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**United States  
Securities and Exchange Commission**  
Washington, D.C. 20549

**Form 10-Q**

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

For the quarterly period ended September 30, 2004

OR

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

Commission File Number 0-27517

**GAIAM, INC.**

(Exact name of registrant as specified in its charter)

**COLORADO**  
(State or other jurisdiction of  
incorporation or organization)

**84-1113527**  
(I.R.S. Employer  
Identification No.)

**360 INTERLOCKEN BLVD.,  
BROOMFIELD, COLORADO 80021**  
(Address of principal executive offices)

**(303) 222-3600**  
(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 and 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 is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).  
YES  NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

<u>Class</u>	<u>Shares outstanding as of October 27, 2004</u>
Class A Common Stock (\$.0001 par value)	9,311,897
Class B Common Stock (\$.0001 par value)	5,400,000

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**FORWARD-LOOKING STATEMENTS**

This report may contain forward-looking statements that involve risks and uncertainties. When used in this discussion, the words “anticipate,” “believe,” “plan,” “estimate,” “expect,” “strive,” “future,” “intend” and similar expressions as they relate to Gaiam or its management are intended to identify such forward-looking statements. Gaiam’s actual results could differ materially from the results anticipated in these forward-looking statements as a result of certain factors set forth under “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” “Market Risk” and elsewhere in this report. Risks and uncertainties that could cause actual results to differ include, without limitation, general economic conditions, competition, loss of key personnel, pricing, brand reputation, acquisitions, security and information systems, legal liability for website content, merchandise supply problems, failure of third parties to provide adequate service, reliance on centralized customer service, overstocks and merchandise returns, reliance on a centralized fulfillment center, increases in postage and shipping costs, e-commerce trends, future Internet related taxes, control of Gaiam by its founder, fluctuations in quarterly operating results, consumer trends, customer interest in our products, the effect of government regulation and other risks and uncertainties included in Gaiam’s filings with the Securities and Exchange Commission. We caution you that no forward-looking statement is a guarantee of future performance, and you should not place undue reliance on these forward-looking statements which reflect our management’s view only as of the date of this report. We undertake no obligation to update any forward-looking information.

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**GAIAM, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands, except share information)

	<u>September 30,</u> <u>2004</u>	<u>December 31,</u> <u>2003</u>
	(Unaudited)	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 9,674	\$ 8,384
Accounts receivable, net	9,292	17,818
Income tax and other receivables	4,817	2,091
Inventory, less allowances	17,259	16,629
Deferred advertising costs	3,408	1,649
Other current assets	1,174	1,280
Total current assets	<u>45,624</u>	<u>47,851</u>
Property and equipment, net	8,957	10,314
Investments	7,865	7,865
Capitalized production costs, net	6,013	6,094
Media library, net	5,578	6,084
Goodwill and other intangibles	9,553	9,509
Deferred tax assets	3,287	3,488
Other assets	385	655
Total assets	<u>\$ 87,262</u>	<u>\$ 91,860</u>
<b>Liabilities and stockholders’ equity</b>		
Current liabilities:		
Accounts payable	\$ 11,021	\$ 12,459
Accrued liabilities	4,919	4,904
Income taxes payable	642	902
Capital lease obligations, current	<u>7</u>	<u>55</u>

Total current liabilities	16,589	18,320
Deferred tax liabilities	883	735
Total liabilities	<u>17,472</u>	<u>19,055</u>
Minority interest	3,686	3,320
Commitments and contingencies		
Stockholders' equity:		
Class A common stock, \$.0001 par value, 150,000,000 shares authorized, 9,311,897 and 9,203,056 shares issued and outstanding at September 30, 2004 and December 31, 2003, respectively	1	1
Class B common stock, \$.0001 par value, 50,000,000 shares authorized, 5,400,000 issued and outstanding at September 30, 2004 and December 31, 2003	1	1
Additional paid-in capital	54,394	53,831
Deferred compensation	(18)	(72)
Accumulated other comprehensive income	601	525
Retained earnings	11,125	15,199
Total stockholders' equity	<u>66,104</u>	<u>69,485</u>
Total liabilities and stockholders' equity	<u>\$ 87,262</u>	<u>\$ 91,860</u>

*See accompanying notes to the condensed consolidated financial statements.*

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GAIAM, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited)  
(In thousands, except per share amounts)

	For the Three Months Ended September 30,	
	2004	2003
Net revenue	\$ 21,023	\$ 23,533
Cost of goods sold	11,196	11,263
Gross profit	<u>9,827</u>	<u>12,270</u>
Expenses:		
Selling and operating	10,270	10,445
Corporate, general and administration	1,881	1,905
Total expenses	<u>12,151</u>	<u>12,350</u>
Loss from operations	<u>(2,324)</u>	<u>(80)</u>
Other income (expense)	83	(14)
Interest income	55	17
Total other income	<u>138</u>	<u>3</u>
Loss before income taxes and minority interest	(2,186)	(77)
Provision for income tax benefit	(856)	(44)
Minority interest in net income of consolidated subsidiaries, net of tax	(200)	(168)
Net loss	<u>\$ (1,530)</u>	<u>\$ (201)</u>
Net loss per share:		
Basic	\$ (0.10)	\$ (0.01)
Diluted	\$ (0.10)	\$ (0.01)
Shares used in computing net loss per share:		
Basic	14,712	14,601
Diluted	14,712	14,601

*See accompanying notes to the condensed consolidated financial statements.*

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GAIAM, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(Unaudited)  
(In thousands, except per share amounts)

	For the Nine Months Ended September 30,	
	2004	2003
Net revenue	\$ 61,829	\$ 66,857
Cost of goods sold	30,786	31,447
Gross profit	<u>31,043</u>	<u>35,410</u>
Expenses:		
Selling and operating	31,398	30,775
Corporate, general and administration	5,932	6,297
Total expenses	<u>37,330</u>	<u>37,072</u>
Loss from operations	<u>(6,287)</u>	<u>(1,662)</u>
Other income	135	2
Interest income	135	44
Total other income	<u>270</u>	<u>46</u>
Loss before income taxes and minority interest	(6,017)	(1,616)
Provision for income tax benefit	(2,269)	(648)
Minority interest in net income of consolidated subsidiaries, net of tax	(326)	(345)
Net loss	<u>\$ (4,074)</u>	<u>\$ (1,313)</u>
Net loss per share:		
Basic	\$ (0.28)	\$ (0.09)
Diluted	\$ (0.28)	\$ (0.09)
Shares used in computing net loss per share:		
Basic	14,671	14,591
Diluted	14,671	14,591

*See accompanying notes to the condensed consolidated financial statements.*

GAIAM, INC.  
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS  
(Unaudited – In thousands)

	For the Nine Months Ended September 30,	
	2004	2003
<b>Operating activities</b>		
Net loss	\$ (4,074)	\$ (1,313)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation	2,131	1,966
Amortization	528	535
Stock compensation	54	54
Minority interest in consolidated subsidiaries	326	345
Deferred tax expense	330	100
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts receivable	5,896	8,269
Inventory	(606)	(783)
Deferred advertising costs	(1,758)	(815)
Capitalized production costs	81	(1,171)
Other current assets	107	(361)
Other assets	254	151
Accounts payable	(1,628)	(1,707)
Accrued liabilities	251	(1,878)
Income taxes payable	(271)	(1,718)
Net cash provided by operating activities	<u>1,621</u>	<u>1,674</u>
<b>Investing activities</b>		

Purchase of property, equipment and media rights	(755)	(1,335)
Payments for acquisitions, net of cash acquired		(3,787)
Net cash used in investing activities	(755)	(5,122)
<b>Financing activities</b>		
Principal payments on capital leases	(48)	(244)
Proceeds from issuance of common stock	427	122
Net cash provided by (used in) financing activities	379	(122)
Effects of exchange rates on cash and cash equivalents	45	—
Net change in cash and cash equivalents	1,290	(3,570)
Cash and cash equivalents at beginning of period	8,384	11,422
Cash and cash equivalents at end of period	\$ 9,674	\$ 7,852
<b>Supplemental cash flow information</b>		
Interest paid	\$ —	\$ 40
Common stock issued for acquisitions	—	348
Income taxes paid	615	1,033

*See accompanying notes to the condensed consolidated financial statements.*

Gaiam, Inc.  
Notes to Interim Condensed Consolidated Financial Statements  
(Unaudited)  
September 30, 2004

1. Interim Condensed Consolidated Financial Statements

Organization and Nature of Operations

Gaiam, Inc. is a multi-channel lifestyle company providing a broad selection of information, products and services to customers who value natural health, personal development, ecological lifestyles and responsible media. Gaiam was incorporated under the laws of the State of Colorado on July 7, 1988.

The accompanying consolidated financial statements include the accounts of Gaiam and its subsidiaries in which Gaiam's ownership is greater than 50% and the subsidiary is considered to be under Gaiam's control. All material intercompany accounts and transaction balances have been eliminated in consolidation.

Preparation of Interim Condensed Consolidated Financial Statements

The interim condensed consolidated financial statements included herein have been prepared by the management of Gaiam pursuant to the rules and regulations of the United States Securities and Exchange Commission, and, in the opinion of management, contain all adjustments (consisting of only normal recurring adjustments) necessary to present fairly Gaiam's consolidated financial position as of September 30, 2004, the interim results of operations for the three and nine months ended September 30, 2004 and 2003, and cash flows for the nine months ended September 30, 2004 and 2003. These interim statements have not been audited. The balance sheet as of December 31, 2003 was derived from Gaiam's audited consolidated financial statements included in Gaiam's annual report on Form 10-K.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. Accounting policies followed by Gaiam are described in Note 1 to the audited financial statements for the fiscal year ended December 31, 2003 included in Gaiam's annual report on Form 10-K. The consolidated financial statements contained herein should be read in conjunction with Gaiam's audited financial statements, including the notes thereto, for the year ended December 31, 2003.

The consolidated financial position, results of operations and cash flows for the interim periods disclosed in this report are not necessarily indicative of future financial results.

Use of Estimates

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Actual results could differ from those estimates.

Reclassifications

Certain reclassifications have been made to prior period amounts to conform to the current period presentations.

### Adoption of Accounting Standards

In December 2003, the Financial Accounting Standards Board (“FASB”) issued a revised FASB Interpretation No. 46, “Consolidation of Variable Interest Entities,” (“FIN 46R”). FIN 46R modifies FIN 46 to include (1) a deferral of the effective date of the provisions related to certain variable interests, (2) additional scope exceptions for certain other variable interests, (3) clarifications on the impact of troubled debt restructurings, and (4) additional guidance on what constitutes a variable interest. Adoption of FIN 46R is required in the financial statements of public entities that have interests in special purposes entities (“SPEs”) for periods ending after December 15, 2003. Adoption by public entities that have interests in all other types of variable interest entities (“VIEs”) is required in financial statements for periods ending after March 15, 2004. Gaiam believes that it has no entities qualifying as SPEs or VIEs, therefore, the adoption of FIN 46R has had no effect on Gaiam’s financial position, results of operations or cash flows.

### Stock-Based Compensation

Gaiam accounts for its stock-based compensation arrangements under the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (“APB No. 25”) and related interpretations, including FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, rather than the alternative fair value accounting allowed by SFAS No. 123, *Accounting for Stock Based Compensation*. Accordingly, no compensation expense is recognized in Gaiam’s consolidated financial statements in connection with stock options granted to employees with exercise prices not less than fair value. Deferred compensation for options granted to employees is determined as the difference between the fair market value of Gaiam’s common stock on the date options were granted and the exercise price. For purposes of this pro-forma disclosure, the estimated fair value of options is assumed to be amortized to expense over the options’ vesting periods.

Compensation expense for options granted to non-employees has been determined in accordance with SFAS No. 123 as the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measured. Had compensation cost for Gaiam’s stock-based compensation plan been determined under the fair value methodology under SFAS No. 123, Gaiam’s net income (loss) and income (loss) per share would have been as follows (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net loss as reported	\$ (1,530)	\$ (201)	\$ (4,074)	\$ (1,313)
Add: Stock-based compensation expense included in reported net loss, net of related tax effects	18	18	54	54
Deduct: Total stock-based compensation expenses determined under fair value based method for all awards, net of related tax effects	(125)	125	(454)	(302)
Pro forma	\$ (1,637)	\$ (58)	\$ (4,474)	\$ (1,561)
Net loss per common share				
As reported	\$ (0.10)	\$ (0.01)	\$ (0.28)	\$ (0.09)
Pro forma	\$ (0.11)	\$ —	\$ (0.30)	\$ (0.11)
Fully diluted net loss per common share				
As reported	\$ (0.10)	\$ (0.01)	\$ (0.28)	\$ (0.09)
Pro forma	\$ (0.11)	\$ —	\$ (0.30)	\$ (0.11)

## 2. Stockholders’ Equity

During the first quarter of 2004, Gaiam issued a total of 11,251 shares of Class A common stock to Gaiam’s independent directors, in lieu of cash compensation, for services rendered in 2003. In addition, for the nine months ended September 30, 2004, Gaiam issued 97,590 shares of Class A common stock upon exercise of options granted under Gaiam’s 1999 Long-Term Incentive Plan.

## 3. Comprehensive Income (Loss)

Gaiam’s comprehensive income (loss) is comprised of net income (loss) and foreign currency translation adjustment, net of income taxes. Comprehensive income (loss), net of related tax effects, was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net loss	\$ (1,530)	\$ (201)	\$ (4,074)	\$ (1,313)
Foreign currency translation adjustment, net	(9)	—	76	—
Comprehensive loss, net of taxes	\$ (1,539)	\$ (201)	\$ (3,998)	\$ (1,313)

#### 4. Earnings (Loss) per Share

Basic earnings (loss) per share excludes any dilutive effects of options, warrants and dilutive securities. Basic earnings (loss) per share is computed using the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed using the weighted average number of common and common stock equivalent shares outstanding during the period. Common equivalent shares of 142 thousand and 94 thousand are excluded from the computation of diluted earnings per share for the three and nine months ended September 30, 2004 and 2003, respectively, because their effect is antidilutive.

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Numerator for basic and diluted loss per share	\$ (1,530)	\$ (201)	\$ (4,074)	\$ (1,313)
Denominator:				
Weighted average shares for basis loss per share	14,712	14,601	14,671	14,591
Effect of dilutive securities:				
Weighted average of common stock, stock options and warrants	—	—	—	—
Denominators for diluted loss per share	14,712	14,601	14,671	14,591
Net loss per share - basic	\$ (0.10)	\$ (0.01)	\$ (0.28)	\$ (0.09)
Net loss per share - diluted	\$ (0.10)	\$ (0.01)	\$ (0.28)	\$ (0.09)

#### 5. Segment Information

Gaiam manages its business and aggregates its operational and financial information in accordance with two reportable segments. The direct to consumer segment contains Gaiam's catalog and Internet

sales channels, while the business segment comprises the retailer, media and corporate account channels.

Although Gaiam is able to track revenues by sales channel, management, allocation of resources and analysis and reporting of expenses is solely on a combined basis, at the reportable segment level.

Contribution margin is defined as net sales, less cost of goods sold and direct expenses. Financial information for Gaiam's business segments was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net revenue:				
Direct to consumer	\$ 11,347	\$ 11,579	\$ 33,776	\$ 33,041
Business	9,676	11,954	28,053	33,816
Consolidated net revenue	21,023	23,533	61,829	66,857
Contribution margin:				
Direct to consumer	38	195	(464)	343
Business	(2,362)	(275)	(5,823)	(2,005)
Consolidated contribution loss	\$ (2,324)	\$ (80)	\$ (6,287)	\$ (1,662)
Reconciliation of contribution margin loss to net loss:				
Other income	138	3	270	46
Income tax benefit	(856)	(44)	(2,269)	(648)
Minority interest in net income of consolidated subsidiaries, net of tax	(200)	(168)	(326)	(345)
Net loss	\$ (1,530)	\$ (201)	\$ (4,074)	\$ (1,313)

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

The following discussion and analysis of Gaiam's financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and related notes included elsewhere in this document.

##### Overview and Outlook

Gaiam is a multi-channel lifestyle company providing information, goods and services to customers who value personal development, healthy living, ecological lifestyles and responsible media. Gaiam was incorporated in Boulder, Colorado in 1988 to support "Conscious Commerce," the practice of making purchasing decisions based on lifestyle and personal values. In 1995, Gaiam began to

expand nationally. In 1996, Gaiaam made a large investment in infrastructure and operating systems to support rapid growth. From 1997 to 2003, Gaiaam's revenues increased from \$19.9 million to \$102 million, representing a compounded annual growth rate of 31.3%.

The direct to consumer segment continues to be an integral part of Gaiaam's outreach and a solid base of business. This segment accounted for 49%, or approximately \$50.5 million, of Gaiaam's revenues during 2003. During the first nine months of 2004, revenues in this segment were \$33.8 million, an increase of 2% over 2003, and represented 55% of total revenue. Through its diverse media reach, the direct to consumer segment provides branding, a sounding board for new product testing, promotional opportunities, consumer education and customer feedback on Gaiaam's and the LOHAS (Lifestyles of Health and Sustainability) industry's focus and future.

With the inception of our business segment in 1998, Gaiaam started to sell directly to retailers, both domestically and abroad. As of the end of 2003, Gaiaam products were available in over 30,000 stores in North America, plus in retailers located in the U.K. and Australia. Gaiaam introduced its "store-within-store" lifestyle

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presentations, which utilize custom fixtures designed and produced by Gaiaam, in late 2000, and the placement of this concept grew to over 3,650 stores by the end of 2003. In 1998, revenues generated by the business segment were \$3.8 million. In 2003, revenues in this segment, which were driven by media sales to retailers, topped \$50 million, representing a compound annual growth rate of approximately 68%, but became difficult to sustain without grass roots development. Gaiaam is diversifying its approach to include a grass roots rollout to the community-based retail and specialty markets, along with more outreach to professional establishments, fitness clubs, and wellness professionals. Gaiaam believes this approach will provide a solid base for expansion and a spring board for new product launches. Gaiaam is also focusing on new media releases, along with an expansion in mass market retailers and bookstores, and new launches into the grocery market. During the third quarter of 2004, Gaiaam received an additional eight feet of shelf space in Target's fall planogram set, which tripled the existing space. Inventory for this expansion started shipping in August 2004, and the full impact of the expansion is expected to be realized in the fourth quarter of 2004.

Despite the net loss of \$4.1 million for the first nine months of 2004, Gaiaam generated cash from operating activities of \$1.6 million for the nine months ended September 30, 2004, and ended the quarter with \$9.7 million in cash, up from \$8.4 million at December 31, 2003, no debt and an unused \$15 million line of credit

#### Results of Operations

The following table sets forth certain financial data as a percentage of revenues for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net revenue	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	53.3%	47.9%	49.8%	47.0%
Gross profit	46.7%	52.1%	50.2%	53.0%
Expenses:				
Selling and operating	48.9%	44.4%	50.8%	46.0%
Corporate, general and administration	8.9%	8.1%	9.6%	9.4%
Total expenses	57.8%	52.5%	60.4%	55.4%
Loss from operations	-11.1%	-0.4%	-10.2%	-2.4%
Other income	0.7%	0.0%	0.4%	0.1%
Income tax benefit	-4.1%	-0.2%	-3.7%	-1.0%
Minority interest in net income of consolidated subsidiaries, net of tax	-1.0%	-0.7%	-0.5%	-0.5%
Net loss	-7.3%	-0.9%	-6.6%	-2.0%

#### Three months ended September 30, 2004 versus September 30, 2003

Revenues of \$21 million for the three months ended September 30, 2004 decreased 10.7% from \$23.5 million for the three months ended September 30, 2003. Gaiaam's decrease in revenues was due to a decrease in the business segment of \$2.3 million, or 19.1% for the quarter. This shortfall resulted from lower sales volumes in the U.S. trade business, primarily in VHS sales which declined more than 80% over 2003 levels, and an increase in markdowns and returns associated with the change out of VHS format for DVD format. Direct to consumer segment revenues were \$11.3 million for the three months ended September 30, 2004, compared to \$11.6 million for the same period in 2003, as Gaiaam suspended distribution of one of its catalog titles for the Spring/Summer seasons. This title generated \$604 thousand in revenue during the third quarter of 2003. Internal revenue growth in both the internet and international operations was 22% for the third quarter.

Gross profit, which consists of revenues less cost of sales (primarily merchandise acquisition costs and in-bound freight), decreased to \$9.8 million for the third quarter of 2004 from \$12.3 million during the same period in 2003. As a percentage of revenue, gross profit declined to 46.7% in 2004 from 52.1% in 2003. This was primarily attributable to declines in the business segment gross margin associated with a change in product mix to accessories with lower gross profit margins than media, increased markdowns given to incent sell-through of VHS inventories, and the write-down of VHS inventory, components and packaging.



Selling and operating expenses (which consist primarily of sales and marketing costs, commission and fulfillment expenses) decreased to \$10.3 million for the three months ended September 30, 2004 as compared to \$10.4 million in the same period of 2003, primarily resulting from lower catalog and e-commerce expenses in the direct to consumer segment. As a percentage of revenues, selling and operating expenses increased to 48.9% in 2004 from 44.4% in 2003 due to the lower sales base in 2004.

Corporate, general and administration expenses remained constant at \$1.9 million for the third quarter of 2004 compared to the same 2003 period, but increased to 8.9% of revenues in 2004 from 8.1% of revenues in 2003 due to the lower sales base in 2004.

Operating losses were \$2.3 million for the three months ended September 30, 2004 compared to \$80 thousand for the three months ended September 30, 2003, primarily due to revenue decreases and lower gross profit margins.

Gaiam recorded \$138 thousand and \$3 thousand in other income for the three months ended September 30, 2004 and 2003, respectively. The share of net income associated with minority interest was \$200 thousand during the third quarter of 2004, compared to the share of net income of \$168 thousand for the comparable 2003 period.

Gaiam recorded an income tax benefit of \$856 thousand for the three months ended September 30, 2004 compared to an income tax benefit of \$44 thousand for the three months ended September 30, 2003. Gaiam's consolidated effective tax rate fluctuates based upon the distribution of earnings/losses between its domestic and foreign operations.

As a result of the factors described above, Gaiam's net loss was \$1.5 million for the three months ended September 30, 2004 compared to a net loss of \$201 thousand recorded for the three months ended September 30, 2003.

#### Nine months ended September 30, 2004 versus September 30, 2003

Revenues of \$61.8 million for the nine months ended September 30, 2004 decreased 7.5% from \$66.9 million for the nine months ended September 30, 2003. Gaiam's decrease in revenues was due to a decrease in the business segment of \$5.4 million, or 16% for the first nine months of 2004. This shortfall resulted from lower sales volumes in the U.S. trade business, particularly in VHS, and an increase in markdowns and returns associated with the change out of VHS format for DVD format. Three of our distributors who service the clubs, Wal-Mart, and the Canadian market generated negative comparative sales of over \$2.1 million from 2003, as these retailers moved to convert their media inventories from the VHS format and re-position their offerings. Direct to consumer segment revenues were \$33.8 million for the nine months ended September 30, 2004, compared to \$33.0 million for the same period in 2003. Internal revenue growth in our internet and international businesses was 14% and 12.6%, respectively, for the first nine months of the year.

Gross profit decreased to \$31 million for the first nine months of 2004 from \$35.4 million during the same period in 2003. As a percentage of revenue, gross profit declined to 50.2% in 2004 from 53% in 2003. This was primarily attributable to a decline of 500 basis points in the business segment gross margin associated with markdowns and other expenses incurred with the changeover from VHS to DVD products. This was partially offset by a favorable change in sales mix from the business segment to the direct to consumer segment, where Gaiam has better overall margins.

Selling and operating expenses increased to \$31.4 million for the nine months ended September 30, 2004 as compared to \$30.8 million in the same period of 2003, primarily resulting from increased sales and marketing efforts in our business segment, both domestically and in our U.K. subsidiary, and in our direct to consumer segment, to support the revenue increases described above. As a percentage of revenues, selling and operating expenses increased to 50.8% in 2004 from 46% in 2003.

Corporate, general and administration expenses decreased to \$5.9 million for the nine months ended September 30, 2004 from \$6.3 million in the comparable 2003 period, and decreased to 9.6% of revenues in 2004 from 9.4% of revenues in 2003. This expense reduction is generally attributable to cost savings negotiated with

service providers and other savings generated by the consolidation of administrative services into Gaiam's Colorado headquarters.

Operating losses increased to \$6.3 million for the nine months ended September 30, 2004 from \$1.7 million for the nine months ended September 30, 2003, primarily due to revenue decreases and lower gross profit margins.

Gaiam recorded \$270 thousand and \$46 thousand in other income, primarily from interest income, for the nine months ended September 30, 2004 and 2003, respectively. The share of net income associated with minority interest was \$326 thousand for the first nine months of 2004, compared to the share of net income of \$345 thousand for the comparable 2003 period.

Gaiam recorded an income tax benefit of \$2.3 million for the nine months ended September 30, 2004 compared to an income tax benefit of \$648 thousand for the nine months ended September 30, 2003.

As a result of the factors described above, Gaiam's net loss was \$4.1 million for the nine months ended September 30, 2004 compared to a net loss of \$1.3 million recorded for the nine months ended September 30, 2003. Despite these losses, Gaiam's cash generated by operations was \$1.6 million for the first nine months of 2004, and Gaiam's cash position increased to \$9.7 million at September 30, 2004, from \$8.4 million at December 31, 2003.

#### Liquidity and Capital Resources

Gaiam's capital needs arise from working capital required to fund our operations, capital expenditures related to replacements, expansions and improvements to Gaiam's infrastructure, development of e-commerce, acquisitions of new businesses, and future growth. These capital requirements depend on numerous factors, including the rate of market acceptance of Gaiam's product offerings, the ability to expand Gaiam's customer base, the cost of ongoing upgrades to Gaiam's product offerings, the level of expenditures for sales and marketing, the level of investment in distribution and other factors. The timing and amount of these capital requirements are variable and cannot accurately be predicted. Additionally, Gaiam will continue to evaluate possible investments in businesses, products and technologies, and increase its sales and marketing programs and brand promotions as needed.

Gaiam has a credit agreement with Wells Fargo, which permits borrowings of up to \$15 million based upon the collateral value of Gaiam's accounts receivable, inventory and certain property and equipment. Borrowings under the credit agreement bear interest at the lower of prime rate less 50 basis points or LIBOR plus 275 basis points. Borrowings are secured by a pledge of Gaiam's assets, and the agreement contains various financial covenants, including covenants prohibiting the payment of cash dividends to Gaiam shareholders and requiring compliance with certain financial ratios. At September 30, 2004, Gaiam had no amounts outstanding under this agreement and complied with all of the financial covenants.

Gaiam's operating activities generated net cash of \$1.6 million and \$1.7 million for the nine months ended September 30, 2004 and 2003, respectively. Gaiam's net cash generated from operating activities for both periods is primarily attributable to a decrease in accounts receivable of \$5.9 million in 2004 and \$8.3 million in 2003, which was partially offset by decreases in accounts payable of \$1.6 million in 2004 and \$1.7 million in 2003. Cash used for deferred advertising costs associated primarily with the holiday catalogs increased to \$1.8 million in 2004 from \$815 thousand for the nine months ended September 30, 2003. For the nine months ended September 30, 2003, Gaiam also used cash to reduce accrued expenses and income taxes payable a combined \$3.6 million. Non-cash charges to net income were \$3.4 million and \$3 million for the nine months ended September 30, 2004 and 2003, respectively.

Gaiam's investing and acquisition activities used net cash of \$755 thousand and \$5.1 million during the first nine months of 2004 and 2003, respectively. Expenditures for property, equipment and media rights were \$755 thousand for the first six months of 2004, as compared to \$1.3 million for the same period in 2003. In January 2003, Gaiam acquired a 50.1% interest in Leisure Systems International Ltd., a distributor of wellness products based in the U.K. Total consideration for the acquisition was approximately \$4.3 million in cash and 50,000 shares of Gaiam Class A common stock.

Gaiam's financing activities generated net cash of \$379 thousand and used cash of \$122 thousand for the nine months ended September 30, 2004 and 2003, respectively. The cash generated by financing activities results primarily from the exercise of stock options under Gaiam's 1999 Long Term Incentive Program. Cash is used to fund principal payments under capitalized leases.

We believe our available cash, cash expected to be generated from operations, and borrowing capabilities on our unused \$15 million line of credit should be sufficient to fund our operations on both a short-term and long-term basis. However, our projected cash needs may change as a result of acquisitions, unforeseen operational difficulties or other factors.

In the normal course of our business, we investigate, evaluate and discuss acquisition, joint venture, minority investment, strategic relationship and other business combination opportunities in the LOHAS market. For any future investment, acquisition or joint venture opportunities, we may consider using then-available liquidity, issuing equity securities or incurring additional indebtedness.

#### Contractual Obligations

Gaiam has commitments pursuant to lease and debt agreements, but does not have any long-term debt obligations or purchase obligations. The following table shows our commitments to make future payments under operating and capital leases as of September 30, 2004 (in thousands):

	Total	< 1 year	1-3 years	3-5 years	> 5 yrs
Operating lease obligations	\$ 3,625	\$ 1,500	\$ 2,125	\$ —	\$ —
Capital lease obligations	7	7	—	—	—
Total contractual cash obligations	\$ 3,632	\$ 1,507	\$ 2,125	\$ —	\$ —

#### Off-Balance Sheet Arrangements

Gaiam does not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as special purpose entities ("SPEs") or variable interest entities ("VIEs") established for the purpose of facilitating off-balance sheet arrangements or other limited purposes. As of September 30, 2004, Gaiam was not involved with any unconsolidated SPEs or VIEs.

#### Critical Accounting Policies

Management believes the following to be critical accounting policies whose application have a material impact on Gaiam's financial presentation and involve a higher degree of complexity, as they require management to make judgments and estimates about matters that are inherently uncertain.

#### *Provisions for Doubtful Accounts and Returns*

Gaiam records a provision for doubtful accounts for all receivables not expected to be collected. Gaiam generally does not

require collateral. Gaiam evaluates the collectibility of accounts receivable based on a combination of factors. In circumstances when we are aware of a specific customer's inability to meet its financial obligations (e.g. bankruptcy filings), Gaiam records a specific reserve for bad debts against amounts due. For all other instances, Gaiam recognizes reserves based on historical experience and review of individual accounts outstanding.

Gaiam records a provision for product returns to be received in future periods at the time the original sale is recognized. The amount of the returns provision is based upon historical experience and future expectations.

#### *Inventory*

Inventory consists primarily of finished goods held for sale and is stated at the lower of cost (first-in, first-out method) or market. Gaiam identifies the inventory items to be written down for obsolescence based on the item's current sales status and condition. If the item is discontinued or slow moving, it is written down based on an estimate of the markdown to retail price needed to sell through its current stock level of the item.

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#### *Goodwill*

Goodwill represents the excess of the purchase consideration over the fair value of assets acquired less liabilities assumed in a business acquisition. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill is no longer amortized but is reviewed for impairment annually or more frequently if impairment indicators arise, on a reporting unit level. The fair value of a reporting unit is compared with its carrying amount, including goodwill. If the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not impaired.

If the carrying amount of a reporting unit exceeds its fair value, the goodwill impairment test is performed to measure the amount of impairment loss. Gaiam has allocated goodwill to two reporting units, and uses a market value method for the purposes of testing for potential impairment. The annual review requires extensive use of financial judgment and estimates. Application of alternative assumptions and definitions, such as a change in the composition of a reporting unit, could yield significantly different results

#### *Investments*

Investments in entities over which Gaiam does not have the ability to exercise significant influence are accounted for under the cost method. Under the cost method of accounting, investments in private companies are carried at cost and are adjusted only for other-than-temporary declines in fair value. Investments under the cost method are included on the accompanying consolidated balance sheet in "Investments."

#### *Capitalized Production Costs*

Capitalized production costs include costs incurred to produce informational media products marketed by Gaiam to retail marketers and direct-mail customers. These costs are deferred for financial reporting purposes until the media is released, then amortized over succeeding periods on the basis of estimated sales. Historical sales statistics are the principal factor used in estimating the amortization rate.

Gaiam has not had any significant changes in its critical accounting policies from its Form 10-K filing for the fiscal year ended December 31, 2003.

#### Risk Factors

We wish to caution you that there are risks and uncertainties that could cause our actual results to be materially different from those indicated by forward-looking statements that we make from time to time in filings with the Securities and Exchange Commission, news releases, proxy statements, annual reports, registration statements and other written communications, as well as oral forward-looking statements made from time to time by representatives of Gaiam. These risks and uncertainties include, but are not limited to, those listed in Gaiam's Annual Report on Form 10-K for the year ended December 31, 2003. These risks and uncertainties and additional risks and uncertainties not presently known to us or that we currently deem immaterial may cause our business, financial condition, operating results and cash flows to be materially adversely affected. Except for the historical information contained herein, the matters discussed in this analysis are forward-looking statements that involve risk and uncertainties, including, but not limited to, general economic and business conditions, competition, pricing, brand reputation, consumer trends, and other factors which are often beyond our control. Gaiam does not undertake any obligation to update forward-looking statements except as required by law.

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

We are exposed to market risks, which include changes in U.S. interest rates and foreign exchange rates. We do not engage in financial transactions for trading or speculative purposes.

Any borrowings we might make under our bank credit facility would bear interest at the lower of prime rate less 50 basis points or LIBOR plus 275 basis points. Gaiam does not have any amounts outstanding under its credit line, so any unfavorable change in interest rates would not have a material impact on Gaiam's results from operations or cash flows unless Gaiam makes borrowings in the future.

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Gaiam purchases a significant amount of inventory from vendors outside of the U.S. in transactions that are primarily U.S. dollar denominated transactions. Because the percentage of our international purchases denominated in currencies other than the U.S. dollar is small, any currency risks related to these transactions are immaterial to Gaiam. A decline in the relative value of the U.S. dollar to other foreign currencies could, however, lead to increased purchasing costs. In order to mitigate this exposure, Gaiam makes virtually all of its purchase commitments in U.S. dollars.

In 2003, Gaiam purchased a 50.1% interest in Leisure Systems International Limited, a U.K. based distributor. Because Leisure Systems' revenues are primarily denominated in foreign currencies, this investment exposes Gaiam to accounting risk associated with foreign currency exchange rate fluctuations. However, we have determined that there was no material market risk exposure to our consolidated financial position, results of operations or cash flows as of September 30, 2004.

**Item 4. Controls and Procedures**

Gaiam maintains disclosure controls and procedures designed to ensure that the information Gaiam must disclose in its filings with the Securities and Exchange Commission is recorded, processed, summarized and reported on a timely basis. Gaiam's chief executive officer and chief financial officer conducted an evaluation of the effectiveness of the design and operation of Gaiam's disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act. Based upon their evaluation as of September 30, 2004, they have concluded that those disclosure controls and procedures are effective for the purpose of ensuring that material information required to be included in this quarterly report is made known to them by others on a timely basis.

Gaiam is continuously seeking to improve the efficiency and effectiveness of its businesses and of its internal controls. This results in refinements to processes throughout Gaiam's operations. However, there has been no change in Gaiam's internal control over financial reporting during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, Gaiam's internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

From time to time, Gaiam is involved in legal proceedings that we consider to be in the normal course of business. We do not believe that any of these proceedings will have a material adverse effect on our business.

**Item 2. Changes in Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders.**

None.

**Item 5. Other Information.**

None.

**Item 6. Exhibits and Reports on Form 8-K.**

a) Exhibits

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<u>Exhibit No.</u>	<u>Description</u>
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 (filed herewith).
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 (filed herewith).
32.1	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).
32.2	Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).

b) Reports on Form 8-K.

On October 15, 2004, Gaiam filed a report on Form 8-K under Item 4.01, "Changes in Registrant's

Accountant” announcing a change in Registrant’s independent accountants.

On October 27, 2004, Gaiam filed a report on Form 8-K relating to its earnings press release for the third quarter 2004.

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### Signatures

In accordance with the requirements of the Securities and Exchange Act, the registrant caused this report to be signed on its behalf, by the undersigned, thereunto duly authorized.

Gaiam, Inc.  
(Registrant)  
October 27, 2004

By: /s/ Jirka Rysavy  
Jirka Rysavy  
Chief Executive Officer

/s/ Janet Mathews  
Janet Mathews  
Chief Financial Officer

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## CERTIFICATION

I, Jirka Rysavy, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Gaiam, 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)) 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) 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
  - (c) 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.

Date: October 27, 2004

/s/ Jirka Rysavy

Jirka Rysavy

Chairman and Chief Executive Officer

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## CERTIFICATION

I, Janet Mathews, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Gaiam, 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)) 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) 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
  - (c) 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.

Date: October 27, 2004

/s/ Janet Mathews

Janet Mathews  
Chief Financial 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 Gaiam, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2004, as filed with the U.S. Securities and Exchange Commission on the date hereof (the "Report"), I, Jirka Rysavy, Chairman and 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 my knowledge:

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

Date: October 27, 2004

/s/ Jirka Rysavy

Jirka Rysavy

Chairman and Chief Executive Officer

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

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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 Gaiam, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2004, as filed with the U.S. Securities and Exchange Commission on the date hereof (the "Report"), I, Janet Mathews, 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 my knowledge:

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

Date: October 27, 2004

/s/ Janet Mathews

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Janet Mathews  
Chief Financial Officer

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

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