u>	<u>539,206</u>
Long-term debt		
Senior secured convertible notes and accrued interest, net of discount	<u>1,309,010</u>	<u>1,077,640</u>
Total long-term debt	<u>1,309,010</u>	<u>1,077,640</u>
Total liabilities	<u>2,810,087</u>	<u>1,616,846</u>
Stockholders' Equity (Deficit)		
Preferred stock, \$0.0001 par value, 3,000,000 shares authorized, zero and 3,000,000 shares issued and outstanding, respectively	-	300
Common Stock, \$0.0001 par value, 1,000,000,000 shares authorized, 687,784,404 and 157,000,000 shares issued and outstanding, respectively	68,779	38,970
Additional Paid-in-Capital	7,827,582	2,643,941
Accumulated deficit	(7,625,206)	(3,020,566)
Total stockholders' equity (deficit)	<u>271,155</u>	<u>(337,355)</u>
Total liabilities and stockholders' equity (deficit)	<u>\$ 3,081,242</u>	<u>\$ 1,279,491</u>

See accompanying notes to these unaudited condensed consolidated financial statements.

(1) The December 31, 2012 capital accounts of the Company have been retroactively restated to reflect the equivalent number of common shares based on the exchange ratio of the merger transaction. See Note 2.

GrowLife, Inc. and Subsidiaries (formerly Phototron Holdings, Inc.)  
Condensed Consolidated Statements of Operations  
(Unaudited)

	For the Three-Month Periods Ended, September 30, 2013	For the Three-Month Periods Ended, September 30, 2012	For the Nine-Month Periods Ended, September 30, 2013	For the Nine-Month Periods Ended, September 30, 2012
Net revenue	\$ 1,313,399	\$ 475,870	\$ 2,939,026	\$ 776,125
Cost of Goods Sold	<u>1,051,776</u>	<u>316,190</u>	<u>2,249,442</u>	<u>516,286</u>
Gross Profit	261,623	159,680	689,584	259,839
General and administrative	902,813	428,926	2,331,554	953,010
Share-based compensation	<u>386,821</u>	<u>105,250</u>	<u>1,214,295</u>	<u>115,500</u>
Loss from operations	(1,028,011)	(374,496)	(2,856,265)	(808,671)
Other income (expense)				
Loss on extinguishment of debt	(750,000)	-	(752,750)	-
Change in fair value of derivative	67,130	473,152	(102,623)	97,153
Other income	35,865	-	35,998	-
Interest expense, net	<u>(129,697)</u>	<u>(69,957)</u>	<u>(929,002)</u>	<u>(138,189)</u>
Net income (loss)	<u>\$ (1,804,713)</u>	<u>\$ 28,699</u>	<u>\$ (4,604,642)</u>	<u>\$ (849,707)</u>
Net loss per share (basic and diluted)	<u>\$ (0.00)</u>	<u>\$ (0.00)</u>	<u>\$ (0.01)</u>	<u>\$ (0.00)</u>
Weighted average shares outstanding (basic and diluted)	<u>644,706,947</u>	<u>324,720,061</u>	<u>549,297,163</u>	<u>260,080,749</u>

See accompanying notes to these unaudited condensed consolidated financial statements.

<sup>(2)</sup> The capital accounts of the Company have been retroactively restated to reflect the equivalent number of common shares based on the exchange ratio of the merger transaction in determining the basic and diluted weighted average shares. See Note 2.

GrowLife, Inc. and Subsidiaries (formerly Phototron Holdings, Inc.)  
Condensed Consolidated Statements of Cash Flows  
(Unaudited)

	Nine Months ended September 30,	
	2013	2012
<b>Operating Activities</b>		
Net loss	\$ (4,604,642)	\$ (849,707)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	13,916	2,085
Increase in reserve for obsolete/impaired inventory	50,000	-
Fair value of warrants issued	250,000	-
Fair value of vested stock options and amortization	-	26,563
Amortization of intangible assets	87,747	-
Amortization of debt discount	809,874	58,388
Common stock issued for services rendered	1,214,295	115,500
Change in fair value of derivative liability	102,623	(97,153)
Loss on extinguishment of debt	752,750	-
Imputed interest on related party notes payable	-	6,336
Stock dividend issued to certain investors	-	(445,715)
Changes in assets and liabilities		
Accounts receivable	46,663	704
Inventory	176,897	(57,718)
Prepaid expenses	31,259	-
Other receivable	(18,730)	-
Deposits	(15,909)	(21,122)
Accounts payable	(128,423)	134,191
Accrued expenses	93,400	61,287
Accrued interest on convertible notes payable	116,327	79,987
Deferred revenue	(14,994)	-
<b>Net cash used in operating activities</b>	<b>(1,036,947)</b>	<b>(986,374)</b>
<b>Investing Activities</b>		
Cash paid to acquire Rocky Mountain Hydroponics	(550,000)	-
Cash paid to acquire Greners.com, Inc.	-	(250,000)
Cash acquired upon acquisition of Rocky Mountain Hydroponics	(1,398)	-
Cash acquired upon acquisition of Phototron Holdings, Inc.	-	9,825
Cash paid for store improvements	(5,500)	-
<b>Net cash used in investing activities</b>	<b>(556,898)</b>	<b>(240,175)</b>
<b>Financing Activities</b>		
Proceeds from the issuance of common stock	623,260	5,000
Proceeds from the issuance of 10% convertible note	156,000	-
Proceeds from the issuance of convertible notes	-	1,389,663
Proceeds from options exercised	9,000	-
Proceeds from notes payable	1,130,000	-
Proceeds from convertible notes payable, related party	-	413,680
Payments on notes payable and accrued interest	(196,508)	(193,000)
Payments on notes payable, related party	-	(65,947)
Proceeds from credit line	26,177	-
Advances from related party	-	(183,103)
<b>Net cash provided by financing activities</b>	<b>1,747,929</b>	<b>1,366,293</b>
<b>Net increase in cash</b>	<b>154,084</b>	<b>139,744</b>
Cash, beginning of period	36,602	24,437
<b>Cash, end of period</b>	<b>\$ 190,686</b>	<b>\$ 164,181</b>
<b>Supplemental disclosure of cash flow information</b>		
Cash paid for interest	\$ 4,865	\$ -

Cash paid for income taxes	\$ -	\$ -
<b>NON-CASH TRANSACTIONS</b>		
Common stock issued to acquire Rocky Mountain Hydroponics/Evergreen Garden Center	\$ 275,000	\$ -
12% Senior Secured Convertible Notes issued to acquire Rocky Mountain Hydroponics/Evergreen Garden Center	\$ 800,000	\$ -
6% Senior secured convertible notes converted into common stock, principal and interest	\$ 1,359,572	\$ -
7% Senior secured convertible notes converted into common stock, principal and interest	\$ 700,000	\$ -
Notes payable for Greners acquisition converted into common stock, principal and interest	\$ 156,000	\$ -
Common stock issued for cashless exercise of options	\$ 368	\$ -
Notes payable converted into 6% convertible notes payable	\$ -	\$ 1,917,790

See accompanying notes to these unaudited condensed consolidated financial statements.

**GROWLIFE, INC. AND SUBSIDIARIES (formerly Phototron Holdings, Inc.)**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**Nine-Months Ended September 30, 2013 (Unaudited)**

**NOTE 1 – DESCRIPTION OF BUSINESS AND ORGANIZATION**

GrowLife, Inc. (formerly Phototron Holdings, Inc.) (“GrowLife”, the “Company”, “we,” “us,” “our”, “our company”) is a holding company with multiple operating businesses that manufacture and supply branded equipment and expendables in the USA for urban gardening, inclusive of equipment and expendables for growing of medical marijuana. Wholly owned GrowLife companies include SGT, Growlife Hydroponics, Urban Garden, 58Hydro.com, Phototron, Rocky Mountain Hydroponics, Evergreen Garden Centers and Greners. In addition to promotion and sales of GrowLife owned brands, GrowLife companies distribute and sell over 3,000 products through on-line distribution channels, Greners.com and 58Hydro.com, our on-line superstores, and through retail sales in Company owned stores in California, Colorado, Maine, Massachusetts and New Hampshire. GrowLife’s website, www.cannabis.org is expected to provide GrowLife with another widely recognized and authoritative channel for branded product promotion and sales. GrowLife and its business units are organized and directed to operate strictly in accordance with all applicable state and federal laws.

GrowLife is actively engaged in improving and expanding its line of branded products through organic development, business alliances and acquisition. Consistent with this strategy, GrowLife has recently announced its commitment to collaboration in sales and marketing of a modularized line of turn-key grow containers under the brand “PharmPod” and is actively engaged in developing other business alliances and evaluating branded products for acquisition. GrowLife is also actively engaged in building upon its direct to customers sales business by expansion and promotion of Greners.com, StealthGrow.com, Phototron.com and other unique online channels of distribution. Finally, GrowLife is actively engaged in pursuing acquisitions that will allow its GrowLife Hydroponics retail sales division business to expand regionally in the United States.

On June 7, 2013, GH completed the purchase of all the ownership and membership interests (the “Subject Interest”) of Rocky Mountain Hydroponics, LLC., a Colorado limited liability company (“RMC”), Evergreen Garden Center, LLC, a Maine limited liability company (“EGC”) and Evergreen Garden Center, LLC, a Delaware limited liability company (“EGC II”)(collectively the “RMH Companies”). The effective date of the Stock Purchase Agreement was June 7, 2013 (“RMH/EGC Agreement”). The RMH/EGC Agreement included all of the assets and liabilities of the RMH Companies, and in specific, their four (4) retail hydroponics stores, which are located in Vail and Boulder, Colorado, Peabody, Massachusetts, and Portland, Maine. Per the terms of the RMH/EGC Agreement, GrowLife paid the former owners of the RMH Companies \$550,000 in cash, \$800,000 in 12% Secured Convertible Notes, and \$275,000 (7,857,141 shares at \$0.035/share) in shares of GrowLife’s common stock. Details are disclosed in “ **NOTE 6 – PURCHASE – ROCKY MOUNTAIN HYDROPONICS and EVERGREEN GARDEN CENTER**” .



## **NOTE 2 – SIGNIFICANT ACCOUNTING POLICIES**

### **Basis of Presentation**

The accompanying condensed consolidated financial statements include the accounts of the Company. Intercompany accounts and transactions have been eliminated. The preparation of these condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles (“GAAP”).

The condensed consolidated financial statements of the Company and the accompanying notes included in this Quarterly Report on Form 10-Q are unaudited. In the opinion of management, all adjustments necessary for a fair presentation of the Condensed Consolidated Financial Statements have been included. Such adjustments are of a normal, recurring nature. The Condensed Consolidated Financial Statements, and the accompanying notes, are prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) and do not contain certain information included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2013. Therefore, the interim Condensed Consolidated Financial Statements should be read in conjunction with that Annual Report on Form 10-K.

### **Going Concern**

The accompanying unaudited condensed consolidated financial statements have been prepared assuming that the Company will continue as a going concern. This basis of accounting contemplates the recovery of the Company’s assets and the satisfaction of its liabilities. For the nine months ended September 30, 2013, the Company incurred a net loss of \$4,604,642 and cash used in operations was \$1,036,947. The Company has experienced recurring operating losses and negative operating cash flows since inception, and has financed its working capital requirements during this period primarily through the recurring issuance of notes payable and advances from a related party. These facts indicate that there is substantial doubt of the Company’s continuation as a going concern.

Successful completion of the Company’s development programs and its transition to attaining profitable operations is dependent upon obtaining additional financing. The Company does not have sufficient resources to fund its operations for the next twelve months. Accordingly, the Company needs to raise additional funds in order to satisfy its future working capital requirements, which it may not achieve on commercially reasonable terms.

Continued negative cash flows and lack of liquidity create significant uncertainty about the Company’s ability to fully implement its operating plan, as a result of which the Company may have to reduce the scope of its planned operations. If cash resources are insufficient to satisfy the Company’s liquidity requirements, the Company would be required to scale back or discontinue its operations.

## **Reverse Merger Accounting**

The Merger was accounted for as a reverse-merger and recapitalization in accordance with GAAP. SGT was the acquirer for financial reporting purposes and the Company was the acquired company. Consequently, the assets and liabilities and the operations that are reflected in the historical financial statements prior to the Merger will be those of SGT and will be recorded at the historical cost basis of the Company. The consolidated financial statements after completion of the Merger include the assets and liabilities of the Company and SGT, historical operations of SGT and operations of the Company from the closing date of the Merger. Common stock and the corresponding capital amounts of the Company pre-merger have been retroactively restated as capital stock shares reflecting the exchange ratio in the Merger. In conjunction with the Merger, SGT received no cash and assumed no liabilities from the Company.

## **Use of Estimates**

In preparing these unaudited condensed interim consolidated financial statements in conformity with GAAP, management is required to make estimates and assumptions that may affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amount of revenues and expenses during the reporting periods. Actual results could differ from those estimates. Significant estimates and assumptions included in our consolidated financial statements relate to the valuation of long-lived assets, estimates of sales returns, inventory reserves and accruals for potential liabilities, and valuation assumptions related to equity instruments and share based payments.

## **Revenue**

Revenue is recognized on the sale of a product when the product is shipped, which is when the risk of loss transfers to our customers, and collection of the sale is reasonably assured. A product is not shipped without an order from the customer and the completion of credit acceptance procedures. The majority of our sales are cash or credit card; however, we occasionally extend terms to our customers. Accounts receivable are reviewed periodically for collectability.

## **Sales Returns**

We allow customers to return defective products when they meet certain established criteria as outlined in our sales terms and conditions. It is our practice to regularly review and revise, when deemed necessary, our estimates of sales returns, which are based primarily on actual historical return rates. We record estimated sales returns as reductions to sales, cost of sales, and accounts receivable and an increase to inventory. Returned products which are recorded as inventory are valued based upon the amount we expect to realize upon its subsequent disposition. As of September 30, 2013 and December 31, 2012, there was no reserve for sales returns, which are minimal based upon our historical experience.

## **Warranty Costs**

Estimated future warranty obligations related to certain products are provided by charges to operations in the period in which the related revenue is recognized. Estimates are based, in part, on historical experience. During the year ended December 31, 2012 we negotiated a \$46,000 credit with one of our vendors for future expected warranty repairs to defective units. This amount will be used to offset expected repairs in future periods. As of September 30, 2013, the Company had utilized the entire \$46,000 credit available as of December 31, 2012 and had concluded its business relationship with this particular vendor.

### **Shipping and Handling Fees and Cost**

For the nine months ended September 30, 2013 and 2012, shipping and handling fees billed to customers totaled \$186,887 and \$61,068, respectively, and were included in revenue. For the three months ended September 30, 2013 and 2012, shipping and handling fees billed to customers totaled \$50,058 and \$48,529, respectively, and were included in revenue.

For the nine months ended September 30, 2013 and 2012, shipping and handling costs of \$151,269 and \$82,818, respectively, were included in cost of goods sold. For the three months ended September 30, 2013 and 2012, shipping and handling costs of \$48,566 and \$53,662, respectively, were included in cost of goods sold.

### **Advertising Costs**

Advertising costs are expensed as incurred and are included in general and administrative expenses in the amount of \$190,847 and \$158,158, for the nine months ended September 30, 2013 and 2012, respectively. For the three months ended September 30, 2013 and 2012, advertising costs of \$66,378 and \$84,377, respectively, were included in general and administrative expenses.

### **Fair Value of Financial Instruments**

ASC Topic 820 defines fair value, establishes a framework for measuring fair value, establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosure requirements for fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

Level 1 - Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 - Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 - Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The carrying value of cash, accounts receivable, accounts payables, due to related party, notes payable, and convertible notes approximates their fair values due to their short-term maturities.

## Derivative financial instruments

The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. For derivative financial instruments that are accounted for as liabilities, the derivative instrument is initially recorded at its fair value and is then re-valued at each reporting date, with changes in the fair value reported in the consolidated statements of operations. For stock-based derivative financial instruments, the Company uses a weighted average Black-Scholes-Merton option pricing model to value the derivative instruments at inception and on subsequent valuation dates. The classification of derivative instruments, including whether such instruments should be recorded as liabilities or as equity, is evaluated at the end of each reporting period. Derivative instrument liabilities are classified in the balance sheet as current or non-current based on whether or not net-cash settlement of the derivative instrument could be required within 12 months of the balance sheet date.

During the nine months ended September 30, 2013, the Company issued warrants to Gemini Master Fund, LTD (“GMF”) (see “NOTE 18 – STOCKHOLDERS’ EQUITY/DEFICIT”) entitling GMF to purchase, at their discretion, 5,000,000 shares of the Company’s common stock. The warrants were issued on May 1, 2013 in connection with the \$280,000 OID Bridge Note that was also issued on May 1, 2013. The warrants have a five-year term with an original exercise price of \$0.05 per share. The warrants vest immediately and are exercisable in whole, or in part, at any time and from time to time on or after the issue date and on or before the termination date. Per the terms of the Common Stock Purchase Warrant (the “Warrant Agreement”) between the Company and GMF, the exercise price was reset on June 4, 2013 to \$0.035 per share due to the Company’s sale/issuance of shares at \$0.035 per share under its Subscription Agreement.

On June 30, 2013, the Company valued the warrants at \$250,000 using the Black-Scholes option pricing model using the following assumptions: (i) dividend yield of 0%; (ii) expected volatility of 240%; (iii) risk free rate of 0.04%, and (iv) an expected term of 5 years. The Company expensed the entire \$250,000 as a non-cash charge to “warrants issued expense” during the three month period ended June 30, 2013. Details are disclosed in “NOTE 18 – STOCKHOLDERS’ EQUITY/DEFICIT”.

On September 5, 2013, the exercise price was reset again to \$0.02156 per share as a result of the Company issuing shares of its common stock at said per share price in relation to a debt conversion related to the Company’s 7% Convertible Note (see “NOTE 16 – 7% CONVERTIBLE NOTE”). On September 30, 2013, the Company valued the warrants at \$312,500 using the Black-Scholes option pricing model using the following assumptions: (i) dividend yield of 0%; (ii) expected volatility of 230%; (iii) risk free rate of 0.02% and (iv) expected term of 4.5 years. The Company fully expensed the \$62,500 increase in the value of the warrants as a non-cash charge to “change in fair value of derivative” during the three month period ended September 30, 2013.

The Company has determined that the warrants are a derivative liability due to the “reset” clause associated with the exercise price. As a result, the Company recorded a \$312,500 “derivative liability” on its balance sheet as of September 30, 2013 in relation to these warrants. Details are disclosed in “Note 9 – DERIVATIVE LIABILITY”.

On August 29, 2013, the Company issued a 7% Convertible Note (the “7% Note”) to W-Net Fund I, L.P. (the “Holder”), a Delaware limited partnership, in exchange for the Revolving Promissory Note originally issued on June 7, 2013 by the Company to the Holder and amended on August 6, 2013 (the “Exchanged Note”) (see “NOTE 16 – 7% CONVERTIBLE NOTE”). Per the terms of the 7% Note, the Holder can, at its sole discretion, convert the outstanding and unpaid principal and interest into fully paid and nonassessable shares of the Company’s common stock. The conversion price for the period of time from the date of this 7% Note through and including September 30, 2014 is the lesser of (a) \$0.025 per share and (b) seventy percent (70%) of the average of the three (3) lowest daily volume weighted average closing prices occurring during the twenty (20) consecutive trading days immediately preceding the applicable conversion date on which the Holder elects to convert all or part of this 7% Note, subject to adjustment as provided in this 7% Note. The conversion price is \$0.025 per share for the period of October 1, 2014 through the maturity date of September 30, 2015, subject to adjustment as provided in this 7% Note.

On September 5, 2013, the Holder converted \$550,000 of principal into 25,510,204 shares of the Company’s common stock at a conversion price of \$0.02156 per share. On September 17, 2013, the Holder converted \$150,000 of principal into 6,957,328 shares of the Company’s common stock at a conversion price of \$0.02156 per share. As of September 30, 2013, there was \$50,000 of principal outstanding in relation to the 7% Note.

The Company has determined that the 7% Note is a derivative liability due to the “reset” clause associated with the conversion price. On August 29, 2013, the Company valued the derivative value of the 7% Note using the Black Scholes option pricing model (see “NOTE 9 – DERIVATIVE LIABILITY”) and determined the value of the derivative liability associated with the 7% Note to be \$640,074. The Company recorded the \$640,074 as a derivative liability as of August 29, 2013 and it also recorded a corresponding \$640,074 non-cash “loss on extinguishment of debt”.

On both September 5<sup>th</sup> and 17<sup>th</sup>, 2013, which were the above mentioned conversion dates, the Company revalued the derivative liability related to the \$700,000 that had been converted. The Company determined that the value of the derivative liability had decreased by \$185,529, which the Company recorded by decreasing the derivative liability associated with the 7% Note by \$185,529 while also recording a \$185,529 non-cash gain to “change in fair value of derivative”. Upon conversion of the \$700,000, in the aggregate, on September 5<sup>th</sup> and 17<sup>th</sup>, the Company reclassified the remaining \$411,874 of the derivative liability related to the \$700,000 converted as an increase to “additional paid-in capital”.

As of September 30, 2013, the Company had a total derivative liability of \$411,071, of which \$312,500 was in relation to the warrants and \$98,571 in relation to the 7% Note.

See “NOTE 9 – DERIVATIVE LIABILITY” for a more detailed analysis of the Company’s derivative liability.

### **Loss Per Share**

Basic loss per share is computed by dividing the net loss applicable to common stockholders by the weighted average number of shares of common stock outstanding during the year. Diluted loss per share is computed by dividing the net loss applicable to common stockholders by the weighted average number of common shares outstanding plus the number of additional common shares that would have been outstanding if all potentially dilutive common shares had been issued, using the treasury stock method. Potentially dilutive common shares were excluded from the diluted loss per share calculation because they were anti-dilutive.

As of September 30, 2013, there were 112,046,731 dilutive securities which are considered anti-dilutive and are not included in diluted loss per share. The following details the dilutive securities as of September 30, 2013:

Options	2,351,187
Warrants	5,000,000
6% senior secured convertible notes - principal & interest	78,554,181
12% senior secured convertible notes - principal & interest	23,718,103
7% convertible notes - principal & interest	2,423,260
	<u>112,046,731</u>

### **Stock Based Compensation**

We periodically issue stock options and warrants to employees and non-employees in non-capital raising transactions for services and for financing costs. We account for stock option and warrant grants issued and vesting to employees based on Financial Accounting Standards Board (FASB) ASC Topic 718, "Compensation – Stock Compensation", whereas the award is measured at its fair value at the date of grant and is amortized ratably over the vesting period. We account for stock option and warrant grants issued and vesting to non-employees in accordance with ASC Topic 505, "Equity", whereas the value of the stock compensation is based upon the measurement date as determined at either (a) the date at which a performance commitment is reached, or (b) at the date at which the necessary performance to earn the equity instruments is complete.

### **Inventories**

Inventories are recorded on a first in first out basis. Inventory consists of purchased finished goods and components held for resale. Inventory is valued at the lower of cost or market. The reserve for inventory was \$77,843 at September 30, 2013 and \$27,843 at December 31, 2012.

### **Property and Equipment**

Property and equipment are stated at cost. Assets acquired held under capital leases are initially recorded at the lower of the present value of the minimum lease payments discounted at the implicit interest rate (35% for assets currently held under capital lease) or the fair value of the asset. Major improvements and betterments are capitalized. Maintenance and repairs are expensed as incurred. Depreciation is computed using the straight-line method over an estimated useful life of five years. Assets acquired under capital lease are depreciated over the lesser of the useful life or the lease term. At the time of retirement or other disposition of property and equipment, the cost and accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in the consolidated statements of operations.

## Goodwill and Intangible Assets

The Company evaluates the carrying value of goodwill during the fourth quarter of each year and between annual evaluations if events occur or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying amount. Such circumstances could include, but are not limited to (1) a significant adverse change in legal factors or in business climate, (2) unanticipated competition, or (3) an adverse action or assessment by a regulator. When evaluating whether goodwill is impaired, the Company compares the fair value of the reporting unit to which the goodwill is assigned to the reporting unit's carrying amount, including goodwill. The fair value of the reporting unit is estimated using a combination of the income, or discounted cash flows, approach and the market approach, which utilizes comparable companies' data. If the carrying amount of a reporting unit exceeds its fair value, then the amount of the impairment loss must be measured. The impairment loss would be calculated by comparing the implied fair value of reporting unit goodwill to its carrying amount. In calculating the implied fair value of reporting unit goodwill, the fair value of the reporting unit is allocated to all of the other assets and liabilities of that unit based on their fair values. The excess of the fair value of a reporting unit over the amount assigned to its other assets and liabilities is the implied fair value of goodwill.

We make critical assumptions and estimates in completing impairment assessments of goodwill and other intangible assets. Our cash flow projections look several years into the future and include assumptions on variables such as future sales and operating margin growth rates, economic conditions, market competition, inflation and discount rates. A 10% decrease in the estimated discounted cash flows for the reporting units tested would result in an impairment that is not material to our results of operations. A 1.0 percentage point increase in the discount rate used would also result in an impairment that is not material to our results of operations.

We amortize the cost of other intangible assets over their estimated useful lives, which range up to ten years, unless such lives are deemed indefinite. Intangible assets with indefinite lives are tested in the third quarter of each fiscal year for impairment, or more often if indicators warrant.

We recorded \$87,747 and zero, of amortization charges related to other intangible assets for the nine months ending September 30, 2013 and September 2012, respectively.

## Recently Issued Accounting Pronouncements

### Adopted

Effective January 2012, the Company adopted ASU No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs (ASU 2011-04). ASU 2011-04 represents the converged guidance of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) on fair value measurement. A variety of measures are included in the update intended to either clarify existing fair value measurement requirements, change particular principles requirements for measuring fair value or for disclosing information about fair value measurements. For many of the requirements, the FASB does not intend to change the application of existing requirements under Accounting Standards Codification (ASC) Topic 820, Fair Value Measurements. ASU 2011-04 was effective for interim and annual periods beginning after December 15, 2011. The adoption of this update did not have a material impact on the consolidated financial statements.

In July, 2012, the FASB issued guidance on testing for indefinite-lived intangible assets for impairment. The new guidance allows an entity to simplify the testing for a drop in value of intangible assets such as trademarks, patents, and distribution rights. The amended standard reduces the cost of accounting for indefinite-lived intangible assets, especially in cases where the likelihood of impairment is low. The changes permit businesses and other organizations to first use subjective criteria to determine if an intangible asset has lost value. The amendments to U.S. GAAP will be effective for fiscal years starting after September 15, 2012. The adoption of this update did not have a material impact on the consolidated financial statements and related disclosures.

Effective January 2013, we adopted FASB ASU No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities (ASU 2011-11). The amendments in ASU 2011-11 require the disclosure of information on offsetting and related arrangements for financial and derivative instruments to enable users of its financial statements to understand the effect of those arrangements on its financial position. Amendments under ASU 2011-11 will be applied retrospectively for fiscal years, and interim periods within those years, beginning after January 1, 2013. The adoption of this update did not have a material impact on the consolidated financial statements.

Not Adopted

In April 2013, the FASB issued ASU No. 2013-07, Presentation of Financial Statements (Top 205): Liquidation Basis of Accounting. The objective of ASU No. 2013-07 is to clarify when an entity should apply the liquidation basis of accounting and to provide principles for the measurement of assets and liabilities under the liquidation basis of accounting, as well as any required disclosures. The amendments in this standard is effective prospectively for entities that determine liquidation is imminent during annual reporting periods beginning after December 15, 2013, and interim reporting periods therein. We are evaluating the effect, if any, adoption of ASU No. 2013-07 will have on our consolidated financial statements.

### **NOTE 3 – ACQUISITION - SGT**

On March 21, 2012, we entered into the Merger Agreement. The Closing of the transactions contemplated by the Merger Agreement occurred on April 5, 2012. At the Closing, (a) MergerCo was merged with and into SGT; (b) SGT became our wholly-owned subsidiary; and (c) all SGT shares of common stock were exchanged for shares of our common stock and shares of our Series A Preferred Stock. At the Closing, we issued to SGT's former stockholders, in exchange for the 200 shares of SGT's common stock outstanding immediately prior to the Merger, 157,000,000 shares of our common stock and 3,000,000 shares of Series A Preferred Stock.

Since after the Merger former holders of SGT's common stock owned in excess of 50% of our fully-diluted shares of common stock, and as a result of certain other factors, including that all members of our executive management are members of SGT's management, SGT is deemed to be the acquiring company and we are deemed to be the legal acquirer for accounting purposes, and the Merger was accounted for as a reverse merger and a recapitalization in accordance with GAAP. The accompanying consolidated financial statements of GrowLife and its subsidiaries reflect the historical activity of SGT, and the historical stockholders' equity of SGT has been retroactively restated for the equivalent number of shares received in the exchange after giving effect to the differences in par value offset to additional paid-in capital. In connection with the Merger Agreement, we are deemed to have issued an additional 152,343,383 shares of common stock to our stockholders existing prior to the Merger.



The Company has estimated that the fair value of the 152,343,383 common shares issued to our stockholders existing prior to the Merger to be \$300,000; the purchase price has been allocated to specific identifiable tangible and intangible assets at their fair value at the date of the purchase in accordance with Accounting Standards Codification 805, "Business Combinations", as follows:

Assets	\$ 248,494
Intangible assets	225,000
Goodwill	634,128
Total	<u>1,107,622</u>
Less fair value of liabilities assumed	<u>(807,622)</u>
Purchase price	<u>\$ 300,000</u>

The intangible assets relate to customer lists and will be amortized over their respective life of three years.

On December 31, 2012, we recorded an impairment of goodwill of \$634,128.

See "NOTE 6 – PURCHASE – ROCKY MOUNTAIN HYDROPONICS and EVERGREEN GARDEN CENTER" for unaudited pro-forma results of operations as if the acquisition had occurred at the beginning of the period for the nine months ended September 30, 2013 and 2012.

#### **NOTE 4 – ASSET PURCHASE – GREINERS.COM**

On July 23, 2012, we completed the purchase of substantially all of the assets of Greiners, related to the online retail business currently operated by Greiners, pursuant to the terms of an Asset Purchase Agreement. The Assets included equipment, finished goods, materials and supplies, contract rights, domain names and implemented and operational components of software. In addition, the Company assumed certain of Greiners' liabilities which included Greiners' liabilities and obligations under its contracts and all express and implied warranties related to any materials supplied by Greiners prior to the closing date.

In consideration for the assets of Greiners, the Company agreed to pay to Greiners an aggregate of \$450,000, of which \$250,000 was paid in cash on the closing date and the remaining portion of the purchase price was paid in the form of a Note issued by the Company to Greiners in the original principal amount of \$200,000.

The Company has estimated that the fair value of the assets purchased to be \$450,000; The purchase price has been allocated to specific identifiable tangible and intangible assets at their fair value at the date of the purchase in accordance with Accounting Standards Codification 805, "Business Combinations", as follows:

Assets	\$ 93,000
Intangible assets	233,500
Goodwill	123,500
Total	<u>450,000</u>
Less fair value of liabilities assumed	<u>—</u>
Purchase price	<u>\$ 450,000</u>

The intangible assets relate to customer lists and will be amortized over three years.

See “NOTE 6 – PURCHASE – ROCKY MOUNTAIN HYDROPONICS and EVERGREEN GARDEN CENTER” for unaudited pro-forma results of operations as if the acquisition had occurred at the beginning of the period for the nine months ended September 30, 2013 and 2012.

#### **NOTE 5 – PURCHASE – URBAN GARDEN**

On October 22, 2012, GH completed the purchase of all of the UG Shares from the UG Sellers. The effective date of the UG Agreement was October 24, 2012. The UG Agreement included all of the assets and liabilities of Urban Garden which includes the inventory of the store located at 22516 Ventura Blvd., Woodland Hills, CA 91364 and various other assets. GH also assumed the liabilities of Urban Garden which were valued at \$70,761. GrowLife CEO Sterling Scott personally guaranteed this liability. In consideration for the UG Shares, GrowLife agreed to pay to the Sellers an aggregate of 3,906,250 shares of the Company’s common stock valued at \$156,250.

The Company has estimated that the fair value of the assets purchased to be \$227,011. The purchase price has been allocated to specific identifiable tangible and intangible assets at their fair value at the date of the purchase in accordance with Accounting Standards Codification 805, “Business Combinations”, as follows:

Inventory	\$ 35,000
Intangible assets	60,000
Goodwill	132,011
Total	<u>227,011</u>
Less fair value of liabilities assumed	<u>(70,761)</u>
Purchase price	<u>\$ 156,250</u>

The intangible assets relate to customer lists and trade names will be amortized over their respective life of five years.

See “NOTE 6 – PURCHASE – ROCKY MOUNTAIN HYDROPONICS and EVERGREEN GARDEN CENTER” for unaudited pro-forma results of operations as if the acquisition had occurred at the beginning of the period for the nine months ended September 30, 2013 and 2012.

#### **NOTE 6 – PURCHASE – ROCKY MOUNTAIN HYDROPONICS and EVERGREEN GARDEN CENTER**

On June 7, 2013, GH completed the purchase of Rocky Mountain Hydroponics, LLC., a Colorado limited liability company (“RMC”), and Evergreen Garden Center, LLC, a Maine limited liability company (“EGC”). The effective date of the RMH/EGC Agreement was June 7, 2013. The RMH/EGC Agreement included all of the assets and liabilities of the RMH Companies, and in specific, their 4 retail hydroponics stores, which are located in Vail and Boulder, Colorado, Peabody, Massachusetts, and Portland, Maine. Per the terms of the RMH/EGC Agreement, GrowLife, Inc. paid the former owners of the RMH Companies \$550,000 in cash, \$800,000 in 12% Secured Convertible Notes, and \$275,000 (7,857,141 shares at \$0.035/share) in shares of GrowLife, Inc.’s common stock.

The Company has estimated that the fair value of the assets purchased to be \$2,012,614. The purchase price has been allocated to specific identifiable tangible and intangible assets at their fair value at the date of the purchase in accordance with Accounting Standards Codification 805, "Business Combinations", as follows:

Assets	\$ 907,131
Intangible assets	90,000
Goodwill	1,015,483
Total	<u>2,012,614</u>
Less fair value of liabilities assumed	(387,614)
Purchase price	<u>\$ 1,625,000</u>

At the time of this filing the Company had retained the services of an independent third-party to perform a detailed valuation and purchase price allocation with regard to its purchase of RMH/EGC. Should the results of the third party evaluation differ from those above; the Company will make the necessary financial adjustments at that time.

The Company will expense the \$90,000 of intangible assets at the rate of \$1,500 per month over 5 years, with the Company recording \$4,500 of amortization expense related to these intangible assets during the three month period ended September 30, 2013. For the nine months ended September 30, 2013, the Company has expensed \$6,000 related to these intangible assets.

The following are unaudited pro-forma results of operations as if the acquisitions had occurred at the beginning of the period for the nine months ended September 30, 2013 and 2012. Note that these pro-forma results include the operating results of SGT, Phototron, Greners, Urban Garden, and Rocky Mountain Hydroponics/Evergreen Garden Center:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
Revenue	\$ 1,313,399	\$ 1,778,511	\$ 4,574,169	\$ 5,578,167
Cost of revenue	<u>1,051,776</u>	<u>1,272,599</u>	<u>3,376,555</u>	<u>3,914,892</u>
Gross profit	261,623	505,912	1,197,614	1,663,275
General and administrative expenses	902,813	790,750	2,808,211	2,645,211
Share-based compensation	<u>386,921</u>	<u>105,250</u>	<u>1,214,295</u>	<u>115,500</u>
Loss from operations	(1,028,011)	(390,088)	(2,824,892)	(1,097,436)
Other income	35,865	-	36,811	-
Interest expense, net	(129,697)	(69,957)	(929,002)	(257,237)
Loss on extinguishment of debt	(750,000)	-	(752,750)	-
Change in fair value of derivative	<u>67,130</u>	<u>473,152</u>	<u>(102,623)</u>	<u>97,153</u>
Net income (loss)	<u>\$ (1,804,713)</u>	<u>\$ 13,107</u>	<u>\$ (4,572,456)</u>	<u>\$ (1,257,520)</u>
Net loss per share (basic and diluted)	<u>\$ (0.00)</u>	<u>\$ 0.00</u>	<u>\$ (0.01)</u>	<u>\$ (0.00)</u>
Weighted average shares outstanding (basic and diluted)	<u>563,153,746</u>	<u>336,483,454</u>	<u>507,616,893</u>	<u>271,844,142</u>

## NOTE 7 – INVENTORIES

Inventories are comprised of the following as of:

	September 30, 2013	December 31, 2012
	(Unaudited)	
Raw materials	\$ 147,277	\$ 167,413
Finished goods	809,888	218,406
Less: inventory reserve	(77,843)	(27,843)
Inventory, net	<u>\$ 879,322</u>	<u>\$ 357,976</u>

During the three-month period ended September 30, 2013, the Company recorded a \$50,000 non-cash general and administrative expense related to inventory impairment. This charge relates to slow-moving and/or obsolete inventory at the Company's retail stores. The Company reviews its inventory on a periodic basis to identify products that are slow moving and/or obsolete, and if such products are identified, the Company records the appropriate inventory impairment charge at such time.

## NOTE 8 – PROPERTY AND EQUIPMENT

Property and equipment consists of the following as of:

	September 30, 2013	December 31, 2012
	(Unaudited)	
Machines and equipment	\$ 40,633	\$ 5,554
Furniture and fixtures	49,787	6,997
Computer equipment	52,304	10,920
Vehicles	22,539	-
Leasehold improvements	53,040	10,790
Total property and equipment	218,303	34,261
Accumulated depreciation	(156,714)	(14,889)
Total property and equipment, net	<u>\$ 61,589</u>	<u>\$ 19,372</u>

Depreciation expense for the nine months ended September 30, 2013 and 2012 was \$13,916 and \$2,085, respectively. Depreciation for the three months ended September 30, 2013 and 2012 was \$6,331 and \$2,085, respectively.

## NOTE 9 – DERIVATIVE LIABILITY

In April 2008, the FASB issued a pronouncement that provides guidance on determining what types of instruments or embedded features in an instrument held by a reporting entity can be considered indexed to its own stock for the purpose of evaluating the first criteria of the scope exception in the pronouncement on accounting for derivatives. This pronouncement was effective for financial statements issued for fiscal years beginning after December 15, 2008. The adoption of these requirements can affect the accounting for warrants and many convertible instruments with provisions that protect holders from a decline in the stock price (or “down-round” provisions). For example, warrants or conversion features with such provisions are no longer recorded in equity. Down-round provisions reduce the exercise price of a warrant or convertible instrument if a company either issues equity shares for a price that is lower than the exercise price of those instruments or issues new warrants or convertible instruments that have a lower exercise price.

During fiscal year 2012, which ended December 31, 2012, the Company issued the 6% Notes and the Company determined that the conversion feature in these 6% Notes created a derivative liability. The derivative liability was initially valued using the weighted-average Black-Scholes-Merton option pricing model, which approximates the Monte Carlo and other binomial valuation techniques, with the following assumptions; (i) dividend yield of 0%; (ii) expected volatility of 74%; (iii) risk free rate of 0.04% and (iv) expected term of 3.08 years. Based upon this model, the Company determined an initial value of \$592,326. On December 31, 2012, the Company determined there was no longer a derivative liability related to these 6% Notes and fully expensed the value of the initial derivative liability as of December 31, 2012.

During the three month period ended March 31, 2013, the Company issued a 10% Convertible Note (see “NOTE 14 – 10% SENIOR CONVERTIBLE NOTE”) in the principal amount of \$156,000. As of March 31, 2013 the entire balance of the 10% Convertible Note had been converted into 6,270,413 shares of the Company’s common stock. The Company determined that the conversion feature was considered a beneficial conversion feature and determined its value on the date of conversion to be \$156,000. Accordingly, the beneficial conversion feature has been accounted for as a valuation discount to the 10% Convertible Note and was fully amortized as of March 31, 2013 via effective interest method, with the Company recording \$156,000 non-cash interest expense and \$2,750 non-cash loss on extinguishment of debt. The Company had no derivative liability with regard to this note as of March 31, 2013.

During the three month period ended March 31, 2013, the Company evaluated the conversion feature of the 10% Convertible Note and determined that there was a derivative liability. The derivative liability was initially valued using the Black-Scholes option pricing model, with the following assumptions; (i) dividend yield of 0%; (ii) expected volatility of 309%; (iii) risk free rate of 0.11% and (iv) expected term of 0.5 years. Based upon this model, the Company determined an initial value of \$158,745. The Company fully expensed as of March 31, 2013 as a \$169,753 non-cash charge to change in fair value of derivative liability. As of March 31, 2013, BME had converted all of the principal and accrued interest into 6,270,413 shares of the Company’s common stock. The Company determined there was no longer a derivative liability related to this 10% Convertible Note.

During the nine months ended September 30, 2013, the Company issued warrants to GMF (see “NOTE 18 – STOCKHOLDERS’ EQUITY/DEFICIT”) entitling GMF to purchase, at their discretion, 5,000,000 shares of the Company’s common stock. The warrants were issued on May 1, 2013 in connection with the \$280,000 OID Bridge Note that was also issued on May 1, 2013. The warrants have a five-year term with an original exercise price of \$0.05 per share. The warrants vest immediately and are exercisable in whole, or in part, at any time and from time to time on or after the issue date and on or before the termination date. Per the terms of the Common Stock Purchase Warrant (the “Warrant Agreement”) between the Company and GMF, the exercise price was reset on June 4, 2013 to \$0.035 per share due to the Company’s sale/issuance of shares at \$0.035 per share under its Subscription Agreement. On September 5, 2013, the exercise price was reset again to \$0.02156 per share as a result of the Company issuing shares of its common stock at said per share price in relation to a debt conversion related to the Company’s 7% Convertible Notes (see “NOTE 16 – 7% CONVERTIBLE NOTE”).

On June 30, 2013, the Company valued the warrants at \$250,000 using the Black-Scholes option pricing model using the following assumptions: (i) dividend yield of 0%; (ii) expected volatility of 240%; (iii) risk free rate of 0.04% and (iv) expected term of 5 years. The Company fully expensed the entire \$250,000 as a non-cash charge to “warrants issued expense” during the three month period ended June 30, 2013.

On September 30, 2013, the Company valued the warrants at \$312,500 using the Black-Scholes option pricing model using the following assumptions: (i) dividend yield of 0%; (ii) expected volatility of 230%; (iii) risk free rate of 0.02% and (iv) expected term of 4.5 years. The Company fully expensed the \$62,500 increase in the value of the warrants as a non-cash charge to “change in fair value of derivative”.

On August 29, 2013, the Company issued a 7% Convertible Note (the “7% Note”) to W-Net Fund I, L.P. (the “Holder”), a Delaware limited partnership, in exchange for the Revolving Promissory Note originally issued on June 7, 2013 by the Company to the Holder and amended on August 6, 2013 (the “Exchanged Note”) (see “NOTE 16 – 7% CONVERTIBLE NOTE”). Per the terms of the 7% Note, the Holder can, at its sole discretion, convert the outstanding and unpaid principal and interest into fully paid and nonassessable shares of the Company’s common stock. The conversion price for the period of time from the date of this 7% Note through and including September 30, 2014 is the lesser of (a) \$0.025 per share and (b) seventy percent (70%) of the average of the three (3) lowest daily volume weighted average closing prices occurring during the twenty (20) consecutive trading days immediately preceding the applicable conversion date on which the Holder elects to convert all or part of this 7% Note, subject to adjustment as provided in this 7% Note. The conversion price is \$0.025 per share for the period of October 1, 2014 through the maturity date of September 30, 2015, subject to adjustment as provided in this 7% Note.

On September 5, 2013, the Holder converted \$550,000 of principal into 25,510,204 shares of the Company’s common stock at a conversion price of \$0.02156 per share. On September 17, 2013, the Holder converted \$150,000 of principal into 6,957,328 shares of the Company’s common stock at a conversion price of \$0.02156 per share. As of September 30, 2013, there was \$50,000 of principal outstanding in relation to the 7% Note.

The Company has determined that the 7% Note is a derivative liability due to the “reset” clause associated with the conversion price. On August 29, 2013, which represents the date that the Revolving Promissory Note was exchanged for the 7% Convertible Note, the Company valued the derivative liability of the 7% Note using the Black Scholes option pricing model using the assumptions detailed below. Also, as a result of the above mentioned conversions, the Company has valued the derivative liability of the 7% Note in three portions:

	1st Conversion	2nd Conversion	Outstanding 09.05.13	Total
Original principal amount	\$ 550,000	\$ 150,000	\$ 50,000	\$ 750,000
Conversion Date	09.05.13	09.17.13		
Conversion price per share	\$ 0.02156	\$ 0.02156	\$ 0.02156	
Amount converted	\$ 550,000	\$ 150,000		\$ 700,000
Shares	25,510,204	6,957,328	2,319,109	
Stock price 08.29.13	\$ 0.04	\$ 0.04	\$ 0.04	
Volatility	21.0%	21.0%	21.0%	
Risk free rate	0.02%	0.02%	0.02%	
Per share derivative value	\$ 0.018	\$ 0.018	\$ 0.018	
Derivative value 08.29.13	<u>\$ 469,388</u>	<u>\$ 128,015</u>	<u>\$ 42,671</u>	<u>\$ 640,074</u>

Accordingly, on August 29, 2013, the Company recorded a derivative liability of \$640,074 in relation to the 7% Note while also recording a corresponding \$640,074 non-cash “loss on extinguishment of debt”. The Company also determined that the exchange of the Revolving Promissory Note for the 7% Convertible Note created a beneficial conversion feature, the value of which was determined to be \$109,926 (\$750,000 – \$640,074). Accordingly, the Company recorded a \$109,926 non-cash “loss on extinguishment of debt” and a corresponding \$109,926 increase to “additional paid-in capital”.

On both September 5<sup>th</sup> and 17<sup>th</sup>, 2013, the above mentioned dates of conversion, the Company revalued the converted portion of the derivative liability, which was originally valued at \$597,403 (\$469,388+\$128,015), using the Black-Scholes option pricing model and the assumptions detailed below:

	1st Conversion	2nd Conversion	Total
Original principal amount	\$ 550,000	\$ 150,000	\$ 700,000
Conversion Date	09.05.13	09.17.13	
Conversion price per share	\$ 0.02156	\$ 0.02156	
Amount converted	\$ 550,000	\$ 150,000	\$ 700,000
Shares	25,510,204	6,957,328	
Stock price on date of conversion	\$ 0.03000	\$ 0.05000	
Volatility	21.0%	21.0%	
Risk free rate	0.02%	0.02%	
Per share derivative value	\$ 0.0084	\$ 0.028	
Derivative value on conversion date	<u>\$ 214,286</u>	<u>\$ 197,588</u>	<u>\$ 411,874</u>

The resulting \$411,874 derivative value attributed to the \$700,000 of converted debt resulted in a \$185,529 reduction in the original \$597,403 value recorded on August 29, 2013. As a result, the Company recorded a \$185,529 reduction in the value of the derivative liability and a corresponding \$185,529 non-cash gain to “change in fair value of derivative” during the three months ending September 30, 2013. The remaining \$411,874 derivative liability (\$597,403 - \$185,529) related to the \$700,000 converted on September 5<sup>th</sup> and 17<sup>th</sup> 2013 was reclassified from a “derivative liability” to “additional paid-in capital” as of September 30, 2013.

On September 30, 2013, the Company revalued the derivative liability related to the \$50,000 of outstanding principal related to the 7% Note. The Company used the Black-Scholes option pricing model using the following assumptions: (i) dividend yield of 0%; (ii) expected volatility of 21%; (iii) risk free rate of 0.02% and (iv) expected term of 6 months. This resulted in a value of \$98,571 as of September 30, 2013, an increase of \$55,900 from the \$42,671 as of August 29, 2013. The Company fully expensed the \$55,900 as a non-cash charge to “change in fair value of derivative” during the three-month period ended September 30, 2013.

As of September 30, 2013, the Company had a total derivative liability of \$411,071, of which \$312,500 was in relation to the warrants and \$98,571 in relation to the 7% Note.

## NOTE 10 – NOTES PAYABLE AND ACCRUED INTEREST

As of December 31, 2012, the Company had \$193,180 of notes payable and accrued interest. During the nine month period ended September 30, 2013, the Company eliminated all of the \$193,180 of notes payable and accrued interest that it owed as of December 31, 2012. The details regarding the repayment of these notes payable during the nine months ended September 30, 2013 are as follows:

	Principal & Accrued Interest 12.31.12	YTD 2013 Accrued Interest	YTD 2013 Payments Made	Balance as of 09.30.13
Greners	\$ 153,250	\$ 2,750	\$ 156,000	\$ -
Brian Sagheb	24,287	578	24,865	-
W-Net Fund I, L.P. - Revolver	15,643	-	15,643	-
	<u>\$ 193,180</u>	<u>\$ 3,328</u>	<u>\$ 196,508</u>	<u>\$ -</u>

The \$156,000 paid to Greners represents payment in full of the note payable that the Company issued in July 2012 in relation to its acquisition of Greners.com (see “NOTE 4 – ASSET PURCHASE – GREINERS.COM”). The \$24,865 paid to Mr. Sagheb, a former Phototron officer, is payment in full for a loan that he made to the Company. The payment of \$15,643 to W-Net Fund I, LP represents payment of the outstanding principal on a \$150,000 revolving credit line. As stated above, as of September 30, 2013 the Company had repaid in full all amounts due related to the notes payable that were owed as of December 31, 2012.

On May 1, 2013, the Company entered into a Securities Purchase Agreement with a certain “accredited investor” (“Investor”), for the sale and purchase of a \$280,000 original issue discount secured 0% nonconvertible promissory note due October 31, 2013 (the “OID Note”). The OID Note is secured by obligations of the Company. The Company and each of its subsidiaries has granted and pledged to the OID Note Purchaser a continuing security interest in all personal property of the Company and its subsidiaries. Except for the original issue discount, the OID Note does not carry interest unless and until there is an Event of Default, in which case the outstanding balance would carry interest at 18% per annum. The Company can prepay the OID Note, in whole or in part, at any time without penalty.

At closing, the Company received gross proceeds of \$250,000 for such private placement, with the remaining \$30,000 retained by the OID Note Purchaser as prepaid interest. The Company recorded the \$30,000 as prepaid interest and subsequently expensed \$10,000 of it during the three month period ended June 30, 2013. As of June 30, 2013, the Company had recorded \$20,000 of prepaid interest that will be expensed at the rate of \$5,000 per month for the months of July through October 2013.

As of September 30, 2013, the Company had a balance owed of \$280,000 with regard to this OID Note.

During the nine months ended September 30, 2013, the Company was advanced, in the aggregate, \$850,000 on its revolving promissory note (see “NOTE 11 – REVOLVING PROMISSORY NOTE”). On August 29, 2013, \$750,000 was converted into a 7% Convertible Note (see “NOTE 16 – 7% CONVERTIBLE NOTE”), leaving an outstanding principal balance of \$100,000 as of September 30, 2013. Accrued and unpaid interest related to the \$100,000 principal totaled \$211 as of September 30, 2013, all of which was recorded as interest expense during the three months ended September 30, 2013. The following table summarizes notes payable and accrued interest as of September 30, 2013:



	Principal	Accrued Interest	Balance as of 09.30.13
Gemini OID Note	\$ 280,000	\$ -	\$ 280,000
W-Net Fund I, L.P. - Revolver	100,000	211	100,211
	<u>\$ 380,000</u>	<u>\$ 211</u>	<u>\$ 380,211</u>

#### **NOTE 11 – REVOLVING PROMISSORY NOTE**

On June 6, 2013 the Company issued a Revolving Promissory Note (the “Revolving Note”) in the amount of \$550,000 to W-Net Fund I, L.P. (the “Holder”). Per the terms of the Revolving Note, the Holder agrees to make advances to the Company from time to time during the 14 month Revolving Note term, at its sole discretion, in an aggregate principal amount at any one time outstanding which does not exceed \$550,000 (the “Revolving Credit Commitment”). During the term of the Revolving Note, the Company may use the Revolving Credit Commitment by borrowing, prepaying any advances under the Revolving Note in whole or in part, and re-borrowing, all in accordance with the terms and conditions of the Revolving Note.

As set forth in the terms of the Revolving Note, the term is for a period of fourteen months, with the expiration date being July 31, 2014. Interest accrues from the date of any advances on any principal amount withdrawn, and on accrued and unpaid interest thereon, at the rate of 7% per annum (calculated on the basis of a 365 day year for the actual number of days elapsed), compounded annually. The Company was also obligated to pay the Holder a \$5,000 transaction fee, which was deducted from the initial advance of funds and recorded as a general and administrative expense by the Company during the three month period ending June 30, 2013.

On August 6, 2013, the Company and W-Net amended the terms of the Revolving Note to increase the maximum amount of the advances that the Company could request under the Revolving Note from the original amount of \$550,000 to the revised amount of \$750,000. The Revolving Note was also amended to state that any additional requests for additional draws by the Company under the Revolving Note shall be at the sole discretion of W-Net. These were the only terms of the Revolving Note that were amended.

During the six months ending June 30, 2013, the Company had been advanced \$550,000 in principal, with the funds being used to purchase RMH/EGC (see “NOTE 6 – PURCHASE – ROCKY MOUNTAIN HYDROPONICS and EVERGREEN GARDEN CENTER”).

Between August 1 and August 29, 2013, the Company was advanced an additional \$200,000, which resulted in total outstanding advances in the amount of \$750,000, which was the revised maximum amount of advances permissible to the Company.

On August 29, 2013, the \$750,000 outstanding balance and accrued and unpaid interest on the Revolving Note was exchanged for a 7% convertible note (see “NOTE 16 – 7% CONVERTIBLE NOTE”), which reduced to zero the amount of advances on the Revolving Note.

On September 20, 2013, the Company was advanced \$100,000 on the Revolving Note.

During the three month period ended September 30, 2013, the Company recorded \$6,986 of interest expense related to the Revolving Note. For the nine months ending September 30, 2013, interest expense totaling \$9,201 was recorded by the Company in relation to this note. As of September 30, 2013, total principal and interest owed on the Revolving Note was \$100,211 and is recorded on the Company's balance sheet as "notes payable and accrued interest" as of September 30, 2013 (see "NOTE 10 – NOTES PAYABLE AND ACCRUED INTEREST").

#### **NOTE 12 – NOTES PAYABLE, RELATED PARTY**

On March 14, 2013, an employee of the Company loaned us \$25,000 via a note payable. Per the terms of the note, the principal accrues interest at the rate of 6% per year with a term of 90 days. The note does not require any principal and/or interest payments during the 90-day term, but the Company can make, at its sole discretion, principal and/or interest payments in any amount it chooses during the 90 day term. At the conclusion of the note's 90-day term the Company is required to pay, in full, any and all unpaid principal and/or interest.

On June 26, 2013, the Company signed a revised agreement with this related party that extends the term through September 30, 2013. All of the other terms and conditions remained unchanged from the original agreement.

On March 20, 2013, the same employee of the Company who loaned us \$25,000 via a note payable purchased 2,000,000 shares of the Company's common stock at a price of \$0.035 per share. The aggregate proceeds to the Company were \$70,000. The shares were purchased as part of the Company's Subscription Agreement dated December 2011.

On September 6, 2013, the Company issued 1,224,918 shares of its common stock at a per share price of \$0.021 as payment in full of the \$25,000 principal and \$723 of accrued and unpaid interest. As of September 30, 2013, this related party had voluntarily terminated his employment with the Company to pursue other business opportunities and the Company had satisfied this obligation in full.

During the nine month period ending September 30, 2013, the Company had recorded \$723 of interest expense related to this note, of which \$279 was recorded as interest expense during the three months ending September 30, 2013.

#### **NOTE 13 – 6% SENIOR CONVERTIBLE NOTES**

On September 28, 2012, the Company entered into an amendment and exchange agreement ("Exchange Agreement") with W-Net, Europa International, Inc., Sterling Scott, Robert Shapiro, Lauri Bilawa, Carla Badaracco and Forglen, LLC (the "Investors"). The Exchange Agreement provided for the issuance of new 6% Senior Convertible Notes (the "6% Notes") that replaced the 6% Senior Convertible Notes that were previously issued during 2012. The 6% Notes accrue interest at the rate of 6% per annum and have a maturity date of April 15, 2015. No cash payments are required; however, accrued interest shall be due at maturity. In the event of a default the Investors may declare the entire principal and accrued interest to be due and payable. Default interest will accrue at the rate of 12% per annum. The 6% Notes are secured by substantially all of the assets of the Company.

The 6% Notes are convertible into common stock at the rate of \$0.007 per share. The Company has determined that the conversion feature is considered a beneficial conversion feature and determined its value to be \$785,459 as of December 31, 2012, which the Company recorded as a debt discount to the 6% Notes. As of December 31, 2012 the Company owed principal of \$1,795,077 and accrued interest of \$68,022 on these 6% Notes.

During the nine months ended September 30, 2013, the Company did not borrow any additional principal related to these notes. In fact, the Company's outstanding principal balance decreased by \$1,286,397 due to certain holders of these 6% Notes converting some, and in the case of five note holders, all of their outstanding principal into shares of the Company's common stock.

The following is a summary of the year-to-date 2013 transactions related to the Company's 6% Notes:

6% senior secured convertible notes - principal & accrued interest as of 12.31.12	\$ 1,863,099
Principal converted into common stock YTD 2013	(1,286,397)
Accrued interest converted into common stock YTD 2013	(73,175)
Accrued and unpaid interest YTD 2013	46,352
6% senior secured convertible notes - principal & accrued interest as of 09.30.13	<u>549,879</u>
Debt discount related to conversion feature as of 12.31.12	\$ (785,459)
Debt discount amortized as interest expense YTD 2013	653,873
Debt discount related to conversion feature as of 09.30.13	<u>(131,586)</u>
Balance as of September 30, 2013	<u>\$ 418,293</u>

As previously stated, the Company has determined that the conversion feature on the 6% Notes is a beneficial conversion feature, and the Company determined that the value of the beneficial conversion feature had decreased to \$446,421 as of March 31, 2013. Accordingly, the Company recorded non-cash interest expense of \$339,038 to reflect the change in the value of the debt discount as of March 31, 2013.

During the three month period ending June 30, 2013, the Company determined that the value of the beneficial conversion feature had decreased to \$203,968 as of June 30, 2013. As a result, the Company recorded non-cash interest expense of \$242,453 to reflect the change in the value of the debt discount as of June 30, 2013.

During the three month period ending September 30, 2013, the Company determined that the value of the beneficial conversion feature had decreased to \$131,586 as of September 30, 2013. As a result, the Company recorded non-cash interest expense of \$72,382 during the three months ended September 30, 2013 to reflect the change in the value of the debt discount as of September 30, 2013.

#### **NOTE 14 – 10% SENIOR CONVERTIBLE NOTE**

On January 8, 2013, the Company issued a 10% convertible note (the “10% Convertible Note”) to Black Mountain Equities, Inc (“BME”). The rate of interest on the convertible note is 10%, and BME, at its sole discretion, can convert both the principal and accrued interest into shares of the Company’s common stock. The conversion price was the lesser of (a) \$0.04 per share or (b) 70% of the average of the 3 lowest daily volume weighted average closing prices occurring during the 20 consecutive trading days immediately preceding the applicable conversion date on which BME elects to convert all or part of the note.

During the three month period ended March 31, 2013, BME converted all of the principal and accrued interest into 6,270,413 shares of the Company’s common stock. The Company determined that the conversion feature was considered a beneficial conversion feature and determined its value on the date of conversion to be \$156,000. Accordingly, the beneficial conversion feature has been accounted for as a valuation discount to the 10% Convertible Note and was fully amortized as of March 31, 2013 via effective interest method, with the Company recording \$156,000 non-cash interest expense and \$2,750 non-cash loss on extinguishment of debt.

The 10% Convertible Note was issued to BME in conjunction with the Exchange Agreement entered into on January 8, 2013 by and among the Company and BME. Per the terms and conditions the Exchange Agreement, BME purchased the Company’s note payable to Greners (the “Greners Note”), which was originally issued in July 2012 to the former owners of Greners (see “NOTE 4 – ASSET PURCHASE – GREINERS.COM”), from Donna Klauenburch and Tao Klauenburch (the “Sellers”), general partners who formerly did business as Greners.com (collectively, “Greners”) and from whom the Company purchased Greners.

BME purchased the Greners Note from the Sellers for \$153,250, which represented the outstanding principal and accrued, and unpaid, interest owed at the time of BME’s purchase of the Greners Note on January 8, 2013. During the three month period ended March 31, 2013, BME converted all of the outstanding principal and interest related to the 10% Convertible Note into 6,270,413 shares of the Company’s common stock, which the Company valued at \$156,000. In effect, the Grener’s Note was replaced by the 10% Convertible Note, which resulted in the Company recording \$156,000 of non-cash interest expense and a \$2,750 non-cash loss on extinguishment of debt, which reflects the difference between the \$153,250 that BME paid the Sellers for the Grener’s Note and the \$156,000 value of the 6,270,413 shares of the Company’s common stock issued to BME upon conversion of the 10% Convertible Note.

As of September 30, 2013, this note and all related interest had been paid in full.

#### **NOTE 15 – 12% SENIOR SECURED CONVERTIBLE NOTE**

On June 7, 2013, in conjunction with its acquisition of Rocky Mountain Hydroponics and Evergreen Garden Center (“RMH/EGC”) (see “NOTE 6 – PURCHASE – ROCKY MOUNTAIN HYDROPONICS and EVERGREEN GARDEN CENTER”), the Company issued \$800,000 of 12% Senior Secured Convertible Notes (the “12% Convertible Notes”) to the former owners of RMH/EGC.

The 12% Convertible Notes have a 2 year term, with the expiration date being June 8, 2015. The 12% Convertible Notes are secured by substantially all of the Company's assets, which include the assets of all of the Company's subsidiaries. Interest accrues daily on the outstanding principal amount at an annual rate of 12 percent and begins accruing on the Original Issue Date (June 7, 2013). Interest is calculated on the basis of a 360-day year, consisting of 12 thirty (30) calendar day periods.

The holders of the 12% Convertible Notes can, at their sole discretion, convert any, or all, of the outstanding principal and accrued and unpaid interest into shares of the Company's common stock. The conversion price is set at \$0.035 per share, which is subject to adjustment in the event of any stock splits, stock dividends, and similar events. Per the terms of these 12% Convertible Notes, any conversion by the holders must be for at least an amount equal to the greater of (a) \$35,000 of the principal amount of these 12% Convertible Notes and any accrued but unpaid interest thereon, and (b) 5,000,000 shares of common stock (such number to be appropriately adjusted for any stock splits, stock dividends, and similar events).

In the event of a default by the Company, the outstanding principal amount of these 12% Convertible Notes, plus accrued but unpaid interest, liquidated damages, and other amounts owing in respect thereof through the date of acceleration, shall become, at the holder's sole discretion, immediately due and payable in cash. In addition, in the event of a default, the rate of interest will increase to 18% and will be calculated in the same manner described above.

During the three month period ended September 30, 2013, the Company recorded \$24,000 of interest expense in relation to these 12% Convertible Notes. During the nine month period ended September 30, 2013, the Company had recorded 30,134 of interest expense related to these notes. As of September 30, 2013, there had been no conversion by the Holders of these 12% Convertible Notes and the total outstanding principal and accrued and unpaid interest was \$830,134.

#### **NOTE 16 – 7% CONVERTIBLE NOTE**

On August 29, 2013, the Company issued a 7% Convertible Note (the "7% Note") to W-Net Fund I, L.P. (the "Holder"), a Delaware limited partnership, in exchange for the Revolving Promissory Note originally issued on June 7, 2013 by the Company to the Holder and amended on August 6, 2013 (the "Exchanged Note"). Per the terms of the 7% Note, the original principal balance is \$750,000 and is not secured by any collateral or any assets pledged to the Holder. The maturity date is September 30, 2015, and the annual rate of interest is seven percent (7%), which increases to twenty-four percent (24%) per annum, or the maximum rate permitted under any applicable law, in the event of default. Subject to certain limitations, the Holder can, at its sole discretion, convert the outstanding and unpaid principal and interest into fully paid and nonassessable shares of the Company's common stock. The conversion price for the period of time from the date of this 7% Note through and including September 30, 2014 is the lesser of (a) \$0.025 per share and (b) seventy percent (70%) of the average of the three (3) lowest daily volume weighted average closing prices occurring during the twenty (20) consecutive trading days immediately preceding the applicable conversion date on which the Holder elects to convert all or part of this 7% Note, subject to adjustment as provided in this 7% Note. The conversion price is \$0.025 per share for the period of October 1, 2014 through the maturity date of September 30, 2015, subject to adjustment as provided in this 7% Note. At any time after the 12-month period immediately following the date of this 7% Note, the Company has the option to pre-pay the entire outstanding principal amount of this 7% Note by paying to the Holder an amount equal to one hundred and fifty percent (150%) of the principal and interest then outstanding. The Company's obligations under this 7% Note will accelerate upon a bankruptcy event with respect to the Company or any subsidiary, any default in the Company's payment obligations under this 7% Note, the Company's failure to issue shares of its common stock in connection with a conversion of this 7% Note, the Company's or any subsidiary's breach of any provision of any agreement providing for indebtedness of the Company or such subsidiary in an amount exceeding \$100,000, the common stock of the Company being suspended or delisted from trading on the Over the Counter Bulletin Board (the "Primary Market") market and the OTCQB, the Company losing its status as "DTC Eligible" or the Company becoming late or delinquent in its filing requirements with the Securities and Exchange Commission. Upon any such acceleration of this 7% Note, the Company shall be obligated to pay an amount equal to the greater of (i) one hundred and twenty percent (120%) of the outstanding principal of this 7% Note (plus all accrued but unpaid interest) and (ii) the product of (a) the highest closing price for the Company's common stock for the five (5) days on which the Primary Market is open for business immediately preceding such acceleration and (b) a fraction, the numerator of which is the outstanding principal of this 7% Note, and the denominator of which is the applicable conversion price as of the date of determination.

On September 5, 2013, the Holder converted \$550,000 of principal into 25,510,204 shares of the Company's common stock at a per share conversion price of \$0.02156. On September 17, 2013, the Holder converted an additional \$150,000 of principal into 6,757,328 shares of the Company's common stock at a per share conversion price of \$0.02156. As of September 30, 2013, there was \$50,000 of principal outstanding in relation to this note.

On August 29, 2013, the date on which the Revolving Promissory Note was exchanged for the 7% Convertible Note, the Company recorded a \$750,000 non-cash "loss on extinguishment of debt" while also recording a corresponding \$640,074 "derivative liability" (see "NOTE 9 – DERIVATIVE LIABILITY") and a \$109,926 increase in "additional paid-in capital" as related to the beneficial conversion feature associated with this 7% Note.

During the three and nine month periods ending September 30, 2013, the Company recorded interest expense of \$1,592 in relation to this 7% Note. As of September 30, 2013, the outstanding principal and accrued and unpaid interest related to this 7% Note totaled \$60,583. Note that \$8,991 of the accrued and unpaid interest was originally related to the Revolving Promissory Note and was part of the debt exchange on August 29, 2013.

Due to the "reset" clause in this 7% Note relating to the conversion price, the Company has determined that the conversion feature is considered a beneficial conversion feature and thereby creates a derivative liability for the Company, which is detailed in "NOTE 9 – DERIVATIVE LIABILITY".

#### NOTE 17 – LONG-TERM CONVERTIBLE NOTES PAYABLE

The following table summarizes the Company's long-term convertible notes payable as of September 30, 2013:

	Principal	Accrued Interest	Debt Discount	Total as of 09.30.13
6% Senior secured convertible notes	\$ 508,680	\$ 41,199	\$ (131,586)	\$ 418,293
12% Senior secured convertible notes	800,000	30,134	-	830,134
7% Senior secured convertible note	50,000	10,583	-	60,583
	<u>\$ 1,358,680</u>	<u>\$ 81,916</u>	<u>\$ (131,586)</u>	<u>\$ 1,309,010</u>

#### NOTE 18 – STOCKHOLDERS' EQUITY/ DEFICIT

##### Common Stock

During the nine month period ended September 30, 2013, the Company issued 234,187,473 shares of its common stock related to the conversion of notes payable and convertible notes. The shares were valued at \$2,241,296 and consisted of both principal and unpaid and accrued interest

During the nine month period ended September 30, 2013, the Company issued 17,807,433 shares of its common stock for cash. The shares were sold at a price of \$0.035 per share and generated proceeds to the Company in the amount of \$623,260.

During the nine month period ended September 30, 2013, the Company issued 32,822,333 shares of its common stock for services rendered and wages to its employees. These shares were valued at \$1,173,747 and are detailed as follows:

<b>Shares for Services</b>	
Wages paid to Company employees	\$ 238,208
Consulting	566,333
Cannabis.org expenses	29,334
GrowLife Productions expenses	65,000
Public/Investor relations	221,700
Product/inventory acquired	18,172
Board Member compensation	35,000
	<u>\$ 1,173,747</u>

During the nine month period ended September 30, 2013, the Company issued 1,254,249 shares of its common stock as payment for the Company's June through November 2013 monthly rent for its office in Woodland Hills, California. These shares were valued at \$40,548 by the Company.

During the nine month period ended September 30, 2013, the Company issued 3,680,773 shares of its common stock in relation to the cashless exercise of stock options. These shares were valued at zero by the Company.

During the nine month period ended September 30, 2013, the Company issued 470,237 shares of its common stock in relation to the exercise of stock options by Eric Shevin, who joined the Company's Board of Directors in April 2013. These shares generated proceeds to the Company in the amount of \$9,000.

During the nine month period ended September 30, 2013, the Company issued 7,857,141 shares of its common stock in relation to its purchase of RMH/EGC (see "NOTE 6 – PURCHASE – ROCKY MOUNTAIN HYDROPONICS and EVERGREEN GARDEN CENTER"). These shares were valued at \$275,000 and were issued to the former owners of RMH/EGC .

#### **Preferred Stock**

On March 19, 2013, pursuant to the terms and conditions of the Merger Agreement, the Company cancelled all of the 3,000,000 shares of its Series A Preferred Stock that were issued and outstanding. Per the terms of the Merger Agreement, the Company was required to attain specified net revenue and gross profit milestones by May 1, 2013 in order for the shares to vest and be distributed to the former shareholders of SGT. On March 19, 2013, applicable parties agreed that the milestones would not be met so the Series A Preferred Stock was returned to the Company and subsequently cancelled

#### **Stock options**

On April 5, 2012, the date of the Merger, Phototron had certain stock options outstanding that had been granted to its employees, officers and directors. The terms of these stock options remained unchanged as a result of the Merger and are summarized below:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding December 31, 2011	30,861,087	\$ 0.07		
Granted	-	-		
Exercised	-	-		
Forfeited or expired	(18,009,900)	0.05		
Outstanding December 31, 2012	<u>12,851,187</u>	<u>\$ 0.10</u>	<u>8.46</u>	<u>-</u>
Forfeited or expired	<u>(10,500,000)</u>			
Vested or expected to vest at September 30, 2013	<u>2,351,187</u>	<u>\$ 0.02</u>	<u>7.61</u>	<u>-</u>

## Warrants

During the nine months ended September 30, 2013, the Company issued warrants to GMF entitling GMF to purchase, at their discretion, 5,000,000 shares of the Company's common stock. The warrants were issued on May 1, 2013 in connection with the \$280,000 OID Bridge Note that was also issued on May 1, 2013. The warrants have a five-year term with an original exercise price of \$0.05 per share. The warrants vest immediately and are exercisable in whole, or in part, at any time and from time to time on or after the issue date and on or before the termination date per the terms of the Common Stock Purchase Warrant (the "Warrant Agreement") between the Company and GMF. The exercise price was reset on June 4, 2013 to \$0.035 per share due to the Company's sale/issuance of shares at \$0.035 per share under its Subscription Agreement. On September 5, 2013, the exercise price was reset again to \$0.02156 per share as a result of the Company issuing shares of its common stock at said per share price in relation to a debt conversion related to the Company's 7% Convertible Notes (see "NOTE 16 – 7% CONVERTIBLE NOTE").

On June 30, 2013, the Company valued the warrants at \$250,000 using the Black-Scholes option pricing model using the following assumptions: (i) dividend yield of 0%; (ii) expected volatility of 240%; (iii) risk free rate of 0.04% and (iv) expected term of 5 years. The Company fully expensed the entire \$250,000 as a non-cash charge to "warrants issued expense" during the three month period ended June 30, 2013.

On September 30, 2013, the Company valued the warrants at \$312,500 using the Black-Scholes option pricing model using the following assumptions: (i) dividend yield of 0%; (ii) expected volatility of 230%; (iii) risk free rate of 0.02% and (iv) expected term of 4.5 years. The Company fully expensed the \$62,500 increase in the value of the warrants as a non-cash charge to "change in fair value of derivative liability" during the three month period ended September 30, 2013.



The table below summarizes the Company's warrant activity during the nine months ended September 30, 2013:

	Warrants	Weighted Average Exercise Price	Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding, December 31, 2012	-	\$ -	-	\$ -
Issued	5,000,000	\$ 0.02156	4.58	\$ 312,500
Outstanding, September 30, 2013	<u>5,000,000</u>	<u>\$ 0.02156</u>	<u>4.58</u>	<u>\$ 312,500</u>

#### NOTE 19 – SUBSEQUENT EVENTS

On October 11, 2013, the Company issued 7% Convertible Notes (the "7% Notes") to four (4) accredited investors (the "Holders") with the aggregate principal amount of \$850,000. The 7% Notes are not secured by any collateral or any assets pledged to the Holders. The maturity date is September 30, 2015, and the annual rate of interest is seven percent (7%), which increases to twenty-four percent (24%) per annum, or the maximum rate permitted under any applicable law, in the event of default. Subject to certain limitations, the Holders can, at their sole discretion, convert the outstanding and unpaid principal and interest into fully paid and nonassessable shares of the Company's common stock. The conversion price for the period of time from the date of these 7% Notes through and including September 30, 2014 is the lesser of (a) \$0.025 per share and (b) seventy percent (70%) of the average of the three (3) lowest daily volume weighted average closing prices occurring during the twenty (20) consecutive trading days immediately preceding the applicable conversion date on which the Holders elect to convert all or part of their 7% Notes, subject to adjustment as provided in these 7% Notes. The conversion price is \$0.025 per share for the period of October 1, 2014 through the maturity date of September 30, 2015, subject to adjustment as provided in these 7% Notes. The Company is required to reserve, at all times, thirty-four million (34,000,000) shares of its common stock, in the aggregate, for conversion of these 7% Notes. At any time after the 12-month period immediately following the date of these 7% Notes, the Company has the option to pre-pay the entire outstanding principal amount of these 7% Notes by paying to the Holders an amount equal to one hundred and fifty percent (150%) of the principal and interest then outstanding. The Company's obligations under these 7% Notes will accelerate upon a bankruptcy event with respect to the Company or any subsidiary, any default in the Company's payment obligations under these 7% Notes, the Company's failure to issue shares of its common stock in connection with a conversion of any of these 7% Notes, the Company's or any subsidiary's breach of any provision of any agreement providing for indebtedness of the Company or such subsidiary in an amount exceeding \$100,000, the common stock of the Company being suspended or delisted from trading on the Over the Counter Bulletin Board (the "Primary Market") market and the OTCQB, the Company losing its status as "DTC Eligible" or the Company becoming late or delinquent in its filing requirements with the Securities and Exchange Commission. Upon any such acceleration of these 7% Notes, the Company shall be obligated to pay an amount equal to the greater of (i) one hundred and twenty percent (120%) of the outstanding principal of these 7% Notes (plus all accrued but unpaid interest) and (ii) the product of (a) the highest closing price for the Company's common stock for the five (5) days on which the Primary Market is open for business immediately preceding such acceleration and (b) a fraction, the numerator of which is the outstanding principal of these 7% Notes, and the denominator of which is the applicable conversion price as of the date of determination.

On October 11, 2013, the Company and Gemini Master Fund (the “Holder”), signed a Conversion, Warrant Exercise and Note Retirement Agreement (the “Agreement”) whereby both the Company and the Holder agreed to convert the \$280,000 OID Note (the “Note”) entered into on May 1, 2013 by and between the Company and the Holder, into 8,000,000 shares of the Company’s common stock, which equates to \$0.035 per share. Per the terms of the Note, the Company was obligated to repay the entire \$280,000 on or before October 31, 2013. Per the terms of the Agreement, upon issuance of the 8,000,000 shares of the Company’s common stock to the Holder, the repayment of the Note has been satisfied in full.

On October 11, 2013, Gemini Master Fund (the “Holder”) exercised its cashless exercise option on the 5,000,000 warrants (see “NOTE –18 – STOCKHOLDERS’ EQUITY/DEFICIT”) whereby the Holder received 9,000,000 shares of the Company’s common stock.

On October 22, 2013, the Company issued 1,142,857 shares of its common stock at \$0.035 per share for cash proceeds of \$40,000. The shares were issued to an accredited investor who also owns Grass Roots Research and Distribution, Inc. (“GRRD”), which is a paid consultant of the Company. GRRD provides the Company market research, assistance in drafting research reports related to the Company, and posting said research reports on GRRD’s website. This same individual purchased an additional 428,572 shares of the Company’s common for cash proceeds of \$15,000 on November 6, 2013. Both stock purchases were part of the Company’s Subscription Agreement dated December 2011.

On October 25, 2013, the Company issued 7,000,000 shares of its common stock, in the aggregate, to 4 accredited individuals for cash proceeds of \$245,000. These stock purchases were part of the Company’s Subscription Agreement dated December 2011 and were issued at \$0.035 per share.

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

*This discussion summarizes the significant factors affecting our operating results, financial condition and liquidity and cash flows for the months ended September 30, 2013 and 2012. The discussion and analysis that follows should be read together with the condensed consolidated financial statements and the notes to the financial statements included elsewhere in this report. Except for historical information, the matters discussed in this Management's Discussion and Analysis of Financial Condition and Results of Operations are forward looking statements that involve risks and uncertainties and are based upon judgments concerning various factors that are beyond our control. Our actual results could differ materially from the results anticipated in any forward-looking statements as a result of a variety of factors, including those discussed in the section of our Annual Report on Form 10-K for the year ended December 31, 2012 filed with the Securities and Exchange Commission on April 1, 2013, captioned "Risk Factors."*

### **Overview**

#### *General*

GrowLife companies manufacture and supply branded equipment and expendables that promote and enhance the experience and the quality of indoor and outdoor urban gardening. In addition to manufacturing and marketing proprietary GrowLife owned brands such as Stealth Grow and Phototron , GrowLife companies are active from coast to coast in the United States in specialty market retail from store locations and through our ownership of prominent on-line retailers Greeners.com, 58Hydro.com and StealthGrow.com GrowLife also controls the premier industry portal [www.cannabis.org](http://www.cannabis.org) , which we believe will serve as another widely recognized and authoritative social channel for branded product promotion, sales and information as and to the extent the regulatory landscape changes. To complement brand awareness and to drive product sales during 2013, GrowLife also launched company business units that are active in industry events, media and consulting services for the urban gardening industry.

GrowLife's focus on the urban gardening industry in the United States is limited to strictly legal products. Our business units are organized and operated in accordance with applicable state and federal laws. Accordingly, if and to the extent that state and federal laws permit the nationwide legal use of marijuana and/or medical marijuana, we expect to commercialize our products in that market.

Year-to-date 2013 revenue from net sales increased to \$2,939,026 from the \$776,125 recorded in the comparable period in 2012. For the quarter ended September 30, 2013, revenue was \$1,313,399, an increase of \$837,529, or 176 %, over the \$475,870 for the same period in 2012. We believe that our significant revenue growth is a result of (1) our strategic acquisitions, (2) product expansion, and (3) business alliances.

Expansion and growth remain driving themes for GrowLife in 2013. GrowLife is actively engaged in building and integrating its national sales channels both brick and mortar stores and on-line stores. Our GrowLife Hydroponics business unit currently includes store locations in California, Colorado, Massachusetts, Maine and New Hampshire. The store locations are expected to help the Company actively expand its retail sales operations and build upon its direct-to-customers sales business by expansion and promotion of products to a wider consumer market. While we expect to maintain a high ratio of success from our new initiatives, from time to time GrowLife will determine to discontinue some initiatives in favor of cost containment and intense focus by the Company on its more profitable business opportunities. As a result of technical uncertainties and costs, GrowLife has decided, for the present, to discontinue efforts to complete, and pursue market traction with, its SG Sensors initiative. GrowLife remains actively engaged in exploring strategic acquisitions that will enhance the profitable expansion of the Company in the United States.

Through its wholly owned subsidiaries and divisions, GrowLife is positioning for rapid expansion of the scope of its business operations in the event of a substantive relaxation of state and federal laws related to cultivation, distribution and sale of cannabis related products, including industrial hemp. The pace of regulatory reform on a state and federal level from a prohibition stance to a tax and regulate approach, which are inherently uncertain future events, will largely determine the pace and the precise scope of expansion for GrowLife divisions and subsidiaries into portions of the business of cannabis in the United States in which GrowLife does not currently participate.

*Principal Channels:*

GROWLIFE HYDROPONICS owns and operates specialty hydroponics stores in California, Colorado, Massachusetts, Maine and New Hampshire. Our stores strive to provide realistic, hands on product demonstrations of core technology in a one-stop shopping environment with well-informed full service sales and technical staff.

GRENERS.COM, 58HYDRO.COM and STEALTHGROW.COM are GrowLife owned and operated on-line suppliers of a full range of hydroponic equipment for shipment worldwide. All of our on-line sales channels take pride in a commitment to service, sales and next day delivery of GrowLife company brands along with over 3,000 products SKU's sourced from all over the world, in most cases uniquely for the requirements of our specialty market.

CANNABIS.ORG is an information portal for the medical marijuana industry that is in development by GrowLife with the objective of establishing the premier informational portal for the industry worldwide that, in the event of regulatory change, can also be a major revenue driver for expansion of GrowLife brands and a platform for establishing additional partnering and revenue share relationships and direct revenue generation through a myriad of ad revenue opportunities.

*Other:*

GROWLIFE PRODUCTIONS is a wholly owned business unit dedicated to the promotion of GrowLife's core brands through co-production and co-sponsorship of entertainment, lifestyle, music, and film events across the country. GrowLife Productions aims to foster a growing community around GrowLife brands.

## Results of Operations

### Three and Nine Months Ended September 30, 2013 Compared to September 30, 2012

#### *Revenue and cost of revenue*

For the three months ended September 30 2013, our revenue was \$1,313,399, which represents an increase of \$837,529 as compared to the \$475,870 for the same three-month period in 2012. This increase was mainly due to the successful implementation of our acquisition program, which included the June 7, 2013 acquisition of RMH/EGC (see “NOTE 6 – PURCHASE – ROCKY MOUNTAIN HYDROPONICS and EVERGREEN GARDEN CENTER”).

For the nine months ended September 30 2013, our revenue was \$2,939,026 as compared to \$776,125 for the same period in fiscal year 2012. As previously stated, the increase in revenue is primarily due to the Company’s acquisition strategy, as the 2013 results include revenue from Urban Garden Supply and RMH/EGC . Fiscal year 2012 results do not contain any revenue from these two business units, as they were each acquired after September 30, 2012.

Cost of revenue for the three month periods ended September 30, 2013 and 2012 was \$1,051,776 and \$316,190, respectively. For the nine months ended September 30, 2013, cost of revenue totaled \$2,249,442 while cost of revenue for the same nine-month period in 2012 totaled \$516,286. As previously stated, the fiscal year 2013 results include cost of revenue from Urban Garden Supply and RMH/EGC . Fiscal year 2012 results do not contain any cost of revenue from these two business units, as they were each acquired after September 30, 2012.

Gross profit for the three-month periods ending September 30, 2013 and 2012 was \$261,623 and \$159,680, respectively. Year-to-date 2013 gross profit was \$689,584 and the same period in 2012 recorded gross profit of 259,839.

#### *Expenses*

Total general and administrative expenses for the three months ended September 30, 2013 were \$1,289,634, an increase of \$755,458 from the \$534,176 incurred during the same three-month period in 2012. Non-cash general and administrative expenses for the three months ended September 30, 2013 totaled \$456,730, with \$280,000 related to common stock issued for consulting services, \$48,375 related to common stock issued to employees, \$31,749 related to the amortization of intangible assets, \$20,000 related to common stock issued as compensation to Board members, \$20,274 related to common stock issued as payment for rent, \$50,000 related to inventory impairment, and \$6,332 of depreciation expense. General and administrative expenses for the three and nine month periods ended September 30, 2013 include expenses to support both RMH/EGC and Urban Garden Supply, which were acquired after September 30, 2012 and therefore have no general and administrative expenses in the three and nine month periods ending September 30, 2012.

For the nine-month periods ending September 30, 2013 and 2012, general and administrative expenses were \$3,545,849 and \$1,068,510, respectively. Included in the \$3,545,849 of general and administrative expenses for the nine months ended September 30, 2013 was \$1,584,270 of non-cash expenses that consisted of \$882,367 related to common stock issued for consulting services, \$273,208 related to common stock issued to employees and Board members, \$250,000 related to warrant expense (see "NOTE 18 – STOCKHOLDERS' EQUITY/DEFICIT"), \$27,032 related to common stock issued as payment for rent, \$50,000 related to inventory impairment, \$87,747 related to the amortization of intangible assets, and \$13,916 of depreciation expense. The general and administrative expenses for year-to-date 2013 include expenses to support both RMH/EGC and Urban Garden Supply, which have no corresponding expense in the same nine-month period in fiscal year 2012 because both entities were acquired after September 30, 2012.

*The following is a brief analysis of select general and administrative expenses:*

Consulting expenses totaled \$380,667 during the three-month period ended September 30, 2013. This consisted primarily of \$280,000 in non-cash expense paid to third-party firms by the issuance of 7,000,000 shares of the Company's common stock. These firms were retained by the Company to assist in fundraising endeavors while also assisting in promoting the GrowLife name/brand. For the nine months ended September 30, 2013, consulting expenses totaled \$875,316, of which \$718,000 were for the previously mentioned third-party consulting firms, \$17,000 were for consulting services relating to StealthGrow, and \$88,499 was for consultants working for RMH/EGC .

Accounting, tax preparation, and audit fees during the three months ended September 30, 2013 were \$63,950, which consisted of \$32,190 to our independent outside auditors, \$13,200 for tax preparation, and \$18,560 to other third-party consultants. For the nine months ended September 30, 2013, accounting, tax preparation, and audit fees were \$223,335, which consisted primarily of \$83,906 to our independent outside auditors, \$13,200 for tax preparation, and \$101,893 to other third-party consultants. One of these third party consultants, whose contract with the Company was terminated as of June 30, 2013, was paid \$30,000 in cash and \$53,333 by the issuance of 5,333,334 shares of the Company's common stock during the six months ended June 30, 2013.

Advertising expense during the three months ended September 30, 2013 was \$66,378, with year-to-date 2013 advertising expense totaling \$190,847. The Company recorded year-to-date 2013 advertising expense of \$101,264 for Phototron, \$56,387 for Greners, and \$33,196 to promote the GrowLife name/brand and its retail stores.

Rents, repairs, and security totaled \$261,851 during the nine months ended September 30, 2013. For the nine month period ending September 30, 2013, the Company incurred rents, repairs, and security totaling \$142,060 in relation to Urban Garden Supply and RMH/EGC . There were no such expenses incurred during the same nine-month period in fiscal year 2012, as these entities had not been acquired as of September 30, 2012.

During the nine months ended September 30, 2013, the Company incurred expenses of \$230,734 in relation to new business development. This consisted of \$98,258 for the Company's Cannabis.org website/joint venture, \$92,976 in relation to GrowLife Productions, Inc., \$15,000 in relation to the STVB joint venture, and \$24,500 relating to other potential joint ventures. No such expenses were recorded in the same nine-month period of fiscal year 2012. Of the \$230,734 expense recorded for new business development, \$71,000 was non-cash and was paid by the issuance of 1,762,300 shares of the Company's common stock.

The Company recorded investor relations/public relations expense of \$403,473 during the nine months ending September 30, 2013. Of this, \$301,700 was non-cash and was paid via the issuance of 7,620,000 shares of the Company's common stock. For the three-month period ended September 30, 2013, investor relations/public relations expense was \$304,547, of which \$280,000 was non-cash as previously mentioned. As a publicly traded company, the Company frequently issues press releases and other promotional information, all of which comes at a cost to the Company. These press releases and other promotional materials are considered necessary by the Company as a way to keep the investment community apprised of both the Company's operations and strategic vision.

Legal expenses totaled \$56,411 during the nine months ended September 30, 2013 and \$11,731 for the three months ended September 30, 2013. Being a publicly traded company requires filings with the Securities and Exchange Commission ("SEC"), which often requires the Company to retain independent outside legal counsel to review these, and other, critical filings and documents.

Website production relating to the Company's Phototron business was \$36,313 during the nine months ended September 30, 2013. The website is substantially all new in terms of graphics/design and has a significantly improved, and more efficient, online ordering system.

During the nine-month period ended September 30, 2013, the Company recorded \$45,000 in compensation to members of its Board of Directors, all of which was non-cash and paid via the issuance of shares of the Company's common stock.

During the nine-month period ended September 30, 2013, the Company recorded \$250,000 in non-cash expense related to warrants issued (see "NOTE 18 – STOCKHOLDERS' EQUITY/DEFICIT"). The Company also recorded \$87,747 of amortization expense related to its intangible assets, of which \$37,149 was recorded in the three-month period ended September 30, 2013.

During the three-month period ended September 30, 2013, the Company recorded a \$50,000 non-cash general and administrative expense related to inventory impairment. This charge relates to slow-moving and/or obsolete inventory at the Company's retail stores. The Company reviews its inventory on a periodic basis to identify products that are slow moving and/or obsolete, and if such products are identified, the Company records the appropriate inventory impairment charge at such time.

#### *Other Expenses*

During the quarter ended September 30, 2013, the Company incurred net other expenses totaling \$776,702 versus net other income of \$403,195 during the same period in fiscal year 2012. Included in the \$776,702 for the quarter ending September 30, 2013 was \$750,000 of non-cash expense related to the extinguishment of debt relating to the exchange of the Company's Revolving Promissory Note for the 7% Convertible Note (see "NOTE 16 – 7% CONVERTIBLE NOTE") and \$129,697 of interest expense. These expenses were partially offset by a \$67,130 non-cash gain related to the fair value of the Company's derivative liabilities and \$35,865 of other income related to rent owed the Company by a subtenant at its Boulder, Colorado facility.

Other expenses for the nine months ending September 30, 2013 and 2012 were \$1,748,377 and \$41,036, respectively. The \$1,748,377 for the nine-month period ended September 30, 2013 consisted of \$752,750 in non-cash charges relating to the extinguishment of debt, \$809,874 of non-cash interest expense related to the Company's convertible notes payable, \$102,623 of non-cash expense related to the change in the fair value of the Company's derivative liabilities, and \$119,128 of interest expense. These expenses were partially offset by \$35,998 of other income related to rent owed the Company by a subtenant at its Boulder, Colorado facility.

Note that \$1,665,247, or 95%, of the \$1,748,377 of year-to-date 2013 "Other Expense" is non-cash, which means it does not have an adverse effect on the Company's cash flows.

#### Loss

The net loss for the three month period ended September 30, 2013 was \$1,804,713 with the same period in fiscal 2012 generating net income of \$28,699. As noted above in "Other Expenses", a significant portion of the Company's net loss for year-to-date 2013 is related to non-cash expenses. The following is a brief summary of the non-cash expenses incurred by the Company year-to-date 2013:

	<b>YTD 2013</b>
Net loss - GAAP basis	\$ (4,604,642)
Less non-cash expenses:	
Non cash interest expense	809,874
Non cash warrant expense	250,000
Change in fair value of derivative	102,623
Amortization of intangible assets	87,747
Loss on extinguishment of debt	752,750
Depreciation of plant & equipment	13,916
Services rendered for common stock	1,214,295
Total non-cash expenses	<u>3,231,205</u>
Net loss excluding non-cash items - Non-GAAP basis	<u>\$ (1,373,437)</u>

#### Liquidity and Capital Resources

As of September 30, 2013, we had a working capital deficiency of \$287,275 as compared to a working capital deficiency of \$67,202 at December 31, 2012. The Company has relied, and will continue to rely, on funds generated through operations, through loans, and through the selling of shares of our common stock to fund our operations.

During the nine months ended September 30, 2013, the Company used \$1,036,947 of cash to fund its operating activities as compared to \$986,374 used to fund operations in the same period last year.

The Company used \$5,500 of cash to make leasehold improvements on one of its stores during the nine months ended September 30, 2013 while using zero during the same nine-month period in fiscal 2012.



During the nine months ended September 30, 2013, the Company generated net proceeds of \$1,747,929 through financing activities, with \$1,130,000 from the issuance of short-term notes payable, \$623,260 generated by the sale of 17,807,433 shares of its common stock at \$0.035 per share, \$156,000 generated through the issuance of a 10% convertible note, \$26,177 from payable credit line, and \$9,000 from the exercising of 470,237 shares of common stock via a stock option with an exercise price of \$0.019 per share. The \$1,944,437 of gross proceeds generated via financing activities during the nine-month period ended September 30, 2013 was partially offset by \$196,508 in debt and interest payments made by the Company. During the same nine-month period in fiscal 2012, the Company generated net proceeds of \$1,366,293 via \$1,389,663 from the issuance of convertible notes, \$413,680 from the issuance of convertible notes to a related party, and \$5,000 from the issuance of common stock for cash. The \$1,808,343 of gross proceeds generated during the nine months ended September 30, 2012 were partially offset by the \$193,000 paid on notes payable and accrued interest, the \$183,103 of member advances that were repaid, and the repayment of \$65,947 of related party notes payable.

Unless our operations generate significant revenues and cash flows from operating activities, our continued operations will depend on whether we are able to raise additional funds through various potential sources, such as equity and debt financing, other collaborative agreements and strategic alliances. Our management is actively engaged in seeking additional capital to fund our operations in the short to medium term. We also intend to obtain, where appropriate, increases of the amounts available to us under existing revolving promissory notes. Such additional funds may not become available on acceptable terms and there can be no assurance that any additional funding that we do obtain will be sufficient to meet our needs in the long term.

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

Not Applicable.

### **Item 4. Controls and Procedures**

#### **Evaluation of Disclosure Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer, who serves as our principal executive officer and our Chief Financial officer, who serves as our principal financial and accounting officer, as appropriate, to allow timely decisions regarding required disclosure as defined in Rules 13a-15 (e) and 15d-15(e) of the Exchange Act.

As of September 30, 2013, our Chief Executive Officer and Chief Financial Officer conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that as of September 30, 2013, our disclosure controls and procedures were not effective due to the limited size of our staff and budget. The following weaknesses/areas of concern were uncovered by our evaluation:

- A computerized accounting system that is not linked among the Company's different physical locations
- A lack of an offsite backup for the Company's critical computerized data
- A lack of a detailed, and written, set of company policies and procedures
- Our information systems lack sufficient controls limiting access to key applications and data
- Our inventory system lacks standardized product descriptions and effective controls to ensure the accuracy, valuation and timeliness of the financial accounting process around inventory, including a lack of accuracy and basis for valuation resulting in adjustments to the amount of cost of revenues and the carrying amount of inventory.

## **Changes in Internal Control over Financial Reporting and Remediation of the Material Weaknesses**

During the three-month period ended September 30, 2013, no changes to our internal control over financial reporting were identified that materially affected, or were reasonably likely to materially affect, our internal control over financial reporting.

We are investing in efforts to improve the control environment and intend to commit resources to the continuous improvement of the design, implementation, documentation, testing, and monitoring of our internal controls. The Company is currently working to centralize its accounting functions in its northern California facility. The Company is also in the process of evaluating different Accounting and Point-of-Sale (POS) software systems, with one such accounting software system currently being tested by the Company.

### **Remediation Plans**

Management, in coordination with the input, oversight and support of our Board of Directors, intends to strengthen our internal control over financial reporting and to address the material weaknesses described above. In addition to improving the effectiveness and compliance with key controls, our remediation efforts will involve ongoing business and accounting process improvements and the implementation of key system enhancements. The process and system enhancements will be generally designed to simplify and standardize business practices and to improve timeliness and access to associated accounting data through increased systems automation, appropriate limitations around IT access, as well as timely testing of controls throughout the fiscal year. While we expect some remedial actions to be essentially implemented by the end of fiscal 2013, some may not be in place for a sufficient period of time to help us certify that material weaknesses have been fully remediated as of the end of the three-month period ended September 30, 2013. We will continue to develop our remediation plans and implement additional measures during the remainder of fiscal 2013 and into fiscal 2014.

### **Inherent Limitation on the Effectiveness of Internal Controls**

The effectiveness of any system of internal control over financial reporting is subject to inherent limitations, including the exercise of judgment in designing, implementing, operating, and evaluating the controls and procedures, and the inability to eliminate misconduct completely. Accordingly, any system of internal control over financial reporting can only provide reasonable, not absolute, assurances. In addition, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. We intend to continue to monitor and upgrade our internal controls as necessary or appropriate for our business, but cannot assure you that such improvements will be sufficient to provide us with effective internal control over financial reporting.

**PART II  
OTHER INFORMATION**

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

On July 18, 2013, the Company issued 3,000,000 shares of its common stock to a third-party consultant. These shares were issued on a non-cash basis and were compensation for services rendered. These shares were valued at \$120,000 in the aggregate and \$0.04 per share.

On July 18, 2013, the Company issued 2,000,000 shares of its common stock to a third-party consultant. These shares were issued on a non-cash basis and were compensation for services rendered. These shares were valued at \$80,000 in the aggregate and \$0.04 per share.

On August 15, 2013, the Company issued 27,297,747 shares of its common stock to a certain holder of the Company's 6% Convertible Notes. The conversion price was \$0.007 per share and resulted in a \$172,293 reduction in the outstanding principal balance of the 6% Convertible Notes and payment in full for all accrued and unpaid interest.

On August 26, 2013, the Company issued 702,592 shares of its common stock to its landlord at 20301 Ventura Blvd, Woodland Hills, CA. These shares were payment in full for the Company's monthly rent for September, October, and November 2013. These shares were valued at \$20,274 in the aggregate and \$0.0289 per share.

On August 30, 2013, the Company issued 2,000,000 shares of its common stock to a third-party consultant. These shares were issued on a non-cash basis and were compensation for services rendered. These shares were valued at \$80,000 in the aggregate and \$0.04 per share.

On September 5, 2013, the Company issued 25,510,204 shares of its common stock to a certain holder of the Company's 7% Convertible Notes. The conversion price was \$0.02156 per share and resulted in a \$550,000 reduction in the outstanding principal balance of the 7% Convertible Notes.

On September 6, 2013, the Company issued 1,224,918 shares of its common stock to a former employee of the Company as payment in full of both principal and accrued interest related to \$25,000 loaned to the Company in March 2013. These shares were issued at \$0.021 per share.

On September 17, 2013, the Company issued 6,957,328 shares of its common stock to a certain holder of the Company's 7% Convertible Notes. The conversion price was \$0.02156 per share and resulted in a \$150,000 reduction in the outstanding principal balance of the 7% Convertible Notes.

On September 20, 2013, the Company issued 519,200 shares of its common stock to an unrelated third party in exchange for product/inventory valued at \$18,172 in the aggregate. The shares were issued at a price of \$0.035 per share.

On September 30, 2013, the Company issued 537,500 shares of its common stock to certain employees. These shares were issued on a non-cash basis and were compensation for services rendered. These shares were valued at \$48,375 in the aggregate and \$0.09 per share.

On September 30, 2013, the Company issued 1,000,000 shares of its common stock to its two (2) independent members of the Company's Board of Directors. These shares were issued on a non-cash basis and were compensation for services rendered during the April – June 2013 period. These shares were valued at \$20,000 in the aggregate and \$0.02 per share.

In connection with the above stock sales, we did not pay any underwriting discounts or commissions. None of the sales of securities described or referred to above was registered under the Securities Act of 1933, as amended (the "Securities Act"). We had or one of our affiliates had a prior business relationship with each of the purchasers, and no general solicitation or advertising was used in connection with the sales. In making the sales without registration under the Securities Act, we relied upon the exemption from registration contained in Section 4(2) of the Securities Act.

**Item 6. Exhibits**

**Exhibit Index**

<u>Exhibit Number</u>	<u>Description of Exhibit</u>
10.1	Amendment to Revolving Promissory Note dated August 6, 2013, by and among GrowLife, Inc. and W-Net Fund I, L.P. Incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K filed with the Securities and Exchange Commission on August 9, 2013.
10.2	Form of 7% Convertible Note. Incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K filed with the Securities and Exchange Commission on September 3, 2013.
31.1	Certificate of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended.
31.2	Certificate of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities and Exchange Act of 1934, as amended.
32.1	Certificate of Chief Executive Officer pursuant to Rule 13a-14(b) under the Securities and Exchange Act of 1934, as amended.
32.2	Certificate of Chief Financial Officer pursuant to Rule 13a-14(b) under the Securities and Exchange Act of 1934, as amended.
101	XBRL Exhibit

**SIGNATURES**

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

Date: November 14, 2013

GROWLIFE, INC.

By: /s/ Sterling Scott  
Sterling Scott  
Chief Executive Officer

Date: November 14, 2013

By: /s/ John Genesi  
John Genesi  
Chief Financial Officer

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER PURSUANT TO  
SECURITIES EXCHANGE ACT RULES 13a-14(a) AND 15d-14(a)  
AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Sterling Scott, certify that:

1. I have reviewed this report on Form 10-Q of GrowLife, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: November 14, 2013

/s/ Sterling Scott  
Sterling Scott  
Chief Executive Officer  
(Principal Executive Officer)

**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER PURSUANT TO  
SECURITIES EXCHANGE ACT RULES 13a-14(a) AND 15d-14(a)  
AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, John Genesi, certify that:

1. I have reviewed this report on Form 10-Q of GrowLife, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: November 14, 2013

/s/ John Genesi

John Genesi  
Chief Financial Officer  
(Principal Financial Officer)

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of GrowLife, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2013, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Sterling Scott, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

- (a) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (b) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: November 14, 2013

/s/ Sterling Scott  
Sterling Scott  
Chief Executive Officer  
(Principal Executive Officer)

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**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of GrowLife, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2013, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, John Genesi, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

- (a) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (b) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: November 14, 2013

/s/ John Genesi  
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John Genesi  
Chief Financial Officer  
(Principal Accounting Officer)

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