

Surna Inc.
Form 10-K
April 16, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended December 31, 2014

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 000-54286

SURNA, INC.

(Exact name of registrant as specified in its charter)

Nevada	27-3911608
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1780 55th Street, Suite C, Boulder, Colorado 80301

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(Address of principal executive offices) (Zip Code)

Registrant's telephone number (303) 993-5271

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act: Common Stock, par value \$0.00001 per share.

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

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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Large accelerated filer Accelerated filer

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

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. \$48,471,738 on June 30, 2014.

The number of shares outstanding of the registrant's common stock as of April 7, 2015 is 119,682,768

DOCUMENTS INCORPORATED BY REFERENCE — NONE

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Information contained in this Annual Report on Form 10-K contains “forward-looking statements.” These forward-looking statements are contained principally in the sections titled “Business” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and are generally identifiable by use of the words “may,” “will,” “should,” “expect,” “anticipate,” “estimate,” “believe,” “intend,” or “project” or the negative of these words or other variations on these words or comparable terminology. The forward-looking statements herein represent our expectations, beliefs, plans, intentions, or strategies concerning future events, including but not limited to: our future financial performance; the continuation of historical trends; the sufficiency of our cash balances for future needs; our future operations; the relative cost of our operation methods as compared to our competitors; new production projects, entry and expansion into new markets; achieving status as an industry leader; our competitive advantages over our competitors; brand image; our ability to meet market demands; the sufficiency of our resources in funding our operations; our intention to engage in mergers and acquisitions; and our liquidity and capital needs. Our forward-looking statements are based on assumptions that may be incorrect, and there can be no assurance that any projections or other expectations included in any forward-looking statements will come to pass. Moreover, our forward-looking statements are subject to various known and unknown risks, uncertainties and other factors that may cause our actual results, performance, or achievements to be materially different from future results, performance or achievements expressed or implied by any forward-looking statements. These risks, uncertainties, and other factors include but are not limited to: the risks of limited management, labor and financial resources; the risks generally associated with develop-stage companies; our ability to establish and maintain adequate internal controls; our ability to develop and maintain a market in our securities; and our ability to obtain financing, if and when needed, on terms that are acceptable. Except as required by applicable laws, we undertake no obligation to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

As used in this Form 10-K the terms:

“Surna”, “we”, “us”, or “our” refers to Surna, Inc., a Nevada corporation, and unless the context requires otherwise, its wholly-owned subsidiaries, including Safari Resource Group, Inc. and Hydro Innovations, LLC.

PART I

ITEM 1. BUSINESS.

Overview

Surna Inc. (“the Company”, “we”, or “our”) is a technology company that designs, manufactures, and distributes state-of-the-art systems for controlled environment agriculture (“CEA”). Our products offer growers improved process control while simultaneously reducing the energy and resources required to maximize crop yield. Currently, the Company’s revenues derive largely from supplying industrial-grade technology to state-regulated cannabis cultivation facilities with nominal revenue as well from other indoor agricultural producers including organic herb and vegetable producers. Ultimately, we plan to provide full-scale, energy-efficient solutions for all aspects of a CEA facility.

We have a team of more than ten engineers with expertise in electrical, mechanical, optical, and thermodynamic engineering, as well as extensive cultivation experience. That team enables Surna to offer energy-efficient, turnkey solutions that include facility design, equipment manufacturing, and installation of our comprehensive line of lighting, cooling, and dehumidification systems that are optimized for indoor operations. Because of our specific expertise, our products are easily tailored and uniquely suited for state-regulated cannabis cultivation. Moreover, our technology is particularly valuable to state-regulated cannabis producers because growing cannabis is an extremely resource-intensive endeavor, and our technology can make a significant impact on the bottom line and long-term sustainability of such a facility. Furthermore, we anticipate that the already substantial demand for CEA products designed for cannabis will continue to grow as more states and countries begin to permit and regulate cannabis use and cultivation.

Research and Development

We engage in new product development and improvement both through our internal research and development staff and in partnership with other commercial entities. In fiscal 2014, we spent \$319,430 towards the development of new products such as the lighting reflector, the hybrid building, and integrated software systems, and in 2013 we spent \$100 on research to development.

Intellectual Property

We rely on a combination of patent and trademark filings, laws that protect intellectual property, confidentiality procedures, and contractual restrictions with our employees and others to establish and protect our intellectual property rights. As of April 14, 2015, the Company has ten pending patent applications. The pending patent applications are a combination of Utility and Design patent applications that provide coverage around certain core Company technology. If issued, Design patents provide protection for 15 years from the date of issue. Utility patents provide protection for 20 years from the earliest non-Provisional application filing date. We also are actively pursuing trademark registration around our core brand (“Surna”) in the United States and select foreign jurisdictions, as well as the Surna logo and the combined Surna logo and name in the United States. These are contained in three applications with the USPTO. Subject to ongoing use and renewal, trademark protection is potentially perpetual.

Products

Surna Chillers. Surna’s cornerstone technology and products are state-of-the-art liquid cooling systems that provide more efficient thermal cooling solutions that have a number of advantages over typical air conditioning products:

Liquid-based cooling systems are more efficient. Our cooling systems and proprietary technologies rely on liquid, instead of air, as a medium for heat exchange, which is widely understood to increase efficiencies and versatility. Surna’s systems can reduce the costs associated with cooling facilities by anywhere from 10-75%, depending on the specific environment and the version of our system the client chooses.

Closed-loop cooling systems reduce opportunities for contamination. Typical air conditioning systems provide a vector for contaminants to enter a grow room because they are vulnerable to pollutants from outside the building. Surna’s chillers use closed loop systems of cooled liquid, so there are fewer opportunities for outside contaminants to infiltrate a grow room. This allows our customers to focus on maintaining their plants and worry less about potential cross-pollination or contamination by molds, mildews, pests, and communicable plant diseases.

Redundancy is essential. Due to the high value of indoor crops like cannabis, systems need to be designed with redundancy in mind in order to minimize the likelihood of crop loss due to system failure. Surna’s chillers are easily scalable and allow for redundant system design without significant cost.

Surna Reflectors. Surna has developed a new reflector that optimizes light-on-target reflectivity by using compound parabola morphology. Moreover, the premier reflector model incorporates Surna's unique cooling capabilities for even greater efficiency gains. The liquid-cooled version of the reflector is designed to connect directly to Surna's chillers or cooling towers so that the heat (an unfortunate byproduct of the necessary lighting) can be removed before it is transferred to a grow room, thereby reducing overall cooling needs and substantially reducing associated energy consumption. The company is currently releasing its liquid-cooled reflectors under a limited beta-test license. Two other models, the vented and forced-air reflectors, will also be available for use with any climate control system.

Because of the energy-intensive nature of indoor cannabis cultivation, even small improvements in the energy efficiency of any component can have a significant impact on a business's bottom line. While typical reflectors achieve approximately 70% light-on-target reflectivity, Surna's new reflector is expected to achieve close to 90% or better. Thus, Surna is optimistic the industry will quickly adopt its new reflector.

Hybridized Greenhouses. The Company is currently developing a hybrid structure to combine the advantages of a greenhouse with those of an indoor grow operation. Relying on natural sunlight, greenhouses offer much lower energy costs, but they often lack the environmental controls necessary to grow the best products, and they lack the security features necessitated by some state and international regulations. The Company anticipates that its hybrid facility will combine the best of both worlds at an economical price point for growers and hopes to complete a proof-of-concept within the next twelve months.

Additional Targeted Products. We expect to expand our existing engineering department to include MEP (mechanical, electrical, and plumbing) services that will assist in engineering commercial scale indoor grow operations. By combining strategic acquisitions and in-house engineering, we aim to bring game-changing new technologies to the state-regulated cannabis and indoor agriculture marketplace, which will contribute to our dramatic growth.

Furthermore, as part of our overall strategy to gain market share and create recurring revenue streams, we also plan to develop an integrated software platform that combines all of the indoor agriculture systems (lighting, temperature, humidity, environment, grow media, nutrients, etc.) into one user-friendly platform that will monitor the system in real time to provide information to both the gardener and an automated oversight facility. The system is being designed to inform the gardener of irregularities relating to the agriculture in real time and provide a database of the system and its characteristics as compared and overlaid with the plant performance under various conditions.

Operating segments

We currently operate in one primary business segment, which encompasses designing, manufacturing, and distributing indoor climate control systems, including but not limited to chillers, lights, reflectors, and irrigation systems, for use in conjunction with the state-regulated cannabis and CEA industry.

Competition

We face competition from other participants in the CEA equipment business. The sector has a large number of providers offering small, medium, and large products for cooling solutions. Companies selling chiller products are also numerous. The number of companies directly in competition with Surna is limited, however, by our current emphasis on cannabis. Most CEA and air-conditioning companies are not currently offering products directly to cannabis grow operations in the U.S. due to the current federal statutes regarding cannabis. We are one of a few companies offering technology and product solutions tailored to cannabis cultivation.

We believe we can compete effectively with our competitors by continuing to develop our intellectual property. There is no assurance, however, that our ability to market our products successfully will not be impacted by competition that now exists or may later develop.

Employees

As of April 14, 2015, we have 35 employees. We may, however, utilize the services of a number of consultants, independent contractors, and professionals. Proceeding in this manner allows us to operate efficiently and pragmatically. Additional employees will be hired in the future as our business expands.

Government Regulation

Our chillers are subject to state and municipal regulations regarding energy-efficiency standards often incorporated into building codes. Many states and municipalities have adopted some version of Standard 90.1 as published by the American Society of Heating, Refrigerating, and Air-Conditioning Engineers (ASHRAE); however, some states and municipalities have or may in the future adopt alternative standards that may be more or less restrictive than Standard 90.1. Similarly, Standard 90.1 is itself regularly updated—most recently in 2013. Each update of the standard generally reflects the availability of increasingly efficient technologies, resulting in stricter energy-efficiency requirements. The Company anticipates that its products will comply with these standards.

Otherwise, the Company is subject substantially to the same government regulations that affect businesses generally. See, however, Item 1A - Risk Factors – “Federal regulation and enforcement may adversely affect the implementation of

marijuana laws and regulations may negatively impact our revenues and profits,” “We could be found to be violating laws related to marijuana,” and “Variations in state and local regulation and enforcement in states that have legalized cannabis that may restrict marijuana-related activities, including activities related to cannabis, may negatively impact our revenues and profits.”

Our Corporate History

We were incorporated in the State of Nevada on October 15, 2009 and had intended to develop Complex Event Processing commercial software applications when we sold 75,000,000 shares of common stock to 7bridge Capital Management Limited for \$15,000. In 2010 we sold 4,175,000 shares of our common stock at \$0.02 per share to 51 new private shareholders and raised \$83,500, excluding expenses. On May 16, 2011, we declared a stock dividend of 4 new shares for each 1 share held with a record date of May 18, 2011. These additional shares were issued immediately after the record date. On May 18, 2011, our Board of Directors and stockholders approved an increase in authorized capital from 100,000,000 common shares to 350,000,000 common shares and 150,000,000 preferred shares.

Acquisition of Surna Media, Inc. We completed two acquisitions from related parties during 2011 pursuant to which we expanded the scope of our business by entering the online gaming market in the People's Republic of China ("PRC"). On June 20, 2011, we completed an agreement for the purchase of computer equipment located in the PRC from Kopere Limited ("Kopere"), a Hong Kong company controlled by Cherry Ping-Wai Lim, a former director, in exchange for the issuance to Ms. Lim of 200,000 common shares. In September 2011, we entered the online gaming business by acquiring Flying Cloud Information Technology Co. Ltd. ("Flying Cloud"), a PRC Wholly Foreign-Owned Entity (a "WFOE"). We completed this acquisition through a share exchange with the shareholders of Surna Media, Inc., a corporation organized under the laws of the British Virgin Islands ("BVI") and the indirect parent company of the PRC entity. Through the share exchange, we issued 20,000,000 of our common shares in exchange for all the shares of Surna Media, Inc. The prior shareholders of Surna Media, Inc. included Lim Clarke & Co Limited, a company owned and controlled by our then directors.

Trebor Resource Management Group, Inc. Effective March 25, 2014, we completed the issuance of a dividend of all of our ownership in Trebor Resource Management Group, Inc. ("Trebor"), a wholly-owned subsidiary, to our shareholders, resulting in Trebor becoming a separate entity. Trebor was seeking to identify and develop joint opportunities with third parties in the mining business in the Philippines. See Item 1A - Risk Factors – "If it were determined that our spin-off of Trebor Resource Management Group, Inc. in March 2014 violated federal or state securities laws, we could incur monetary damages, fines or other damages that could have a material adverse effect on our financial condition and prospects."

Acquisition of Safari Resource Group, Inc. On March 26, 2014, we exchanged 80,201,250 shares of our unregistered shares of common stock and 77,220,000 shares of our unregistered shares of preferred stock for 100% of the outstanding common stock of Safari Resource Group, Inc. ("Safari"), a Nevada corporation. Safari possessed intellectual property and strategic relationships that were integral to Surna's entrance into the CEA and state-regulated cannabis markets.

Spin-off of Surna Media, Inc. On June 30, 2014, we entered into a separation agreement with Lead Focus Limited, a British Virgin Islands company, which is owned by a combination of prior officers, directors, and others, in which we sold our subsidiary, Surna Media, Inc. (“Surna Media”), including Surna Media’s subsidiaries, Surna HK and Flying Cloud, in exchange for a payment of \$1 in cash and the buyer’s assumption of all of the liabilities of Surna Media and its subsidiaries. As a result of this sale, we eliminated from our balance sheet all assets and liabilities associated with Surna Media and recorded a credit of \$2,643,881 to our additional paid in capital. As a result of this sale, we ceased our operations relating to the development of web and mobile games, social networks, telecommunication services, IT support services, and open-source software.

Acquisition of Hydro Innovations, LLC. On July 25, 2014, we acquired 100% of the membership interests of Hydro Innovations, LLC, a Colorado limited liability company (“Hydro”) from its owners, Stephen Keen and Brandy Keen (the “Keens”), for a price of \$500,000 payable by our assumption of a \$250,000 promissory note on the books and records of Hydro and the delivery to the Keens of a \$250,000 promissory note from us. The Keens’ promissory note bears interest at the rate of 6% per annum and is payable in monthly installments of \$5,000 with a balloon payment for the balance of accrued interest and principal due on July 18, 2016, though it may be prepaid in whole or in part at any time. In addition, we entered into employment agreements with the Keens. Pursuant to the terms of Brandy Keen’s employment agreement, we agreed to employ Brandy Keen as our Vice President of Sales for a period of three years beginning on July 18, 2014 and pay her an annual base salary of \$96,000, as well as certain stock compensation, which is subject to review annually by our Board of Directors. Pursuant to the terms of Stephen Keen’s employment agreement, we agreed to employ Stephen Keen as our Vice President of Research and Development for a period of three years beginning on July 18, 2014 and to pay him an annual base salary of \$96,000, as well as certain stock compensation, which is subject to review annually by our Board of Directors. Notwithstanding the 3-year term, both of the Keens employment agreements are at-will.

Agrisoft Development Group, LLC. On January 8, 2015, we agreed to acquire 66% of the total membership interests in Agrisoft Development Group, LLC (“Agrisoft”) from its members Jim Willett and Forbeez Capital, LLC for an aggregate purchase price of \$4,000,001. The purchase price will be paid 50% in our common stock and 50% will be in the form of a two-year promissory note in the aggregate principal amount of \$2,000,000, with interest accruing at 8% annually, payable in quarterly installments of \$150,000, with the first \$150,000 payment due 90 days following the closing date, and with a balloon payment due at maturity. On February 23, 2015, we amended our agreement to acquire an interest in Agrisoft whereby each of the parties to the agreement agreed that they may terminate the agreement at any time and if the sellers terminate, we may elect to have all loans we made to Agrisoft converted to equity. For purposes of determining the ownership interest we may acquire upon conversion of such loan, Agrisoft will be valued at \$6,000,000. The closing for this transaction was extended to July 1, 2015.

ITEM 1A. - RISK FACTORS.

Risks Related to Our Business

If it were determined that our spin-off of Trebor Resource Management Group, Inc. in March 2014 violated federal or state securities laws, we could incur monetary damages, fines or other damages that could have a material adverse effect on our financial condition and prospects.

As we previously reported, effective March 25, 2014, we effected the issuance of a dividend/spin-off of all of our ownership our wholly owned subsidiary, Trebor Resource Management Group, Inc. (“Trebor”), to our shareholders, resulting in Trebor becoming a separate entity (the “Spin-off”). The issuance of Trebor stock was completed on a one-for-one basis to our shareholders of record on March 21, 2014.

Under Staff Legal Bulletin No. 4 promulgated by the Division of Corporation Finance (the “Division”) of the Securities and Exchange Commission (the “SEC”), the Division expressed its view that the shares of a subsidiary spun off from a reporting company are not required to be registered under the Securities Act of 1933, as amended (the “Securities Act”) when certain conditions are met. Although we intended to comply with the guidance set forth in Staff Legal Bulletin No. 4, we inadvertently failed to follow all of the steps necessary to rely on this guidance.

If it were determined that the Spin-off did not satisfy the conditions for an exemption from registration, the SEC and relevant state regulators could impose monetary fines or other sanctions as provided under relevant federal and state securities laws. Such regulators could also require us to make a rescission offer, which is an offer to repurchase the securities, to the holders of Trebor shares. This could also give certain current and former holders of the Trebor shares a private right of action to seek a rescission remedy under Section 12(a)(2) of the Securities Act. In general, this remedy allows a successful claimant to sell its shares back to the parent company in return for their original investment.

We are unable to quantify the extent of any monetary damages that we might incur if monetary fines were imposed, rescission were required or one or more other claims were successful. As of the date of this filing, we are not aware of any pending or threatened claims that the Spin-off violated any federal or state securities laws, and we do not believe that assertion of such claims by any current or former holders of the Trebor shares is probable. However, there can be no assurance that any such claim will not be asserted in the future or that the claimant in any such action will not prevail. The possibility that such claims may be asserted in the future will continue until the expiration of the applicable federal and state statutes of limitations, which generally vary from one to three years from the date of sale. Claims under the antifraud provisions of the federal securities laws, if relevant, would generally have to be brought within two years of discovery, but not more than five years after occurrence.

We are solely dependent upon the funds we have raised so far and the support of our majority shareholders to continue our operations, which may be insufficient to achieve significant revenues, and we may need to obtain additional financing which may not be available to us.

We may require additional cash resources to finance our continued growth or other future developments, including any investments or acquisitions we may decide to pursue. We may need additional funds to complete further development of our business plan to achieve a sustainable sales level where ongoing operations can be funded out of revenues.

We may be unable to secure additional funding in the future or to obtain such funding on favorable terms.

The amount and timing of such additional financing needs will vary principally depending on the timing of new product launches, investments and/or acquisitions, and the amount of cash flow from our operations. If our resources are insufficient to satisfy our cash requirements, we may seek to issue additional equity or debt securities or obtain a credit facility. The issuance of additional equity securities or securities convertible into our ordinary shares could result in additional dilution to our shareholders. The incurrence of indebtedness would result in increased debt service obligations and could result in operating and financing covenants that would restrict our operations. Our ability to obtain additional capital on acceptable terms is subject to a variety of uncertainties. Financing may not be available in amounts or on terms acceptable to us, if at all, especially if there is a recession or other events causing volatilities in the capital markets worldwide.

Even if we obtain more customers, there is no assurance that we will make a profit.

Even if we obtain more customers, there is no guarantee that we will be able to attract enough customers to buy our products and services for us to operate profitably. Because we are a small company and do not have much capital, we must limit our products and services. Because we will be limiting our marketing activities, we may not be able to attract enough customers to buy our products to operate profitably. If we cannot operate profitably, we may have to suspend or cease operations.

If we fail to establish or maintain an effective system of internal controls over financial reporting, we may be unable to accurately report our financial results or prevent fraud, and investor confidence and the market price of our shares may, therefore, be adversely impacted.

Our reporting obligations as a public company will place a significant strain on our management, operational and financial resources and systems for the foreseeable future. We will be required to prepare a management report on our

internal controls over financial reporting containing our management's assessment of the effectiveness of our internal controls over financial reporting. In addition, depending on our market capitalization, our independent registered public accounting firm may be required to attest to and report on our management's assessment of the effectiveness of our internal controls over financial reporting. Our management may conclude that our internal controls over our financial reporting are not effective. Moreover, even if our management concludes that our internal controls over financial reporting are effective, our independent registered public accounting firm may still decline to attest to our management's assessment or may issue a report that is qualified if it is not satisfied with our controls or the level at which our controls are documented, designed, operated or reviewed, or if it interprets the relevant requirements differently from us.

Our principal shareholders have substantial influence over our company and their interests may not be aligned with the interests of our other holders of our ordinary shares.

This concentration of ownership may discourage, delay or prevent a change in control of our company, which could deprive our shareholders of an opportunity to receive a premium for their shares as part of a sale of our company and might reduce the price of our shares. Alternatively, these principal shareholders may cause a merger, consolidation or change of control transaction even if it is opposed by our other shareholders. As a result, no assurance can be made that the prices paid or to be paid by the Company for the assets acquired or to be acquired were fair to our Company or its shareholders.

Federal regulation and enforcement may adversely affect the implementation of marijuana laws and regulations may negatively impact our revenues and profits.

Currently, twenty-three states and the District of Columbia permit some form of cannabis use and cultivation. Some other states permit the possession and use of cannabidiol (CBD) oil in some contexts. There are efforts in many other states to begin permitting cannabis use and/or cultivation in various contexts. Nevertheless, the federal government continues to prohibit cannabis in all its forms as well as its derivatives. Until Congress amends the Controlled Substances Act (the “CSA”), there is a risk that federal authorities may enforce current federal law. Enforcement of the CSA by federal authorities could impair the Company’s revenues and profits, and it could even force the Company to cease operating entirely. The risk of strict federal enforcement of the CSA in light of congressional activity, judicial holdings, and stated federal policy, including enforcement priorities, remains uncertain.

In March of 2015, the Compassionate Access, Research Expansion, and Respect States Act of 2015 (the “CARERS Act”) was introduced for consideration into both houses of Congress. This legislation would (a) stop federal prosecution of individuals acting in compliance with applicable state law for violations the CSA, (b) remove cannabis from Schedule I of the CSA to Schedule II, (c) expand access to cannabidiol, (d) provide legal safe harbor and other protections for banking services provided to cannabis-related businesses, (e) modify the process for obtaining cannabis for research purposes, and (f) permit Department of Veterans Affairs healthcare providers to recommend cannabis to veterans in states where it would otherwise be permitted.

The Attorneys General for Oklahoma and Nebraska have filed suit against Colorado for its cannabis regulatory regime. The suit was filed directly with the U.S. Supreme Court under its principles of original jurisdiction. Previously, the Supreme Court has held that drug prohibition is a valid exercise of federal authority under the commerce clause; however, it has also held that states themselves are not required to adopt or enforce federal laws with which it disagrees.

In an effort to provide guidance to federal law enforcement, the Department of Justice (the “DOJ”) has issued Guidance Regarding Marijuana Enforcement to all United States Attorneys in a memorandum from Deputy Attorney General David Ogden on October 19, 2009, in a memorandum from Deputy Attorney General James Cole on June 29, 2011 and in a memorandum from Deputy Attorney General James Cole on August 29, 2013. Each memorandum provides that the DOJ is committed to enforcement of the CSA but the DOJ is also committed to using its limited investigative and prosecutorial resources to address the most significant threats in the most effective, consistent and rational way.

The August 29, 2013, memorandum provides updated guidance to federal prosecutors concerning marijuana enforcement in light of state laws legalizing medical and recreational marijuana possession in small amounts. The memorandum sets forth certain enforcement priorities that are important to the federal government:

- Distribution of marijuana to children;
- Revenue from the sale of marijuana going to criminals;
- Diversion of medical marijuana from states where is legal to states where it is not;
- Using state authorized marijuana activity as a pretext of other illegal drug activity;
- Preventing violence in the cultivation and distribution of marijuana;
- Preventing drugged driving;
- Growing marijuana on federal property; and
- Prevent possession or use of marijuana on federal property.

The DOJ has not historically devoted resources to prosecuting individuals whose conduct is limited to possession of small amounts of marijuana for use on private property but relied on state and local law enforcement to address marijuana activity. In the event the DOJ reverses stated policy and begins strict enforcement of the CSA in states that have laws legalizing medical marijuana and recreational marijuana in small amounts, there may be a direct and adverse impact to our revenue and profits.

We could be found to be violating laws related to marijuana.

Currently, there are twenty-three states plus the District of Columbia that have laws and/or regulation that recognize in one form or another legitimate medical uses for cannabis and consumer use of cannabis in connection with medical treatment. Many other states are considering similar legislation. Conversely, under the CSA the policy and regulations of the Federal government and its agencies is that cannabis has no medical benefit and a range of activities including cultivation and use of cannabis is prohibited. Until Congress amends the CSA, there is a risk that federal authorities may enforce current federal law. The risk of strict enforcement of the CSA in light of congressional activity, judicial holdings and stated federal policy remains uncertain. If we are found to be in violation of laws in jurisdictions where the sale, possession or use of medical cannabis is not permitted there may be a direct and adverse effect on revenues and profits of the Company.

Variations in state and local regulation and enforcement in states that have legalized cannabis that may restrict marijuana-related activities, including activities related to cannabis may negatively impact our revenues and profits.

Individual state laws do not always conform to the federal standard or to other states' laws. A number of states have decriminalized marijuana to varying degrees, other states have created exemptions specifically for medical cannabis, and several have both decriminalization and medical laws. Two states, Colorado, and Washington, have legalized the recreational use of cannabis. Variations exist among states that have legalized, decriminalized or created medical marijuana exemptions. Alaska and Colorado have limits on the number of homegrown marijuana plants that can be grown. In most states the cultivation of marijuana for personal use continues to be prohibited except for those states that allow small scale cultivation by the individual in possession of medical marijuana need care or that person's caregiver. Active enforcement of state laws that prohibit personal cultivation of marijuana may indirectly and adversely affect revenue and profits of the Company.

It is possible that federal or state legislation could be enacted in the future that would prohibit us or potential customers from selling our products, and if such legislation were enacted, our revenues could decline.

We are not aware of any federal or state regulation that regulates the sale of cultivation equipment to commercial cannabis growers. The extent to which the regulation of drug paraphernalia under the CSA is applicable to our business and the sale of our product is found in the definition of drug paraphernalia. Our products are designed for commercial cannabis and agricultural use in accordance with state law.

Our independent registered public accounting firm has expressed substantial doubt about our ability to continue as a going concern.

Our auditors have included a “going concern” provision in their opinion on our financial statements, expressing substantial doubt that we can continue as an ongoing business for the next twelve months. Our financial statements do not include any adjustments that may result from the outcome of this uncertainty. If we are unable to successfully raise the capital we need we may need to reduce the scope of our business to fully satisfy our future short-term liquidity requirements. If we cannot raise additional capital or reduce the scope of our business, we may be otherwise unable to achieve our goals or continue our operations. While we believe that we will be able to raise the capital we need to continue our operations, there can be no assurances that we will be successful in these efforts or will be able to resolve our liquidity issues or eliminate our operating losses.

Our inability to effectively manage our growth could harm our business and materially and adversely affect our operating results and financial condition.

Our strategy envisions growing our business. We plan to expand our product, sales, administrative and marketing organizations. Any growth in or expansion of our business is likely to continue to place a strain on our management and administrative resources, infrastructure and systems. As with other growing businesses, we expect that we will need to further refine and expand our business development capabilities, our systems and processes and our access to financing sources. We also will need to hire, train, supervise and manage new employees. These processes are time consuming and expensive, will increase management responsibilities and will divert management attention. We cannot assure that we will be able to:

expand our products effectively or efficiently or in a timely manner;

allocate our human resources optimally;

meet our capital needs;

identify and hire qualified employees or retain valued employees; or

effectively incorporate the components of any business or product line that we may acquire in our effort to achieve growth.

Our inability or failure to manage our growth and expansion effectively could harm our business and materially and adversely affect our operating results and financial condition.

Our operating results may fluctuate significantly based on customer acceptance of our products. As a result, period-to-period comparisons of our results of operations are unlikely to provide a good indication of our future performance.

Management expects that we will experience substantial variations in our net sales and operating results from quarter to quarter due to customer acceptance of our products. If customers don't accept our products, our sales and revenues will decline, resulting in a reduction in our operating income or possible increase in losses.

If we do not successfully generate additional products and services, or if such products and services are developed but not successfully commercialized, we could lose revenue opportunities.

Our future success depends, in part, on our ability to expand our product and service offerings. To that end we have engaged in the process of identifying new product opportunities to provide additional products and related services to our customers. The processes of identifying and commercializing new products is complex and uncertain, and if we fail to accurately predict customers' changing needs and emerging technological trends our business could be harmed. We may have to commit significant resources to commercializing new products before knowing whether our investments will result in products the market will accept. Furthermore, we may not execute successfully on commercializing those products because of errors in product planning or timing, technical hurdles that we fail to overcome in a timely fashion, or a lack of appropriate resources. This could result in competitors providing those solutions before we do and a reduction in net sales and earnings.

The success of new products depends on several factors, including proper new product definition, timely completion and introduction of these products, differentiation of new products from those of our competitors, and market acceptance of these products. There can be no assurance that we will successfully identify new product opportunities, develop and bring new products to market in a timely manner, or achieve market acceptance of our products or that products and technologies developed by others will not render our products or technologies obsolete or noncompetitive.

Our future success depends on our ability to grow and expand our customer base. Our failure to achieve such growth or expansion could materially harm our business.

To date, our revenue growth has been derived from the sale of our products. Our success and the planned growth and expansion of our business depend on us achieving greater and broader acceptance of our products and expanding our commercial customer base. There can be no assurance that customers will purchase our products or that we will continue to expand our customer base. If we are unable to effectively market or expand our product offerings, we will be unable to grow and expand our business or implement our business strategy. This could materially impair our

ability to increase sales and revenue and materially and adversely affect our margins, which could harm our business and cause our stock price to decline.

Our suppliers could fail to fulfill our orders for parts used to assemble our products, which would disrupt our business, increase our costs, harm our reputation and potentially cause us to lose our market.

We depend on third party suppliers for materials used to assemble our products. These suppliers could fail to produce products to our specifications or in a workmanlike manner and may not deliver the units on a timely basis. Our suppliers may also have to obtain inventories of the necessary parts and tools for production. Any change in our suppliers to resolve production issues could disrupt our ability to fulfill orders. Any change in our suppliers to resolve production issues could also disrupt our business due to delays in finding new suppliers, providing specifications and testing initial production. Such disruptions in our business and/or delays in fulfilling orders would harm our reputation and would potentially cause us to lose our market.

Our inability to effectively protect our intellectual property would adversely affect our ability to compete effectively, our revenue, our financial condition and our results of operations.

We may be unable to obtain intellectual property rights to effectively protect our branding. Our ability to compete effectively may be affected by the nature and breadth of our intellectual property rights. While we intend to defend against any threats to our intellectual property rights, there can be no assurance that any such actions will adequately protect our interests. If we are unable to secure in