



**SAVE THE WORLD AIR, INC.**

**2011 ANNUAL REPORT**



March 31, 2011

To Our Shareholders:

I am pleased to report that in this past year, STWA has seized opportunities to grow its business and provide shareholders with financial rewards for their many years of support of the company. In this letter to you, the owners of STWA, I will take this opportunity to recap the milestone events of 2010 and tell you why we believe 2011 is shaping up to be an exciting time for both you and the company.

As you are aware, our country and the global economy are going through significant changes that will require foresight and vision. The current political climate provides incentives for clean energy development and carbon reduction technologies to both manage our consumption of energy and protect our environment. Although these are lofty goals, they will take years to develop and implement. Recognizing that we have the technology to improve the efficiency of energy assets, we have focused our efforts this past year to design, develop and license products which can lead to cost savings in the movement of oil and petroleum products and create fuel efficiency for fleets using fuel oils such as diesel. In 2010 we made great strides in these two areas.

Working with the U.S. Department of Energy we received permission to field test a product prototype of our Applied Oil Technology (AOT™) that enables crude oil pipelines to operate more efficiently, increasing daily capacity while reducing power requirements, downtime and the need to add and remove costly chemical additives. We engaged Colfax Corporation (NYSE: CFX), a global supplier of fluid handling solutions, pumps and systems for commercial, marine, defense, industrial, lubrication, oil and gas and power generation, to produce a full scale AOT™ product prototype for testing at the Department of Energy's Rocky Mountain Oil Field Testing Center (RMOTC) in Wyoming. Working with the RMOTC, the Pipeline Research Council International (PRCI) is under contract with STWA. Our AOT™ technology has already been proven in laboratory tests to reduce crude oil viscosity and successful field-testing provides the link between product development and bringing that technology to industry. We consider this development to be a significant milestone towards realizing the commercial application of our technology. There is a large worldwide demand for products that can increase the efficiency of existing infrastructure associated with the production and transportation of derived fuels. Our goal is to use our technology to meet those demands.

We have not lost sight of the opportunities with our ELEKTRA™ product which offers potential fuels cost savings for vehicles powered by diesel engines. Because of the large number of variables such as engine types and specs, driving and load conditions, climate and diesel fuel additives it has taken longer to reach that point where we can have a deliverable product. We are continuing with our efforts in that market area but because of the breakthrough and huge potential our AOT™ technology offers we have chosen to focus our attention in that area.

Operationally, we continued to run a very lean organization and maintained tight control over our cost structure in 2010. We improved our balance sheet position by focusing on reducing our liabilities and lowered our debt to take advantage of the opportunities that lie before us. We strengthened our working relationship with Temple University and achieved our payment obligations covering our licensing agreements. We continue to develop a maturing intellectual product portfolio as we work closely with Temple to bring advanced electrorheological products to market.

In closing, I would like to thank you for your unwavering belief in our mission. The success we have achieved in entering real-world applications with our technology would not have been possible without your continued support and vision. I have never seen a more loyal shareholder base, which drives home the importance of our mission. We look forward to the extraordinary opportunities ahead and remain committed to maximizing the value of your business.

Yours Faithfully,

Cecil Bond Kyte  
Chairman & CEO

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

**Form 10-K**

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

**For the fiscal year ended December 31, 2010**

**or**

☐ **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

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

**Commission File Number 0-29185**

**Save the World Air, Inc.**

*(Exact name of registrant as specified in its charter)*

**Nevada**

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

**52-2088326**

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

**735 State Street, Suite 500**

**Santa Barbara, California 93101**

*(Address, including zip code, of principal executive offices)*

**(805)-845-3581**

*(Registrant's telephone number, including area code)*

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

**Securities registered pursuant to Section 12(g) of the Exchange Act: Common Stock, \$0.001 par value.**

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of 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 definition of "large accelerated filer," "accelerated filer" and "small reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☒

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates (excluding voting shares held by officers and directors) as of June 30, 2010 was \$32,136,131.

The number of shares of the Registrant's Common Stock outstanding as of March 15, 2011 was 93,221,916

**DOCUMENTS INCORPORATED BY REFERENCE**

Transitional Small Business Disclosure Format (Check one) Yes ☐ No ☒

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**SAVE THE WORLD AIR, INC.**  
**FORM 10-K**  
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## **PART I**

### **Forward-Looking Statements**

This Annual Report on Form 10-K contains forward-looking statements. These forward-looking statements include predictions regarding our future:

- revenues and profits;
- customers;
- research and development expenses and efforts;
- scientific and other third-party test results;
- sales and marketing expenses and efforts;
- liquidity and sufficiency of existing cash;
- technology and products;
- the outcome of pending or threatened litigation; and
- the effect of recent accounting pronouncements on our financial condition and results of operations.

You can identify these and other forward-looking statements by the use of words such as “may,” “will,” “expects,” “anticipates,” “believes,” “estimates,” “continues,” or the negative of such terms, or other comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements.

Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth below under the heading “Risk Factors.” All forward-looking statements included in this document are based on information available to us on the date hereof. We assume no obligation to update any forward-looking statements.

#### **Item 1. Business**

*The discussion of our business is as of the date of filing this report, unless otherwise indicated.*

##### **Overview**

Save the World Air, Inc. (“STWA” or “Company” or “we”) designs, licenses and develops products to improve energy efficiency of large-scale energy production and improve diesel engine performance reducing emissions and improving fuel economy. We are a green technology company that leverages a suite of patented, patent-pending and licensed intellectual properties related to the treatment of fuels. Technologies patented by or licensed to us utilize either magnetic or uniform electrical fields to alter physical characteristics of fuels and are designed to create cleaner combustion. Cleaner combustion has been shown to improve performance, enhance fuel economy and/or reduce harmful emissions in laboratory testing.

We have two product lines; Applied Oil Technology (“AOT”) and ELEKTRA™.

Applied Oil Technology is transitioning from the research and development stage to full-scale commercial prototypes, and is in testing with the U.S. Department of Energy. ELEKTRA is in the research and development stage.

We obtained three licenses (the “Licenses”) from Temple University for their patent-pending uniform electric field technology, which provide the intellectual property foundations upon which the AOT and ELEKTRA products are based. The AOT technology consists of passing crude oil through an array of dynamically-controlled electrical fields to reduce the viscosity of the oil, making it easier to pump through oil pipelines. The ELEKTRA technology consists of passing fuel through a dynamically-controlled electrical field to assist in the atomization of fuel via fuel injectors. ELEKTRA introduces a uniform electrical field into the fuel flow to reduce the viscosity of diesel fuel, enabling smaller droplets to be released into the combustion chamber of a diesel engine. At December 31, 2010, the Company owed to Temple University a total of \$721,785 for the License Agreement, Maintenance Fees, R&D Agreement and penalties and we were in default in those payments. On March 28, 2011, the Company completed its final adjusted payment to Temple University for all obligations outstanding on the License Agreements and the R&D Agreement. (See “9B. Other Information”).

The Company holds US Patent # 6901917, effective May 21, 2001 for “DEVICE FOR SAVING FUEL AND REDUCING EMISSIONS” covered in the United States, Australia, Canada, China, Russia, India, Indonesia and Mexico for the legacy technology.

We are also working with Temple University and Colfax Corporation (NYSE: CFX) to assist in the development of the commercial version of the AOT technology product line for oil refineries and pipelines. The AOT product line uses the same dynamically-controlled strong electrical field concepts to reduce viscosity as ELEKTRA but is designed for pipeline applications that use thicker, more viscous fuels than the ELEKTRA market. The AOT product is intended to improve the speed of highly viscous fluids such as crude oil traveling through pipelines.

We operate in a highly competitive industry. Many of our activities are subject to governmental regulation. We have taken aggressive steps to protect our intellectual property. See “Competition”, “Government Regulation and Environmental Matters” and “Intellectual Property” below.

There are significant risks associated with our business, our Company and our stock. See “Risk Factors” below.

We are a development stage Company that generated minimal revenues in 2006 and 2007. We did not generate any sales or revenues in 2008, 2009 or 2010. Our expenses to date have been funded primarily through the sale of stock and convertible debt, as well as proceeds from the exercise of stock purchase warrants. We raised capital in 2010 and will need to raise substantial additional capital in 2011, and beyond, to fund our sales and marketing efforts, continuing research and development, and certain other expenses, until our revenue base grows sufficiently to cover such expenditures. See “Management’s Discussion and Analysis” below.

Our company was incorporated on February 18, 1998, as a Nevada corporation, under the name Mandalay Capital Corporation. We changed our name to Save the World Air, Inc. on February 11, 1999, following the acquisition of marketing and manufacturing rights of the ZEFS (legacy) technologies. Our mailing address is 735 State Street, Suite 500, Santa Barbara, California 93101. Our telephone number is (805) 845-3581. Our corporate website is [www.stwa.com](http://www.stwa.com).

Our common stock is quoted under the symbol “ZERO” on the Over-the-Counter Bulletin Board.

## **Recent Developments**

In 2010, the company formed a relationship with Colfax Corporation to assist in the product development of commercial prototypes of the AOT technology. The initial prototype has been constructed and is being used for testing by the U.S. Department of Energy.

In 2010, the Company was approved for testing by the US Department of Energy for testing its new technology at the US DOE Rocky Mountain Oilfield Testing Center, at the US Naval Petroleum Reserve #3 near Casper, Wyoming.

In 2010, the Company contracted with Pipeline Research Council International (PRCI) for testing of the Company’s AOT technology.

In 2010, Dr. RongjiaTao of Temple University confirmed the AOT technology’s effects at nano-scale level using a neutron-scattering beam at the US National Institute of Standards and Technology (NIST).

In 2010, the Company satisfied its R&D Agreement obligations with Temple University.

On February 24, 2009, we received notice from the California Air Resources Board (CARB) that we have been issued an Executive Order (EO number D-659) approving the legacy technology for road-going applications. A CARB Executive Order is recognized by the EPA, meaning the product can also be legally sold in all 50 states subject to any applicable state regulations.

## **Our Business Strategy**

Our business strategy is to provide the energy production and transportation industries with cost effective products to reduce their ongoing operation costs, and potentially reduce their initial capital expenditure costs. In addition, our strategy is to provide the commercial transportation industry, military and other diesel-powered machinery operators with products to reduce their ongoing operation costs associated with fuel consumption, and potentially reduce their fuel consumption emissions.

We believe there is a large worldwide demand for products which can increase the efficiency of existing infrastructure associated with the production and transportation of hydrocarbon derived fuels. We also believe that

there is a large worldwide demand for products, which can increase the efficiency of existing infrastructure and assets associated with the maritime, military, construction, over the road and rail transportation, power generation and all other large diesel-powered systems and vehicles.

Our intent is to collaborate with established educational institutions such as Temple University, and industry partners such as Colfax Corporation to commercialize our technology, and leverage their facilities, expertise, sales channels, and infrastructure. This will allow us to maximize the effectiveness of bringing our products to market while eliminating capital requirements and risk. This model will allow us to accelerate all of our timelines, and retain a very competitive, and efficient corporate entity structure.

### ***Our Products and Technologies***

#### ***Applied Oil Technology (AOT)***

##### **New Technology to Reduce Oil Transportation Costs via Viscosity Reduction**

There is a direct correlation between the time and expense of extracting and transporting crude oil with its viscosity. STWA aims to provide a turnkey solution to change the way that oil explorers, drillers and wholesalers manage oil, thereby improving their efficiency and profitability.

AOT increases the flow rate of crude oil in pipelines by as much as 20% with ultra-low ongoing energy costs. The product also delivers cost reductions in pipeline operation by reducing the need for drag reducing agents, diluents and heating to lower crude oil viscosity to move oil through pipelines.

Prior to the development of AOT, the industry has used a variety of other methods to increase oil flow in pipelines, primarily by reducing the viscosity of the oil. Reducing viscosity improves crude oil flow because it reduces the friction and drag introduced by the crude oil “rubbing” up against itself and the interior of the pipeline. With less friction, crude oil flows faster and requires less energy to pump.

There is forecasted to be substantial increases in oil and gas demand over the upcoming years as the global economy recovers. The rapid growth in areas such as India and China are increasing the needs for new pipeline construction in order to handle increased production and deliveries of crude oil and its derivatives to cope with the rapidly increasing demand. Advancements in technology will be needed to improve extraction from non-conventional oil and gas sources, such as shale and sands to address the increases in demand.

Our research indicates that the global market for new oil and gas pipelines, upgrades, extensions and maintenance was worth \$62.6Bn in 2009. Growth in this sector is expected to be substantial from 2010 – 2020 as global energy demands increase, with Asia representing the majority of this growth.

Our AOT technology directly addresses this market, as it is designed to enable faster throughput rates of crude oil, increasing daily delivery capacities, and reducing operational direct expenses associated with crude oil transmission through pipelines.

#### **AOT’s market drivers are:**

- **Increased Global Demand for Oil.**  
With the US and global economies beginning to recover and accelerate, the demand for energy increases. In addition, emerging nations such as India and China are accelerating their thirst for oil as their manufacturing sectors build new facilities to address expanding economies.
- **New Drilling Discoveries and Techniques.**  
Recent and emerging technological advancements are enabling crude oil discoveries and supplies to be made in harsher climates and from more unconventional sources such as shale and oil sands. Cold, remote oil fields stand to benefit from viscosity reduction technology, making them more competitive.
- **Oil and Gas Price Increases.**  
As demand outpaces readily available supplies, new pipelines and pipeline technologies will be required to prevent supply shortages. Greater price increases accelerate demand for additional pipelines and/or technology to improve delivery throughput capacities.

We have entered into a research and development agreement (“R&D Agreement”) with Temple University and Colfax Corporation to develop the AOT technology into commercialized products. Under the R&D Agreement Temple University is conducting an ongoing research project towards expanding the scope of, and developing products utilizing, the technologies covered under the Licenses, including a device utilizing a magnetic field to reduce crude oil viscosity for crude oil (paraffin and mixed base) and edible oil flow in pipelines. The AOT technology is designed to improve energy efficiency of large-scale energy production. The patented and patent

pending AOT™ (Applied Oil Technology), co-developed with Temple University, provides efficient and cost-effective means of improving the efficacy of crude oil transport.

#### **Applications for AOT include:**

Crude oil extraction & delivery systems, including oil platforms, oil fields and distribution pipeline networks. The technology reduces viscosity of crude oil, reducing the energy requirements for pipeline transmission systems. We believe that AOT is a ground-breaking innovation for petrochemical delivery systems worldwide.

Crude oil and its derivatives are fluids in suspension, meaning they have a base fluid with particulate matter “suspended” within. These suspended particles when rubbing together create drag within the fluid, increasing the overall viscosity and making it more difficult to pump the oil through domestic distribution and export pipeline networks. Using electromagnetism, Dr. Rongjia Tao, Chair, Department of Physics, Temple University expanded on STWA’s legacy technology with an innovative in-line device that introduces short, precise electric pulse bursts within the fluid flow, forcing the particulate matter to align in the field direction. When this happens, the particulate matters’ natural tendency to combine into clusters is enhanced. This enables the total surface area per unit of dissolved particulate matter to decrease. This, in turn, provides more volume within the fluid for the suspended particles to move, thereby reducing particle rubbing and friction, which reduces the oil’s viscosity.<sup>1</sup> This improves flow.

This is potentially a high-margin, high-demand product.

Prior to the development of AOT, the industry has used a variety of other methods to increase oil flow in pipelines, primarily by reducing the viscosity of the oil. Reducing viscosity improves crude oil flow because it reduces the friction and drag introduced by the crude oil “rubbing” up against itself and the interior of the pipeline. With less friction, crude oil flows faster and requires less energy to pump.

AOT has competitive advantages versus these existing methods of reducing viscosity. In some cases it can replace existing methods; in most cases it is a complimentary technology that reduces the overall cost of viscosity reduction.

In 2004, STWA approached Temple University with a research grant to expand on the Company’s legacy technology (ZEFS, MK IV, Mag ChrgR and the ECO ChrgR), with Dr. Rongjia Tao, Chairman, Temple University Physics Department as principal investigator for the development and commercialization of improving oil flow using electric fields. We then assigned the original patent application for this technology “Method and Apparatus for a Treatment of a Fluid” to Temple University. In March 2008, Dr. Tao published *Final Report Reducing the Viscosity of Crude Oil by Pulsed Electric and Magnetic Field* disclosing a series of tests where crude oil viscosity was reduced by as much as 50%. In 2009, we captured a series of tests on video and also demonstrated the technology to Colfax Corporation. In August, 2010, chief scientist, Dr. Tao had confirmed the technology’s effects using a neutron-scattering beam at the National Institute of Standards and Technology (NIST). In November 2010, we announced that we had engaged Colfax Corporation to build a prototype to be tested at the US Department of Energy RMOTC in Casper, Wyoming. In January, 2011, we announced we were contracting with the Pipeline Research Council International for the testing of the Applied Oil Technology at the US Department of Energy.

#### **ELEKTRA**

##### **New Emissions Reduction and Fuel Efficiency Technology**

STWA’s patented and patent pending ELEKTRA™, co-developed with Temple University, improves diesel engine performance reducing emissions and improving fuel economy, by assisting in fuel atomization just prior to combustion. The ELEKTRA technology is designed to be installed in the fuel supply lines of vehicles and, because there are very few variations in the size and type of those lines, we anticipate that a relatively small number of variable capacity devices and a selection of installation adapters will cover most vehicle installations.

We have obtained a license from Temple University for its patent-pending electric field technology, called ELEKTRA™. The ELEKTRA technology consists of passing fuel through a specific strong electrical field. A 2008 paper published by Dr. Rongjia Tao, Ph.D., Chair of the Physics Department at Temple University titled “Electrorheology Leads to Efficient Combustion” says that ELEKTRA lowers the viscosity of fuel, resulting in better atomization of the fuel and improved combustion.

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<sup>1</sup> Recent scientific research on the Company’s technology at the US National Institute of Standards and Technology NIST has confirmed the technology’s effect on crude oil molecules. The report can be found at the following link: [http://www.stwa.com/STWA/whitepapers/STWA\\_Crude\\_Oil\\_Electrorheology\\_Neutron\\_Scattering\\_Test\\_at\\_NIST.pdf](http://www.stwa.com/STWA/whitepapers/STWA_Crude_Oil_Electrorheology_Neutron_Scattering_Test_at_NIST.pdf)



Using electromagnetism, Dr. Rongjia Tao, Chair, Department of Physics, Temple University expanded on STWA's legacy technology with an innovative in-line device that introduces short, precise electric pulse bursts within the fluid flow, forcing the particulate matter to align in the field direction. When this happens, the particulate matters' natural tendency to combine into clusters is enhanced. This enables the total surface area per unit of dissolved particulate matter to decrease. This, in turn, provides more volume within the fluid for the suspended particles to move, thereby reducing particle rubbing and friction, which reduces the fuel's viscosity.

The Company entered into a research and development agreement (R&D Agreement) in 2007 with Temple University to conduct further research on the AOT/ELEKTRA technology. Under the R&D Agreement Temple University will conduct a 24-month research project towards expanding the scope of, and developing products utilizing, the technologies covered under the Licenses, including design and manufacture of prototypes utilizing electric fields to improve diesel, gasoline and kerosene fuel injection in engines using such fuels and a device utilizing a magnetic field to reduce crude oil viscosity for crude oil (paraffin and mixed base) and edible oil flow in pipelines. If the research project yields results within the scope of the technologies licensed pursuant to the Licenses, those results will be deemed included as rights licensed to the Company pursuant to the Licenses. If the research project yields results outside of the scope of the technologies covered by the Licenses, the Company has a six-month right of first negotiation to enter into a new worldwide, exclusive license agreement with Temple University for the intellectual property covered by those results.

The Company has entered into three License Agreements with Temple University covering Temple University's current patent applications concerning certain electric field effects on gasoline, kerosene and diesel fuel particle size distribution, and concerning electric field effects on crude oil and edible oil viscosity. Initially, the License Agreements are exclusive and the territory licensed to the Company is worldwide. Pursuant to the License Agreements, the Company will pay to Temple University license fees in the aggregate amount of \$300,000. A payment of \$50,000 was due on November 1, 2006; a payment of \$100,000 was due on March 2, 2007; a payment of \$75,000 was due on February 2, 2008 and the final payment is due on February 2, 2009. Annual maintenance fees of \$25,000 for the first license were due on November 1, 2007, November 1, 2008, and November 1, 2009. Annual maintenance payments of \$150,000 for two of the licenses were due January 1, 2008 and January 1, 2009. In addition, each License Agreement separately provides that the Company will pay royalties to Temple University on net sales of products incorporating the technology licensed under that License Agreement in an amount equal to 7% of the first \$20 million of net sales, 6% of the next \$20 million of net sales and 5% of net sales in excess of \$40 million. Sales under the three License Agreements are not aggregated for purposes of calculating the royalties payable to Temple University. In addition, the Company has agreed to bear all costs of obtaining and maintaining patents in any jurisdiction where the Company directs Temple University to pursue a patent for either of the licensed technologies. Should the Company not wish to pursue a patent in a particular jurisdiction, that jurisdiction would not be included in the territory licensed to the Company.

On November 10, 2008, the Company received written notice from Temple University of a material breach relating to required payments under the License Agreements. The notice provides the Company with 60 days' notice to cure the material breach. The Company's failure to cure could result in a termination of the License Agreements. Under the License Agreements the Company is subject to a penalty of 1% per month of the amounts due and unpaid under the License Agreements. As of December 31, 2010, the Company was in default in the total amount of \$721,785 which includes \$256,785 of penalty interest and the Company has accrued this in the accompanying financial statements. On March 28, 2011, the Company completed its final adjusted payment to Temple University for all obligations outstanding on the License Agreements and the R&D Agreement. (See "9B. Other Information").

The Company also entered into a research and development agreement (R&D Agreement) with Temple University to conduct further research on the ELEKTRA technology. Under the R&D Agreement Temple University will conduct a 24-month research project towards expanding the scope of, and developing products utilizing, the technologies covered under the License Agreements, including design and manufacture of prototypes utilizing electric fields to improve diesel, gasoline and kerosene fuel injection in engines using such fuels and a device utilizing a magnetic field to reduce crude oil viscosity for crude oil (paraffin and mixed base) and edible oil flow in pipelines. If the research project yields results within the scope of the technologies licensed pursuant to the License Agreements, those results will be deemed included as rights licensed to the Company pursuant to the License Agreements. If the research project yields results outside of the scope of the technologies covered by the License Agreements, the Company has a six-month right of first negotiation to enter into a new worldwide, exclusive license agreement with Temple University for the intellectual property covered by those results. Pursuant to the R&D Agreement, the Company will make payments to Temple University in the aggregate amount of \$500,000.

On November 10, 2008, the Company received written notice of default from Temple University of a material breach relating to required payments under the R&D Agreement. The notice provides the Company with 60 days to cure the material breach. The Company's failure to cure the breach could result in the termination of the

R&D Agreement. At December 31, 2010, the Company has paid in full the amount of \$500,000 under the R&D Agreement.

We believe that the applications for products incorporating the ELEKTRA technology will include diesel, maritime diesel, aviation and military diesel, applications. Subject to our cash flow and liquidity limitations, we are currently developing diesel tractor trailer applications and our present intention, subject to change, is to seek joint venture partners to commercialize the ELEKTRA technology in various applications. Subject to adequate financing, we currently believe that we may be able to commence sales of ELEKTRA products by the third quarter of 2011.

### ***Research and Development***

The Company has engaged the Colfax Corporation in 2010 to assist in the development of commercialized versions of its technology with the intent to test and bring to market.

Colfax Corporation is a major manufacturer of industrial pumps and fluid handling technologies used on many ships worldwide. Colfax adds value to the ELEKTRA implementation in these areas:

- Engineering team with skills to complete product design
- Manufacturing capability for prototype and production product
- Distribution to sell, deliver and support ELEKTRA worldwide
- Colfax Corporation assists advancement of ELEKTRA's mesh configuration
- Colfax Corporation's existing products piggyback ELEKTRA devices for additional efficiency gains and product extensions
- Colfax alliance gets ELEKTRA to market with less capital than STWA development of dedicated engineering, manufacturing and distribution

The Company entered into a research and development agreement (R&D Agreement) in 2007 with Temple University to conduct further research on the ELEKTRA technology. Under the R&D Agreement Temple University will conduct a 24-month research project towards expanding the scope of, and developing products utilizing, the technologies covered under the License Agreements, including design and manufacture of prototypes utilizing electric fields to improve diesel, gasoline and kerosene fuel injection in engines using such fuels and a device utilizing a magnetic field to reduce crude oil viscosity for crude oil (paraffin and mixed base) and edible oil flow in pipelines.

### ***Independent Laboratory and Scientific Testing***

The Company is currently working with the U.S. Department of Energy to test its technology at the Department of Energy's Rocky Mountain Oilfield Testing Center (RMOTC), near Casper, Wyoming. This third-party testing is to establish independently verified data related to the Company's technology as applied to commercial use in a controlled facility, using a commercial-scale prototype co-developed with Colfax Corporation.

On August 2 and 3, 2010, a group led by Dr. Rongjia Tao from Temple University conducted experiments at the National Institute of Standards and Technology (NIST) Center for Neutron Research (CNR). NIST, an agency of the U.S. Department of Commerce, founded in 1901 in Gaithersburg, Maryland, is the nation's first federal physical science research laboratory.

Dr. Tao's team used the NG7 SANS (Small Angle Neutron Scattering) beam to investigate at a nano-scale level, the effects produced by STWA's Technology. The NG7 line was built as a joint effort between Exxon Corporation and the U.S. Government for fluid research, and uses the relatively new technique of neutron reflectometry to investigate the near-surface structure of many materials at the molecular level. The tests captured data and pictures with and without the field, confirming scientific evidence of its effect at a molecular level. The report can be found at the following link: [http://www.stwa.com/STWA/whitepapers/STWA\\_Crude\\_Oil\\_Electrorheology\\_Neutron\\_Scattering\\_Test\\_at\\_NIST.pdf](http://www.stwa.com/STWA/whitepapers/STWA_Crude_Oil_Electrorheology_Neutron_Scattering_Test_at_NIST.pdf) Testing of the technology as applied to crude oil extraction and transmission has been conducted at Temple University in their Physics Department

### ***Sales and Marketing***

#### **Applied Oil Technology**

Manner in Which Product or Work Pipeline Industry's Mission:

The Pipeline Industry is in the business of oil production and transportation. Pipeline construction is highly expensive. The Company's AOT technology potentially reduces the pipe diameters and pump sizes needed for new pipeline construction dramatically saving on capital expenditure.

For example, the 800-mile Alyeska Pipeline uses DRA, Drag Reducing Agent to reduce viscosity.<sup>2</sup> An article in Petroleum News in 2007 highlighted that billions of dollars can be saved by lowering viscosity of crude oil:

Management believes that AOT will provide the same potential savings in constructing new pipelines, at much less cost to operate and much less environmental impact than DRA. Additionally, for existing pipelines, this technology increases their daily revenue potential by moving more oil in a given time and pipe diameter and potentially postpones new construction.

Management believes that AOT will be an attractive option for producers and pipeline operators in its ability to reduce the operation costs associated with crude oil transport. The oil industry is a very large, yet tightly-knit, focused community. Management believes that The Company's affiliation with Pipeline Research Council International (PRCI) will be beneficial in its ability to rapidly disseminate information pertaining to AOT's effectiveness in improving pipeline efficiency.

PRCI is a community of the world's leading pipeline companies, and the vendors, service providers, equipment manufacturers, and other organizations supporting our industry. Since 1952, PRCI has been recognized around the world as a unique forum within the energy pipeline industry delivering great value to its members and the industry — both quantitative and qualitative — through the development and deployment of research solutions to the operational, maintenance, and regulatory challenges that face it.

The majority of the world's largest oil and gas pipelines are fully-integrated companies, which are involved in all stages of petrochemical production from extraction to delivery. The companies explore for and produce, own the pipelines for transport, and refine the petrochemicals for wholesale and retail sale. Management believes that the Company's AOT technology is of interest at every level of the extraction, production, transport and delivery to these 'super major' companies.

Management believes that the industry is actively seeking new and innovative cost-savings and throughput capacity improvement technology such as the Company's Applied Oil Technology (AOT). Management believes that targeted messaging to pipeline operators via trade journals and industry trade shows will create strong worldwide demand for the Company's Applied Oil Technology.

#### **Growing Markets:**

China, a net importer of oil, and the world's most populated country, is the second highest consumer of oil behind the US whose energy needs are forecast to be increasing 150% by 2020. Its oil consumption rate is growing at seven times that of the US, and China is investing heavily in new oil pipelines and infrastructure to accommodate this ramp-up. It is forecasted that 70% of China's imported oil will be coming from the Mid-East and Central Asia by 2015. Management believes that The Company's AOT technology holds the potential to provide advantages for the Chinese pipeline industry to assist in this growth.

India, a net importer of oil, is the second most populated country and is directly competing with China in securing oil supplies and infrastructure to fuel its own rapid growth. India currently imports 70% of its oil, and is forecast to increase this number to 85% by 2020. India is investing heavily in pipelines and infrastructure to accommodate this ramp-up. Management believes that the Company's AOT technology holds the potential to provide advantages for the Indian pipeline industry to assist in this growth.

Asia boasts the global region with the largest growth forecasts and is expected to grow from \$20.9Bn in 2010 to \$32.1Bn in 2020. Asia is a very promising region in that its growth is largely being fueled by state-owned companies under direction from their respective governments. The total market forecast for this region is expected to be worth up to \$306.5Bn from 2010 to 2020. Management believes that there is the potential for strong interest in the Company's AOT technology in these regions.

#### **Declining Markets:**

The US is currently the largest consumer of oil, yet its market forecast is not as strong over the 2010-2020 timeline as other regions, due to its markets being more closely linked to the financial markets, which suffered greatly in the 2008+ economic downturn. The MidEast, Asian, and European markets were more insulated to this exposure due to their industries being largely government backed. The North American does have a large number of new pipelines planned, yet their development has been halted until they become economically viable, pending economic recovery. The North American market however is forecast to see large growth rates as the economic recovery takes hold. The North American market is forecast to rise from \$6.4Bn in 2010 to \$16.9Bn in 2020 with the majority of growth from 2010-2015 of 23% CAGR and a decline in the 2015-2020 of -1.5% CAGR. The total

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<sup>2</sup> "TAPS' reduced flow to reflect N. Slope decline", *Oil & Gas Journal*, June 10, 1996, p.30.

market forecast for this region is expected to be worth \$162.3Bn from 2010-2020. Management believes that there is the potential for strong interest in the Company's AOT technology in this region.

The Australian market is forecast to decline in the second half of the decade as its infrastructure matures to full saturation with sufficient transmission line capacity, low relative population in comparison to other regions, and increasing use of alternative energies. The Australian market is expected to grow from \$1.8n in 2010 to \$3.3Bn in 2020, with the majority of growth from 2010-2015 of 13.8% CAGR and a decline in the 2015-2020 of -0.8% CAGR. The total market forecast for this region is expected to be worth \$32.7Bn from 2010-2020. Management believes that there is the potential for strong interest in the Company's AOT technology in these regions.

### **AOT Market Summary:**

Despite the recent publicity and interest in the public eye related to the negative aspects associated with the use of fossil-fuels, the reality is that the global use of fossil fuels will continue to be very strong into the foreseeable future. Petrochemicals are forecast to continue to be the mainstay of the global energy supply, until alternative and emerging energy sources are discovered and developed. Management believes that the Company's AOT technology will become a rapidly implemented and increasingly attractive option for producers and operators as they expand their operations to accommodate the rapidly rising demand for global crude oil supplies. New pipelines are being constructed, new fields are being discovered, and new infrastructure is being built to handle the increasing demand around the globe. Management believes that these new pipelines and infrastructure can benefit from the advantages the Company's AOT technology can provide.

### **ELEKTRA**

Management believes that there is a large and active market for a product such as ELEKTRA that can reduce the fuel consumption of diesel engines. In 2006, the US Department of Transportation published that there were 3.1 million "Truck, combination" (tractor trailers), Busses and Class I locomotives in service in the US. According to the Specialty Equipment Manufacturing Association's "2004/05 Diesel Market Study," there were 3.1 million Diesel Light Trucks registered in the US and 151,427 diesel cars sold in the US since 1991.

In a 2010 paper published by Dr. Rongjia Tao, Ph.D., Chair of the Physics Department at Temple University titled "Electrorheology Leads to Efficient Combustion," Dr. Tao stated that over six months of testing that ELEKTRA increased highway mileage of a Mercedes 300D 19% , from 32 mpg to 38 mpg and increased city mileage 12% to 15%.

The Company has had preliminary discussions with the American Trucking Association and with AITA (America's Independent Truckers Association, Inc). The SAE (Society of Automotive Engineers) has advised us that once the Type II fuel evaluation test results in verifying a meaningful fuel savings, they will publish a story on the product along with the test results and accompanying photos and contact information.

Subject to proper capitalization, we intend to embark upon a sales and marketing program through distributors in the trucking industry.

### **Market Drivers**

The California Air Resources Board (ARB) has established regulations that are driving the need for new emissions reduction technologies. ARB has established the following regulations on ship emissions:

"Requires use of cleaner fuels within 24 nautical mile zone of the California coastline

July 1, 2009

- use marine gas oil (averages 0.3% sulfur), or
- use marine diesel oil with a 0.5% sulfur limit

January 1, 2012

- use marine gas oil with a 0.1% sulfur limit, or
- use marine diesel oil with a 0.1% sulfur limit

Applies to main and auxiliary engines, and auxiliary boiler<sup>3</sup>

ARB will grant exemptions to vessels that apply for a temporary experimental or research exemption.

"Temporary Experimental or Research Exemption

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<sup>3</sup> Air Quality Maritime Working Group Meeting USE OF LOW SULFUR DISTILLATE FUELS IN OCEAN-GOING VESSEL, April 28, 2010, California Environmental Protection Agency

Provided for research projects that will advance the state of knowledge of exhaust control technology or characterization of emissions

- Allows for the use of noncompliant fuel
- Applicant must provide progress reports and all test data and other project results
- Exemption possible for up to 3 years, with an extension possible
- Application process takes about 30 days”

Cargo ships primarily use a high-sulfur content, undistilled fuel known as Bunker-C or residual oil because it is inexpensive. Low sulfur ship fuels such as MDO (Marine Diesel Oil) can cost up to six times as much as Bunker-C. Additionally, ships have to shut down and clean out their fuel systems when switching from Bunker-C to MDO. This can add an extra day to every inbound ocean voyage, greatly increasing the operating cost for ship fleets. A technology that could deliver emissions reduction with Bunker-C and avoid shipping companies having to switch to MDO could avoid dramatic cost increases in shipping.

In the United States, California, through the California Air Resources Board (“CARB”), continues to set the strictest emission standards for the country and the United States Environmental Protection Agency (“EPA”) has indicated it may adopt more stringent emission standards, which would be applicable throughout the United States. Former California Governor Arnold Schwarzenegger had also announced his intent to seek greenhouse gas (“GHG”) legislation and the United States Congress is also considering GHG legislation.

Governments internationally recognize the serious effects caused by air pollution and many nations have enacted legislation to mandate that engine manufacturers be required to reduce exhaust emissions caused by their products. As evidenced by the overwhelming participation in the establishment of the Kyoto Accord, many nations are moving towards tighter GHG emissions control as well. The European Union (“EU”) currently requires all member nations to adopt EURO 3 emissions standards for motorcycles and EURO 4 emissions standards for automobiles and trucks. Some Eastern European countries contemplating EU admission, and certain Asian countries, have also announced gradual phase-in of EURO standards, including China, Indonesia, Vietnam, Thailand and India.

Management believes that US EPA, CARB and international governments will continue to lower emission standards below even these recent levels. Yet, the cost of adding emissions control devices to engines or vehicles has always been a challenge, since manufacturers shift the cost of such devices to the consumer. In developing nations, where incomes are extremely low, economics and the lack of government resources have hampered progress.

Management believes that having the US DOE (US Department of Energy) test results verifying that AOT improves flow rates and reduces energy consumption will be the milestone that will allow the Company to begin closing sales of the product line. Management believes that the product line, integrated into the customers existing infrastructure may be able to yield higher throughput capacity and/or reduce energy requirements of the pumps moving the oil through the pipelines due to lower viscosity.

Upon completion of our tests and the results being published, management will seek contracts within the oil production and transportation industries and the selection of a manufacturing company as follows:

#### ***Selecting a Manufacturing Partner***

We intend to outsource the manufacturing of the AOT technology and are looking for three things in selecting a manufacturing partner. We are currently interviewing candidates.

- Existing proven, large-scale manufacturing and distribution for oil producers and transport hardware
- Existing relationships with oil producers and pipeline operator decisionmakers
- Forward-looking proactive corporate vision looking to boldly expand their market share

#### ***ELEKTRA***

As a result of six months of field testing and refining, we are refitting the ELEKTRA with a new power supply and electronics to optimize the exposure of the fuel to the electric field in an attempt to create peak efficiency. Dr. Luke Turgeon and his company has been retained by us to bring simulation and electronic design skills in an attempt to allow us to go from design to a stable cost effective volume production in the fastest time possible.

Management believes that having the SAE (Society of Automotive Engineers) Type II test results verifying that ELEKTRA saves 10% of more on fuel consumption will be the milestone that will allow the Company to begin closing sales of the product. The 10% fuel savings target is for the after-market ELEKTRA product. Management believes that the OEM product, integrated into the manufacturer's design may be able to yield higher levels of fuel savings due to the fact that the manufacturer will have ELEKTRA communicate the engine's electronics to optimize the advantageous effect as the fuel flow changes over time.

Upon completion of our tests and the results being published, management will seek contracts within the trucking industry and the selection of a manufacturing company as follows:

#### ***Selecting a Manufacturing Partner***

We intend to outsource the manufacturing of the ELEKTRA and are looking for three things in selecting a manufacturing partner. We are currently interviewing candidates.

- Existing proven, large-scale manufacturing and distribution for transportation OEMs
- Existing relationships with fleet managers of large diesel truck operators
- Forward-looking proactive corporate vision looking to boldly expand their market share

#### **Competition**

The oil industry is highly competitive. We are aware of only two currently available competitive technologies in widespread use for reducing the viscosity of oil throughout the world. Many of our competitors have greater financial, research, marketing and staff resources than we do. For instance, oil pipeline operators use heat and/or chemical additives to reduce the viscosity of crude oil to improve flow in pipelines, but, these methods are expensive and/or pose environmental and/or refinery challenges. Management believes that The Company's AOT technology presents advantages over traditional methods, yet the industry's willingness to experiment with said new technology may pose some challenges in acceptance.

The automotive and motor engine industry is highly competitive. We have many competitors in the United States and throughout the world developing technologies to make engines more environmentally friendly and fuel-efficient. Many of our competitors have greater financial, research, marketing and staff resources than we do. For instance, automobile manufacturers have already developed catalytic converters on automobiles in order to reduce emissions, but, as discussed above, this creates greenhouse gases and makes controlling emissions costly and complex. The industry has also proposed high-pressure fuel injection systems for gas and diesel applications but these modifications are extremely expensive.

Although we are unaware of any technologies that compete directly with our technologies, there can be no assurance that any unknown existing or future technology will be, superior to products incorporating the AOT or ELEKTRA technology may provide the benefits of all of emission reductions, fuel efficiency and engine performance enhancement. There are competing products which provide one or more of the beneficial attributes of our AOT or ELEKTRA technology, but not all three benefits. Additionally, we believe that those competing products that show benefit in more than one area demonstrate greater benefit in only one area and provide only minimal improvements in other areas.

Competing emissions reduction products are largely comprised of catalytic converters and alternative fuels. Catalytic converters are much more expensive than products incorporating our AOT or ELEKTRA technology, and are sensitive and subject to damage caused by the poor quality or adulteration of fuel commonly used in developing nations. In addition, while catalytic converters reduce emissions, they do not improve fuel efficiency or engine performance. Domestically, there are a large number of manufacturers and distributors of catalytic converters, such as Engelhart Inc., Dow Corning Inc., Delphi Corporation and Car Sound Exhaust System, Inc., among others. Internationally, most catalytic converters are manufactured and distributed by Engelhart Inc., Delphi Corporation and a large number of smaller businesses in a fragmented industry.

Alternative fuels such as hydrogen, electricity, liquid natural gas and ethanol, generally require more costly conversions and the fuels are not readily available, if at all, in most of the world.

We are not aware of any other technology using magnetic, uniform electrical field fuel treatments or products based on such technology which has been proven to significantly improve fuel mileage. There are many products currently on the market that claim to increase fuel efficiency. We believe that the majority of these products have not undergone or provided independent scientific validation from a recognized third party, or testing at a certified laboratory. Fuel injection does improve fuel efficiency and performance, but is extremely expensive from the perspective of the developing nations of the world. Major domestic and international manufacturers and

distributors of fuel injection systems include Delphi Corporation, Robert Bosch Corporation, Siemens Corporation, and a large number of smaller businesses in a fragmented industry.

We are not aware of any other technology using magnetic, uniform electrical field fuel treatments or products based on such technology which has been proven to significantly improve performance. There are many products which a consumer can purchase to increase overall performance. All of the most effective such products, including forced induction, nitrous oxide injection and exotic exhaust, are very expensive, increase emissions, reduce fuel efficiency and shorten the life of the engine. Major domestic and international manufacturers and distributors of performance-enhancing systems include Holley Performance Products, Inc., Nitrous Express Inc., Paxton Automotive Corporation, Eaton Corporation, Vortec Engineering LLC, Flowermaster, Inc., Hedman Manufacturing, Inc., Gibson Performance, Inc. and a large number of smaller businesses in a fragmented industry.

#### **Government Regulation and Environmental Matters**

Our research and development activities are not subject to any governmental regulations that would have a significant impact on our business and we believe that we are in compliance with all applicable regulations that apply to our business as it is presently conducted. Our products, as such, are not subject to certification or approval by the EPA or other governmental agencies domestically or internationally. Instead, such agencies test and certify a sample engine fitted with our products. Depending upon whether we manufacture or license our products in the future and in which countries such products are manufactured or sold, we may be subject to regulations, including environmental regulations, at such time.

#### **U.S. Government Regulation**

We are currently pursuing EPA and CARB executive order exemptions for our products. These exemptions would signify that our products do not adversely affect vehicles emissions and would allow our products to be used on emissions control equipped on and off-road vehicles. We are also submitting our technologies to the EPA under the "511 Program" which was established in 1970 to evaluate new emissions and fuel saving technologies for cars and trucks. In April 2007, we made a formal request that the EPA consider our carbureted 4-stroke engine device as part of this program, even though there are few carbureted cars and trucks left on the road, because the EPA is tightening emissions regulation on motorcycle, utility and non-road vehicles. We believe that these applications are well suited for our technologies. We are unable to estimate the time it may take for the EPA to act upon our application or predict whether or not such application will be favorably received, especially considering that we are asking the EPA to amend its existing program.

#### **EU Regulation**

The current EU emissions standard for motorcycles is EURO 3, and for automobiles and trucks the emissions standard is EURO 4. Although there is not a EURO 4 standard for motorcycles currently, the current trend appears to be for stricter regulation. On the other hand, the automobile standard is currently moving towards adopting EURO 5 standards by 2011 and EURO 6 by 2014. These standards are difficult to attain and the automotive industry is spending billions of Euros to engineer solutions. European auto manufacturers are becoming increasingly at odds with the European Commission ("EC"), the body which evaluates the industry and makes regulatory standards recommendations to the EU, over CO2 emissions regulations.

The CO2 emissions limits are currently a voluntary agreement between the EU and the auto manufacturers. The EU target is to reach an average CO2 emission of 120 g/km for all new passenger cars by 2012. However it has become increasingly clear that the voluntary agreement will not succeed. The average CO2 emissions per car have dropped only to 160 g/km in 2005, whereas the average was 186 g/km in 1995. Because of this, lawmakers have started considering regulation. In late 2005, the European Parliament passed a resolution in support of mandatory CO2 emissions standards to replace the current voluntary agreement. In late 2006, the EC announced that it was working on a proposal for a legally-binding limit CO2 emissions from cars. The EC is also proposing the doubling of the fuel efficiency of new cars by 2020.

Currently the only accepted method for reducing a vehicle's CO, THC and NOx emissions is catalytic converters, but this system converts these gases into largely CO2 and N2O, both GHGs. Therefore the lower the CO, THC and NOx output, the higher the CO2 production. The only remedy is increasing fuel efficiency and the automakers argue this is costly and results in small low-power vehicles which consumers will not want to buy.

#### **Intellectual Property**

#### **ELEKTRA and APPLIED OIL TECHNOLOGY (AOT)**

On May 14, 2004, we filed a patent application in Australia with respect to certain technology (Method and Apparatus for a Treatment of a Fluid). We entered into a license agreement with Temple University (the "2004

License Agreement”), for a research project with Dr. Rongjia Tao as principal investigator. That project and the related products involve the development and commercialization of underwater and cold temperature applications for improving oil flow under different temperature and pressure conditions. In connection with the 2004 License Agreement, we assigned the original patent application for this technology to Temple University and agreed to assign all subsequent patent applications for this technology to Temple University. Under the 2004 License Agreement, we have the right to file additional patent applications, at our sole expense but for the benefit of Temple University, in various countries. We have exclusive rights to this technology only in countries where we file patent applications. In 2005, 2006 and 2007, we filed several additional patent applications in various countries. As a result of Dr. Tao’s recently announced progress in reducing viscosity of crude oil with magnetic pulses, we believe that this technology may have commercial viability. We are maintaining the patent applications in the countries in which we have filed them, while we continue to explore the commercial benefits of pursuing this opportunity in these and possibly other countries.

### **Method and Apparatus for Treatment of a Fluid**

Cullen & Co Reference: 040540

Applicant: Temple University of the Commonwealth System of Higher Education

### ***Summary of Invention***

*Treating oils with magnetic fields to improve viscosity.*

### ***Claim 1 (PCT Application)***

An apparatus for the magnetic treatment of a fluid which produces at least one magnetic field for a period of time,  $T_c$  at or above a critical magnetic field strength,  $H_c$ , the period  $T_c$  and the field strength  $H_c$  determined relative to one another and dependant upon the properties of the fluid. (All clear ISR)

### ***Priority Date***

The priority date is 14 May 2004 from Australian patent application 2004902563. (The GCC application was refiled and therefore the priority date for that application will be set at the actual filing date of the refiled application).

Country	Number	Filing date	Status
GCC *	GCC/P/2005/5066	22-August-2005	Application Allowed/Accepted
Brazil	0510871-3	13-May-2005	Examination requested 29 April 2008 - awaiting report
Canada	2566739	13-May-2005	Examination requested - awaiting report
China (Method)	200580023369.3	13-May-2005	Application Allowed/accepted
China (Apparatus)	NA		Instructions sent to Agent
Algeria	60593	13-May-2005	ABANDONED on Client’s instructions
Eurasia	200602114	13-May-2005	GRANTED – Russia Only
Egypt	PCT 1087/2006	13-May-2005	Application filed – awaiting examination
United Kingdom	624025.3	13-May-2005	GRANTED
Indonesia	WO0200603429	13-May-2005	Granted
Libya	3560/2008	28-January-2008	Application filed - awaiting examination
Mexico	PA/a/2006/013206	13-May-2005	GRANTED
Norway	20065632	13-May-2005	Application filed – awaiting examination
United States	11/519168	13-May-2005	Application filed – awaiting examination

\* Covers Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates, and Bahrain.

### **Legacy Technology**

MAG ChargR™/ECO ChargR™, (legacy)

Our MAG ChargR™ and ECO ChargR™ products use fixed magnetic fields to alter some physical properties of fuel by incorporating our patented and patent-pending ZEFS and MK IV technologies. We differentiate MAG ChargR and ECO ChargR products based on their differing attributes and marketing focus. ECO ChargR products are primarily designed to reduce harmful emissions and MAG ChargR products are primarily designed to enhance performance and fuel economy. Our ECO ChargR product is intended to reduce exhaust emissions in vehicle and small utility motors. We intend that the ECO ChargR will be marketed primarily to original equipment manufacturers (“OEMs”) as well as to pilot and government-mandated emissions programs. Our MAG ChargR



product is intended to increase power and improve mileage. MAG ChargR is being marketed to municipal fleets and to the specialty consumer accessories market for many types of vehicles, including but not limited to cars, trucks, motorcycles, scooters, all terrain vehicles (“ATVs”), snowmobiles, personal watercraft and small utility motors.

Our first revenues in 2006 and 2007 were generated from initial sales in Asia for our ECO ChargR product in the motorcycle industry. We plan on commencing sales of ECO ChargR to customers in the United States in the motorcycle industry in second quarter of 2010. We also plan on commencing initial sales of our MAG ChargR in the United States in the automobile and motorcycle industry in the second quarter of 2010.

#### ***ZEFS and MK IV Technologies in MAG ChargR and ECO ChargR (legacy)***

The ZEFS and the MK IV technology in the MAG ChargR and ECO ChargR products place a magnetic field in and around the fuel and air that lowers fuel thickness and influences oxygen to improve combustion. MAG ChargR and ECO ChargR contain permanent rare-earth magnets, which produce a very strong magnetic field. This field, when arranged in specific manner of shape and strength, causes a change in the fuel as it passes through the field. As fuel passes through the magnetic field, a change in the fuel occurs facilitating a decline in both viscosity and surface tension. This allows for finer atomization, resulting in a more optimized mixture and therefore more efficient combustion. Depending on the specific application of these products to specific makes and models of vehicles, this improved combustion may offer one or more of the following benefits; (i) lower emissions, (ii) more horsepower and torque and (iii) improved fuel economy.

The paper titled, “Viscosity Reduction in Liquid Suspensions by Electric or Magnetic Fields” published by Dr. Rongjia Tao, Ph.D., of Temple University, shows that applying a magnetic field reduces thickness (viscosity) of oil by 17%. The paper “Magnetic Field Effects on the Combustion Processes in Diffusion Flames” published by LSU in 2005 demonstrates that oxygen is attracted to a magnetic field. The ZEFS and MK IV technologies used in the MAG ChargR and ECO ChargR products use these properties of reduced fuel viscosity and influenced flow of oxygen to improve combustion.

Improved combustion increases engine power and performance. We have introduced the ECO ChargR, which incorporated our MK IV technology, and the MAG ChargR, which incorporates either our ZEFS or MK IV technologies, depending upon the application. We have designed and tested various versions of our MAG ChargR and ECO ChargR products for use on 2- and 4-stroke carbureted and fuel injection gasoline engines.

We differentiate our MAG ChargR and ECO ChargR products based on their differing attributes and marketing focus. ECO ChargR products are primarily designed for devices with engines that fall outside environmental regulation and often do not have emissions control systems. MAG ChargR products are primarily designed for engines already subject to environmental regulation and vehicles that often do already have some emissions control technology.

Additionally, ECO ChargR products are primarily designed to reduce harmful emissions and MAG ChargR products are primarily designed to enhance performance and fuel economy. The ECO ChargR is intended to reduce exhaust emissions in vehicle and small utility motors. ECO ChargR products will be marketed primarily to OEMs as well as to pilot and government-mandated emissions programs. The MAG ChargR is intended to increase power and improve mileage. MAG ChargR products will be marketed primarily to the specialty consumer accessories market for many types of vehicles, including but not limited to cars, trucks, motorcycles, scooters, ATVs, snowmobiles, personal watercraft and small utility motors. Because our MAG ChargR and ECO ChargR products are customized to specific brands, models and engine sizes, these products will require hundreds of individually developed models to accommodate the market.

MAG ChargR and ECO ChargR have been developed for one-, two- and four- barrel carbureted and fuel injection engines. These products are easily fitted to the base plates of carburetors and fuel injection systems; the devices are compact, there are no moving parts. They are also inexpensive to produce, extremely durable and unaffected by poor quality fuel.

We believe that testing by the Company, as well as by independent third-party laboratories, has demonstrated that both MAG ChargR and ECO ChargR generate significant reductions in THC and CO emissions and, in the case of MAG ChargR, also improve fuel efficiency by lowering gas consumption and increase engine performance.

#### ***Research and Development (legacy)***

In late 2005, we established a research and product development facility in Morgan Hill, California. We have tested products incorporating our ZEFS and MK IV technologies for multiple makes and models of automobiles, motorcycles and ATVs. We are engaged in research and development of additional prototypes and products, including ELEKTRA and other magnetic technologies and products, at our Morgan Hill facility.

The Company has entered into a research and development agreement (R&D Agreement) with Temple University to conduct further research on the ELEKTRA technology. Under the R&D Agreement Temple University will conduct a 24-month research project towards expanding the scope of, and developing products utilizing, the technologies covered under the License Agreements, including design and manufacture of prototypes utilizing electric fields to improve diesel, gasoline and kerosene fuel injection in engines using such fuels and a device utilizing a magnetic field to reduce crude oil viscosity for crude oil (paraffin and mixed base) and edible oil flow in pipelines.

### ***Independent Laboratory and Scientific Testing***

#### ***ECO ChargR (ZEFS Technology) (legacy)***

The four internationally recognized emissions standards testing agencies for the certification of motor vehicles, parts, systems and aftermarket devices are the EPA, CARB, United Kingdom Vehicle Certification Agency (“VCA”) and Technischer Überwachungs-Verein (TUV-Germany/EU).

Independent third-party laboratories have conducted tests of devices incorporating our ZEFS and MK IV technologies. We believe that research and testing using government standard test equipment in Thailand has demonstrated that the tested devices incorporating our ZEFS technology improves performance.

In 2006, testing on a device incorporating our MK IV technology for Harley-Davidson style motors was conducted at the EPA and CARB certified testing facility Olson Labs. We believe that these tests yielded results that would allow these motors to meet current and future EPA and CARB emissions standards without expensive fuel injection and catalytic converters.

Further testing on a used 4-stroke motorcycle incorporating our ZEFS technology was conducted in November 2005 in Bangkok, Thailand at Automotive Emission Laboratory, Pollution Control Department, Ministry of Natural Resources and Environment of Thailand, and was performed jointly with S.P. Suzuki of Thailand, the authorized distributor of Suzuki products in Thailand. The test results show a 35.8% decrease in CO (Carbon Monoxide); a 3.00% decrease in THC (Hydrocarbons) and a 85.3% decrease in NOx (Oxides of Nitrogen).

In addition, during the testing horsepower increased at all ranges, peaking at 18.8% at 50km/h and fuel economy increased 33% over the baseline tests.

Also in May 2006, at the request of the office of the Minister of Energy for the Kingdom of Thailand, we participated in a “hot start” test at the testing laboratories of the Thai petroleum company, the PTT Public Company Limited, of products incorporating our MK IV technology for fuel efficiency. In this test, the Thai distributor for Suzuki Motorcycles, SP Suzuki, supplied a new 125cc 4-stroke Best motor scooter to be tested without our preparing or participating in the installation of a device incorporating our ECO ChargR (MK IV technology). The mean test results showed an average 5.13% improvement in fuel efficiency.

In February 2007, tests were performed at Olson Labs for the purpose of evaluating the emissions reduction and fuel efficiency improvement benefits of our ECO ChargR product. The mean test results were as follows:

	Total Hydrocarbon (THC) Emissions (gms/km)		
	<u>Suzuki 110cc</u>	<u>RevTech 100cc</u>	<u>Merch 125cc</u>
% Improvement	21.0%	7.5%	5.1%
	Carbon Monoxide (CO) Emissions (gms/km)		
	<u>Suzuki 110cc</u>	<u>RevTech 100cc</u>	<u>Merch 125cc</u>
% Improvement	28.8%	37.6%	25.5%
	Oxides of Nitrogen (NOx) Emissions (gms/km)		
	<u>Suzuki 110cc</u>	<u>RevTech 100cc</u>	<u>Merch 125cc</u>
% Improvement	4.5%	-44.0%	6.4%
	Fuel Economy (miles per gallon)		
	<u>Suzuki 110cc</u>	<u>RevTech 100cc</u>	<u>Merch 125cc</u>
% Improvement	4.6%	3.5%	0.0%

### ***MAG ChargR (legacy)***

In October 2004, we commenced initial marketing efforts for MAG ChargR and ECO ChargR products incorporating our ZEFS and MK IV technology. We are focused on selling or licensing our technologies and products domestically and internationally to the consumer specialty accessories market, to municipalities, to motorcycle, automobile, carburetor, fuel-injection and diesel engine manufacturers and exhaust and muffler OEMs. We have made presentations of our MAG ChargR and ECO ChargR products to OEMs in the United States, Asia and Europe. We have had discussions with the Department of General Services in California which maintains a fleet of more than 50,000 vehicles including more than 5000 police cars.

On most automobiles, the MAG ChargR is installed between the throttle body and the intake manifold. The geometry of this part of the engine varies with each automobile make, manufacturer, year and engine displacement. STWA has identified dozens of MAG ChargR models that will fit popular models from Cadillac, Chevrolet, Chrysler, Dodge, Ford, GMC, Hummer, Isuzu, Jeep, Lincoln, Mercury, Mitsubishi, Nissan, Pontiac and Toyota. The MAG ChargR models selected include nine of the top 50 bestselling automobiles of all time.

In determining the order to bring MAG ChargR models to market, the following criteria have been considered.

- Size of the installed base of cars applicable to an individual MAG ChargR model
- Probability that the owner of such an automobile would purchase and aftermarket performance enhancement product
- Level of improvement that MAG ChargR delivers for a specific make, model, year and displacement

On February 20, 2010, we entered into a distribution agreement for the MagChargR with Magnumforce Race Car Fabrication, Inc. (Magnumforce). The agreement provides for an initial order of \$125,000, payment of which is contingent upon Magnumforce selling our product to its customers. The product was tested in 2007 in connection with fuel savings and emission reduction and the CARB certification was necessary before distribution and sales could occur. Magnumforce manufactures and markets a broad line of racing and high performance products for Dodge, Chrysler and Plymouth vehicles through multiple points of distribution.

We have also had discussions with Brothers Performance and Motorcycle Products Consulting Incorporated (MPCI) to carry the MAG ChargR product.

According to SEMA, buying behavior has shifted in the last twelve months with enthusiasts now purchasing more performance products online than at retail. To that end, we have targeted online retailers as distribution partners.

### ***ECO ChargR (legacy)***

In July 2006, we entered into a separate agreement with SS Sales, to provide exclusive marketing and promotional services in the western United States and western Canada for our MAG ChargR and ECO ChargR products. SS Sales will be paid a commission equal to 5% of the gross amount actually collected on contracts we enter into during the contract term for existing or future customers introduced by SS Sales. SS Sales is owned by Nathan Shelton, one of the directors of the Company since February 12, 2007. We also have an agreement pending with Scaffidi-Bolio & Associates to be our sales agents in a defined territory in the eastern United States and eastern Canada.

### ***MAG ChargR and ECO ChargR (legacy)***

As of December 15, 2010, the Company has built and tested three working prototypes of the MAG ChargR for the following make, model and engine configurations.

<u>Make</u>	<u>Model</u>	<u>Year</u>	<u>Engine</u>
Chrysler	SRT8	2006	6.1L Hemi
Dodge	Challenger	2010	6.1L Hemi
Chevrolet	Suburban	2005	4.6L Big Block

Of these three models, the Company has received and published the following test results for product performance.

<u>Make</u>	<u>Model</u>	<u>Year</u>	<u>Engine</u>	<u>HP Increase @4680 RPM</u>	<u>Torque Increase @4680 RPM</u>
Chrysler	SRT8	2006	6.1L Hemi	3.4%	5.4%
Chevrolet	Suburban	2005	Big Block	11.5%	8.9%

In order to start sales in California, the Company is required to obtain a certification for the MAG ChrgR from the California Air Resources Board (CARB). The Company has received CARB certification and can now sell and distribute throughout the United States.

For the MAG ChrgR product roll-out, we will attempt to have the product ready for the ten most popular general purpose automobiles listed above and the ten most popular Muscle Cars that fit our value proposition. According to Musclecarfacts.net on December 14, 2010, the ten most popular Muscle Cars in 2010 are, in order; the 2010 Camaro, the 1967 Camaro, the 1969 Camaro, the 1970 Challenger, the 1974 GTO, the 1970 AMX, the 1970 Barracuda, the 1969 AMX, the 1968 Camaro, and the 1968 AMX.

The manufacture of the magnets used in products incorporating our ZEFS or MK IV technologies requires a rare-earth metal, neodymium. Neodymium is readily available in China, at relatively stable prices.

#### ZEFS Patent Applications (legacy)

In December 1998, we acquired all of the marketing and manufacturing rights to the ZEFS technologies from the purported inventor of the technology in exchange for 5,000,000 shares of our common stock, \$500,000 and \$10 royalty for each unit sold. In November 2002, under our settlement with the bankruptcy trustee for the estate of the purported inventor and his wife, the trustee transferred all ownership and legal rights to an existing international patent application for the ZEFS MK I technology to us. In exchange for these rights, we issued to the bankruptcy trustee a warrant to purchase 500,000 shares of our common stock at \$1.00 share and granted a \$0.20 royalty on each device we sell.

In May 2002, we settled a dispute with Kevin "Pro" Hart, who claimed proprietary rights to the ZEFS technologies. In November 2002, under our settlement with the bankruptcy trustee for the estate of Mr. Hart, the trustee assigned all ownership and legal rights to the international patent application for the ZEFS technology to us, in exchange for an option to purchase 500,000 shares of our common stock at \$1.00 share and a \$0.20 royalty on each device we sell. Mr. Hart died in March 2006.

We obtained the patent application for the ZEFS MK1 device originally filed in Australia on May 19, 2000. The United States Patent and Trademark Office issued the patent on 7 June 2005 for the ZEFS MK1 device. The duration of the patent is 20 years from the date the original application was filed. Overall, we have applied for a patent on an international basis in approximately 64 countries worldwide.

#### **Device For Saving Fuel and Reducing Emissions [MK1] (legacy)**

Cullen & Co Reference : 015090

#### ***Summary of Invention***

*A fuel saving device has a disk like nonmagnetic body provided with a central opening and a number of permanent magnets having opposed polarities positioned about the central opening to provide multidirectional magnetic fields. The device is positioned in a fuel air mixture to reduce emissions.*

#### ***Claim 1 (US Granted)***

A method of improving the fuel economy and emission outputs of a combustion engine, the method including the step of

- i. interposing a fuel saving device within an air/fuel environment at or after an air/fuel mixing point of a fuel system for the engine characterized in that the fuel saving device comprises;
  - a. a non-magnetic body having
    - i. an opening therein having an axial dimension and a radial dimension and defining an air/fuel flow pathway,
    - ii. the axial dimension of the opening co-axial with flow pathway within the air/fuel environment, and
  - b. at least three magnets, each magnet having a polar axis oriented substantially parallel to the flow pathway, at least two said magnets being substantially opposed, the polar axis of the opposed magnets being in the same direction, with the at least third magnet's polar axes being in the opposite direction, the at least three magnets positioned to provide multiple overlapping and

interacting fields of magnetic force, such that the air/fuel mixture is subjected to ore than one magnetic field as it passes through the opening.

### ***Priority Date***

The priority date is 19 May 2000 from Australian patent application PQ7629.

An International patent application was filed (PCT/AU01/00585) having a filing date of 21 May 2001.

Patent applications have been filed in the following countries:

Country	Number	Filing date	Status
Australia	2001258057	21 May 2001	GRANTED
Bosnia & Herzegovina	BAP 021290A	21 May 2001	ABANDONED on client's instructions
Brazil	0111365-8	21 May 2001	ABANDONED on client's instructions
Bulgaria	107391	21 May 2001	ABANDONED on client's instructions
Canada (small entity status)	2409195	21 May 2001	GRANTED
China	01809802.9	21 May 2001	GRANTED
Columbia	02115018	21 May 2001	ABANDONED on client's instructions
Croatia	P20020982A	21 May 2001	ABANDONED on client's instructions
Czech Republic	PV 2002-4092	21 May 2001	ABANDONED on client's instructions
Eurasian +++	200201237	21 May 2001	GRANTED. Renewed in Russia only.
Europe ++	019331222.2	21 May 2001	Awaiting examination
Georgia	4098/01-2002	21 May 2001	ABANDONED on client's instructions
Hong Kong	04100327.0	21 May 2001	Registered
Hungary	P 03 01796	21 May 2001	ABANDONED on client's instructions
India	IN/PCT/2002/01523	21 May 2001	Allowed/Accepted
Indonesia	WO0200202844	21 May 2001	GRANTED
Israel	152902	21 May 2001	ABANDONED on client's instructions
Korea [South]	2002-7015531	21 May 2001	Under examination – response filed.
Japan	586731/2001	21 May 2001	Under examination – response filed.
Mexico	PA/A/2002/011365	21 May 2001	GRANTED
Morocco	PV/26.964	21 May 2001	ABANDONED on client's instructions
New Zealand	523113	21 May 2001	ABANDONED on client's instructions
Norway	20025531	21 May 2001	ABANDONED on client's instructions
Poland	P358837	21 May 2001	Response filed
Serbia	P-870/02	21 May 2001	ABANDONED on client's instructions
Singapore	93310	21 May 2001	ABANDONED on client's instructions
	[WO 01/90562]		
South Africa	2002/10013	21 May 2001	ABANDONED on client's instructions
Sri Lanka	12918	21 May 2001	Lapsed
Trinidad & Tobago	TT/A/2002/00213	21 May 2001	ABANDONED on client's instructions
Ukraine	20021210144	21 May 2001	ABANDONED on client's instructions
United States	6901917	21 May 2001	GRANTED
Vietnam	1-2002-01168	21 May 2001	ABANDONED on client's instructions

++European patent application covers Austria Belgium Switzerland Lichtenstein Cyprus Germany Denmark Spain Finland France Great Britain Greece Ireland Italy Luxembourg Netherlands Portugal Sweden Turkey Lithuania Latvia Slovenia Romania Macedonia.

+++ The Eurasian Patent Convention was signed on September 9, 1994 in Moscow by the Heads of the Governments of the Republic of Azerbaijan, the Republic of Armenia, the Republic of Belarus, Georgia, the Republic of Kazakstan, the Kyrgyz Republic, the Republic of Moldova, the Russian Federation, the Republic of Tajikistan, Ukraine and came into force on August 12, 1995 after Turkmenistan, Belarus and Tajikistan deposited their instruments of accession to the Convention to the WIPO Director General, on March 1, 1995, May 8, 1995 and May 12, 1995 respectively. To date, the Convention is also ratified by the Russian Federation, the Republic of Kazakhstan, Republic of Azerbaijan, the Kyrgyz Republic, the Republic of Moldova and the Republic of Armenia. The Eurasian Patent was validated in all member states; however, it was renewed in Russia only.

## Next Actions and Costs

Each national patent application will be processed according to the peculiar requirements of the national Patent Office. Therefore, it is not possible to provide an accurate and complete summary of the next action and cost as in many cases, the deadline for the next action depends on the backlog with the national Patent Office.

However, generally, a renewal fee is payable in most countries each year on 21 May.

Additionally, for the above cases that have not yet been granted (e.g. pending patent applications), it will be necessary to pay fees from time to time such as examination fees, processing fees, grant fees etc. Again, we are not able to specify exactly when these fees will occur but as a rule of thumb, you should budget for US\$1500 per pending application per year.

## Device for Saving Fuel and Reducing Emissions [MK4] (legacy)

Cullen & Co Reference: 050847

### Summary of Invention

*Similar to Mark I device but with stacked magnets.*

### Statement of Invention (Provisional Application)

*In one form, the invention resides in a fuel saving device comprising a support body having at least one flow opening therein and a periphery which adapts the support body for positioning within a sealed environment of a fuel system of a combustion engine in a manner in which the longitudinal axis of the at least one flow opening is co-axial with a fluid flow path, and a plurality of permanent magnets, the polar axes of all magnets oriented parallel to the flow path through the opening, characterised in that the magnets are provided in at least two stacks, each stack containing at least two magnets, the magnets of each stack each have a polar axis extending in the same direction with the magnets of at least one stack having polar axes extending in opposite direction to the other of the at least two stacks. In one form, the invention resides in a fuel saving device comprising a support body having at least one flow opening therein and a periphery which adapts the support body for positioning within a sealed environment of a fuel system of a combustion engine in a manner in which the longitudinal axis of the at least one flow opening is co-axial with a fluid flow path, and a plurality of permanent magnets, the polar axes of all magnets oriented parallel to the flow path through the opening, characterised in that the magnets are provided in at least two stacks, each stack containing at least two magnets, the magnets of each stack each have a polar axis extending in the same direction with the magnets of at least one stack having polar axes extending in opposite direction to the other of the at least two stacks.*

### Priority Date

The priority date is 21 June 2005 from Australian patent application 2005903248.

Country	Number	Filing date	Status
Australia	2006261578	20-June-2006	Examination requested
China	200680030319.2	20-June-2006	GRANTED
Europe	To be advised	20-June-2006	Application filed - awaiting Examination Report
India	262/KOL NP/2008	20-June-2006	Examination requested – Awaiting Report
Japan	2008-517269	20-June-2006	Examination requested – Awaiting Report
Korea	2008-7001473	20-June-2006	Examination to be requested by 20 June 2011
Malaysia	PI 20062013	02-May-2006	Examination to be requested by 2 May 2011
Taiwan	95115220	28-April-2006	ABANDONED on Client's instructions
Thailand	601001997	02-May-2006	Examination to be requested by 17 January 2012
United States	11/922601	20-June-2006	Application filed - awaiting filing report

## ***Trademarks***

### **ECO ChargR™**

<b>Country</b>	<b>Number</b>	<b>Filing Date</b>	<b>Status</b>
Australia	1121860	4 July 2006	GRANTED
Madrid *	1121860	4 January 2007	GRANTED
Canada	1330199	4 January 2007	Accepted – awaiting Registration Certificate
Indonesia	D00 2007 000330	4 January 2007	Application filed – awaiting examination
Malaysia	2007/00156	4 January 2007	Application filed – awaiting examination
Thailand	649741	4 January 2007	Application filed – awaiting examination
Taiwan	96000462	4 January 2007	Under examination – response filed.

\* Madrid Protocol application designates the following countries:

- China
- European Community
- United States
- Japan
- Korea
- Singapore
- Vietnam

### **MAG ChargR™**

<b>Country</b>	<b>Number</b>	<b>Filing Date</b>	<b>Status</b>
Australia	1121864	4 July 2006	Registered Co-Existence Agreement with Mag Instruments
Madrid	1121864	4 January 2007	GRANTED
Canada	1330200	4 January 2007	Under examination – response filed
Indonesia	D00 2007 000331	4 January 2007	Application filed – awaiting examination
Malaysia	2007/00157	4 January 2007	Application filed – awaiting examination
Thailand	649742	4 January 2007	Application filed – awaiting examination
Taiwan	96000465	4 January 2007	Allowed/Accepted.

### **STWA PERFORMANCE™**

<b>Country</b>	<b>Number</b>	<b>Filing Date</b>	<b>Status</b>
Australia	1140033	11 July 2006	GRANTED
Madrid	1140033	10 July 2007	GRANTED

## ***Non-Disclosure Agreements***

To further protect our intellectual property, we have entered into agreements with certain employees and consultants, which limit access to, and disclosure or use of, our technology. There can be no assurance, however, that the steps we have taken to deter misappropriation of our intellectual property or third party development of our technology and/or processes will be adequate, that others will not independently develop similar technologies and/or processes or that secrecy will not be breached. In addition, although management believes that our technology has been independently developed and does not infringe on the proprietary rights of others, there can be no assurance that our technology does not and will not so infringe or that third parties will not assert infringement claims against us in the future. Management believes that the steps they have taken to date will provide some degree of protection; however, no assurance can be given that this will be the case.

## ***Employees***

As of December 31, 2010, we had eight full-time employees. As of such date, we also utilized the services of nineteen part-time consultants to assist us with various matters, including engineering investment relations, public relations, accounting and sales and marketing. We intend to hire additional personnel to provide services when they are needed on a full-time basis. We recognize that our efficiency largely depends, in part, on our ability to hire and retain additional qualified personnel as and when needed and we have adopted procedures to assure our ability to do so.

## **Item 1A. Risk Factors**

***We have a history of losses, and we cannot assure you that we will ever become or remain profitable. As a result, you may lose your entire investment.***

We generated our first revenues from operations in late 2006 and we have incurred net losses every year since our inception in 1998. For the fiscal years ended December 31, 2009 and 2010, we had net losses of \$9,494,906 and \$6,194,950, respectively. To date, we have dedicated most of our financial resources to research and development, general and administrative expenses and initial sales and marketing activities. We have funded all of our activities through sales of our securities, including equity and debt. We anticipate net losses and negative cash flow to continue until such time as our products are brought to market in sufficient amounts to offset operating losses. We have significantly reduced both our research and development efforts, and our sales and marketing efforts, during the past year. Consequently, we will need to generate substantial additional funds, from a combination of revenue and external financing activities, to fund our operations. Our ability to achieve profitability is dependent upon our continuing research and development, product development, and sales and marketing efforts, to deliver viable products and the Company's ability to successfully bring them to market. Although our management is optimistic that we will succeed in marketing products incorporating our AOT and ELEKTRA technologies, there can be no assurance that we will ever generate significant revenues or that any revenues that may be generated will be sufficient for us to become profitable or thereafter maintain profitability. If we cannot generate sufficient revenues or become or remain profitable, we may have to cease our operations and liquidate our business.

***Our independent auditors have expressed doubt about our ability to continue as a going concern, which may hinder our ability to obtain future financing.***

In their report dated March 30, 2011, our independent auditors stated that our consolidated financial statements for the year ended December 31, 2010 were prepared assuming that we would continue as a going concern. Our ability to continue as a going concern is an issue raised as a result of our recurring negative cash flows from operations and accumulated deficit. We had an accumulated deficit of \$58,432,920 as of December 31, 2010. Our ability to continue as a going concern is subject to our ability to obtain significant additional capital to fund our operations and to generate revenue from sales, of which there is no assurance. The going concern qualification in the auditor's report could materially limit our ability to raise additional capital. If we fail to raise sufficient capital, we may have to liquidate our business and you may lose your investment.

***Since we have not yet begun to generate positive cash flow from operations, our ability to continue operations is dependent on our ability to either begin to generate positive cash flow from operations or our ability to raise capital from outside sources.***

We have not generated positive cash flow from operations and have relied on external sources of capital to fund operations. We had \$101,645 in cash at December 31, 2010 and negative cash flow from operations of \$3,142,980 for the year ended December 31, 2010.

We currently do not have credit facilities available with financial institutions or other third parties, and historically have relied upon best efforts third-party funding. Though we have been successful at raising capital on a best efforts basis in the past, we can provide no assurance that we will be successful in any future best-efforts financing endeavors. We will need to continue to rely upon financing from external sources to fund our operations for the foreseeable future. If we are unable to raise sufficient capital from external sources to fund our operations, we may need to curtail operations.

***We will need substantial additional capital to meet our operating needs, and we cannot be sure that additional financing will be available.***

As of December 31, 2010 and thereafter, our expenses ran, and are expected to continue to run, at a "burn rate" of approximately \$220,000 per month, which amount could increase during 2011. We are not currently able to fund operations on a current basis, and we will require substantial additional capital in order to operate. In order to fund some of our capital needs, we conducted private offerings of our securities in 2009 and 2010. While discussion regarding additional interim and permanent financings are being actively conducted, management cannot predict with certainty that the equity line of credit will be available to provide adequate funds, or any funds at all, or whether any additional interim or permanent financings will be available at all or, if it is available, if it will be available on favorable terms. If we cannot obtain needed capital, our research and development, and sales and marketing plans, business and financial condition and our ability to reduce losses and generate profits will be materially and adversely affected.



***We will need additional capital to repay certain short-term debt as it matures.***

At December 31, 2010, the Company was in default on the 2008 Winter Offering of notes in the amount of \$6,697 and the 2009 Spring Offering of notes in the amount of \$6,455. Negotiations are being conducted to convert these notes into shares of the Company's common stock.

We have \$386,760 remaining principal amount of convertible subordinated notes due in November 2011 to certain investors. In November 2010, we issued \$940,347 convertible notes in our 2010 Fall Offering #2 to certain investors, of which \$386,760 will be due in November 2011.

Due to the Company's limited capital resources, management cannot predict with certainty that there will be cash available to repay these obligations, and other obligations, on their respective maturity dates. If we do not raise adequate funds, we would be unable to repay these obligations as they mature during the next twelve months and we could default on such obligations.

***As a company with an unproven business strategy, our limited history of operations makes evaluation of our business and prospects difficult.***

Our business prospects are difficult to predict because of our limited operating history, early stage of development and unproven business strategy. Since our incorporation in 1998, we have been and continue to be involved in development of products using our technology, establishing manufacturing and marketing of these products to consumers and industry partners. Although we believe our technology and products in development have significant profit potential, we may not attain profitable operations and our management may not succeed in realizing our business objectives.

***If we are not able to devote adequate resources to product development and commercialization, we may not be able to develop our products.***

Our business strategy is to develop, manufacture and market products incorporating our AOT and ELEKTRA technologies. We also intend to develop, manufacture and market products incorporating the ELEKTRA technology. We believe that our revenue growth and profitability, if any, will substantially depend upon our ability to:

- raise additional needed capital for research and development;
- complete development of our products in development; and
- successfully introduce and commercialize our new products.

Certain of our products are still under various stages of development. Because we have limited resources to devote to product development and commercialization, any delay in the development of one product or reallocation of resources to product development efforts that prove unsuccessful may delay or jeopardize the development of other product candidates. Although our management believes that it can finance our product development through private placements and other capital sources, if we do not develop new products and bring them to market, our ability to generate revenues will be adversely affected.

***The commercial viability of AOT technologies remains largely unproven and we may not be able to attract customers.***

Despite the fact that have entered into various distribution agreements and made some initial sales of our products to distributors, to the best of our knowledge, no consumer or pipeline manufacturer has used the products incorporating the AOT technologies to reduce crude oil viscosity to date. Accordingly, the commercial viability of our devices is not known at this time. If commercial opportunities are not realized from the use of products incorporating the AOT technologies, our ability to generate revenue would be adversely affected. There can be no assurances that we will be successful in marketing our products, or that customers will ultimately purchase our products. Failure to have commercial success from the sale of our products will significantly and negatively impact our financial condition.

***The commercial viability of the ELEKTRA technology remains largely unproven and we may not be able to attract customers.***

To the best of our knowledge, no consumer or automobile manufacturer has used the products incorporating the ELEKTRA technology to reduce motor vehicle emissions to date. Accordingly, the commercial viability of our devices is not known at this time. If commercial opportunities are not realized from the use of

products incorporating the ELEKTRA technology, our ability to generate revenue would be adversely affected. There can be no assurances that we will be successful in marketing our products, or that customers will ultimately purchase our products. Failure to have commercial success from the sale of our products will significantly and negatively impact our financial condition.

***We were in default in payments due Temple University***

At December 31, 2010, the Company owed to Temple University a total of \$721,785 for the Maintenance Fees and penalties and we were in default in those payments. The Company's failure to cure the default could result in the termination of the License and R&D Agreements. On March 28, 2011, the Company completed its final adjusted payment to Temple University for all obligations outstanding on the License Agreements and the R&D Agreement. (See "9B. Other Information").

***If our products and services do not gain market acceptance, it is unlikely that we will become profitable.***

The market for products that reduce harmful motor vehicle emissions is evolving and we have many successful competitors. Automobile manufacturers have historically used various technologies, including catalytic converters, to reduce exhaust emissions caused by their products. At this time, our technology is unproven, and the use of our technology by others is limited. The commercial success of our products will depend upon the adoption of our technology by auto manufacturers and consumers as an approach to reduce motor vehicle emissions. Market acceptance will depend on many factors, including:

- the willingness and ability of consumers and industry partners to adopt new technologies;
- the willingness and ability of consumers and industry partners to adopt new technologies;
- the willingness of governments to mandate reduction of motor vehicle emissions;
- our ability to convince potential industry partners and consumers that our technology is an attractive alternative to other technologies for reduction of motor vehicle emissions;
- our ability to manufacture products and provide services in sufficient quantities with acceptable quality and at an acceptable cost; and
- our ability to place and service sufficient quantities of our products.

If our products do not achieve a significant level of market acceptance, demand for our products will not develop as expected and it is unlikely that we will become profitable.

***We need to outsource and rely on third parties for the manufacture, sales and marketing of our products, and our future success will be dependent on the timeliness and effectiveness of the efforts of these third parties.***

We do not have the required financial and human resources or capability to manufacture market and sell our products. Our business model calls for the outsourcing of the manufacture, and sales and marketing of our products in order to reduce our capital and infrastructure costs as a means of potentially improving our financial position and the profitability of our business. Accordingly, we must enter into agreements with other companies that can assist us and provide certain capabilities that we do not possess. We have entered into certain distribution agreements, but we may not be successful in entering into additional such alliances on favorable terms or at all. Even if we do succeed in securing additional distribution agreements, we may not be able to maintain them. Furthermore, any delay in entering into agreements could delay the development and commercialization of our products and reduce their competitiveness even if they reach the market. Any such delay related to our existing or future agreements could adversely affect our business.

We do not currently have an agreement in place for the manufacture of products incorporating our ZEFS or MK IV technologies.

***If any party to which we have outsourced certain functions fails to perform its obligations under agreements with us, the development and commercialization of our products could be delayed or curtailed.***

To the extent that we rely on other companies to manufacture, sell or market our products, we will be dependent on the timeliness and effectiveness of their efforts. If any of these parties do not perform its obligations in a timely and effective manner, the commercialization of our products could be delayed or curtailed because we may not have sufficient financial resources or capabilities to continue such development and commercialization on our own.

***Any revenues that we may earn in the future are unpredictable, and our operating results are likely to fluctuate from quarter to quarter.***

We believe that our future operating results will fluctuate due to a variety of factors, including:

- delays in product development;
- market acceptance of our new products;
- changes in the demand for, and pricing, of our products;
- competition and pricing pressure from competitive products;
- manufacturing delays; and
- expenses related to, and the results of, proceedings relating to our intellectual property.

A large portion of our expenses, including expenses for our facilities, equipment and personnel, is relatively fixed and not subject to further significant reduction. In addition, we expect our operating expenses will increase in 2011 as we continue our research and development and increase our production and marketing activities, among other activities. Although we expect to generate revenues from sales of our products, revenues may decline or not grow as anticipated and our operating results could be substantially harmed for a particular fiscal period. Moreover, our operating results in some quarters may not meet the expectations of stock market analysts and investors. In that case, our stock price most likely would decline.

***Nondisclosure agreements with employees and others may not adequately prevent disclosure of trade secrets and other proprietary information.***

In order to protect our proprietary technology and processes, we rely in part on nondisclosure agreements with our employees, licensing partners, consultants, agents and other organizations to which we disclose our proprietary information. These agreements may not effectively prevent disclosure of confidential information and may not provide an adequate remedy in the event of unauthorized disclosure of confidential information. In addition, others may independently discover trade secrets and proprietary information, and in such cases we could not assert any trade secret rights against such parties. Costly and time-consuming litigation could be necessary to enforce and determine the scope of our proprietary rights, and failure to obtain or maintain trade secret protection could adversely affect our competitive business position. Since we rely on trade secrets and nondisclosure agreements, in addition to patents, to protect some of our intellectual property, there is a risk that third parties may obtain and improperly utilize our proprietary information to our competitive disadvantage. We may not be able to detect unauthorized use or take appropriate and timely steps to enforce our intellectual property rights.

***The manufacture, use or sale of our current and proposed products may infringe on the patent rights of others, and we may be forced to litigate if an intellectual property dispute arises.***

If we infringe or are alleged to have infringed another party's patent rights, we may be required to seek a license, defend an infringement action or challenge the validity of the patents in court. Patent litigation is costly and time consuming. We may not have sufficient resources to bring these actions to a successful conclusion. In addition, if we do not obtain a license, do not successfully defend an infringement action or are unable to have infringed patents declared invalid, we may:

- incur substantial monetary damages;
- encounter significant delays in marketing our current and proposed product candidates;
- be unable to conduct or participate in the manufacture, use or sale of product
- candidates or methods of treatment requiring licenses;
- lose patent protection for our inventions and products; or
- find our patents are unenforceable, invalid, or have a reduced scope of protection.

Parties making such claims may be able to obtain injunctive relief that could effectively block our ability to further develop or commercialize our current and proposed product candidates in the United States and abroad and could result in the award of substantial damages. Defense of any lawsuit or failure to obtain any such license could substantially harm the company. Litigation, regardless of outcome, could result in substantial cost to and a diversion of efforts by the Company to operate its business.

***We may face costly intellectual property disputes.***

Our ability to compete effectively will depend in part on our ability to develop and maintain proprietary aspects of our technologies and either to operate without infringing the proprietary rights of others or to obtain rights to technology owned by third parties. Our pending patent applications, specifically patent rights of the MK IV, ELEKTRA and CAT-MATE technologies, may not result in the issuance of any patents or any issued patents that will offer protection against competitors with similar technology. Patents we have received for our ZEFS technologies, and which we may receive, may be challenged, invalidated or circumvented in the future or the rights created by those patents may not provide a competitive advantage. We also rely on trade secrets, technical know-how and continuing invention to develop and maintain our competitive position. Others may independently develop substantially equivalent proprietary information and techniques or otherwise gain access to our trade secrets.

***We may not be able to attract or retain qualified senior personnel.***

We believe we are currently able to manage our current business with our existing management team. However, as we expand the scope of our operations, we will need to obtain the full-time services of additional senior management and other personnel. Competition for highly-skilled personnel is intense, and there can be no assurance that we will be able to attract or retain qualified senior personnel. Our failure to do so could have an adverse effect on our ability to implement our business plan. As we add full-time senior personnel, our overhead expenses for salaries and related items will increase compensation packages, these increases could be substantial.

***If we lose our key personnel or are unable to attract and retain additional personnel, we may be unable to achieve profitability.***

Our future success is substantially dependent on the efforts of our senior management, particularly Cecil Bond Kyte, our Chief Executive Officer, Charles R. Blum, our President and Eugene E. Eichler, our Interim Chief Financial Officer. The loss of the services of members of our senior management may significantly delay or prevent the achievement of product development and other business objectives. Because of the scientific nature of our business, we depend substantially on our ability to attract and retain qualified marketing, scientific and technical personnel, including consultants. There is intense competition among specialized automotive companies for qualified personnel in the areas of our activities. If we lose the services of, or do not successfully recruit key marketing, scientific and technical personnel, the growth of our business could be substantially impaired. We do not maintain key man insurance for any of these individuals.

***We expect to incur increased costs under the Sarbanes-Oxley Act of 2002.***

As a public company, we incur significant legal, accounting and other expenses. In addition, the Sarbanes-Oxley Act of 2002, as well as related rules adopted by the SEC, has imposed substantial requirements on public companies, including certain corporate governance practices and requirements relating to internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act. We expect these rules and regulations to increase our legal and financial compliance costs and to make some activities more time-consuming and costly. Effective disclosure of controls and procedures and internal controls are necessary for us to produce reliable financial reports and are important in helping prevent financial fraud generally. In order to accomplish this, we have retained an outside consulting firm to assist us in implementing proper procedures. We will incur significant up-front expenses to do so. If we are unable to achieve and maintain adequate disclosure controls and procedures and internal controls, our business and operating results could be harmed.

***Changes in stock option accounting rules may adversely affect our reported operating results, our stock price, and our ability to attract and retain employees.***

In December 2004, the Financial Accounting Standards Board ("FASB") published new rules that will require companies such as us to record all stock-based employee compensation as an expense. The new rules apply to stock options grants, as well as a wide range of other share-based compensation arrangements including restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. As required by FASB, we adopted these rules effective January 1, 2006. As a small company with limited financial resources, we have depended upon compensating our officers, directors, employees and consultants with such stock based compensation awards in the past in order to limit our cash expenditures and to attract and retain officers, directors, employees and consultants. Accordingly, if we continue to grant stock options or other stock based compensation awards to our officers, directors, employees, and consultants, our future earnings, if any, will be reduced (or our future losses will be increased) by the expenses recorded for those grants. These compensation expenses may be larger than the compensation expense that we would be required to record were we able to compensate these persons with cash in lieu of securities. Since we are a small company, the expenses we may have to record as a result of future options grants may be significant and may materially negatively affect our reported financial results.

***Currently, there is only very limited trading in our stock, so you may be unable to sell your shares at or near the quoted bid prices if you need to sell your shares.***

The shares of our common stock are thinly-traded on the OTC Bulletin Board, meaning that the number of persons interested in purchasing our common shares at or near bid prices at any given time may be relatively small or non-existent. This situation is attributable to a number of factors, including the fact that we are a small company engaged in a high risk business which is relatively unknown to stock analysts, stock brokers, institutional investors and others in the investment community that can generate or influence daily trading volume and valuation. Should we even come to the attention of such persons, they tend to be risk-averse and would be reluctant to follow an unproven, early stage company such as ours or purchase or recommend the purchase of our shares until such time as we became more seasoned and viable. As a consequence, there may be periods of several days or more when trading activity in our shares is minimal or non-existent, as compared to a seasoned issuer which has a large and steady volume of trading activity that will generally support continuous trading without negatively impacting our share price. We cannot provide any assurance that a broader or more active public trading market for shares of our common stock will develop or be sustained. Due to these conditions, we cannot give any assurance that shareholders will be able to sell their shares at or near bid prices or at all.

***The market price of our stock is volatile.***

The market price for our common stock has been volatile during the last year, ranging from a closing price of \$0.82 on March 24, 2010 to a closing price of \$0.20 on September 2, 2010, and a closing price of \$0.39 on March 15, 2011. Additionally, the price of our stock has been both higher and lower than those amounts on an intra-day basis in the last year. Because our stock is thinly traded, its price can change dramatically over short periods, even in a single day. The market price of our common stock could fluctuate widely in response to many factors, including:

- developments with respect to patents or proprietary rights;
- announcements of technological innovations by us or our competitors;
- announcements of new products or new contracts by us or our competitors;
- actual or anticipated variations in our operating results due to the level of development expenses and other factors;
- changes in financial estimates by securities analysts and whether any future earnings of ours meet or exceed such estimates;
- conditions and trends in our industry;
- new accounting standards;
- general economic, political and market conditions and other factors; and
- the occurrence of any of the risks described in this Memorandum.

***Substantial sales of common stock could cause our stock price to fall.***

In the past year, there have been times when average daily trading volume of our common stock has been extremely low, and there have been many days in which no shares were traded at all. At other times, the average daily trading volume of our common stock has been high. Nevertheless, the possibility that substantial amounts of common stock may be sold in the public market may adversely affect prevailing market prices for our common stock and could impair our ability to raise capital through the sale of our equity securities.

***Potential issuance of additional shares of our common stock could dilute existing stockholders.***

We are authorized to issue up to 200,000,000 shares of common stock. To the extent of such authorization, our Board of Directors has the ability, without seeking stockholder approval, to issue additional shares of common stock in the future for such consideration as the Board of Directors may consider sufficient. The issuance of additional common stock in the future will reduce the proportionate ownership and voting power of the common stock offered hereby.

***Our common stock is subject to penny stock regulation, which may make it more difficult for us to raise capital.***

Our common stock is considered penny stock under SEC regulations. It is subject to rules that impose additional sales practice requirements on broker-dealers who sell our securities. For example, broker-dealers must

make a suitability determination for the purchaser, receive the purchaser's written consent to the transaction prior to sale, and make special disclosures regarding sales commissions, current stock price quotations, recent price information and information on the limited market in penny stock. Because of these additional obligations, some broker-dealers may not effect transactions in penny stocks, which may adversely affect the liquidity of our common stock and shareholders' ability to sell our common stock in the secondary market. This lack of liquidity may make it difficult for us to raise capital in the future.

#### **Item 1B. Unresolved Staff Comments**

None

#### **Item 2. Properties**

Our Executive Offices are located at 735 State Street, Suite 500, Santa Barbara, California 93101 and our engineering, production and testing facility is located at 235 Tennant Avenue, Morgan Hill, California 95037. In September 2005, the Company entered into a lease for the term September 1, 2005 through August 31, 2007 and carried an option to renew for two additional years at the then prevailing market rate. Monthly rent was \$2,240 per month under this lease. The lease was amended in February 2006 for additional space. Monthly rate under the amended lease was \$4,160 per month. The Company renewed this lease on August 9, 2007 for an additional two-year term. The rent is \$4,640 per month for the first six months of the new term of the lease and \$5,480 per month for the remaining eighteen months of the new term of the lease. We believe that this space is adequate for our current and planned needs.

In March 2009, the Company entered into a sublease agreement for its executive offices in Santa Barbara, California. The term of the lease was for \$3,520 per month from April 1, 2010 through December 31, 2010 and \$3,630 per month from January 1, 2011 to December 31, 2010.

In November 2010, the Company entered into a lease agreement for its executive offices in Santa Barbara, California. The term of the lease was for \$5,830 per month from January 1, 2011 through December 31, 2013.

#### **Item 3. Legal Proceedings**

We have concluded our litigation in previous matters involving the Company's prior Chairman and Chief Executive, Jeffrey Muller and all related matters and are of the current opinion that the Company no longer faces litigation liability in connection with those cases. We are continuing to ensure the Company's obligations are fully in compliance with a previous injunction order entered by a Federal District Court over six years ago to timely file all of the Company's financial and related reports. The Company will shortly be petitioning the Federal District Court to dissolve the compliance injunction on the basis that for more than a six-year period, under the Company's new administrative and executive leadership, it has been in full compliance with the Company's SEC financial and reporting obligations. We can provide no assurance that such action to dissolve the injunction would be successful.

There is no other litigation of any significance with the exception of the matters that have arisen under, and are being handled in, the normal course of business.

##### ***Litigation Involving Former Executive Officer***

As previously reported, on April 7, 2010, Bruce McKinnon, the former CEO of the Company, and the Company entered into an Agreement Re: Collection on Judgment ("Judgment") (the "Settlement Agreement"), wherein McKinnon, among other things, agreed to cease further collection efforts on the Judgment, and the Company, among other things, agreed to satisfy the Judgment for, and McKinnon agreed to accept as full and final satisfaction of the Judgment, subject to certain payment waivers described below, a total amount of \$360,000, plus interest of ten percent (10%) per annum from March 15, 2010, on the unpaid balance until paid, payable as follows: \$30,000 on April 7, 2010; \$85,000 on or before April 15, 2010; and, \$15,000 per month commencing on June 1, 2010, until paid. As of December 31, 2010, all payments have been made on time and the balance due is \$155,270. The Settlement Agreement also provides that if the Company makes all payments thereunder, on a timely basis, McKinnon will waive final payments due him in the amount of \$35,000.

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

Not Applicable

## PART II

### Item 5. Market for Common Equity and Related Stockholder Matters

Through May 21, 2007, our common stock was traded on the Over the Counter Bulletin Board (the “OTCBB” under the symbol “ZERO”. Effective May 22, 2007, our common stock was removed from the OTCBB and placed on the “Pink Sheets”. Effective February 8, 2010, our common stock was reinstated and currently trades on the OTCBB. The following table sets forth the high and low bid prices of the Company’s common stock for the quarters indicated as quoted on the Pink Sheets or the OTCBB, as applicable, as reported by Yahoo Finance. These quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not represent actual transactions.

	2010		2009	
	High	Low	High	Low
First Quarter	\$ 0.82	\$ 0.47	\$ 0.50	\$ 0.38
Second Quarter	\$ 0.74	\$ 0.32	\$ 0.43	\$ 0.25
Third Quarter	\$ 0.45	\$ 0.20	\$ 0.42	\$ 0.22
Fourth Quarter	\$ 0.54	\$ 0.28	\$ 0.58	\$ 0.28

According to the records of our transfer agent, we had 975 stockholders of record of our common stock at March 15, 2011. The Company believes that the number of beneficial owners is substantially higher than this amount.

We do not pay a dividend on our common stock and we currently intend to retain future cash flows to finance our operations and fund the growth of our business. Any payment of future dividends will be at the discretion of our Board of Directors and will depend upon, among other things, our earnings, financial condition, capital requirements, level of indebtedness, contractual restrictions in respect to the payment of dividends and other factors that our Board of Directors deems relevant.

#### Issuances of Unregistered Securities in Last Fiscal Year

Transactions”). **2009 Fall Offering.** From October 2 2009, through January 15, 2010, the Company conducted a private offering (the “2009 Fall Offering”) consisting of an aggregate of \$1,588,125 of Convertible Promissory Notes. The Notes were sold for \$1,186,875 net proceeds, and the Company converted existing liabilities of \$401,250 to these Notes. The Notes are convertible into 6,352,500 shares of our common stock and in addition investors received warrants to purchase up to 6,352,500 shares of our common stock. (See “Details of Recent Financing”)

**2010 Winter Offering.** From February 15, 2010 through June 30, 2010, we conducted a private offering (the “2010 Winter Offering”) and issued Convertible Notes in the aggregate face amount of \$885,863. These Notes were sold for an aggregate purchase price of \$805,330 net proceeds. The Notes are convertible into 2,214,657 shares of our common stock and in addition, investors received warrants entitling the holders to purchase up to 2,214,657 shares of our common stock. (See “Details of Recent Financing Transactions”)

**2010 Spring Offering.** From April 15, 2010 through April 30, 2010, we conducted a private offering (the “2010 Spring Offering”) and issued Convertible Notes in the aggregate face amount of \$143,000. These Notes were sold for an aggregate purchase price of \$130,000 net proceeds. The Notes are convertible into 357,000 shares of our common stock and in addition, investors received warrants entitling the holders to purchase up to 357,000 shares of our common stock. (See “Details of Recent Financing Transactions”).

**2010 Summer Offering.** From June 14, 2010 through July 31, 2010, we conducted a private offering (the “2010 Summer Offering”) and issued Convertible Notes in the aggregate face amount of \$392,150. These Notes were sold for an aggregate purchase price of \$356,500 net proceeds. The Notes are convertible into 1,568,600 shares of our common stock and in addition, investors received warrants entitling the holders to purchase up to 1,568,600 shares of our common stock. (See “Details of Recent Financing Transactions”).

**2010 Fall Offering.** From August 10, 2010 through September 30, 2010, we conducted a private offering (the “2010 Fall Offering”) and issued Convertible Notes in the aggregate face amount of \$174,482. These Notes were sold for an aggregate purchase price of \$158,620 net proceeds. The Notes are convertible into 697,928 shares of our common stock and in addition, investors received warrants entitling the holders to purchase up to 697,928 shares of our common stock. (See “Details of Recent Financing Transactions”).

**2010 Fall Offering #2.** From October 4, 2010 through November 30, 2010, we conducted a private offering (the “2010 Fall Offering #2”) and issued Convertible Notes in the aggregate face amount of \$940,347. These Notes were sold for an aggregate purchase price of \$854,861 net proceeds. The Notes are convertible into 3,761,386 shares of our common stock and in addition, investors received warrants entitling the holders to purchase up to 3,761,386 shares of our common stock. (See “Details of Recent Financing Transactions”).

The sales of the securities described above were made in reliance on the exemptions from registration set forth in Section 4 (2) of the Securities Act of 1933, as amended (the “Act”), or Regulations D or S promulgated thereunder.

#### ***Other Issuances***

During the year ended December 31, 2010 we issued an aggregate of 20,163,798 shares of our common stock as follows:

- During 2010, we issued 3,710,099 shares of our common stock for services valued in the aggregate at \$1,385,137. We valued the shares at prices ranging from \$0.43 to \$0.48 per share.
- During 2010, we issued 170,000 shares of our common stock to our employees as compensation valued in the aggregate \$91,700. We valued the shares at prices ranging from \$0.52 to \$0.55 per share.
- During 2010, we issued 12,121 shares of our common stock to settle \$4,121 of outstanding accounts payable. We valued the shares at \$0.34 per share.
- During 2010 we issued 16,076,023 shares of our common stock in exchange for conversion of \$4,417,417 of Convertible Notes. We valued the shares at prices ranging from \$0.15 to \$0.50.
- During 2010, we issued 195,555 shares of our common stock for exercised options valued at \$.027.

#### **Item 6. Selected Consolidated Financial Data**

Not Applicable

#### **Item 7. Management’s Discussion and Analysis or Plan of Operation**

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the Consolidated Financial Statements and supplementary data referred to in Item 7 of this Form 10-K.

This discussion contains forward-looking statements that involve risks and uncertainties. Such statements, which include statements concerning future revenue sources and concentration, selling, general and administrative expenses, research and development expenses, capital resources, additional financings and additional losses, are subject to risks and uncertainties, including, but not limited to, those discussed above in Item 1 and elsewhere in this Form 10-K, particularly in “Risk Factors,” that could cause actual results to differ materially from those projected. Unless otherwise expressly indicated, the information set forth in this Form 10-K is as of December 31, 2010, and we undertake no duty to update this information.

#### **Overview**

We are a development stage company that generated its first initial revenues in the fourth quarter of 2006. Our focus is on research and development, and initial sales and marketing, of products incorporating our proprietary and patented technology, which is designed to reduce harmful emissions, and/or improve fuel efficiency and engine performance on equipment and vehicles driven by internal combustion engines. We have devoted the bulk of our efforts to the completion of the design, the development of our production models, testing of devices and the promotion of our products in the marketplace. We anticipate that these efforts will continue during 2011.

Our expenses to date have been funded primarily through the sale of stock and convertible debt, as well as proceeds from the exercise of stock purchase warrants. We raised capital in 2010 and will need to raise substantial additional capital in 2011, and possibly beyond, to fund our sales and marketing efforts, continuing research and development, and certain other expenses, until our revenue base grows sufficiently.



## Results of Operation

There were no revenues and cost of sales for the fiscal year ended December 31, 2010 and 2009.

Operating expenses were \$4,293,631 for the fiscal year ended December 31, 2010, compared to \$3,042,465 for the fiscal year ended December 31, 2009, an increase of \$1,251,166. The increase is attributable to increases in non-cash expenses of \$1,048,930 and cash expenses of \$202,236. Specifically, the increase in non-cash expenses is attributable to increases in stocks, options and warrants given to consultants (\$908,556), employees (\$139,383) and depreciation expense (\$991). The increase in cash expenses is attributable to increases in consulting and professional fees (\$202,593), salaries and benefits expenses (\$98,231) and travel (\$27,586); offset by decreases in corporate expenses (\$64,099) and office and other expenses (\$62,075).

Research and development expenses were \$427,982 for the fiscal year ended December 31, 2010, compared to \$428,139 for the fiscal year ended December 31, 2009, a decrease of \$157. This decrease is primarily attributable to a decrease in research and development expenses of \$113,233; offset by increase in testing tools and supplies of \$86,776 and travel expenses of \$26,300.

Other expense were \$4,772,493 for the fiscal year ended December 31, 2010, compared to \$2,723,546 for the fiscal year ended December 31, 2009, an increase of 2,048,947. This increase is attributable to an increase in interest and financing expense of \$2,431,058 and cost of private placement of \$617,709; offset by income from change in fair value of derivative liabilities of \$722,345, decrease in cost to induce conversion of certain notes of \$132,363 and an increase in other income of \$145,112.

We had a net loss of \$9,494,906 or \$0.12 per share for the fiscal year ended December 31, 2010 compared to a net loss of \$6,194,950, or \$0.09 per share for the fiscal year ended December 31, 2009.

## Liquidity and Capital Resources

### General

We have incurred negative cash flow from operations in the developmental stage since our inception in 1998. As of December 31, 2010, we had cash of \$101,645 and an accumulated deficit of \$58,432,920. Our negative operating cash flow in 2010 was funded primarily through the sale convertible notes.

The accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. As reflected in the accompanying consolidated financial statements, we had a net loss of \$9,494,906 and a negative cash flow from operations of \$3,142,980 for the year ended December 31, 2010, and had a working capital deficiency (excluding our derivative liability) of \$2,837,727 and a stockholders' deficiency of \$6,416,299 at December 31, 2010. These factors raise substantial doubt about our ability to continue as a going concern. Our ability to continue as a going concern is dependent upon our ability to raise additional funds and implement our business plan. The consolidated financial statements do not include any adjustments that might be necessary if the we are unable to continue as a going concern

During 2010, we raised an aggregate of \$3,217,735 gross and net proceeds from the issuance of Convertible Notes, as follows:

- Gross and net proceeds of \$939,924 from the issuance of convertible notes and warrants in a 2009-Fall Offering. The face amount of the notes is \$1,243,625.
- Gross and net proceeds of \$805,330 from the issuance of convertible notes and warrants in a 2010 Winter Offering. The face amount of the notes is \$885,863.
- Gross and net proceeds of \$130,000 from the issuance of convertible notes and warrants in a 2010 Spring Offering. The face amount of the notes is \$143,000.
- Gross and net proceeds of \$334,000 from the issuance of convertible notes and warrants in a 2010 Summer Offering. The face amount of the notes is \$392,150.
- Gross and net proceeds of \$158,620 from the issuance of convertible notes and warrants in a 2010 Fall Offering. The face amount of the notes is \$174,482.
- Gross and net proceeds of \$849,861 from the issuance of convertible notes and warrants in a 2010 Fall Offering #2. The face amount of the notes is \$940,347.

## **Details of Recent Financing Transactions**

### ***2008 Fall Offering***

From September 8, 2008 to October 31, 2008, we conducted an offering (the “2008 Fall Offering”) of up to \$500,000 aggregate face amount of its Convertible Notes. A total of \$198,220 aggregate face amount of the 2008 Fall Notes were sold for an aggregate purchase price of \$180,200 net proceeds. Therefore, while the stated interest on the 2008 Fall Notes is 0%, the implied interest rate on the 2008 Fall Notes is 10%. The 2008 fall notes matured on the first anniversary of the date of issuance. The 2008 Fall Notes are convertible, at the option of the noteholders, into shares of common stock of the Company (the “Conversion Shares”) at a conversion price equal to the average of the closing bid price of the Company’s common stock for the five trading days preceding the closing date of the 2008 Fall Offering (the “Conversion Price”). Up to 1,321,466 Conversion Shares are issuable at a Conversion Price of \$0.15 per share.

Each of the investors in the 2008 Fall Offering received, for no additional consideration, a warrant (the “2008 Fall Warrants”), entitling the holder to purchase a number of shares of the Company’s common stock equal to 50% of the number of shares of common stock into which the (2008 Fall Notes) are convertible (the “2008 Fall Warrant Shares”). Each 2008 Fall Warrant is exercisable on a cash basis only at a price of \$0.50 per share, and is exercisable for a period of two years from the date of issuance. Up to 660,734 2008 Fall Warrant Shares are initially issuable upon exercise of the 2008 Fall Warrants.

The aggregate value of the Fall 2008 Offering Warrants issued in connection with the October 31, 2008 closing were valued at \$53,320 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of 4.68%; dividend yield of 0%; volatility factors of the expected market price of common stock of 145.98%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$126,880. The value of the Fall 2008 Offering Warrants, the beneficial conversion feature, and the transaction fees of \$18,020 are considered as debt discount and were amortized over the life of the Note.

As of December 31, 2010, investors have converted \$198,220 of the Convertible Notes into 1,367,773 shares of the Company’s common stock, which included 46,307 shares issued for late penalty and interest. At December 31, 2010, there was no outstanding balance.

### ***2008 Winter Offering***

From November 24, 2008 to December 5, 2008, we conducted an offering (the “2008 Winter Offering”) of up to \$500,000 aggregate face amount of its Convertible Notes. A total of \$524,700 aggregate face amount of the 2008 Winter Notes were sold for an aggregate purchase price of \$477,000 net proceeds. Therefore, while the stated interest on the 2008 Winter Notes is 0%, the implied interest rate on the 2008 Winter Notes is 10%. The 2008 Winter Notes will mature on the first anniversary of the date of issuance. The 2008 Winter Notes are convertible, at the option of the noteholders, into shares of common stock of the Company (the “Conversion Shares”) at a conversion price equal to the average of the closing bid price of the Company’s common stock for the five trading days preceding the closing date of the 2008 Winter Offering (the “Conversion Price”). Up to 3,086,470 Conversion Shares are issuable at a Conversion Price of \$0.17 per share.

Each of the investors in the 2008 Winter Offering received, for no additional consideration, a warrant (the “2008 Winter Warrants”), entitling the holder to purchase a number of shares of the Company’s common stock equal to 50% of the number of shares of common stock into which the (2008 Winter Notes) are convertible (the “2008 Winter Warrant Shares”). Each 2008 Winter Warrant is exercisable on a cash basis only at a price of \$0.30 per share, and is exercisable for a period of two years from the date of issuance. Up to 1,543,235 2008 Winter Warrant Shares are initially issuable upon exercise of the 2008 Winter Warrants.

The aggregate value of the Winter 2008 Offering Warrants issued in connection with the December 5, 2008 closing were valued at \$168,925 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of 3.42%; dividend yield of 0%; volatility factors of the expected market price of common stock of 153.56%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$308,075. The value of the Winter 2008 Offering Warrants, the beneficial conversion feature, and the transaction fees of \$47,700 are considered as debt discount and were amortized over the life of the Note.

As of December 31, 2010, investors have converted \$519,200 of the Convertible Notes into 3,054,117 shares of the Company’s common stock. As of December 31, 2010, one note was in default and the outstanding balance was \$6,697, including \$1,197 in penalties and interest.

### ***2009 Winter Offering #1***

From January 13, 2009 to January 26, 2009, we conducted and concluded a private offering (the “Winter 2009 Offering I”) of up to \$250,000 aggregate face amount of its convertible notes (the “Winter 2009 Notes”) with 8 accredited investors. A total of \$250,000 aggregate face amount of the Winter 2009 Notes were sold for an aggregate purchase price of \$250,000. The Winter 2009 Notes bear interest at 10% per annum, payable at maturity. The Winter 2009 Notes mature three months from their date of issuance. The Winter 2009 Notes are convertible, at the option of the noteholder, into shares of common stock of the Company (the “Conversion Shares”) at an initial conversion price equal to the average of the closing bid price of the Company’s common stock for the five trading days preceding the closing dates of the Winter 2009 Offering (the “Conversion Price”). Up to 694,444 Conversion Shares are initially issuable at a Conversion Price of \$0.36 per share.

Each of the investors in the Winter 2009 Offering received, for no additional consideration, a warrant (the “Winter 2009 Warrants”), entitling the holder to purchase a number of shares of the Company’s common stock equal to 50% of the number of shares of common stock into which the Winter 2009 Notes are convertible (the “Warrant Shares”). Each Winter 2009 Warrant is exercisable on a cash basis only at an initial price of \$0.50 per share, and is exercisable immediately upon issuance and for a period of two (2) years from the date of issuance. Up to 347,722 Warrant Shares are initially issuable on exercise of the Winter 2009 Warrants.

The aggregate value of the Winter 2009 Offering Warrants issued in connection with the January 26, 2009 closing were valued at \$66,178 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of 0.85%; dividend yield of 0%; volatility factors of the expected market price of common stock of 151.42%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$183,822. The value of the Winter 2009 Offering Warrants and the beneficial conversion feature are considered as debt discount and were amortized over the life of the notes.

As of December 31, 2010 investors have converted \$200,000 of the Convertible Notes plus \$39,761 of penalty and interest into 780,307 shares of the Company’s common stock. In addition, the Company has paid \$50,000 plus penalty and interest as a redemption of one of the defaulted convertible notes. There was no outstanding balance at December 31, 2010.

### ***2009 Winter Offering #2***

From February 4, 2009 to March 12, 2009, we conducted and concluded a private offering (the “Winter 2009 Offering II”) of up to \$250,000 aggregate face amount of its convertible notes (the “Winter 2009 #2 Notes”) with 17 accredited investors. A total of \$247,302 aggregate face amount of the Winter 2009 #2 Notes were sold for an aggregate purchase price of \$224,820. While the stated interest rate on the Winter 2009 #2 Notes is 0%, the implied interest rate on the Winter 2009 #2 Notes is 10% per annum. The Winter 2009 #2 Notes mature on the first anniversary of their date of issuance. The Winter 2009 #2 Notes are convertible, at the option of the noteholder, into shares of common stock of the Company (the “Conversion Shares”) at an initial conversion price equal to the average of the closing bid price of the Company’s common stock for the five trading days preceding the closing dates of the Winter 2009 #2 Offering (the “Conversion Price”). Up to 772,818 Conversion Shares are initially issuable at a Conversion Price of \$0.32 per share.

Each of the investors in the Winter 2009 #2 Offering received, for no additional consideration, a warrant (the “Winter 2009 #2 Warrants”), entitling the holder to purchase a number of shares of the Company’s common stock equal to 50% of the number of shares of common stock into which the Winter 2009 #2 Notes are convertible (the “Warrant Shares”). Each Winter 2009 #2 Warrant is exercisable on a cash basis only at an initial price of \$0.50 per share, and is exercisable immediately upon issuance and for a period of two (2) years from the date of issuance. Up to 386,409 Warrant Shares are initially issuable on exercise of the Winter 2009 #2 Warrants.

We received \$224,820 in net proceeds in the Winter 2009 #2 Offering which was used for general corporate purposes and working capital. The aggregate value of the Winter 2009 #2 Offering Warrants issued in connection with the January 26, 2009 closing were valued at \$62,028 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of 1.03%; dividend yield of 0%; volatility factors of the expected market price of common stock of 156%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$161,791. The value of the Winter 2009 #2 Offering Warrants, the beneficial conversion feature, and the transaction fees of \$22,482 are considered as debt discount and were amortized over the life of the Note.

As of December 31, 2010, investors have converted \$247,302 of the Convertible Notes plus \$6,876 in penalty and interest into 794,306 shares of the Company's common stock. There is no outstanding balance at December 31, 2010.

### ***2009 Spring Offering***

From March 17, 2009 to April 30, 2009, we conducted and concluded a private offering (the "Spring 2009 Offering") of up to \$300,000 aggregate face amount of its convertible notes (the "Spring 2009 Notes") with 11 accredited investors. A total of \$181,500 aggregate face amount of the Spring 2009 Notes were sold for an aggregate purchase price of \$165,000. The Spring 2009 Notes mature on the first anniversary of their date of issuance, are convertible, at the option of the noteholder, into up to 672,222 shares of our common stock at a conversion price of \$0.27 per share.

Each of the investors in the Spring 2009 Offering received, for no additional consideration, a warrant (the "Spring 2009 Warrants"), entitling the holder to purchase a number of shares of our common stock equal to 50% of the number of shares of common stock into which the Spring 2009 Notes are convertible (the "Warrant Shares"). Each Spring 2009 Warrant is exercisable on a cash basis only at an initial price of \$0.50 per share, and is exercisable for a period of two years. Up to 336,111 Warrant Shares are initially issuable on exercise of the Spring 2009 Warrants.

We received \$165,000 in net proceeds in the Spring 2009 Offering which was used for general corporate purposes and working capital. The aggregate value of the Spring 2009 Offering Warrants issued in connection with the April 30, 2009 closing were valued at \$39,994 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of 0.94%; dividend yield of 0%; volatility factors of the expected market price of common stock of 156.39%; and an expected life of two years (statutory term) and vest immediately upon issuance. We also determined that the notes contained a beneficial conversion feature of \$96,827. The value of the Spring 2009 Offering Warrants, the beneficial conversion feature, and the transaction fees of \$16,500 are considered as debt discount and were amortized over the life of the Note.

As of December 31, 2010, investors have converted \$176,000 of the Convertible Notes plus penalty and interest of \$7,538 into 679,768 shares of our common stock. As of December 31, 2010 one note was in default and the outstanding balance was \$6,455 which includes \$955 of penalty and interest.

### ***2009 Summer Offering***

From June 9, 2009 to September 28, 2009, we conducted and concluded a private offering (the "Summer 2009 Offering") of up to \$500,000 aggregate face amount of its convertible notes (the "Summer 2009 Notes") with interest compounded quarterly at the annual rate of seven percent (7%) payable at maturity. A total of \$467,500 Summer 2009 Notes were sold to 17 accredited investors. The Summer 2009 Notes mature on the second anniversary of the closing of this offering and will be convertible, at the option of the noteholder, into up to 1,870,000 shares of our common stock at a conversion price of \$0.25 per share.

Each of the investors in the Summer 2009 Offering will receive, for no additional consideration, a warrant (the "Summer 2009 Warrants"), entitling the holder to purchase a number of shares of our common stock equal to 100% of the number of shares of common stock into which the Summer 2009 Notes are convertible (the "Warrant Shares"). Each Summer 2009 Warrant is exercisable on a cash basis only at an initial price of \$0.30 per share, and is exercisable for a period of thirty six months. Up to 1,870,000 Warrant Shares are initially issuable on exercise of the Summer 2009 Warrants.

Each of the warrant agreements included an anti-dilution provision that allowed for the automatic reset of the exercise price upon any future sale of common stock or warrants at or below the current exercise price. We considered the current Financial Accounting Standards Board guidance of "Determining Whether an Instrument Indexed to an Entity's Own Stock" which indicates that any adjustment to the fixed amount (either conversion price or number of shares) of the instrument regardless of the probability or whether or not within the issuers' control, means the instrument is not indexed to the issuers own stock. Accordingly, we determined that as the strike price of these warrants contain exercise prices that may fluctuate based on the occurrence of future offerings or events, and as such is not a fixed amount. As a result, we determined that these warrants are not considered indexed to our own stock and characterized the fair value of these warrants as derivative liabilities upon issuance.

We determined that the fair value of the warrant liability at issuance on September 28, 2009 to be \$668,525 based upon a weighted average Black-Sholes-Merton calculation. We recorded the full value of the derivative as a liability at issuance with an offset to valuation discount. As the fair value of the liability of \$668,525 exceeded the note value of \$467,500, the excess of the liability over the note amount of \$201,025 was considered as a cost of the

private placement and recorded as such in 2009. The fair value of the warrant liability as of December 31, 2010 was \$804,100 (see Note 8).

As of December 31, 2010, investors have converted \$467,500 of the Convertible Notes plus \$5,002 of penalties and interest into 1,891,564 shares of our common stock. There was no outstanding balance at December 31, 2010.

### ***2009 Wellfleet Offering***

On November 20, 2009, we completed a private financing of \$75,000 principal amount of 7% Convertible Promissory Notes (the “Notes”) and 300,000 Common Stock Purchase Warrants exercisable at \$.30 per share (the “Warrants”), pursuant to a Securities Purchase Agreement (the “Purchase Agreement”) with 3 accredited investors (the “Note Offering”), through Sandgrain Securities, Inc., as placement agent.

The Notes are initially convertible into our common stock at a price of \$.25 per share and accrue interest at 7% per year with a default rate of 10%, payable quarterly in cash. Interest payments are payable in stock at the sole discretion of the Note holders, or, in the event that shares issuable thereon are registered under the Securities Act of 1933, as amended (the “Act”), or otherwise freely tradable pursuant to Rule 144, at our discretion. The Notes and any unpaid interest are due and fully payable on September 28, 2012. The conversion price of the Notes is adjustable for corporate events such as merger, reclassification or stock splits.

Pursuant to the terms of the Purchase Agreement, and among other terms, in the event we conduct any subsequent financings (each, a “Follow On Offering”) of any kind other than an offering of securities substantially similar to the Notes and Warrants or certain other exempted issuances enumerated in the Notes, the Notes may, at the discretion of each holder thereof, be exchanged in whole or in part to the extent of outstanding principal and/or interest in such Note, into the securities offered in the Follow On Offering, by applying and exchanging the outstanding principal and interest of such Notes towards the purchase price of the securities offered in such Follow On Offering, at the same price and terms of the Follow On Offering.

We paid a placement agent fee to Sandgrain Securities, Inc. of (i) \$6,000 in cash, (ii) 24,000 shares of Common Stock constituting 8% of the number of Conversion Shares initially issuable upon exercise of the Notes, and (iii) 24,000 warrants, substantially similar to the Warrants sold to investors (the “Placement Agent Warrants”), in connection with the Note Offering, in addition to legal fees.

Each of the warrant agreements included an anti-dilution provision that allowed for the automatic reset of the exercise price upon any future sale of common stock or warrants at or below the current exercise price. We considered the current Financial Accounting Standards Board guidance of “Determining Whether an Instrument Indexed to an Entity’s Own Stock” which indicates that any adjustment to the fixed amount (either conversion price or number of shares) of the instrument regardless of the probability or whether or not within the issuers’ control, means the instrument is not indexed to the issuers own stock. Accordingly, we determined that as the strike price of these warrants contain exercise prices that may fluctuate based on the occurrence of future offerings or events, and as such is not a fixed amount. As a result, we determined that these warrants are not considered indexed to our own stock and characterized the fair value of these warrants as derivative liabilities upon issuance.

We determined that the fair value of the warrant liability at issuance on November 20, 2009 to be \$75,000 based upon a weighted average Black-Sholes-Merton calculation. We recorded the full value of the derivative as a liability at issuance with an offset to valuation discount. The fair value of the warrant liability as of December 31, 2010 was \$129,000 (see Note 8).

As of December 31, 2010 investors have converted \$50,000 of the Convertible Notes plus \$1,750 of accrued interest into 207,000 shares of the Company’s common stock. The outstanding balance at December 31, 2010 was \$27,011 which includes \$2,011 of accrued interest.

### ***2009 Fall Offering***

From October 2, 2009 to January 15, 2010, we conducted and completed a private offering (the “Fall 2009 Offering”) consisting of an aggregate of \$1,588,125 of 7% Convertible Promissory Notes (the “Notes”) with interest compounded quarterly at the annual rate of 7% payable at maturity, and warrants to purchase an aggregate of 6,352,500 shares of our common stock (the “Fall 2009 Warrants”). We received \$1,284,425 net proceeds, of which \$344,500 was received as of December 31, 2009. The Fall 2009 Notes mature on the second anniversary of the closing of this offering and will be convertible, at the option of the noteholder, into up to 6,352,500 shares of our common stock at a conversion price of \$0.25 per share. The Fall 2009 Warrants are for a term of three years at an exercise price of \$0.30 per share.

Each of the warrant agreements included an anti-dilution provision that allowed for the automatic reset of the exercise price upon any future sale of common stock or warrants at or below the current exercise price. We considered the current Financial Accounting Standards Board guidance of “Determining Whether an Instrument Indexed to an Entity’s Own Stock” which indicates that any adjustment to the fixed amount (either conversion price or number of shares) of the instrument regardless of the probability or whether or not within the issuers’ control, means the instrument is not indexed to the issuers own stock. Accordingly, we determined that as the strike price of these warrants contain exercise prices that may fluctuate based on the occurrence of future offerings or events, and as such is not a fixed amount. As a result, we determined that these warrants are not considered indexed to our own stock and characterized the fair value of these warrants as derivative liabilities upon issuance.

We determined that the fair value of the warrant liability at issuances to be \$3,027,815 based upon a weighted average Black-Scholes-Merton calculation (See Note 8), of which, \$654,978 was recorded on December 31, 2009 and \$2,372,837 was recorded on January 15, 2010. We recorded the full value of the derivative of \$2,372,837 as a liability at issuance with an offset to valuation discount. As the fair value of the liability of \$2,372,837 exceeded the note value of \$1,243,625, the excess of the liability over the note amount of \$1,129,212 was considered to be cost of the private placement and was recorded during the period. The fair value of the warrant liability as of December 31, 2010 was \$2,731,575 (see Note 8).

As of December 31, 2010, investors have converted \$1,553,125 of the Convertible Notes plus interest of \$9,781 into 6,251,623 shares of our common stock. The outstanding balance at December 31, 2010 was \$37,409 which includes \$3,739 in accrued interest.

### ***2010 Winter Offering***

From February 15, 2010 to March 31, 2010, we conducted a private offering (the “Winter 2010 Offering”) consisting of an aggregate of \$885,863 face amount of its Convertible Promissory Notes (the “Winter 2010 Notes”) have been sold for an aggregate purchase price of \$805,330. While the stated interest rate on the Winter 2010 Notes is 0%, the implied interest rate on the Winter 2010 Notes is 10% per annum. The Winter 2010 Notes mature on the first anniversary of their date of issuance. The Winter 2010 Notes are convertible, at the option of the noteholder, into 2,214,657 shares of common stock of our (the “Conversion Shares”) at an initial conversion price of \$0.40 per share (the “Conversion Price”).

Each of the investors in the Winter 2010 Offering received, for no additional consideration, a warrant (the “Winter 2010 Warrants”), entitling the holder to purchase a number of shares of the Company’s common stock equal to 100% of the number of shares of common stock into which the Winter 2010 Notes are convertible (the “Warrant Shares”). Each Winter 2010 Warrant is exercisable on a cash basis only at an initial price of \$0.40 per share, and is exercisable immediately upon issuance and for a period of two (2) years from the date of issuance. Up to 2,214,657 Warrant Shares are initially issuable to date on exercise of the Winter 2010 Warrants.

We received \$805,330 in net proceeds in the Winter 2010 Offering which was used for general corporate purposes and working capital. The aggregate value of the Winter 2010 Offering Warrants issued were valued at \$476,268 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of 1.02; dividend yield of 0%; volatility factors of the expected market price of common stock of 135%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$329,062. As of December 31, 2010, the aggregate value of the Winter 2010 Offering Warrants, the beneficial conversion feature and the transaction fees of \$80,533 are considered as debt discount and were fully amortized in conjunction with the conversion of the notes.

As of December 31, 2010, investors have converted \$885,863 of the Convertible Notes into 2,214,657 shares of the Company’s common stock. There was no outstanding balance at December 31, 2010.

### ***2010 Spring Offering***

From April 15, 2010 to April 30, 2010, we conducted a private offering (the “Spring 2010 Offering”) consisting of an aggregate of \$143,000 face amount of its Convertible Promissory Notes (the “Spring 2010 Notes”) have been sold for an aggregate purchase price of \$130,000. While the stated interest rate on the Spring 2010 Notes is 0%, the actual interest rate on the Spring 2010 Notes is 10% per annum. The Spring 2010 Notes mature on the first anniversary of their date of issuance. The Spring 2010 Notes are convertible, at the option of the noteholder, into 357,500 shares of common stock of the Company (the “Conversion Shares”) at an initial conversion price of \$0.40 per share (the “Conversion Price”).

Each of the investors in the Spring 2010 Offering received, for no additional consideration, a warrant (the “Spring 2010 Warrants”), entitling the holder to purchase a number of shares of the Company’s common stock equal to 100% of the number of shares of common stock into which the Spring 2010 Notes are convertible (the “Warrant Shares”). Each Spring 2010 Warrant is exercisable on a cash basis only at an initial price of \$0.40 per share, and is

exercisable immediately upon issuance and for a period of two (2) years from the date of issuance. Up to 357,500 Warrant Shares are initially issuable to date on exercise of the Spring 2010 Warrants.

We received \$130,000 in net proceeds in the Spring 2010 Offering which was used for general corporate purposes and working capital. The aggregate value of the Spring 2010 Offering Warrants issued were valued at \$62,730 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of .41; dividend yield of 0%; volatility factors of the expected market price of common stock of 110%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$67,270. As of December 31, 2010, the aggregate value of the Spring 2010 Offering Warrants, the beneficial conversion feature and the transaction fees of \$13,000 are considered as debt discount and were fully amortized in conjunction with the conversion of the notes.

As of December 31, 2010, investors have converted \$143,000 of the Convertible Notes into 357,000 shares of the Company's common stock. There was no outstanding balance at December 31, 2010.

### ***2010 Summer Offering***

From June 14, 2010 to July 31, 2010, we conducted and concluded a private offering (the "Summer 2010 Offering") consisting of up to \$500,000 aggregate face amount of its convertible notes (the "Summer 2010 Notes"). A total of \$392,150 Summer 2010 Notes were sold to twenty six accredited investors for an aggregate purchase price of \$374,000. While the stated interest rate on the Summer 2010 Notes is 0%, the actual interest rate on the Summer 2010 Notes is 10% per annum. The Summer 2010 Notes mature on the first anniversary of the closing of this offering and will be convertible, at the option of the noteholder, into up to 1,568,600 shares of our common stock at a conversion price of \$0.25 per share (the "Conversion Price").

Each of the investors in the Summer 2010 Offering will receive, for no additional consideration, a warrant (the "Summer 2010 Warrants"), entitling the holder to purchase a number of shares of our common stock equal to 100% of the number of shares of common stock into which the Summer 2010 Notes are convertible (the "Warrant Shares"). Each Summer 2010 Warrant is exercisable on a cash basis only at an initial price of \$0.30 per share, and is exercisable for a period of twenty four months. Up to 1,568,600 Warrant Shares are initially issuable on exercise of the Summer 2010 Warrants.

We received \$334,000 in net proceeds in the Summer 2010 Offering which was used for general corporate purposes and working capital. The aggregate value of the Summer 2010 Offering Warrants issued were valued at \$209,512 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of .55; dividend yield of 0%; volatility factors of the expected market price of common stock of 132%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$146,988. As of December 31, 2010, the aggregate value of the Summer 2010 Offering Warrants, the beneficial conversion feature and the transaction fees of \$35,650 are considered as debt discount and were fully amortized in conjunction with the conversion of the notes.

As of December 31, 2010, investors have converted \$392,150 of the Convertible Notes into 1,568,600 shares of the Company's common stock. There was no outstanding balance at December 31, 2010.

### ***2010 Fall Offering***

From August 10, 2010 to September 30, 2010, we conducted and concluded a private offering (the "Fall 2010 Offering") consisting of up to \$600,000 aggregate face amount of its convertible notes (the "Fall 2010 Notes"). A total of \$174,482 Fall 2010 Notes were sold to ten accredited investors for an aggregate purchase price of \$158,620. While the stated interest rate on the Fall 2010 Notes is 0%, the actual interest rate on the Fall 2010 Notes is 10% per annum. The Fall 2010 Notes mature on the first anniversary of the closing of this offering and will be convertible, at the option of the noteholder into 697,928 shares of the Company's common stock at a conversion price of \$0.25 per share (the "Conversion Price").

Each of the investors in the Fall 2010 Offering will receive, for no additional consideration, a warrant (the "Fall 2010 Warrants"), entitling the holder to purchase a number of shares of our common stock equal to 100% of the number of shares of common stock into which the Fall 2010 Notes are convertible (the "Warrant Shares"). Each Fall 2010 Warrant is exercisable on a cash basis only at an initial price of \$0.30 per share, and is exercisable for a period of twenty four months. Up to 697,928 Warrant Shares are initially issuable on exercise of the Fall 2010 Warrants.

We received \$158,620 in net proceeds in the Fall 2010 Offering which was used for general corporate purposes and working capital. The aggregate value of the Fall 2010 Offering Warrants issued were valued at \$88,113 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of .42; dividend yield of 0%; volatility factors of the expected market price of common stock of 135%; and an

expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$70,507. As of December 31, 2010, the aggregate value of the Fall 2010 Offering Warrants, the beneficial conversion feature and the transaction fees of \$15,862 are considered as debt discount and were fully amortized in conjunction with the conversion of the notes.

As of December 31, 2010, investors have converted \$174,482 of the Convertible Notes into 697,928 shares of the Company's common stock. There was no outstanding balance at December 31, 2010.

### ***2010 Fall Offering #2***

From October 4, 2010 to November 30, 2010, we conducted and concluded a private offering (the "Fall 2010 Offering #2") consisting of up to \$3,000,000 aggregate face amount of its convertible notes (the "Fall 2010 Notes"). A total of \$940,347 Fall 2010 #2 Notes were sold to ten accredited investors for an aggregate purchase price of \$849,861. While the stated interest rate on the Fall 2010 #2 Notes is 0%, the actual interest rate on the Fall 2010 #2 Notes is 10% per annum. The Fall 2010 #2 Notes mature on the first anniversary of the closing of this offering and will be convertible, at the option of the noteholder into 3,761,386 shares of the Company's common stock at a conversion price of \$0.25 per share (the "Conversion Price").

Each of the investors in the Fall 2010 #2 Offering will receive, for no additional consideration, a warrant (the "Fall 2010 #2 Warrants"), entitling the holder to purchase a number of shares of our common stock equal to 100% of the number of shares of common stock into which the Fall 2010 #2 Notes are convertible (the "Warrant Shares"). Each Fall 2010 Warrant is exercisable on a cash basis only at an initial price of \$0.30 per share, and is exercisable for a period of twenty four months. Up to 3,761,386 Warrant Shares are initially issuable on exercise of the Fall 2010 #2 Warrants.

We received \$849,861 in net proceeds in the Fall 2010 #2 Offering which was used for general corporate purposes and working capital. The aggregate value of the Fall 2010 #2 Offering Warrants issued were valued at \$436,986 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of .27; dividend yield of 0%; volatility factors of the expected market price of common stock of 121%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$417,875. As of December 31, 2010, the aggregate value of the Fall 2010 #2 Offering Warrants, the beneficial conversion feature and the transaction fees of \$85,486 are considered as debt discount and will be amortized over the life of the notes.

As of December 31, 2010, investors have converted \$553,587 of the Convertible Notes into 2,214,346 shares of the Company's common stock. The outstanding balance at December 31, 2010 was \$386,760.

### ***Summary***

We have cash on hand to meet expenses only for a short period of time. In order to fund the repayment of our outstanding notes, we must raise additional funds. At December 31, 2010, these notes included the 2008 Winter Notes due in December 2009, the 2009 Spring Notes due in April 2010, the 2009 Wellfleet Notes due in September 2012, 2009 Fall Notes due in January 2012 and the 2010 Fall #2 Notes due in November 2011. In addition to the funds required to continue to operate our business, including without limitation the expenses we will incur in connection with the license and research and development agreements with Temple University, costs associated with product development and commercialization of the ELEKTRA technology, costs to manufacture and ship our products, costs to design and implement an effective system of internal controls and disclosure controls and procedures, costs of maintaining our status as a public company by filing periodic reports with the SEC, and costs required to protect our intellectual property. In addition, as discussed below, we have substantial contractual commitments, including without limitation salaries to our executive officers pursuant to employment agreements, certain severance payments to a former officer and consulting fees, during the remainder of 2010 and beyond.

In light of the Company's financial commitments over the next several months and its liquidity constraints, we have implemented cost reduction measures in all areas of operations, including but not limited to personnel lay-offs, marketing and advertising, deferral of placing orders to manufacturers of our ECO ChargR and MAG ChargR products for sale to our existing distributors, research and development and product development of ELEKTRA products, and certain other expenses. We intend to review these measures on an ongoing basis and make additional decisions as may be required.

No assurance can be given that any future financing will be available or, if available, that it will be on terms that are satisfactory to the Company.



## Contractual Obligations

The following table discloses our contractual commitments for future periods. Long-term commitments are comprised of operating leases and minimum guaranteed compensation payments under employment and other agreements. See Note 10 to Notes to Consolidated Financial Statements, "Commitments and Contingencies".

<u>Year ending December 31,</u>	<u>Operating Leases <sup>(1)</sup></u>	<u>Guaranteed Payments</u>
2011	\$ 69,960	\$ 410,802 <sup>(2)</sup>
2012	69,960	17,567 <sup>(3)</sup>
2013	69,960	
Total	<u>\$ 209,880</u>	<u>\$ 428,369</u>

(1) Consists of rent for our Santa Barbara Facility expiring on December 31, 2013. (For description of this property, see Part 1, Item 2, and "Property").

(2) Consists of an aggregate of \$210,802 in total compensation, including base salary and certain contractually-provided benefits, to an executive officer, pursuant to an employment agreement that expires on January 30, 2012 and \$200,000 in licensing maintenance fees to Temple University.

(3) Consists of an aggregate of \$17,567 in total compensation, including base salary and certain contractually-provided benefits to an executive officer, pursuant to an employment agreement that expires on January 30, 2011.

**Licensing Fees to Temple University.** For details of the licensing agreements with Temple University, (See "Part I, Item 1, "Business - Our Business Strategy - Our Technologies and Products").

## Critical Accounting Policies and Estimates

Our discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these consolidated financial statements and related disclosures requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, expenses, and related disclosure of contingent assets and liabilities. We evaluate, on an on-going basis, our estimates and judgments, including those related to the useful life of the assets. We base our estimates on historical experience and assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The methods, estimates and judgments we use in applying our most critical accounting policies have a significant impact on the results that we report in our consolidated financial statements. The SEC considers an entity's most critical accounting policies to be those policies that are both most important to the portrayal of a company's financial condition and results of operations and those that require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about matters that are inherently uncertain at the time of estimation. . For a more detailed discussion of the accounting policies of the Company, see Note 2 of the Notes to the Consolidated Financial Statements, "Summary of Significant Accounting Policies".

We believe the following critical accounting policies, among others, require significant judgments and estimates used in the preparation of our consolidated financial statements.

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Certain significant estimates were made in connection with preparing our consolidated financial statements as described in Note 1 to Notes to Consolidated Financial Statements. See Item 7, "Financial Statements". Actual results could differ from those estimates.

## Stock-Based Compensation

The Company periodically issues stock options and warrants to employees and non-employees in non-capital raising transactions for services and for financing costs. The Company accounts for stock option and warrant grants issued and vesting to employees based on the authoritative guidance provided by the Financial Accounting Standards Board whereas the value of the award is measured on the date of grant and recognized over the vesting period. The Company accounts for stock option and warrant grants issued and vesting to non-employees in

accordance with the authoritative guidance of the Financial Accounting Standards Board whereas the value of the stock compensation is based upon the measurement date as determined at either a) the date at which a performance commitment is reached, or b) at the date at which the necessary performance to earn the equity instruments is complete. Non-employee stock-based compensation charges generally are amortized over the vesting period on a straight-line basis. In certain circumstances where there are no future performance requirements by the non-employee, option grants are immediately vested and the total stock-based compensation charge is recorded in the period of the measurement date.

The fair value of the Company's common stock option grant is estimated using the Black-Scholes option pricing model, which uses certain assumptions related to risk-free interest rates, expected volatility, expected life of the common stock options, and future dividends. Compensation expense is recorded based upon the value derived from the Black-Scholes option pricing model, and based on actual experience. The assumptions used in the Black-Scholes option pricing model could materially affect compensation expense recorded in future periods.

### **Recent Accounting Pronouncements**

In June 2009, the FASB issued authoritative guidance on accounting standards codification and the hierarchy of generally accepted accounting principles ("GAAP") effective for interim and annual reporting periods ending after September 15, 2010. The FASB accounting standards codification ("ASC, "Codification") has become the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in accordance with GAAP. All existing accounting standard documents are superseded by the Codification and any accounting literature not included in the Codification will not be authoritative. However, rules and interpretive releases of the SEC issued under the authority of federal securities laws will continue to be sources of authoritative GAAP for SEC registrants. Beginning with the quarter ending September 30, 2009, all references made by the Company to GAAP in its condensed consolidated financial statements use the Codification numbering system. The Codification does not change or alter existing GAAP and, therefore, it does not have an impact on our financial position, results of operations and cash flows.

In June 2009, the FASB made an update to the principle for the consolidation of variable interest entities. Among other things, the update replaces the calculation for determining which entities, if any, have a controlling financial interest in a variable interest entity (VIE) from a quantitative based risks and rewards calculation, to a qualitative approach that focuses on identifying which entities have the power to direct the activities that most significantly impact the VIE's economic performance and the obligation to absorb losses of the VIE or the right to receive benefits from the VIE. The update also requires ongoing assessments as to whether an entity is the primary beneficiary of a VIE (previously, reconsideration was only required upon the occurrence of specific events), modifies the presentation of consolidated VIE assets and liabilities, and requires additional disclosures about a company's involvement in VIE's. This update will be effective for fiscal years beginning after November 15, 2009. The Company does not currently believe that the adoption of this update will have any effect on its consolidated financial position and results of operations.

In October 2009, the FASB issued authoritative guidance on revenue recognition that will become effective for us beginning July 1, 2010, with earlier adoption permitted. Under the new guidance on arrangements that include software elements, tangible products that have software components that are essential to the functionality of the tangible product will no longer be within the scope of the software revenue recognition guidance, and software-enabled products will now be subject to other relevant revenue recognition guidance. Additionally, the FASB issued authoritative guidance on revenue arrangements with multiple deliverables that are outside the scope of the software revenue recognition guidance. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. We believe the adoption of this new guidance will not have a material impact on our financial statements.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the AICPA, and the SEC did not or are not believed by management to have a material impact on the Company's present or future consolidated financial statements.

### **Item 7A. Quantitative and Qualitative Disclosure About Market Risk**

Not Applicable

### **Item 8. Financial Statements**

Our consolidated financial statements as of and for the years ended December 31, 2010 and 2009 are presented in a separate section of this report following Item 15 and begin with the index on page F-1.

## **Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

### **Item 9A(T). Controls and Procedures**

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

Our management evaluated, with the participation of our Chief Executive Officer and Interim Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K. Based on this evaluation, our Chief Executive Officer and Interim Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”) were ineffective as of December 31, 2010, due to the material weaknesses in our internal control over financial reporting described below.

Disclosure controls are procedures that are designed with the objective of ensuring that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms. Disclosure controls are also designed with the objective of ensuring that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Internal control consists of procedures which are designed with the objective of providing reasonable assurance that our transactions are properly authorized, recorded and reported and our assets are safeguarded against unauthorized or improper use, to permit the preparation of our financial statements in conformity with generally accepted accounting principles.

We identified certain matters that constitute material weakness (as defined under the Public Company Accounting Oversight Board Auditing Standard No. 2) in our internal control over financial reporting as discussed on Management’s Annual Report on Internal Control Over Financial Reporting below.

In light of the material weaknesses in internal control over financial reporting described below, we performed additional analysis and other post-closing procedures to ensure that our financial statements were prepared in accordance with generally accepted accounting principles. Despite material weaknesses in our internal control over financial reporting, we believe that the financial statements included in our Form 10-K for the period ended December 31, 2010 fairly present, in all material respects, our financial condition, results of operations, changes in shareholder’s equity and cash flows for the periods presented.

#### ***Management’s Annual Report on Internal Control over Financial Reporting.***

Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transaction and dispositions of our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitation, internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives.

Our Chief Executive Officer, Chief Financial Officer and Controller conducted an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2010 based on the framework in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). A material weakness is a deficiency or a combination of deficiencies in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company’s annual or interim financial statements will not be prevented or detected on a timely basis.

Based on that assessment, we have identified the following material weaknesses and have implemented the following remediation of material weaknesses in internal control over financial reporting:

#### ***Lack of segregation of duties***

We have limited staff in our corporate offices and, as such, there is a lack of segregation of duties. In December 2006 our Controller retired and in January 2007 our Chief Financial officer retired due to medical

problems. We have subsequently hired an Interim Chief Financial Officer and a full-time Controller and our former Controller provides certain financial consulting services.

***Lack of documented and reviewed system of internal control***

We have an internal control weakness due to the lack of a documented and reviewed system of internal control. We have determined that to perform the processes and remediate this internal control deficiency, we will either need to engage an internal control consultant or reassign existing personnel. We have started to enhance some of our key internal control systems surrounding inventory purchasing and control, and to document those changes; however, this process is on-going and the implementation of policies and procedures may take several quarters.

As a result of the material weaknesses described above, management concluded that, as of December 31, 2010, we did not maintain effective internal control over financial reporting based on the criteria established in *Internal Control – Integrated Framework, issued by COSO*.

We are conducting an evaluation to design and implement adequate systems of accounting and financial statement disclosure controls. We expect to complete a review during 2011 to comply with the requirements of the SEC, which as required by SEC rules, will include an opinion from our auditors regarding management's report on internal control over financial reporting for our fiscal year ending 2010. We believe that the ultimate success of our plan to improve our internal control over financial reporting will require a combination of additional financial resources, outside consulting services, legal advice, additional personnel, further reallocation of responsibility among various persons, and substantial additional training of those of our officers, personnel and others, including certain of our directors such as our Chairman of the Board and committee chairs, who are charged with implementing and/or carrying out our plan. It should also be noted that the design of any system of controls and procedures is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

Our annual report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting and management's report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the SEC that permit us to provide only Management's report in this annual report.

**Item 9B. Other Information**

***AOT Testing***

Our Applied Oil Technology (AOT) testing at the U.S. Department of Energy-Naval Petroleum Reserve / Rocky Mountain Oilfield Testing Center (RMOTC) in Wyoming began in late January and is well underway.

In order to move forward with this project, it was necessary to coordinate with several entities. In mid July, 2010 we entered into a Letter of Intent with RMOTC. We then contracted with Colfax Corporation to build the prototype which is being used in this test. In January 2010, we entered into a contract with the Pipeline Research Council International (PRCI) as a partner in the project. We have expended over \$470,000 to Colfax Corporation, the US Department of Energy, National Oilwell Varco and to suppliers and engineering firms to prepare for and conduct the test project.

***Temple University.***

On March 28, 2011, the Company completed its final adjusted payment to Temple University for all obligations outstanding on the License Agreements and the R&D Agreement. This included payments of \$577,837 in 2010 and \$677,422 in the first three months of 2011. We are in current negotiations with Temple to execute new License Agreements to reflect updated technologies. All of these outlays have been made possible through proceeds raised in connection with our recent private investment offerings.

***Resignation of Member of Board of Directors***

On February 18, 2011, Dr. John Price resigned as a member of the Board of Directors. (see "8K") dated February 25, 2011.

***Amendment to Employment Agreement with Chief Executive Officer***

On March 1, 2011, the Board of Directors (the "Board") of Save The World Air, Inc. (the "Company") approved an amendment (the "Amendment") to the employment agreement between the Company and the Company's Chief Executive Officer, Cecil Bond Kyte ("Kyte"), dated January 30, 2009 (the "Employment Agreement").

The initial term of the Kyte Employment Agreement was for one (1) year, renewable for successive one (1) year periods, unless Kyte or the Company provided written notice to the other, no later than October 31<sup>st</sup> of the then current year of the term, that the Employment Agreement would not be renewed;

As early as April 2010, Kyte requested the Board to re-negotiate certain of the non-cash compensation provisions under the Employment Agreement; notwithstanding Kyte's request in the foregoing regard, the Compensation Committee of the Board did not take any action to re-negotiate or change the Employment Agreement; nonetheless, Kyte elected not to terminate the Employment Agreement on October 31, 2010; thus, under provisions of the Employment Agreement, the Employment Agreement is in full force and effect and the term thereof has been extended to January 29, 2012;

1. Kyte, pursuant to provisions of the Employment Agreement, has indicated his intention not to renew the Employment Agreement, by giving notice of such non-renewal on a date no later than October 31, 2011;

2. The Board recognized Kyte's skills, judgment, abilities, contributions and outstanding performance as the Company's Chief Executive Officer ("CEO"), and determined that it is in the Company's best interest for Kyte to remain and continue to serve as the Company's CEO and for Kyte not to terminate the Employment Agreement;

3. Kyte has determined to waive his right, under Section 1 of the Employment Agreement, to terminate the Employment Agreement from March 1, 2011, through October 31, 2015, meaning that the Employment Agreement would remain in full force and effect through at least January 29, 2016, unless the Company determines to terminate the Employment Agreement earlier in accordance with provisions thereunder;

4. Kyte has also determined to waive his right to claim or receive any vested or unvested stock option grants or other benefits under Section 3.7 (Stock Option Grant) of the Employment Agreement, and has agreed to the cancellation of 181,818 stock option grants previously issued to Kyte under Section 3.7 of the Employment Agreement;

5. Kyte and the Board have determined that all terms and conditions set forth in the Employment Agreement shall remain in full force and effect, except for the changes identified in paragraphs 5. and 6., above, and the changes set forth in paragraph 10., below;

6. Kyte has agreed to continue to serve in the role of CEO of the Company through at least January 29, 2016;

7. Kyte has determined more fully to align his interests with the interests of the shareholders of the Company, and, in furtherance thereof, the Company and Kyte have agreed to an amendment of the Employment Agreement, providing for non-cash performance compensation in the form of nonqualified stock options as set forth below in paragraph 10.

8. In furtherance and consideration of the foregoing, the Board determined to amend the Employment Agreement and grant Kyte nonqualified stock options to acquire shares of common stock of the Company (the "Shares"), under the following terms and conditions:

- (i) Stock Option Grant (the "Option"): 17,600,000 Shares;
- (ii) Exercise Price: \$0.25 per share;
- (iii) Term: The Option shall expire ten (10) years from the Effective Date, defined in (iv) below;
- (iv) Effective Date: January 30, 2011;
- (v) Vesting: Twenty percent (20%) of the Option shall vest on the first anniversary of the Effective Date; twenty percent (20%) on the second anniversary of the Effective Date; twenty percent (20%) on the third anniversary of the Effective Date; twenty percent (20%) on the fourth anniversary of the Effective Date; and, twenty percent (20%) on the fifth anniversary of the Effective Date;
- (vi) Accelerated Vesting: In the event of a Change of Control, as defined in the Employment Agreement, all unvested options shall automatically vest on the effective date of such Change of Control. In the event the Company achieves net profit of no less than \$20,000,000, computed in accordance with generally accepted accounting principles, on a cumulative basis during the five (5) year vesting period, all unvested options shall automatically vest;

- (vii) If Kyte's employment with the Company is terminated with or without cause, voluntarily or involuntarily, as such terms are defined in the Employment Agreement, except for a Change of Control, all unvested Options shall terminate and be of no force or effect;
- (viii) The Options and Shares underlying the Options shall not be registered with the Securities and Exchange Commission, and shall be deemed "restricted" securities;
- (ix) The Options shall be nonqualified.

## PART III

### Item 10. Directors and Executive Officers of Registrant

#### ELECTION OF DIRECTORS

##### Composition of Board of Directors

Our bylaws provide that the Board shall consist of between one and eight directors, as determined by the Board from time to time. Following the death of Steven Bolio, at December 31, 2010, the Board consisted of four (4) members elected by the holders of the common stock at the Company's Meeting of Shareholders on April 30, 2009. The Board did not fill the vacancy created by the death of Mr. Bolio. Our directors are elected by our stockholders at each annual meeting of stockholders and will serve until their successors are elected and qualified, or until their earlier resignation or removal. There are no family relationships among any of our current directors or our executive officers.

##### Directors

The following constitute the Board of Directors as of December 31, 2010:

Name	Age	Position	Director Since
Cecil B. Kyte <sup>(1)(3)</sup>	40	Chief Executive Officer, Chairman, Director	2006
Charles R. Blum	72	President, Director	2007
John F. Price PhD <sup>(1)(2)(3)</sup>	66	Director *	2002
Nathan Shelton <sup>(1)(2)</sup>	63	Director	2007

(1) Member of the Audit Committee

(2) Member of the Compensation Committee

(3) Member of the Nominating and Corporate Governance Committee

##### Biographical Information Regarding Directors

**Cecil Bond Kyte** has served as a director since February 21, 2006. In December 2007, Mr. Kyte was elected by the Board of Directors to serve as Chairman of the Board. On January 30, 2010, he was appointed to serve as Chief Executive Officer, replacing Charles R. Blum. For the past twenty years Mr. Kyte has been a pilot in various capacities and flight academy instructor. From February 2000 to November 2002, Mr. Kyte was employed by United States regional carrier, Chautauqua Airways, including service as an airline Captain. After retiring in December 2002, Mr. Kyte has been an investor in a number of businesses, including oil and gas and financial business consulting services. He is a co-founder of SwissGuard International, GmbH, a financial consulting firm based in Zurich, Switzerland. A recent auto-racing achievement, Mr. Kyte won the 2006 SCCA ITA Regional Championship and also "Rookie of the Year" award. Mr., Kyte received a B.S. Degree in Accounting from Long Beach State University.

**Charles R. Blum** was appointed on July 25, 2007 to the Board of directors and engaged as the President and Chief Executive Officer of the Company. In January 2010, Mr. Blum resigned as Chief Executive Officer and continues to serve as President. Mr. Blum spent 22 years as the President/CEO of the Specialty Equipment Market Association (SEMA). SEMA is a trade group representing 6500 business members who are actively engaged in the manufacture and distribution of automotive parts and accessories. SEMA produces the world's largest automotive aftermarket Trade Show which is held annually in Las Vegas, Nevada. Mr. Blum led the association as its members grew from a handful of small entrepreneurial companies into an industry membership that sells over 31 billion dollars of product at the retail level annually. Mr. Blum has a proven record of accomplishment as a senior executive and brings a broad knowledge of the automotive aftermarket to the Company. Mr. Blum attended Rutgers University.

John F. Price, Ph.D., has served as a director since May 2002. He co-founded and has served as Chairman of the Board of Conscious Investing Pty Ltd., located in Sydney, Australia, a software company, since May 2001. In June 1998, Mr. Price founded Price Value, Inc., located in Sydney, Australia, a software company to market software that he developed. He has served as Chairman of the Board of Price Value, Inc., located in Sydney,

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\* As previously reported in our 8K filing on February 25, 2011, Dr. Price resigned as a Director of the Company and as a member of the Committees of the Company.

Australia since 1998. Since October 1997, Mr. Price has held various teaching positions in mathematics and physics at University of New South Wales, located in Sydney, Australia. From 1990 to 1998, he was professor and head of the Mathematics Department at Maharishi University of Management located in Sydney, Australia. Mr. Price received a B.Sc. and M.Sc. from the University of Melbourne and a Ph.D. from the Australian National University.

**Nathan Shelton** has served as our director since February 12, 2007. Mr. Shelton has a long and distinguished career with a number of diverse successful companies primarily related to the automotive industry, holding prominent positions. In 1987 he joined K&N Engineering as President and part owner and built the company into an industry leader. In 2002 he sold his interest in K&N Engineering and founded S&S Marketing, which is engaged in the automotive aftermarket parts rep business, which he currently operates. Mr. Shelton is the recipient of numerous industry related prestigious awards and in 1992, Specialty Equipment Market Association (SEMA) invited him to join its board of directors, which includes serving in capacity as its Chairman from 2002 to 2004. In 2007 he was elected to the SEMA “Hall of Fame”. Mr. Shelton served honorably in the United States Seabees from 1968 to 1972. He attended Chaffey Junior College.

## Executive Officers

The following table sets forth certain information regarding our executive officers as of December 31, 2010:

<u>Name</u>	<u>Age</u>	<u>Position</u>
Cecil Bond Kyte	40	Chief Executive Officer
Charles R. Blum	72	President
Eugene E. Eichler	84	Interim Chief Financial Officer

**For the biographies of Cecil Bond Kyte and Charles R. Blum, please see above under “Biographical Information Regarding Directors.”**

**Eugene E. Eichler**, CPA, has served as our Interim Chief Financial Officer since October 2007. The Company intends to obtain a Chief Financial Officer on a permanent basis to replace Mr. Eichler once a suitable replacement is available. He served as our Chief Executive Officer from October 2005 until November 2006, at which time he separated from the company due to medical disability. He served as our Chief Financial Officer since May 2002 until November 2006 and has been a director since May 2002. Mr. Eichler served as our President from March 2004 to October 2005 and as our Chief Operating Officer from October 2001 to March 2004. Mr. Eichler was the Chief Financial Officer and Firm Administrator of the law firm Masry & Vitito from 1982 to October 2001. From 1974 to 1982, Mr. Eichler provided financial consulting services to Foundation for HMO’s, Acne Care Medical Clinics and Earth Foods, Inc. From 1960 to 1974, Mr. Eichler headed financial consulting services for Milburn Industries and Brown, Eichler & Company. From 1953 to 1960, he held the position of Chief Budgets and Forecasts at North American Aviation. From 1951 to 1953, Mr. Eichler held various audit positions at the Atomic Energy Commission. Mr. Eichler received a B.A. from University of Montana.

## Code of Business Conduct

### CORPORATE GOVERNANCE

We maintain a corporate governance page on our corporate website at [www.stwa.com](http://www.stwa.com), which includes information regarding the Company’s corporate governance practices. Our codes of business conduct and ethics, Board committee charters and certain other corporate governance documents and policies and code of business conduct will be posted on our website. In addition, we will provide a copy of any of these documents without charge to any stockholder upon written request made to Corporate Secretary, Save the World Air, Inc., 735 State Street, Suite 500, Santa Barbara, California 93101. The information on our website is not, and shall not be deemed to be, a part of this proxy statement or incorporated by reference into this or any other filing we make with the Securities and Exchange Commission (the “SEC”).

### Board of Directors

#### *Director Independence*

Our Board of Directors as of December 31, 2010 consisted of four (4) members. As of that date, the Board has affirmatively determined that Messrs. Price and Shelton are independent directors. Mr. Kyte, our Chief Executive Officer and Mr. Blum, our President, are not considered independent.



### ***Meetings of the Board***

The Board held four (4) meetings during 2010, and held one (1) meeting in 2011. Each of the directors attended 75% or more of the aggregate number of meetings of the Board and Committees on which the director served in 2010 and 2011.

Each of our directors is encouraged to attend the Company's 2011 Annual Meeting and to be available to answer any questions posed by stockholders to such director. Because our Board holds one of its regular meetings in conjunction with our Annual Meeting of stockholders, we anticipate that all of the members of the Board will be present for the 2011 Annual Meeting.

### ***Communications with the Board***

The following procedures have been established by the Board in order to facilitate communications between our stockholders and the Board:

- Stockholders may send correspondence, which should indicate that the sender is a stockholder, to the Board or to any individual director, by mail to Corporate Secretary, Save the World Air, Inc. 735 State Street, Suite 500, Santa Barbara, California, 93101 or by e-mail to [questions@stwa.com](mailto:questions@stwa.com).
- Our Secretary will be responsible for the first review and logging of this correspondence and will forward the communication to the director or directors to whom it is addressed unless it is a type of correspondence which the Board has identified as correspondence which may be retained in our files and not sent to directors. The Board has authorized the Secretary to retain and not send to directors communications that: (a) are advertising or promotional in nature (offering goods or services), (b) solely relate to complaints by customers with respect to ordinary course of business customer service and satisfaction issues or (c) clearly are unrelated to our business, industry, management or Board or committee matters. These types of communications will be logged and filed but not circulated to directors. Except as set forth in the preceding sentence, the Secretary will not screen communications sent to directors.
- The log of stockholder correspondence will be available to members of the Board for inspection. At least once each year, the Secretary will provide to the Board a summary of the communications received from stockholders, including the communications not sent to directors in accordance with the procedures set forth above.

Our stockholders may also communicate directly with the non-management directors, individually or as a group, by mail c/o Corporate Secretary, Save the World Air, Inc., 735 State Street, Suite 500, Santa Barbara, California 93101 or by e-mail to [questions@stwa.com](mailto:questions@stwa.com).

The Audit Committee has established procedures, as outlined in the Company's policy for "Procedures for Accounting and Auditing Matters", for the receipt, retention and treatment of complaints regarding questionable accounting, internal controls, and financial improprieties or auditing matters. Any of the Company's employees may confidentially communicate concerns about any of these matters by calling our toll-free number, (877) 872--7892. Upon receipt of a complaint or concern, a determination will be made whether it pertains to accounting, internal controls or auditing matters and if it does, it will be handled in accordance with the procedures established by the Audit Committee.

### ***Committees of the Board***

The Board has a standing Audit Committee, Compensation Committee, and Nominating and Corporate Governance Committee. Each of these committees operates under a written charter. Copies of these charters, and other corporate governance documents, are available on our website, [www.stwa.com](http://www.stwa.com). In addition, we will provide a copy of any of these documents without charge to any stockholder upon written request made to Corporate Secretary, Save the World Air Inc., 735 State Street, Suite 500, Santa Barbara, California 93101.

The composition, functions and general responsibilities of each committee are summarized below.

#### ***Audit Committee***

The Audit Committee currently consists of Messrs. Kyte (chairperson), Price and Shelton. The Board has determined that Mr. Price is an audit committee financial expert, and is independent under rules of the SEC. The Board also believes that Mr. Shelton meets the independence requirements. Mr. Kyte, our Chief Executive Officer is not considered independent. The Audit Committee held a total of four (4) meetings during 2010 and a total of one (1) meeting to date during 2011.

The Audit Committee operates under a written charter. The Audit Committee's duties include responsibility for reviewing our accounting practices and audit procedures. In addition, the Audit Committee has responsibility for reviewing complaints about, and investigating allegations of, financial impropriety or misconduct. The Audit Committee works closely with management and our independent auditors. The Audit Committee also meets with our independent auditors on a quarterly basis, following completion of their quarterly reviews and annual audit, to review the results of their work. The Audit Committee also meets with our independent auditors to approve the annual scope of the audit services to be performed.

As part of its responsibility, the Audit Committee is responsible for engaging our independent auditor, as well as pre-approving audit and non-audit services performed by our independent auditor in order to assure that the provision of such services does not impair the independent auditor's independence.

Please see "Audit Committee Report" below, which provides further details of many of the duties and responsibilities of the Audit Committee.

### **AUDIT COMMITTEE REPORT**

*The following report of the Audit Committee does not constitute soliciting material and should not be deemed filed or incorporated by reference into any of our other filings under the Securities Act or the Exchange Act, except to the extent that we specifically incorporate this report by reference therein, and shall not be deemed to be soliciting material or otherwise deemed filed under either such Act.*

The Audit Committee is currently composed of three (3) directors, Messrs. Kyte (Chairperson), Price and Shelton Kyte. The Board has determined that Mr. Price is an audit committee financial expert, and is independent within the rules of the SEC. The Board also has determined that Mr. Shelton is independent within the rules of the SEC. The duties and responsibilities of a member of the Audit Committee are in addition to his duties as a member of the Board.

The Audit Committee operates under a written charter, which is available on the Company's website. The Board and the Audit Committee believe that the Audit Committee charter complies with the current standards set forth in SEC regulations. There may be further action by the SEC during the current year on several matters that affect all audit committees. The Board and the Audit Committee continue to follow closely further developments by the SEC in the area of the functions of audit committees, particularly as it relates to internal controls for non-accelerated filers, and will make additional changes to the Audit Committee charter and the policies of the Audit Committee as required or advisable as a result of these new rules and regulations. The Audit Committee met four (4) times during 2010 and once (1) to date during 2011.

The Audit Committee's primary duties and responsibilities are to:

- engage the Company's independent auditor;
- monitor the independent auditor's independence, qualifications and performance;
- pre-approve all audit and non-audit services;
- provide an open avenue of communication among the independent auditor, financial and senior management of the Company and the Board; and
- monitor the Company's compliance with legal and regulatory requirements.

Management is responsible for the Company's internal controls and the financial reporting process. The Company's independent auditor is responsible for performing an independent audit of the Company's financial statements in accordance with the standards of the Public Company Accounting Oversight Board and issuing a report thereon. The Audit Committee's responsibility is to monitor and oversee these processes.

The Company is planning to form an internal management group, reporting to the Chief Executive Officer and the Audit Committee that is charged with guiding the Company in meeting the various requirements of Section 404 of the Sarbanes-Oxley Act of 2002. The Audit Committee has begun to implement procedures to ensure that during the course of each fiscal year it devotes the attention that it deems necessary or appropriate to each of the matters assigned to it under its charter.

In overseeing the preparation of the Company's financial statements, the Audit Committee held meetings with the Company's independent auditors, both in the presence of management and privately, to discuss the overall scope and plans for their audit, review and discuss all financial statements prior to their issuance, and discuss significant accounting issues. Management advised the Audit Committee that all financial statements were prepared in accordance with accounting principles generally accepted in the United States of America, and the Audit Committee discussed the statements with both management and the Company's independent auditors. In accordance

with Section 204 of the Sarbanes-Oxley Act and the Statement on Auditing Standards (“SAS”) No. 61 (Communication With Audit Committees) as amended by SAS No. 90 (Audit Committee Communications), the Audit Committee has discussed with the Company’s independent auditors all matters required under the Sarbanes-Oxley Act and the foregoing standards.

With respect to the Company’s independent auditors, the Audit Committee, among other things, discussed with Weinberg & Co., P.A., matters relating to its independence, including the written disclosures made to the Audit Committee as required by the Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees). The Audit Committee also reviewed and approved the audit and non-audit fees of that firm.

On the basis of these reviews and discussions, the Audit Committee (i) appointed Weinberg & Co., P.A. as the independent registered public accounting firm for the 2010 fiscal year and (ii) recommended to the Board that the Board approve the inclusion of the Company’s audited financial statements in the 10-K for filing with the SEC.

Respectfully submitted:

Cecil Bond Kyte (*Chairman*)  
Nathan Shelton

### **COMPENSATION COMMITTEE REPORT**

*The following Report of the Compensation Committee does not constitute soliciting material and should not be deemed filed or incorporated by reference into any of our other filings under the Securities Act of 1933, as amended (the “Securities Act”), or the Exchange Act, except to the extent that we specifically incorporate this report by reference therein.*

The Compensation Committee has furnished this report on executive compensation for the 2010 fiscal year.

The Compensation Committee administers the Company’s executive compensation program. The Compensation Committee has the authority to review and determine the salaries and bonuses of the executive officers of the Company, including the Chief Executive Officer and the other executive officers named in the Summary Compensation Table (the “Named Executive Officers”) appearing elsewhere in this proxy statement, and to establish the general compensation policies for such individuals. The Compensation Committee also has the sole and exclusive authority to make discretionary option grants to all of the Company’s employees under the Company’s 2004 Stock Option Plan (the “2004 Plan”).

The Compensation Committee currently consists of Messrs. Price (chairperson) and Shelton. The Board believes that Messrs. Price and Shelton meet independence requirements. None of our executive officers served on the compensation committee of another entity or on any other committee of the board of directors of another entity performing similar functions during 2010. The Compensation Committee held one (1) meeting during 2010 and held one (1) meeting to date during 2011.

The Compensation Committee operates under a written charter. The charter reflects these various responsibilities, and the Committee is charged with periodically reviewing the charter. In addition, the Committee has the authority to engage the services of outside advisors, experts and others, including independent compensation consultants who do not advise the Company, to assist the Committee.

The Compensation Committee believes that the compensation programs for the Company’s executive officers should reflect the Company’s performance and the value created for the Company’s stockholders. In addition, the compensation programs should support the short-term and long-term strategic goals and values of the Company, reward individual contribution to the Company’s success and align the interests of the Company’s officers with the interests of its stockholders. The committee believes that the Company’s success depends upon its ability to attract and retain qualified executives through the competitive compensation packages it offers to such individuals.

The principal factors that were taken into account in establishing each executive officer’s compensation package for the 2010 fiscal year are described below. However, the Compensation Committee may in its discretion apply entirely different factors, such as different measures of financial performance, for future fiscal years. Moreover, all of the Company’s Named Executive Officers have entered into employment agreements with the Company and many components of each such person’s compensation are set by such agreements.

*Equity-Based Compensation.* The Committee believes in linking long-term incentives to an increase in stock value. Accordingly, it awards stock options under the 2004 Plan with an exercise price equal to the fair market value of the underlying stock on the date of grant that vest and become exercisable over time. The Committee believes that these options encourage employees to continue to use their best efforts and to remain in the Company’s

employ. Options granted to executive officers under the 2004 Plan generally vest and become exercisable in annual 25% increments over a four-year period after grant.

The Committee relies substantially on management of the Company to make specific recommendations regarding which individuals should receive option grants and the amounts of such grants. In 2010, 181,818 option were issued to Cecil B. Kyte as a condition of his Employment Agreement.

The Company grants stock options to executive officers with a cumulative option price of up to \$100,000 as incentive stock options and the remainder as non-qualified stock options, both with an exercise price equal to the fair market value of the Company's common stock on the date of grant. Accordingly, those stock options will have value only if the market price of the Company's common stock increases after that date. In determining the size of stock option grants to executive officers, the Committee bases its decisions on such considerations as similar awards to individuals holding comparable positions in our comparative groups, company performance and individual performance, as well as the allocation of overall share usage attributed to executive officers.

*Compliance with Code Section 162(m).* Section 162(m) of the Code disallows a tax deduction to publicly-held companies for compensation paid to certain of their executive officers, to the extent that compensation exceeds \$1 million per covered officer in any fiscal year. The limitation applies only to compensation which is not considered to be performance based. Non-performance based compensation paid to the Company's executive officers for the 2010 fiscal year did not exceed the \$1 million limit per officer, and the Compensation Committee does not anticipate that the non-performance based compensation to be paid to the Company's executive officers for the 2010 fiscal year will exceed that limit. Because it is unlikely that the cash compensation payable to any of the Company's executive officers in the foreseeable future will approach the \$1 million limit, the Compensation Committee has decided at this time not to take any action to limit or restructure the elements of cash compensation payable to the Company's executive officers. The Compensation Committee will reconsider this decision should the individual cash non-performance based compensation of any executive officer ever approach the \$1 million level.

The Board did not modify any action or recommendation made by the Compensation Committee with respect to executive compensation for the 2010 fiscal year. It is the opinion of the Compensation Committee that the executive compensation policies and plans provide the necessary total remuneration program to properly align the Company's performance and the interests of the Company's stockholders through the use of competitive and equitable executive compensation in a balanced and reasonable manner, for both the short and long term.

Respectfully submitted by:

Nathan Shelton

### **Nominating and Corporate Governance Committee Report**

The Nominating and Corporate Governance Committee currently consists of Messrs. Price (chairperson) and Kyte. The Board believes that Mr. Price meets the independence requirements under rules of the SEC. The Nominating and Corporate Governance Committee held did not meet during 2010 and has not yet met during 2011.

The Nominating and Corporate Governance Committee operates under a written charter. The Nominating and Corporate Governance Committee has the primary responsibility for overseeing the Company's corporate governance compliance practices, as well as supervising the affairs of the Company as they relate to the nomination of directors. The principal ongoing functions of the Nominating and Corporate Governance Committee include developing criteria for selecting new directors, establishing and monitoring procedures for the receipt and consideration of director nominations by stockholders and others, considering and examining director candidates, developing and recommending corporate governance principles for the Company and monitoring the Company's compliance with these principles and establishing and monitoring procedures for the receipt of stockholder communications directed to the Board.

The Nominating and Corporate Governance Committee is also responsible for conducting an annual evaluation of the Board to determine whether the Board and its committees are functioning effectively. In performing this evaluation, the Nominating and Corporate Governance Committee receives comments from all directors and reports annually to the Board with the results of this evaluation.

### **Director Nominations**

The Nominating and Corporate Governance Committee seeks out appropriate candidates to serve as directors of the Company, and the Nominating and Corporate Governance Committee interviews and examines director candidates and makes recommendations to the Board regarding candidate selection. In considering candidates to serve as director, the Nominating and Corporate Governance Committee evaluates various minimum individual qualifications, including strength of character, maturity of judgment, relevant technical skills or financial

acumen, diversity of viewpoint and industry knowledge, as well as the extent to which the candidate would fill a present need on the Board.

The Nominating and Corporate Governance Committee will consider, without commitment, stockholder nominations for director. Nominations for director submitted to this committee by stockholders are evaluated according to the Company's overall needs and the nominee's knowledge, experience and background. A nominating stockholder must give appropriate notice to the Company of the nomination not less than 90 days prior to the first anniversary of the preceding year's annual meeting. In the event that the date of the annual meeting is advanced by more than 30 days or delayed by more than 60 days from the anniversary date of the preceding year's annual meeting, the notice by the stockholder must be delivered not later than the close of business on the later of the 60th day prior to such annual meeting or the tenth day following the day on which public announcement of the date of such annual meeting is first made.

The stockholders' notice shall set forth, as to:

- each person whom the stockholder proposes to nominate for election as a director:
- the name, age, business address and residence address of such person,
- The principal occupation or employment of the person,
- the class and number of shares of the Company which are beneficially owned by such person, if any, and
- any other information relating to such person which is required to be disclosed in solicitations for proxies for election of directors pursuant to Regulation 14A under the Exchange Act and the rules hereunder; and the stockholder giving the notice
- the name and record address of the stockholder and the class and number of shares of the Company which are beneficially owned by the stockholder,
- a description of all arrangements or understandings between such stockholder and each proposed nominee and any other person or persons (including their names) pursuant to which nomination(s) are to be made by such stockholder,
- a representation that such stockholder intends to appear in person or by proxy at the meeting to nominate the persons named in its notice,
- any other information relating to such person which is required to be disclosed in solicitations for proxies for election of directors pursuant to Regulation 14A under the Exchange Act and the rules thereunder.

The notice must be accompanied by a written consent of the proposed nominee to be named as a director.

We have adopted codes of business conduct and ethics for our directors, officers and employees which also meet the requirements of a code of ethics under Item 406 of Regulation S-B. You can access the Company's Code of Business Conduct and Ethics and our Code of Ethics for Senior Executives and Financial Officers on the Corporate Governance page of the Company's website at [www.stwa.com](http://www.stwa.com). Any shareholder who so requests may obtain a printed copy of the Code of Conduct by submitting a request to the Company's Corporate Secretary.

Respectfully submitted by:

Cecil Kyte

**Item 11. Executive Compensation****EXECUTIVE COMPENSATION**

The following table sets forth certain information regarding the compensation earned during the last three fiscal years by the Named Executive Officers:

**Summary Compensation Table**

Name and Principal Position	Fiscal Year	Long-Term Compensation Awards			
		Annual Compensation Salary (\$)	Restricted Stock Awards (\$)	Securities Underlying Options (#)	All Other Compensation (\$)
Cecil Bond Kyte <sup>(1)(4)</sup> Chief Executive Officer	2010	\$ 200,000	\$ 0	181,118	\$ 0
	2009	\$ 183,333	\$ 0	0	\$ 0
Charles R. Blum <sup>(2)(4)</sup> President and Chief Executive Officer	2010	\$ 100,000	\$ 0	0	\$ 0
	2009	\$ 105,682	\$ 0	333,333	\$ 0
	2008	\$ 200,000	\$ 0	400,000	\$ 0
Eugene E. Eichler <sup>(3)(4)</sup> Interim Chief Financial Officer	2010	\$ 120,000	\$ 0	0	\$ 0
	2009	\$ 90,000	\$ 0	0	\$ 0
	2008	\$ 0	\$ 0	0	\$ 0

(1) Mr. Kyte was appointed Chief Executive Officer in January 2009. In 2010, Mr. Kyte earned and was paid \$200,000. See “Employment Agreement” below. In connection with the Amendment to Mr. Kyte’s Employment Agreement, as previously reported in our Form 8K filed on March 9, 2011, options for 181,118 shares of common stock previously granted, were cancelled.)

(2) Mr. Blum was appointed President and Chief Executive Officer in July 2007. In January 20, 2009 Mr. Blum resigned the position of Chief Executive Officer and continues to serve as President. He does not have an “Employment Agreement” at this time. In 2010, Mr. Blum earned \$100,000 all of which was unpaid and accrued.

(3) On October 18, 2007, Mr. Eichler was appointed Interim Chief Financial Officer. He does not have an “Employment Agreement” at this time. In 2010, Mr. Eichler was paid \$80,000 and \$40,000 was accrued and unpaid at December 31, 2010.

(4) The number and value of vested restricted stock based upon the closing market price of the common stock at December 31, 2010 (\$0.54) were as follows: Mr. Kyte 2,152,926 vested shares valued at \$1,162,580, and Mr. Eichler, 1,071,429 vested shares valued at \$578,572.

The portions of the salaries identified above that have been deferred will be paid subject to the Company’s future financial and cash position.

**OPTION GRANTS IN LAST FISCAL YEAR**

The following table sets forth information concerning the stock option grants made to each of the Named Executive Officers during the 2010 fiscal year. No stock appreciation rights were granted to any of the Named Executive Officers during the 2010 fiscal year.

Name	Individual Grants			
	Number of Securities Underlying Options Granted	Percent of Total Options Granted to Employees in Fiscal 2010	Exercise or Base Price Per Share	Expiration Date
Cecil Bond Kyte	181,818	100.0%	\$ 0.55	01/30/20

## AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND YEAR-END OPTION VALUES

No options were exercised by any of the Named Executive Officers during the 2010 fiscal year. The following table sets forth the number of shares of our common stock subject to exercisable and unexercisable stock options which the Named Executive Officers held at the end of the 2010 fiscal year.

Name	Shares Acquired on Exercise (#)	Value Realized (\$)	Number of Securities Underlying Unexercised Options at Fiscal Year-End (#)		Value of Unexercised In-the-Money Options (\$) <sup>(1)</sup>	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Cecil Bond Kyte		\$ —	1,100,000	181,818	\$ 297,000	\$ 0
Charles R. Blum	—	\$ —	922,012	0	\$ 157,387	\$ 0
Eugene E. Eichler	—	\$ —	1,371,127	0	\$ 33,600	\$ 0

<sup>(1)</sup> Market value of our common stock at fiscal year-end minus the exercise price. The closing price of our common stock on December 31, 2010 the last trading day of the year was \$0.54 per share.

## EQUITY COMPENSATION PLAN INFORMATION FOR 2010

The following table sets forth information regarding outstanding options and shares reserved for future issuance under our equity compensation plans as of December 31, 2010:

Plan Category	Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in the First Column)
Equity compensation plans approved by security holders	4,587,488	\$ 0.54	2,412,512
Equity compensation plans not approved by security holders	250,000	\$ 0.40	N/A
Total	4,837,488	\$ 0.53	N/A

## EMPLOYMENT AGREEMENTS

**Agreement with Cecil Bond Kyte.** On January 30, 2009, the Company entered into an employment agreement with Cecil Bond Kyte, pursuant to which he serves as our Chief Executive Officer. The initial term of the agreement became effective on January 30, 2009 and expires on January 30, 2010 and renews automatically for addition one-year periods unless either party has given notice of non-extension prior to October 30, 2010. The agreement provides for a base compensation of \$200,000 per year. Mr. Kyte is eligible to participate in the Company's incentive and benefit plans, including eligibility to receive grants of stock options under the 2004 plan.

Mr. Kyte shall be eligible to receive an annual cash bonus in an amount equal to 2% of the Company's net profit, if any, for its most recently completed fiscal year, computed in accordance with generally accepted accounting principles applied consistently with prior periods. The bonus shall be payable, if at all, on the anniversary date of employment each year of the term; provided that no bonus shall be paid if the Executive is not, on such payment date, in the employ of the Company.

Mr. Kyte shall also receive an option (the "Option") to purchase a number of shares (the "Option Shares") of the Company's common stock equal to the result of (A) 100,000 divided by (B) the closing price per share of the Company's Common Stock on the first anniversary of the Effective Date. The Option shall be an incentive stock option, shall be exercisable at the closing price per share on the first anniversary of the Effective Date, shall be exercisable for ten years from the date of grant and shall vest on the second anniversary of the Effective Date.

Termination of Mr. Kyte's contract will terminate upon his death or disability and may be terminated by the Company with or without cause and may be voluntarily terminated by Mr. Kyte. Termination of Mr. Kyte's employment for any reason shall be effective upon the Date of Termination and he shall only be entitled to receive the compensation accrued through the Date of Termination. In the event of Involuntary Termination, involving merger, consolidation or sale or disposition of all of the Company's assets, Mr. Kyte shall be entitled to receive (i) all compensation that has accrued through the date of termination, plus, (ii) a severance payment equal to one year's compensation, plus he shall be entitled to continue to participate in the Company's employee benefit programs offered to other senior management employees of the Company for a period of 12 months following the date of termination, provided that if at any time while the Company is required to pay severance to Mr. Kyte, his death or disability would cause the severance payments to terminate.

As previously reported in our 8K filing on March 9, 2011, Mr. Kyte's Employment Agreement has been amended.

## Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

### SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information regarding the beneficial ownership of our common stock as of December 31, 2010.

- each person, or group of affiliated persons, known by us to be the beneficial owner of more than 5% of the outstanding shares of our common stock;
- each of our directors;
- our Chief Executive Officer and each of our two other most highly-compensated executive officers serving as such as of December 31, 2010 whose total annual salary and bonus exceeded \$100,000, for services rendered in all capacities to the Company (such individuals are hereafter referred to as the "Named Executive Officers"); and\* all of our directors and executive officers serving as a group.

Name and Address of Beneficial Owner <sup>(1)</sup>	Number of Shares of Common Stock Beneficially Owned <sup>(2)</sup>	Percentage of Shares Beneficially Owned <sup>(2)</sup>
Named Executive Officers and Director		
Cecil Bond Kyte, Chief Executive Officer, Director <sup>(3)</sup>	4,062,103	4.36%
Charles R. Blum, President <sup>(4)</sup>	922,012	1.00%
Eugene E. Eichler, Chief Financial Officer <sup>(5)</sup>	2,942,556	3.15%
Price, John F. – Director <sup>(6)</sup>	733,824	0.80%
Shelton, Nathan – Director <sup>(7)</sup>	296,937	0.32%
All directors and executive officers as a group	8,957,432	9.30%

<sup>(1)</sup> Unless otherwise indicated, the address of each listed person is c/o Save the World Air, Inc., 735 State Street, Suite 500, Santa Barbara, California 93101.

<sup>(2)</sup> Percentage of beneficial ownership is based upon 91,453,194 shares of our common stock outstanding as of December 31, 2010. Beneficial ownership is determined in accordance with the rules of the SEC and generally includes voting or investment power with respect to securities. Shares of common stock subject to options and warrants currently exercisable or convertible, or exercisable or convertible within 60 days, are deemed outstanding for determining the number of shares beneficially owned and for computing the percentage ownership of the person holding such options, but are not deemed outstanding for computing the percentage ownership of any other person. Except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table have sole voting and investment power with respect to all shares of common stock shown as beneficially owned by them.

<sup>(3)</sup> Includes options to purchase 1,311,818 shares of our common stock exercisable currently and warrants to purchase 500,000 shares of our common stock.

<sup>(4)</sup> Includes options to purchase 922,012 shares of our common stock exercisable currently.



- (5) Includes options to purchase 1,371,127 shares of our common stock exercisable currently. and warrants to purchase 500,000 shares of our common stock...
- (6) Includes options to purchase 180,000 shares of our common stock exercisable currently.
- (7) Includes options to purchase 104,585 shares of our common stock exercisable currently.

### Item 13. Certain Relationships and Related Transactions

#### *Loans from related parties*

In May of 2007, a former officer and incumbent director of the Company loaned \$31,404 to pay a company obligation and in August 2007, the same party loaned \$50,000 to the Company so that it could pay certain operating expenses. These amounts are unsecured, bear interest at 6% per annum and are due on demand. At December 31, 2010 the balance of these loans including interest was \$86,947.

#### *Accounts Payable to related parties*

As of December 31, 2010, the Company had accounts payable to related parties in the amount of \$241,176, which was composed of \$186,500 in unpaid Directors Fees, \$54,676 in unreimbursed expenses incurred by Officers and Directors.

### Item 14. Principal Accountant Fees and Services

The Audit Committee has selected Weinberg & Company, P.A. to audit our financial statements for the fiscal year ended December 31, 2010.

Weinberg & Company, P.A. was first appointed in fiscal year 2003, and has audited our financial statements for fiscal years 2002 through 2010.

#### **Audit and Other Fees**

The following table summarizes the fees charged by Weinberg & Company, P.A. for certain services rendered to the Company during 2010 and 2009.

Type of Fee	Amount	
	Fiscal Year 2010	Fiscal Year 2009
Audit <sup>(1)</sup>	\$ 87,883	\$ 87,891
Audit Related <sup>(2)</sup>	0	0
Taxes <sup>(3)</sup>	20,920	10,000
All Other <sup>(4)</sup>	0	0
Total	<u>\$ 108,803</u>	<u>\$ 97,891</u>

- (1) This category consists of fees for the audit of our annual financial statements included in the Company's annual report on Form 10-K and review of the financial statements included in the Company's quarterly reports on Form 10-Q. This category also includes advice on audit and accounting matters that arose during, or as a result of, the audit or the review of interim financial statements, statutory audits required by non-U.S. jurisdictions and the preparation of an annual "management letter" on internal control matters.
- (2) Represents services that are normally provided by the independent auditors in connection with statutory and regulatory filings or engagements for those fiscal years, aggregate fees charged for assurance and related services that are reasonably related to the performance of the audit and are not reported as audit fees. These services include consultations regarding Sarbanes-Oxley Act requirements, various SEC filings and the implementation of new accounting requirements.
- (3) Represents aggregate fees charged for professional services for tax compliance and preparation, tax consulting and advice, and tax planning.
- (4) Represents aggregate fees charged for products and services other than those services previously reported.

## PART IV

### Item 15. Exhibits

- (a) The following documents are filed as part of this Form 10-K.

Financial Statements:

Reference is made to the contents to the consolidated financial statements of Save the World Air, Inc. under Item 7 of this Form 10-K.

- (b) Exhibits:

The exhibits listed below are required by Item 601 of Regulation S-K.

Exhibit No.	Description
3.1(1)	Articles of Incorporation, as amended, of the Registrant.
3.2(1)	Bylaws of the Registrant.
10.1(2)	Commercial Sublease dated October 16, 2003 between the Registrant and KZ Golf, Inc.
10.2(9)	Amendment dated June 15, 2004 to Exhibit 10.1
10.3 (10)	Amendment dated August 14, 2005 to Exhibit 10.1
10.4(10)	General Tenancy Agreement dated March 14, 2006 between the Registrant and Autumlee Pty Ltd.
10.5(3)	Agreement dated December 13, 2002 between the Registrant and RAND.
10.6(2)**	Agreement dated May 7, 2003 between the Registrant and RAND.
10.7(5)	Modification No. 1 dated as of August 21, 2003 to Exhibit 10.5
10.8(5)	Modification No. 2 dated as of October 17, 2003 to Exhibit 10.5
10.9(5)	Modification No. 3 dated as of January 20, 2004 to Exhibit 10.5
10.10(4)	Deed and Document Conveyance between the Trustee of the Property of Jeffrey Ann Muller and Lynette Anne Muller (Bankrupts).
10.11(4)	Assignment and Bill of Sale dated May 28, 2002 between the Registrant and Kevin Charles Hart.
10.12(11)†	Amended and Restated Employment Agreement dated October 5, 2005 between the Registrant and Eugene E. Eichler.
10.13(15)†	Severance Agreement dated November 8, 2006 between the Registrant and Eugene E. Eichler
10.14(11)†	Amended and Restated Employment Agreement dated October 5, 2005 between the Registrant and Bruce H. McKinnon.
10.15(6)	Save the World Air, Inc. 2004 Stock Option Plan
10.16(8)	Form of Incentive Stock Option Agreement under 2004 Stock Option Plan
10.17(8)	Form of Non-Qualified Stock Option Agreement under 2004 Stock Option Plan
10.18(8)	Consulting Agreement dated as of October 1, 2004 between the Registrant and John Fawcett
10.19(7)	License Agreement dated as of July 1, 2004 between the Registrant and Temple University – The Commonwealth System of Higher Education
10.20(8)	Consulting Agreement dated as of November 19, 2004 between the Registrant and London Aussie Marketing, Ltd.
10.21(13)	Amendment dated September 14, 2006 to Exhibit 10.20
10.22(8)†	Employment Agreement dated September 1, 2004 with Erin Brockovich
10.23(15)†	Amendment dated as of July 31, 2006 to Exhibit 10.22
10.24(8)	Assignment of Patent Rights dated as of September 1, 2003 between the Registrant and Adrian Menzell
10.25(8)	Global Deed of Assignment dated June 26, 2004 between the Registrant and Adrian Menzell
10.26(11)†	Amended and Restated Employment Agreement dated as of March 1, 2006 between the Registrant and John Richard Bautista III
10.27(9)	Lease dated August 15, 2005 between the Registrant and Thomas L. Jackson
10.28(10)	Amendment dated February 1, 2006 to Exhibit 10.27
10.29(10)	Form of 9% Convertible Note issued in the 2005 Interim Financing
10.30(10)	Form of Stock Purchase Warrant issued in the 2005 Interim Financing
10.31(10)	Form of Stock Purchase Warrant issued in the 2005 Bridge Financing
10.32(11)	Form of Stock Purchase Warrant issued in 2006 Regulation S financing
10.33(11)	Form of Stock Purchase Warrant issued in 2006 PIPE financing
10.34(12)	Commercial Sublease between the Registrant and KZG Golf dated January 1, 2006
10.35(12)	Investment Agreement dated September 15, 2006 between the Registrant and Dutchess Private Equities Fund

10.36(12)	Registration Rights Agreement dated September 15, 2006 between the registrant and Dutchess Private Equities Fund, LLP
10.37(17)	License Agreement between the Registrant and Temple University dated February 2, 2007
10.38(17)	License Agreement between the Registrant and Temple University dated February 2, 2007
10.39(17)	R&D Agreement between the Registrant and Temple University dated February 2, 2007
10.40(14)	Note Purchase Agreement dated December 5, 2006 between the registrant and Morale Orchards LLC
10.41(14)	Form of Stock Purchase Warrant issued to Morale Orchards LLC
10.42(14)	Form of Convertible Note issued to Morale Orchards LLC
10.43(16)	Consulting Agreement dated January 4, 2007 between the Registrant and Spencer Clarke LLC
10.44(15)	Agreement dated as of July 15, 2006 between the Company and SS Sales and Marketing Group
10.45(15)	Engagement Agreement between the Registrant and Charles K. Dargan II
10.46(15)	Form of 10% Convertible Note issued in 2007 PIPE Offering
10.47(15)	Form of Stock Purchase Warrant issued in 2007 PIPE Offering
10.48(18)	Appointment of New Directors, Nathan Shelton, Steven Bolio and Dennis Kenneally
10.49(19)	Issuance of RAND Final Report
10.50(20)	Delisting from OTCBB to OTC Pink Sheets
10.51(21)	Resignation of Director, Dennis Kenneally
10.52(22)	Resignation of Officer, Bruce H. McKinnon
10.53(23)	Form of 10% Convertible Note issued in 2007 Spring Offering
10.54(23)	Form of Stock Purchase Warrant issued in 2007 Spring Offering
10.55(24)	Termination of North Hollywood Lease
10.56(25)	Modification Agreement of 10% 2007 PIPE Convertible Notes
10.57(26)	Form of 10% Convertible Note issued in 2007 Summer Offering
10.58(26)	Form of Stock Purchase Warrant issued in 2007 Summer Offering
10.59(27)	Resignation of Director, J. Joseph Brown
10.60(28)	Resignation of Chief Financial Officer and Appointment of Interim Chief Financial Officer
10.61(29)	Severance Agreement dated June 15, 2007 between Registrant and Bruce H. McKinnon
10.62(30)	Resignation of Director, Bruce H. McKinnon
10.63(31)	Second Modification Agreement of 10% 2007 PIPE Convertible Notes
10.64(32)	Form of 10% Convertible Note issued in 2007 Fall Offering
10.65(32)	Form of Stock Purchase Warrant issued in 2007 Fall Offering
10.66(33)	Resignation of Director, Joseph Helleis
10.67(34)	Form of 10% Convertible Note issued in 2007/8 Winter Offering
10.68(34)	Form of Stock Purchase Warrant issued in 2007/8 Winter Offering
10.69(34)	Modification and Satisfaction Agreement of Convertible Notes with Morale Orchards, LLP and Matthews & Partners
10.70(35)	Termination of employment relationship with John Bautista
10.71(36)	Form of 10% Convertible Note issued in 2008 Summer Offering
	Form of Stock Purchase Warrant issued in 2008 Summer Offering
10.72(37)	Form of 10% Convertible Note issued in 2008 Fall Offering
	Form of Stock Purchase Warrant issued in 2008 Fall Offering
10.73(38)	Form of 10% Convertible Note issued in 2008 Winter Offering
	Form of Stock Purchase Warrant issued in 2008 Winter Offering
10.74(39)	Letter Agreement with Temple University extending default date
10.75(40)	Notice of first payment to Temple University under Letter Agreement
	Announcement of date of 2010 Annual Shareholder Meeting
	Appointment of Cecil Bond Kyte as new Chief Executive Officer
10.76(41)	Form of 10% Convertible Note issued in 2009 Winter Offering
	Form of Stock Purchase Warrant issued in 2009 Winter Offering
10.77(42)	Employment Agreement with Cecil Bond Kyte
10.78(43)	Form of 10% Convertible Note issued in 2009 Winter #2 Offering
	Form of Stock Purchase Warrant issued in 2009 Winter #2 Offering
10.79(44)	Form of 10% Convertible Note issued in 2009 Spring Offering
	Form of Stock Purchase Warrant issued in 2009 Spring Offering
10.80(45)	Form of 7% Convertible Note issued in 2009 Summer Offering
	Form of Stock Purchase Warrant issued in 2009 Summer Offering
10.81(46)	Passing of Steven Bolio, Company Director
10.82(47)	Form of 7% Convertible Note issued in 2009 Wellfleet Offering
	Form of Stock Purchase Warrant issued in 2009 Wellfleet Offering

10.83(48)	Form of 7% Convertible Note issued in 2009 Fall Offering
	Form of Stock Purchase Warrant issued in 2009 Fall Offering
10.84(49)	Letter to Shareholders
10.85(50)	Form of 10% Convertible Note issued in 2010 Winter Offering
	Form of Stock Purchase Warrant issued in 2010 Winter Offering
1086(51)	Settlement of Bruce H. McKinnon Arbitration Award
1087(52)	Form of 10% Convertible Note Issued in 2010 Spring Offering
	Form of Stock Purchase Warrant issued in to2010 Spring Offering
1088(53)	Form of 10% Convertible Note Issued in 2010 Summer Offering
	Form of Stock Purchase Warrant issued in 2010 Summer Offering
1089(54)	Form of 10% Convertible Note issued in 2010 Fall Offering
	Form of Stock Purchase Warrant issued in 2010 Fall Offering
1090(55)	Form of 10% Convertible Note issued in 2010 Fall Offering #2
	Form of Stock Purchase Warrant issued in 2010 Fall Offering #2
1091(56)	Resignation of Director John A. Price
1092(57)	Form of 10% Convertible Note issued in 2011 Winter Offering
	Form of Stock Purchase Warrant issued in 2011 Winter Offering
1093(58)	Amendment to Employment Contract with Cecil Kyte
	Announcement of date of 2011 Annual Shareholder Meeting
21	List of Subsidiaries
24*	Power of Attorney (included on Signature Page)
31.1*	Certification of Chief Executive Officer of Annual Report Pursuant to Rule 13(a)—15(e) or Rule 15(d)—15(e).
31.2*	Certification of Chief Financial Officer of Annual Report Pursuant to 18 U.S.C. Section 1350.
32.1*	Certification of Chief Executive Officer and Chief Financial Officer of Annual Report pursuant to Rule 13(a)—15(e) or Rule 15(d)—15(e).

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\* Filed herewith.

\*\* Confidential treatment previously requested.

† Management contract or compensatory plan or arrangement.

(1) Incorporated by reference from Registrant's Registration Statement on Form 10-SB (Registration Number 000-29185), as amended, filed on March 2, 2000.

(2) Incorporated by reference from Registrant's Form 10-KSB for the fiscal year ended December 31, 2002.

(3) Incorporated by reference from Registrant's Form 8-K filed on December 30, 2002.

(4) Incorporated by reference from Registrant's Form 8-K filed on November 12, 2002.

(5) Incorporated by reference from Registrant's Form 10-QSB for the quarter ended March 31, 2004.

(6) Incorporated by reference from Appendix C of Registrant's Schedule 14A filed on April 30, 2004, in connection with its Annual Meeting of Stockholders held on May 24, 2004.

(7) Incorporated by reference from Registrant Form 8-K filed on July 12, 2004.

(8) Incorporated by reference from registrant's Form 10-KSB for the fiscal year ended December 31, 2004.

(9) Incorporated by reference from Registrant's Form 10-QSB for the quarter ended September 30, 2005

(10) Incorporated by reference from Registrant's Form 10-KSB for the fiscal year ended December 31, 2005

(11) Incorporated by reference from Registrant's Form SB-2 filed on June 28, 2006 (SEC File No. 333- 333-135415)

(12) Incorporated by reference from Registrant's Form 8-K filed on September 21, 2006

(13) Incorporated by reference from Registrant's Form SB-2 filed on October 6, 2006 (SEC File No. 333-137855)

(14) Incorporated by reference from Registrant's Form 8-K filed on December 11, 2006

(15) Incorporated by reference from Registrant's Form 10KSB for the fiscal year ended December 31, 2006

(16) Incorporated by reference from Registrant's form 8-K filed on January 10, 2007

(17) Incorporated by reference from Registrant's form 8K filed on February 8, 2007

(18) Incorporated by reference from Registrant's form 8K filed on February 16, 2007

(19) Incorporated by reference from Registrant's form 8K filed on May 3, 2007

(20) Incorporated by reference from Registrant's form 8K filed on May 22 2007

- (21) Incorporated by reference from Registrant's form 8K filed on June 8, 2007
- (22) Incorporated by reference from Registrant's form 8K filed on June 15, 2007
- (23) Incorporated by reference from Registrant's form 8K filed on July 2, 2007
- (24) Incorporated by reference from Registrant's form 8K filed on July 18, 2007
- (25) Incorporated by reference from Registrant's form 8K filed on August 30, 2007
- (26) Incorporated by reference from Registrant's form 8K filed on October 9, 2007
- (27) Incorporated by reference from Registrant's form 8K filed on October 23, 2007
- (28) Incorporated by reference from Registrant's form 8K filed on November 9, 2007
- (29) Incorporated by reference from Registrant's Form 10QSB for the nine months ended September 30, 2007
- (30) Incorporated by reference from Registrant's form 8K filed on November 15, 2007
- (31) Incorporated by reference from Registrant's form 8K filed on December 11, 2007
  
- (32) Incorporated by reference from Registrant's form 8K filed on December 20, 2007
- (33) Incorporated by reference from Registrant's form 8K filed on February 25, 2010
- (34) Incorporated by reference from Registrant's form 8K filed on March 11, 2010
- (35) Incorporated by reference from Registrant's form 8K filed on March 27, 2010
- (36) Incorporated by reference from Registrant's form 8K filed on September 3, 2010
- (37) Incorporated by reference from Registrant's form 8K filed on November 6, 2010
- (38) Incorporated by reference from Registrant's form 8K filed on December 11, 2010
- (39) Incorporated by reference from Registrant's form 8K filed on January 13, 2010
- (40) Incorporated by reference from Registrant's form 8K filed on January 27, 2010
- (41) Incorporated by reference from Registrant's form 8K filed on January 26, 2010
- (42) Incorporated by reference from Registrant's form 10K for the twelve months ended December 31, 2010
  
- (43) Incorporated by reference from Registrant's form 8K filed on March 12, 2010
- (44) Incorporated by reference from Registrant's form 8K filed on May 8, 2010
- (45) Incorporated by reference from Registrant's form 8K filed on September 30, 2010
- (46) Incorporated by reference from Registrant's form 8K filed on November 24, 2010
- (47) Incorporated by reference from Registrant's form 8K filed on December 7, 2010
- (48) Incorporated by reference from Registrant's form 8K filed on February 3, 2010
- (49) Incorporated by reference from Registrant's form 8K filed on March 22, 2010
- (50) Incorporated by reference from Registrant's form 8K filed on April 8, 2010
- (51) Incorporated by reference from Registrant's form 8K filed on April 13, 2010
- (52) Incorporated by reference from Registrant's form 8K filed on May 7, 2010
- (53) Incorporated by reference from Registrant's form 8K filed on August 11, 2010
- (54) Incorporated by reference from Registrant's form 8K filed on November 11, 2010
- (55) Incorporated by reference from Registrant's form 8K filed on December 6, 2010
- (56) Incorporated by reference from Registrant's form 8K filed on February 25, 2011
- (57) Incorporated by reference from Registrant's form 8K filed on March 7, 2011
- (58) Incorporated by reference from Registrant's form 8K filed on March 9, 2011

## SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the Registrant has caused this report to be signed on its behalf by the undersigned, hereunto duly authorized.

### Save The World Air, Inc.

Date: March 30, 2011

By: /s/ CECIL BOND KYTE

Cecil Bond Kyte

*Chief Executive Officer*

## POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints, jointly and severally, Cecil Bond Kyte and Eugene E. Eichler, and each of them, as his or her true and lawful attorneys-in-fact and agents, with full power of substitution and re-substitution, for him or her and in his or her name, place and stead, in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he or she might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or any of them, or their or his or her substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934 this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>NAME</u>	<u>TITLE</u>	<u>DATE</u>
<u>/s/ CECIL BOND KYTE</u> Cecil Bond Kyte	Chief Executive Officer and Chairman of the Board Of Directors	March 30 , 2011
<u>/s/ CHARLES R. BLUM</u> Charles R. Blum	President and Director	March 30, 2011
<u>/s/ EUGENE E. EICHLER</u> Eugene E. Eichler	Interim Chief Financial Officer	March 30, 2011
<u>/s/ NATHAN SHELTON</u> Nathan Shelton	Director	March 30, 2011

# **INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

## **SAVE THE WORLD AIR, INC. AND SUBSIDIARY (A DEVELOPMENT STAGE ENTERPRISE) DECEMBER 31, 2010 AND 2009**

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of:  
Save The World Air, Inc. and Subsidiary

We have audited the accompanying consolidated balance sheets of Save The World Air, Inc. and Subsidiary (a development stage enterprise) (the "Company") as of December 31, 2010 and 2009, and the related consolidated statements of operations, stockholders' deficiency and cash flows for the years then ended and for the period from February 18, 1998 (inception) to December 31, 2010. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Save The World Air, Inc. and Subsidiary as of December 31, 2010 and 2009, and the results of their operations and their cash flows for the years then ended and for the period from February 18, 1998 (inception) to December 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the financial statements, the Company has incurred recurring losses from operations since its inception. These matters raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Weinberg & Company, P.A.

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Weinberg & Company, P.A.

Los Angeles, California  
March 30, 2011



**SAVE THE WORLD AIR, INC.**  
**(A DEVELOPMENT STAGE ENTERPRISE)**

**CONSOLIDATED BALANCE SHEETS**

	<u>December 31,</u>	
	<u>2010</u>	<u>2009</u>
<b>ASSETS</b>		
<b>Current assets</b>		
Cash	\$ 101,645	\$ 33,611
Other current assets	29,425	16,453
Total current assets	<u>131,070</u>	<u>50,064</u>
<b>Property and Equipment, net</b>	78,083	100,870
<b>Other assets</b>	8,020	11,020
<b>Total assets</b>	<u>\$ 217,173</u>	<u>\$ 161,954</u>
 <b>LIABILITIES AND STOCKHOLDERS' DEFICIENCY</b>		
<b>Current liabilities</b>		
Accounts payable- related parties	\$ 241,176	\$ 188,820
Accounts payable – license agreements	721,785	1,006,384
Accounts payable- other	450,411	512,161
Accrued expenses	959,827	1,305,605
Accrued professional fees	431,704	442,710
Loan payable- related party and shareholders	86,947	125,233
Convertible debentures, net-of-discount	76,947	485,650
Fair value of derivative liabilities	3,664,675	1,706,343
Total liabilities	<u>6,633,472</u>	<u>5,772,906</u>
 <b>Commitments and contingencies</b>		
 <b>Stockholders' deficiency</b>		
Common stock, \$.001par value: 200,000,000 shares authorized, 91,453,194 and 71,289,396 shares issued and outstanding at December 31, 2010 and 2009, respectively	91,453	71,289
Additional paid-in capital	51,925,168	43,255,773
Deficit accumulated during the development stage	(58,432,920)	(48,938,014)
Total stockholders' deficiency	<u>(6,416,299)</u>	<u>(5,610,952)</u>
<b>Total liabilities and stockholder's deficiency</b>	<u>\$ 217,173</u>	<u>\$ 161,954</u>

See notes to consolidated financial statements.

**SAVE THE WORLD AIR, INC.**  
**(A DEVELOPMENT STAGE ENTERPRISE)**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

	<b>Years Ended December 31,</b>		<b>Inception (February 18, 1998) to December 31, 2010</b>
	<b>2010</b>	<b>2009</b>	
<b>Net sales</b>	\$ —	\$ —	\$ 69,000
<b>Cost of goods sold</b>	—	—	24,120
<b>Gross profit</b>	—	—	44,880
<b>Operating expenses</b>	4,293,631	3,042,465	37,257,954
<b>Research and development expenses</b>	427,982	428,139	6,314,714
<b>Non-cash patent settlement cost</b>	—	—	1,610,066
<b>Loss before other income (expense)</b>	(4,721,613)	(3,470,604)	(45,137,854)
<b>Other income (expense)</b>			
Other income (loss)	145,112	—	143,972
Interest income	—	—	16,342
Interest and financing expense	(4,034,558)	(1,603,500)	(11,592,364)
Change in fair value of derivative liabilities	414,505	(307,840)	106,665
Costs of private placement	(1,129,212)	(511,503)	(1,640,715)
Costs to induce conversion of notes	(168,340)	(300,703)	(469,043)
Loss on disposition of equipment	—	—	(14,426)
Settlement of Debt Due Morale/ Matthews	—	—	(927,903)
Settlement of litigation and debt	—	—	1,089,088
<b>Loss before provision for income taxes</b>	(9,494,106)	(6,194,150)	(58,426,238)
<b>Provision for income taxes</b>	800	800	6,682
<b>Net loss</b>	<u>\$ (9,494,906)</u>	<u>\$ (6,194,950)</u>	<u>\$ (58,432,920)</u>
<b>Net loss per common share, basic and diluted</b>	<u>\$ (0.12)</u>	<u>\$ (0.09)</u>	
<b>Weighted average common shares outstanding, basic and diluted</b>	<u>81,910,267</u>	<u>65,733,871</u>	

See notes to consolidated financial statements.

**SAVE THE WORLD AIR, INC.**  
**(A DEVELOPMENT STAGE ENTERPRISE)**

**CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIENCY**  
**FROM FEBRUARY 18, 1998 (INCEPTION) TO DECEMBER 31, 2010**

	Price per Share	Common Stock		Common Stock to be Issued	Additional Paid-in Capital	Deferred Compensation	Deficit Accumulated During the Development Stage	Total Stockholders' Deficiency
		Shares	Amount					
<b>Balance, February 18, 1998</b> (date of inception)		—	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Issuance of common stock on April 18, 1998	.0015 - .01	10,030,000	10,030	—	14,270	—	—	24,300
Net loss		—	—	—	—	—	(21,307)	(21,307)
<b>Balance, December 31, 1998</b>		10,030,000	\$ 10,030	\$ —	14,270	\$ —	\$ (21,307)	\$ 2,993
Issuance of common stock on May 18, 1999	1.00 - 6.40	198,003	198	—	516,738	—	—	516,936
Issuance of common stock for ZEFS on September 14, 1999	.001	5,000,000	5,000	—	—	—	—	5,000
Stock issued for professional services on May 18, 1999	0.88	69,122	69	—	49,444	—	—	49,513
Net loss		—	—	—	—	—	(1,075,264)	(1,075,264)
<b>Balance, December 31, 1999</b>		15,297,125	\$ 15,297	\$ —	\$ 580,452	\$ —	\$ (1,096,571)	\$ (500,822)

(continued)

**SAVE THE WORLD AIR, INC.**  
**(A DEVELOPMENT STAGE ENTERPRISE)**

**CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIENCY (continued)**  
**FROM FEBRUARY 18, 1998 (INCEPTION) TO DECEMBER 31, 2010**

	Price per Share	Common Stock		Common Stock to be Issued	Additional Paid-in Capital	Deferred Compensation	Deficit Accumulated During the Development Stage	Total Stockholders' Deficiency
		Shares	Amount					
<b>Balance, December 31, 1999</b>		15,297,125	\$ 15,297	\$ —	\$ 580,452	\$ —	\$ (1,096,571)	\$ (500,822)
Issuance of common stock for services								
	\$0.38 - \$5.31	305,810	306	—	588,704	—	—	589,010
Stock issued for employee compensation on February 8, 2000	\$1.03- \$5.31	42,000	42	—	137,378	—	—	137,420
Stock issued for directors fees	\$3.38- \$4.44	56,000	56	—	195,584	—	—	195,640
Common stock cancelled		(55,000)	(55)		(64,245)			(64,300)
Net loss		—	—	—	—	—	(1,270,762)	(1,270,762)
<b>Balance, December 31, 2000</b>		15,645,935	15,646	—	1,437,873	—	(2,367,333)	(913,814)
Issuance of common stock for services	\$0.25- \$1.65	1,339,912	1,340	—	1,031,231	—	—	1,032,571
Stock issued for directors fees	\$0.60- \$0.95	1,100,000	1,100		1,008,900			1,010,000
Intrinsic value of options issued to employees					2,600,000	(2,600,000)		—
Fair value of options issued to non- employees					142,318			142,318
Amortization of deferred compensation						191,667		191,667
Net loss							(2,735,013)	(2,735,013)
<b>Balance, December 31, 2001</b>		<u>18,085,847</u>	<u>\$ 18,086</u>	<u>\$ —</u>	<u>\$ 6,220,322</u>	<u>\$ (2,408,333)</u>	<u>\$ (5,102,346)</u>	<u>\$ (1,272,271)</u>

(continued)

**SAVE THE WORLD AIR, INC.**  
**(A DEVELOPMENT STAGE ENTERPRISE)**

**CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIENCY (continued)**  
**FROM FEBRUARY 18, 1998 (INCEPTION) TO DECEMBER 31, 2010**

	Price per Share	Common Stock		Common Stock to be Issued	Paid-in Capital	Additional Deferred Compensation	Deficit Accumulated During the Development Stage	Total Stockholders' Deficiency
		Shares	Amount					
<b>Balance, December 31, 2001</b>		18,085,847	\$ 18,086	\$ —	\$ 6,220,322	\$ (2,408,333)	\$ (5,102,346)	\$ (1,272,271)
Stock issued for directors fees	0.40	2,150,000	2,150	—	857,850	—	—	860,000
Common stock sold (2,305,000 shares)	0.15 - 0.25	—	—	389,875	—	—	—	389,875
Fair value of options issued to non-employees for services		—	—	—	54,909	(54,909)	—	—
Amortization of deferred compensation		—	—	—	—	891,182	—	891,182
Net loss		—	—	—	—	—	(2,749,199)	(2,749,199)
<b>Balance, December 31, 2002</b>		20,235,847	20,236	389,875	7,133,081	(1,572,060)	(7,851,545)	(1,880,413)
Common stock issued previously paid for	0.15 - 0.25	2,305,000	2,305	(433,750)	431,445	—	—	—
Sale of common stock	\$0.25	9,504,000	9,504	—	2,366,439	—	—	2,375,943
Issuance of common stock for services	\$0.55	83,414	83	—	45,794	—	—	45,877
Common stock issued for convertible debt	\$0.25	2,000,000	2,000	—	498,000	—	—	500,000
Finders' fees related to stock issuances		—	—	43,875	(312,582)	—	—	(268,707)
Common stock sold (25,000 shares)	0.25	—	—	6,250	—	—	—	6,250
Amortization of deferred comp		—	—	—	—	863,727	—	863,727
Net loss		—	—	—	—	—	(2,476,063)	(2,476,063)
<b>Balance, December 31, 2003</b>		34,128,261	\$ 34,128	\$ 6,250	\$ 10,162,177	\$ (708,333)	\$ (10,327,608)	\$ (833,386)

(continued)

**SAVE THE WORLD AIR, INC.**  
**(A DEVELOPMENT STAGE ENTERPRISE)**

**CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIENCY (continued)**  
**FROM FEBRUARY 18, 1998 (INCEPTION) TO DECEMBER 31, 2010**

	Price per Share	Common Stock		Common Stock to be Issued	Additional Paid-in Capital	Deferred Compensation	Deficit Accumulated During the Development Stage	Total Stockholders' Deficiency
		Shares	Amount					
<b>Balance, December 31, 2003</b>		34,128,261	\$ 34,128	\$ 6,250	\$ 10,162,177	\$ (708,333)	\$ (10,327,608)	\$ (833,386)
Common stock issued previously paid for	\$ .25	25,000	25	(6,250)	6,225			—
Sale of common stock	\$ 1.00	1,272,500	1,273	119,000	1,271,227	—	—	1,391,500
Stock issued for services	\$ .15-\$1.70	1,268,560	1,268		1,388,663			1,389,931
Stock issued for directors fees	\$ 1.50	50,000	50	—	74,950	—	—	75,000
Common stock issued for convertible debt	\$ 1.53	60,000	60		91,740	—	—	91,800
Common stock issued upon exercise of warrants and options	\$ .20 -\$.40	960,500	960	—	193,240	—	—	194,200
Common stock issued for patent settlement	\$ 1.24	20,000	20		24,780			24,800
Fair value of warrants issued					1,614,138			1,614,138
Fair value of options issued to employees		—	—	—	248,891	(248,891)	—	—
Fair value of options issued to non-employees		—	—	—	55,381	(55,381)	—	—
Amortization of deferred compensation		—	—	—	—	936,537	—	936,537
Finders' fees related to stock issuances					(88,384)			
Net loss		—	—	—	—	—	(6,803,280)	(6,803,280)
<b>Balance, December 31, 2004</b>		<u>37,784,821</u>	<u>\$ 37,784</u>	<u>\$ 119,000</u>	<u>\$ 15,043,028</u>	<u>\$ (76,068)</u>	<u>\$ (17,130,888)</u>	<u>\$ (2,007,144)</u>

(continued)

**SAVE THE WORLD AIR, INC.**  
**(A DEVELOPMENT STAGE ENTERPRISE)**

**CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIENCY (continued)**  
**FROM FEBRUARY 18, 1998 (INCEPTION) TO DECEMBER 31, 2010**

	Price per Share	Common Stock		Common Stock to be Issued	Additional Paid-in Capital	Deferred Compensation	Deficit Accumulated During the Development Stage	Total Stockholders' Deficiency
		Shares	Amount					
<b>Balance, December 31, 2004</b>		37,784,821	\$ 37,784	\$ 119,000	\$ 15,043,028	\$ (76,068)	\$ (17,130,888)	\$ (2,007,144)
Common stock issued previously paid for	\$ 1.00	119,000	119	(119,000)	118,881	—	—	—
Sale of common stock	\$ 1.00	1,530,500	1,530		1,528,970	—	—	1,530,500
Common stock issued upon exercise of warrants	\$ .40 - \$1.00	500	1	—	199	—	—	200
Common stock to be issued for settlement of payables				612,521				612,521
Fair value of options issued for settlement costs					31,500			31,500
Fair value of warrants issued					18,462			18,462
Fair value of warrants issued and intrinsic value of beneficial conversion associated with convertible notes					1,453,181			1,453,181
Fair value of options issued to employees		—	—	—	243,750	(243,750)	—	—
Amortization of deferred compensation		—	—	—	—	177,631	—	177,631
Finders' fees related to stock issuances					(109,840)			(109,840)
Common stock cancelled		(8,047,403)	(8,047)		8,047			—
Net loss		—	—	—	—	—	(3,115,186)	(3,115,186)
<b>Balance, December 31, 2005</b>		<u>31,387,418</u>	<u>\$ 31,387</u>	<u>\$ 612,521</u>	<u>\$ 18,336,178</u>	<u>\$ (142,187)</u>	<u>\$ (20,246,074)</u>	<u>\$ (1,408,175)</u>

(continued)

**SAVE THE WORLD AIR, INC.**  
**(A DEVELOPMENT STAGE ENTERPRISE)**

**CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIENCY (continued)**  
**FROM FEBRUARY 18, 1998 (INCEPTION) TO DECEMBER 31, 2010**

	Price per Share	Common Stock		Common Stock to be Issued	Additional Paid-in Capital	Deferred Compensation	Deficit Accumulated During the Development Stage	Total Stockholders' Deficiency
		Shares	Amount					
<b>Balance, December 31, 2005</b>		31,387,418	\$ 31,387	\$ 612,521	\$ 18,336,178	\$ (142,187)	\$ (20,246,074)	\$ (1,408,175)
Common stock issued previously paid for		846,549	847	(612,521)	611,674	—	—	—
Sale of common stock	\$ 1.00 - 1.89	1,360,537	1,360	60,000	2,401,048	—	—	2,462,408
Common stock issued upon exercise of warrants	.50 - 1.50	2,583,533	2,584	—	1,794,944	—	—	1,797,528
Common stock to be issued for convertible debt	.70	3,416,186	3,417		2,356,449			2,359,866
Common stock to be issued for out of line of credit	.55 - 1.22	487,483	487		379,610			380,097
Fair value of options issued to employees		—	—	—	2,253,263		—	2,253,263
Fair value of options issued for settlement costs					31,500			31,500
Fair value of warrants issued for services					463,627			463,627
Fair value of warrants issued and intrinsic value of beneficial conversion associated with convertible notes					1,259,696			1,259,696
Write off of deferred compensation		—	—	—	(142,187)	142,187	—	—
Finders' fees related to stock issuances					(284,579)			(284,579)
Fees paid on equity line of credit					(30,402)			(30,402)
Net loss		—	—	—	—	—	(10,181,523)	(10,181,523)
<b>Balance, December 31, 2006</b>		<u>40,081,757</u>	<u>\$ 40,082</u>	<u>\$ 60,000</u>	<u>\$ 29,430,821</u>	<u>\$ —</u>	<u>\$ (30,427,597)</u>	<u>\$ (896,694)</u>

(continued)



**SAVE THE WORLD AIR, INC.**  
**(A DEVELOPMENT STAGE ENTERPRISE)**

**CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIENCY (continued)**  
**FROM FEBRUARY 18, 1998 (INCEPTION) TO DECEMBER 31, 2010**

	Price per Share	Common Stock		Common Stock to be Issued	Additional Paid-in Capital	Deficit Accumulated During the Development Stage	Total Stockholders' Deficiency
		Shares	Amount				
<b>Balance, December 31, 2006</b>		40,081,757	\$ 40,082	\$ 60,000	\$ 29,430,821	\$ (30,427,597)	\$ (896,694)
Common stock issued previously paid for		2,597,524	2,598	(60,000)	57,402	—	—
Common stock to be issued for convertible debt	\$ .17 - .53	1,910,711	1,911		524,569		526,480
Common stock issued for put of line of credit	.27 - .73	1,880,421	1,880		990,175		992,055
Common stock granted for services				4,000			4,000
Fair value of options issued to employees		—	—	—	67,592	—	67,592
Fair value of warrants issued for services					35,340		35,340
Fair value of warrants issued and intrinsic value of beneficial conversion associated with convertible notes							
					1,253,548		1,253,548
Fees paid on equity line of credit					(79,364)		(79,364)
Net loss		—	—	—	—	(6,262,743)	(6,262,743)
<b>Balance, December 31, 2007</b>		<u>46,470,413</u>	<u>\$ 46,471</u>	<u>\$ 4,000</u>	<u>\$ 32,280,083</u>	<u>\$ (36,690,340)</u>	<u>\$ (4,359,786)</u>

(continued)

**SAVE THE WORLD AIR, INC.**  
**(A DEVELOPMENT STAGE ENTERPRISE)**

**CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIENCY (continued)**  
**FROM FEBRUARY 18, 1998 (INCEPTION) TO DECEMBER 31, 2010**

	Price per Share	Common Stock		Common Stock to be Issued	Additional Paid-in Capital	Deficit Accumulated During the Development Stage	Total Stockholders' Deficiency
		Shares	Amount				
<b>Balance, December 31, 2007</b>		46,470,413	\$ 46,471	\$ 4,000	\$ 32,280,083	\$ (36,690,340)	\$ (4,359,786)
Common stock issued for convertible debt	\$ .17 - .53	5,575,082	5,574	16,500	1,936,171	—	1,958,245
Common stock issued for Morale/Matthews settlement	.38	7,421,896	7,422	—	2,776,289	—	2,783,711
Common stock issued for services	.17 - .49	2,398,850	2,399	—	516,230	—	518,629
Common stock issued upon exercise of warrants	.50	1,064,650	1,065	—	531,260	—	532,325
Fair value of options issued as compensations	—	—	—	—	645,745	—	645,745
Fair value of warrants issued and intrinsic value of beneficial conversion with convertible notes	—	—	—	—	1,323,077	—	1,323,077
Fair value of warrants issued to PIPE holders	—	—	—	—	116,913	—	116,913
Common stock issued for services	.17	10,000	10	(4,000)	3,990	—	—
Net loss for the year ended December 31, 2008	—	—	—	—	—	(6,052,724)	(6,052,724)
<b>Balance, December 31, 2008</b>		62,940,891	62,941	16,500	40,129,758	(42,743,064)	(2,533,865)
Common stock issued for convertible debt	.15 - .50	5,730,766	5,730	—	1,431,154	—	1,436,884
Common stock and warrants issued to induce conversion of notes	.15 - .50	459,732	460	—	300,243	—	300,703
Common stock issued for previously converted notes	.17	97,059	97	(16,500)	16,403	—	—
Common stock issued for services	.33 - .51	1,482,000	1,482	—	595,438	—	596,920
Common stock issued for settlement of accounts payable	.20 - .38	495,615	496	—	128,986	—	129,482
Fair value of warrants issued to shareholder for loan	—	—	—	—	1,248	—	1,248
Fair value of options issued as compensation	—	—	—	—	89,802	—	89,802
Common stock issued upon exercise of options	.27	83,333	83	—	22,417	—	22,500
Fair value of warrants and beneficial conversion feature of issued convertible notes	—	—	—	—	540,324	—	540,324
Net loss for the year ended December 31, 2009	—	—	—	—	—	(6,194,950)	(6,194,950)
<b>Balance, December 31, 2009</b>		<u>71,289,396</u>	<u>\$ 71,289</u>	<u>\$ —</u>	<u>\$ 43,255,773</u>	<u>\$ (48,938,014)</u>	<u>\$ (5,610,952)</u>

(continued)

**SAVE THE WORLD AIR, INC.**  
**(A DEVELOPMENT STAGE ENTERPRISE)**

**CONSOLIDATED STATEMENT OF STOCKHOLDERS' DEFICIENCY (continued)**  
**FROM FEBRUARY 18, 1998 (INCEPTION) TO DECEMBER 31, 2010**

	Price per Share	Common Stock		Common Stock to be Issued	Additional Paid-in Capital	Deficit Accumulated During the Development Stage	Total Stockholders' Deficiency
		Shares	Amount				
<b>Balance, December 31, 2009</b>		71,289,396	\$ 71,289	\$ —	\$ 43,255,773	\$ (48,938,014)	\$ (5,610,952)
Common stock issued for convertible debt	\$ .15 - .50	15,851,272	15,851	—	4,401,566	—	4,417,417
Common stock issued to induce conversion of convertible debt	.53	224,751	225	—	118,893	—	119,118
Fair value of warrants issued to induce conversion of convertible debt	—	—	—	—	49,222	—	49,222
Common stock issued for services	.43 - .48	3,710,099	3,710	—	1,381,427	—	1,385,137
Common stock issued as compensation	.52 - .55	170,000	170	—	91,530	—	91,700
Common stock issued for settlement of accounts payable	.34	12,121	12	—	4,109	—	4,121
Fair value of options issued as compensation	—	—	—	—	138,733	—	138,733
Common stock issued upon exercise of options	.27	195,555	196	—	52,604	—	52,800
Fair value of warrants issued for services	—	—	—	—	126,000	—	126,000
Fair value of warrants and beneficial conversion feature of issued convertible notes	—	—	—	—	2,305,311	—	2,305,311
Net loss for the year ended December 31, 2010	—	—	—	—	—	(9,494,906)	(9,494,906)
<b>Balance, December 31, 2010</b>		<u>91,453,194</u>	<u>\$ 91,453</u>	<u>\$ —</u>	<u>\$ 51,925,168</u>	<u>\$ (58,432,920)</u>	<u>\$ (6,416,299)</u>

See notes to consolidated financial statements.

**SAVE THE WORLD AIR, INC. AND SUBSIDIARY**  
**(A DEVELOPMENT STAGE ENTERPRISE)**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Years Ended December 31,</b>		<b>Inception (February 18, 1998) to December 31, 2010</b>
	<b>2010</b>	<b>2009</b>	
<b>Cash flows from operating activities</b>			
Net Loss	\$ (9,494,906)	\$ (6,194,950)	\$ (58,432,920)
Adjustments to reconcile net loss to net cash used in operating activities:			
Write off of intangible assets	—	—	505,000
Settlement of litigation and debt	(145,112)	—	(1,162,320)
Settlement of Debt Due Morale/Matthews	—	—	927,903
Stock based compensation expense	230,433	89,802	3,935,156
Issuance of common stock for services	1,385,137	596,920	7,172,788
Issuance of options for legal settlement	—	—	31,500
Issuance of warrants for legal settlement	—	—	4,957
Issuance of warrants for financing fees	—	1,248	153,501
Issuance of warrants for consulting fees	126,000	—	126,000
Increase in convertible notes related to default	37,138	95,379	296,479
Interest on related party loans	—	22,305	22,305
Patent acquisition cost	—	—	1,610,066
Amortization of issuance costs and original issue debt discounts including beneficial conversion feature-part of interest expense	3,971,577	1,474,745	11,064,631
Fair value of common stock and warrants issued to induce conversion of notes	168,340	300,703	469,043
Costs of private placement convertible notes	1,129,212	511,503	1,640,715
Change in fair value of derivative liability	(414,505)	307,840	(106,665)
Amortization of deferred compensation	—	—	3,060,744
Loss on disposition of assets	—	—	14,426
Depreciation and amortization of leasehold improvements	34,022	33,031	460,182
Bad debt	—	—	1,300
Changes in operating assets and liabilities:			
Accounts receivable	—	—	(1,380)
Prepaid expenses and other	(12,972)	16,822	(29,345)
Other assets	3,000	230	(8,020)
Accounts payable and accrued expenses	71,899	839,321	4,612,331
Accounts payable – license agreements	(284,599)	289,884	5,285
Accounts payable – related parties	52,356	95,817	148,173
Net cash used in operating activities	<u>(3,142,980)</u>	<u>(1,519,400)</u>	<u>(23,478,165)</u>
<b>Cash flows from investing activities</b>			
Purchase of equipment	(11,235)	(1,932)	(566,619)
Proceeds from sale of equipment	—	—	17,478
Net cash used in investing activities	<u>(11,235)</u>	<u>(1,932)</u>	<u>(549,141)</u>

(continued)

(continued)

	Years Ended December 31,		Inception (February 18, 1998) to December 31, 2010
	2010	2009	2010
<b>Cash flows from financing activities</b>			
Net proceeds under equity line of credit	—	—	1,262,386
(Decrease) increase in loans from related parties and shareholders	(10,786)	24,648	623,926
Advances from founding executive officer	—	—	517,208
Net proceeds from issuance of convertible notes and warrants	3,217,735	1,526,820	11,204,928
Repayment of convertible notes	—	(55,871)	(282,121)
Proceeds from exercise of warrants	15,300	—	10,802,574
Net cash provided by financing activities	3,222,249	1,495,597	24,128,951
<b>Net (decrease) increase in cash</b>	68,034	(25,735)	101,645
<b>Cash</b> , beginning of period	33,611	59,346	—
<b>Cash</b> , end of period	<u>\$ 101,645</u>	<u>\$ 33,611</u>	<u>\$ 101,645</u>
<b>Supplemental disclosures of cash flow information</b>			
Cash paid during the year for:			
Interest	<u>\$ 21,294</u>	<u>\$ 36,991</u>	<u>\$ 159,366</u>
Income taxes	<u>\$ 800</u>	<u>\$ 1,600</u>	<u>\$ 6,682</u>
<b>Non-cash investing and financing activities</b>			
Acquisition of intangible asset through advance from related party and issuance of common stock	\$ —	\$ —	\$ 505,000
Deferred compensation for stock options issued for services	—	—	3,202,931
Purchase of property and equipment financed by advance from related party	—	—	3,550
Conversion of related party debt to equity	—	—	515,000
Issuance of common stock in settlement of payable	4,121	129,482	247,584
Cancellation of stock	—	—	8,047
Conversion of accounts payable and accrued expenses to common stock	—	—	612,521
Conversion of accounts payable and accrued expenses to convertible debentures	331,200	—	331,200
Conversion of related party debt to convertible debentures	27,500	—	72,500
Conversion of convertible debentures to common stock	4,417,417	1,436,884	10,785,981
Issuance of shares for settlement of loans and other payable to Morale/Matthews	—	—	2,783,711
Write off of deferred compensation	—	—	142,187
Fair value of derivative liability recorded as note discount	1,243,625	887,000	2,130,625
Proceeds of exercise of options applied to accounts payable	37,500	22,500	60,000
Fair value of warrants and beneficial conversion feature associated with issued convertible notes	2,305,311	540,324	8,246,388

See notes to consolidated financial statements.

**SAVE THE WORLD AIR, INC. AND SUBSIDIARY  
(A DEVELOPMENT STAGE ENTERPRISE)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009  
AND FOR THE PERIOD INCEPTION (FEBRUARY 18, 1998) TO DECEMBER 31, 2010**

**1. Description of business**

***Description of business***

Save the World Air, Inc. (“STWA”) designs, licenses and develops products to reduce operational costs for oil pipelines, and improve fuel economy and reduce emissions from diesel-powered internal combustion engines. The Company is a green technology company that leverages a suite of patented, patent-pending and licensed intellectual properties related to the treatment of fuels. Technologies patented by or licensed to us utilize either magnetic or uniform electrical fields to alter physical characteristics of fuels and are designed to create cleaner combustion. Cleaner combustion has been shown to improve performance, enhance fuel economy and/or reduce harmful emissions in laboratory testing.

The Company was incorporated on February 18, 1998, as a Nevada corporation, under the name Mandalay Capital Corporation. The Company changed its name to Save the World Air, Inc. on February 11, 1999, following the acquisition of marketing and manufacturing rights of the ZEFS technologies. Our executive offices are at 735 State Street, Suite 500, Santa Barbara, California 93101. The telephone number is (805)-845-3561. Our research and development facility is at 235 Tennant Avenue, Morgan Hill, California 95037. The telephone number is (408) 778-0101. The corporate website is [www.stwa.com](http://www.stwa.com). The common stock is quoted under the symbol “ZERO” on the Over-the-Counter Bulletin Board

The Company’s technology has two commercial applications; AOT™ (Applied Oil Technology) and ELEKTRA™ and legacy technologies of ZEFS and MK IV. AOT™ and ELEKTRA™ are nearing the end of the product development cycle, which will culminate in U.S. Department of Energy testing of AOT™ to determine the value of savings the product presents at full scale on an active pipeline within the RMOTC.

The AOT™ and ELEKTRA™ are technologies, which use electric fields to alter some physical properties of petrochemical fluids to reduce viscosity of the fluids. The Company differentiates AOT™ and ELEKTRA™ products based on their differing attributes and marketing focus. AOT™ products are primarily designed to reduce operation costs for oil pipelines, and ELEKTRA™ products are primarily designed to improve fuel economy and reduce emissions from diesel-powered internal combustion engines. Our AOT™ products are intended to reduce the viscosity of crude oil, thereby making it less restrictive to pipeline transport. Our AOT™ products will be marketed primarily to pipeline operators as well as to pilot and government mandated delivery programs. Our ELEKTRA™ products are intended to increase fuel efficiency and reduce emissions. ELEKTRA™ will be marketed primarily to specialty consumer accessories market for many types of diesel-fueled vehicles, including but not limited to trucks, trains, maritime, military and aviation.

***Consolidation policy***

The accompanying consolidated financial statements of Save the World Air, Inc. and Subsidiary include the accounts of Save the World Air, Inc. (the Parent) and its wholly owned subsidiary STWA Asia Pte. Limited, incorporated on January 17, 2006. Intercompany transactions and balances have been eliminated in consolidation.

**2. Summary of significant accounting policies**

***Development stage enterprise***

The Company is a development stage enterprise. All losses accumulated since the inception of the Company have been considered as part of the Company’s development stage activities.

The Company’s focus is on product development and marketing of proprietary devices that are designed to reduce operation costs of petrochemical pipeline transport and fuel efficiency of diesel engines and has not yet generated meaningful revenues. The technologies are called “AOT” and “ELEKTRA”. The Company is currently in the mid-late stages of developing its AOT™ and ELEKTRA™ technologies for commercial applications. Expenses have been funded through the sale of company stock, convertible notes and the exercise of warrants. The Company has taken actions to secure the intellectual property rights to the AOT™ and ELEKTRA™ technologies and is the worldwide exclusive licensee for patent pending technologies associated with the development of ELEKTRA™.

### ***Going concern***

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. As reflected in the accompanying financial statements, the Company had a net loss of \$9,494,106 and a negative cash flow from operations of \$3,101,185 for the year ended December 31, 2010, and had a working capital deficiency (excluding derivative liabilities) of \$2,837,727 and a stockholders' deficiency of \$6,416,299 at December 31, 2010. In addition, the Company is in default of its obligations under its License Agreements with Temple University (see Note 6). These factors raise substantial doubt about the Company's ability to continue as a going concern. The ability of the Company to continue as a going concern is dependent upon the Company's ability to raise additional funds and implement its business plan. The financial statements do not include any adjustments that might be necessary if the Company is unable to continue as a going concern.

We have cash on hand to meet expenses only for a short period of time. In order to fund the repayment of our outstanding notes, we must raise additional funds. At December 31, 2010, these notes included the Winter 2008 Notes due in December 2009, the Spring 2009 Notes due in April 2010, the Wellfleet 2009 Notes due in September 2012, the Fall 2009 Notes due in January 2012 and the Fall 2010 #2 Notes due in November 2011. In addition to the funds required to continue to operate our business, including without limitation the expenses we will incur in connection with the license and research and development agreements with Temple University, costs associated with product development and commercialization of the ELEKTRA technology, costs to manufacture and ship our products, costs to design and implement an effective system of internal controls and disclosure controls and procedures, costs of maintaining our status as a public company by filing periodic reports with the SEC, costs to settle a certain law suit, and costs required to protect our intellectual property. In addition, we have substantial contractual commitments, including without limitation salaries to our executive officers pursuant to employment agreements, certain severance payments to a former officer and consulting fees, during 2010 and beyond.

In light of the Company's financial commitments over the next several months and its liquidity constraints, we have implemented cost reduction measures in all areas of operations, including but not limited to personnel lay-offs, marketing and advertising, deferral of placing orders to manufacturers of our ECO ChargR and MAG ChargR products for sale to our existing distributors, research and development and product development of ELEKTRA products, and certain other expenses. We intend to review these measures on an ongoing basis and make additional decisions as may be required.

Therefore, in addition to the completed 2010 Fall Offering #2, the Company is actively pursuing additional financing alternatives. Subsequent to December 31, 2010, the Company raised an additional \$2,353,111 through the issuance of its convertible notes. (see "Note 12"). No assurance can be given that any future financing will be available or, if available, that it will be on terms that are satisfactory to the Company. At present, we have relatively few financing options available to us.

### ***Revenue Recognition Policy***

The Company recognizes revenue based upon meeting four criteria:

- Persuasive evidence of an arrangement exists;
- Delivery has occurred or services rendered;
- The seller's price to the buyer is fixed or determinable; and
- Collectability is reasonably assured.

The Company contracts with manufacturers of fixed magnetic field products and sells them to various original equipment manufacturers in the motor vehicle and small utility motor markets. The Company negotiates an initial contract with the customer fixing the terms of the sale and then receives a letter of credit or full payment in advance of shipment. Upon shipment, the Company recognizes the revenue associated with the sale of the products to the customer.

### ***Property and equipment and depreciation***

Property and equipment are stated at cost. Depreciation is computed using the straight-line method based on the estimated useful lives of the assets, generally ranging from three to ten years. Expenditures for major renewals and improvements that extend the useful lives of property and equipment are capitalized. Expenditures for repairs and maintenance are charged to expense as incurred. Leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful life of the asset or the lease term.

### ***Impairment of long-lived assets***

Our long-lived assets, such as property and equipment, are reviewed for impairment at least annually, or when events and circumstances indicate that depreciable or amortizable long lived assets might be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of those assets. When specific assets are determined to be unrecoverable, the cost basis of the asset is reduced to reflect the current value.

We use various assumptions in determining the current fair value of these assets, including future expected cash flows and discount rates, as well as other fair value measures. Our impairment loss calculations require us to apply judgment in estimating future cash flows, including forecasting useful lives of the assets and selecting the discount rate that reflects the risk inherent in future cash flows.

If actual results are not consistent with our assumptions and judgments used in estimating future cash flows and asset fair values, we may be exposed to future impairment losses that could be material to our results. Based upon management's annual review, no impairments were recorded for the years ended December 31, 2010 and December 31, 2009.

### ***Loss per share***

Basic loss per share is computed by dividing net loss available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted loss per share reflects the potential dilution, using the treasury stock method, that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the loss of the Company. In computing diluted loss per share, the treasury stock method assumes that outstanding options and warrants are exercised and the proceeds are used to purchase common stock at the average market price during the period. Options and warrants may have a dilutive effect under the treasury stock method only when the average market price of the common stock during the period exceeds the exercise price of the options and warrants. For the years ended December 31, 2010 and 2009, the dilutive impact of outstanding stock options of 4,837,488 and 4,851,225; outstanding warrants of 22,979,068, and 13,346,764 and notes convertible into 1,839,763 and 3,958,655 shares respectively, have been excluded because their impact on the loss per share is anti-dilutive.

### ***Income taxes***

Income taxes are recognized for the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets are recognized for the future tax consequences of transactions that have been recognized in the Company's financial statements or tax returns. A valuation allowance is provided when it is more likely than not that some portion or all of the deferred tax asset will not be realized.

### ***Stock-Based Compensation***

The Company periodically issues stock options and warrants to employees and non-employees in non-capital raising transactions for services and for financing costs. The Company accounts for stock option and warrant grants issued and vesting to employees based on the authoritative guidance provided by the Financial Accounting Standards Board whereas the value of the award is measured on the date of grant and recognized over the vesting period. The Company accounts for stock option and warrant grants issued and vesting to non-employees in accordance with the authoritative guidance of the Financial Accounting Standards Board whereas the value of the stock compensation is based upon the measurement date as determined at either a) the date at which a performance commitment is reached, or b) at the date at which the necessary performance to earn the equity instruments is complete. Non-employee stock-based compensation charges generally are amortized over the vesting period on a straight-line basis. In certain circumstances where there are no future performance requirements by the non-employee, option grants are immediately vested and the total stock-based compensation charge is recorded in the period of the measurement date.

The fair value of the Company's common stock option grant is estimated using the Black-Scholes option pricing model, which uses certain assumptions related to risk-free interest rates, expected volatility, expected life of the common stock options, and future dividends. Compensation expense is recorded based upon the value derived from the Black-Scholes option pricing model, and based on actual experience. The assumptions used in the Black-Scholes option pricing model could materially affect compensation expense recorded in future periods.

### ***Accounting for Warrants and Derivatives***

The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. For derivative financial instruments that are accounted for as liabilities, the derivative instrument is initially recorded at its fair value and is then re-valued at each reporting date, with changes in the fair value reported in the consolidated statements of operations. For stock-based derivative



financial instruments, the Company uses a probability weighted average series Black-Scholes Merton option pricing models to value the derivative instruments at inception and on subsequent valuation dates.

The classification of derivative instruments, including whether such instruments should be recorded as liabilities or as equity, is evaluated at the end of each reporting period. Derivative instrument liabilities are classified in the balance sheet as current or non-current based on whether or not net-cash settlement of the derivative instrument could be required within 12 months of the balance sheet date.

### ***Business and credit concentrations***

The Company's cash balances in financial institutions at times may exceed federally insured limits. As of December 31, 2010 and 2009, before adjustments for outstanding checks and deposits in transit, the Company had \$111,223 and \$79,587, respectively, on deposit with five banks. The deposits are federally insured up to \$250,000 on each bank.

### ***Estimates***

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Certain significant estimates were made in connection with preparing the Company's financial statements. Actual results could differ from those estimates.

### ***Fair value of financial instruments***

Effective January 1, 2008, fair value measurements are determined by the Company's adoption of authoritative guidance issued by the FASB, with the exception of the application of the statement to non-recurring, non-financial assets and liabilities as permitted. The adoption of the authoritative guidance did not have a material impact on the Company's fair value measurements. Fair value is defined in the authoritative guidance as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. A fair value hierarchy was established, which prioritizes the inputs used in measuring fair value into three broad levels as follows:

Level 1—Quoted prices in active markets for identical assets or liabilities.

Level 2—Inputs, other than the quoted prices in active markets, are observable either directly or indirectly.

Level 3—Unobservable inputs based on the Company's assumptions.

The Company is required to use of observable market data if such data is available without undue cost and effort.

The following table presents certain investments and liabilities of the Company's financial assets measured and recorded at fair value on the Company's consolidated balance sheets on a recurring basis and their level within the fair value hierarchy as of December 31, 2010 and 2009.

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Fair value of Derivative Liability-2010	<u>\$</u>	<u>\$</u>	<u>\$ 3,664,675</u>	<u>\$ 3,664,675</u>
Fair value of Derivative Liability-2009	<u>\$</u>	<u>\$</u>	<u>\$ 1,706,343</u>	<u>\$ 1,706,343</u>

### ***Recent Accounting Pronouncements***

In June 2010, the FASB issued authoritative guidance on accounting standards codification and the hierarchy of generally accepted accounting principles ("GAAP") effective for interim and annual reporting periods ending after September 15, 2010. The FASB accounting standards codification ("ASC, "Codification") has become the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in accordance with GAAP. All existing accounting standard documents are superseded by the Codification and any accounting literature not included in the Codification will not be authoritative. However, rules and interpretive releases of the SEC issued under the authority of federal securities laws will continue to be sources of authoritative GAAP for SEC registrants. Beginning with the quarter ending September 30, 2010, all references made by the Company to GAAP in its condensed consolidated financial statements use the Codification numbering system. The Codification does not change or alter existing GAAP and, therefore, it does not have an impact on our financial position, results of operations and cash flows.

In June 2010, the FASB made an updated the principle for the consolidation of variable interest entities. Among other things, the update replaces the calculation for determining which entities, if any, have a controlling financial interest in a variable interest entity (VIE) from a quantitative based risks and rewards calculation, to a qualitative approach that focuses on identifying which entities have the power to direct the activities that most significantly impact the VIE's economic performance and the obligation to absorb losses of the VIE or the right to receive benefits from the VIE. The update also requires ongoing assessments as to whether an entity is the primary beneficiary of a VIE (previously, reconsideration was only required upon the occurrence of specific events), modifies the presentation of consolidated VIE assets and liabilities, and requires additional disclosures about a company's involvement in VIE's. This update will be effective for fiscal years beginning after November 15, 2010. The Company does not currently believe that the adoption of this update will have any effect on its consolidated financial position and results of operations.

In October 2010, the FASB issued authoritative guidance on revenue recognition that will become effective for us beginning July 1, 2010, with earlier adoption permitted. Under the new guidance on arrangements that include software elements, tangible products that have software components that are essential to the functionality of the tangible product will no longer be within the scope of the software revenue recognition guidance, and software-enabled products will now be subject to other relevant revenue recognition guidance. Additionally, the FASB issued authoritative guidance on revenue arrangements with multiple deliverables that are outside the scope of the software revenue recognition guidance. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. We believe the adoption of this new guidance will not have a material impact on our financial statements.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the AICPA, and the SEC did not or are not believed by management to have a material impact on the Company's present or future consolidated financial statements.

### **3. Certain relationships and related transactions**

#### ***Loans from related parties***

In May of 2007, a former officer and incumbent director of the Company loaned \$31,404 to pay a company obligation and in August 2007, the same party loaned \$50,000 to the Company so that it could pay certain operating expenses. These amounts are unsecured, bear interest at 6% per annum and are due on demand. At December 31, 2010 and 2009, the balance of these loans including interest was \$86,947 and \$125,233.

#### ***Accounts Payable to related parties***

As of December 31, 2010, the Company had accounts payable to related parties in the amount of \$241,176, which was composed of \$186,500 in unpaid Directors Fees and \$54,676 in unreimbursed expenses incurred by Officers and Directors. As of December 31, 2009, the amount payable to related parties was \$188,820.

### **4. Property and Equipment**

At December 31, 2010 and 2009, property and equipment consists of the following:

	<b>December 31,</b>	
	<b>2010</b>	<b>2009</b>
Office equipment	\$ 45,133	\$ 33,898
Furniture and fixtures	13,898	13,898
Machinery and equipment	49,986	49,986
Testing equipment	147,312	147,312
Subtotal	256,329	245,094
Less accumulated depreciation	(178,246)	(144,224)
Total	<u>\$ 78,083</u>	<u>\$ 100,870</u>

Depreciation expense for the years ended December 31, 2010 and 2009 was \$34,022 and \$33,031, respectively. Depreciation expense for the period from inception February 18, 1998 through December 31, 2010 was \$460,182.

## 5. Convertible notes and warrants

Convertible debentures consist of the following:

	<u>Maturity dates</u>	<u>December 31, 2010</u>	<u>December 31, 2009</u>
2008 Fall Offering	October 31, 2009	—	81,419
2008 Winter Offering	December 5, 2009	6,697	12,186
2009 Winter #1 Offering	April 26, 2009	—	210,773
2009 Winter #2 Offering	March 12, 2010	—	95,502
2009 Spring Offering	April 30, 2010	6,455	88,000
2009 Summer Offering	September 28, 2010	—	157,765
2009 Wellfleet Offering	September 28, 2012	27,011	75,000
2009 Fall Offering	January 15, 2012	37,409	344,500
2010 Winter Offering	March 31, 2011	—	—
2010 Spring Offering	April 30, 2011	—	—
2010 Summer Offering	July 31, 2011	—	—
2010 Fall Offering	September 30, 2011	—	—
2010 Fall Offering #2	November 30, 2011	386,760	—
Sub-total		464,332	1,065,145
Less, remaining debt discount		(387,385)	(579,495)
Convertible debentures, net, others		<u>\$ 76,947</u>	<u>\$ 485,650</u>

### ***2008 Fall Offering***

From September 8, 2008 to October 31, 2008, the Company conducted an offering (the “2008 Fall Offering”) of up to \$500,000 aggregate face amount of its Convertible Notes. A total of \$198,220 aggregate face amount of the 2008 Fall Notes were sold for an aggregate purchase price of \$180,200 net proceeds. Therefore, while the stated interest on the 2008 Fall Notes is 0%, the implied interest rate on the 2008 Fall Notes is 10%. The 2008 fall notes matured on the first anniversary of the date of issuance. The 2008 Fall Notes are convertible, at the option of the noteholders, into shares of common stock of the Company (the “Conversion Shares”) at a conversion price equal to the average of the closing bid price of the Company’s common stock for the five trading days preceding the closing date of the 2008 Fall Offering (the “Conversion Price”). Up to 1,321,466 Conversion Shares are issuable at a Conversion Price of \$0.15 per share.

Each of the investors in the 2008 Fall Offering received, for no additional consideration, a warrant (the “2008 Fall Warrants”), entitling the holder to purchase a number of shares of the Company’s common stock equal to 50% of the number of shares of common stock into which the (2008 Fall Notes) are convertible (the “2008 Fall Warrant Shares”). Each 2008 Fall Warrant is exercisable on a cash basis only at a price of \$0.50 per share, and is exercisable for a period of two years from the date of issuance. Up to 660,734 2008 Fall Warrant Shares are initially issuable upon exercise of the 2008 Fall Warrants.

The aggregate value of the Fall 2008 Offering Warrants issued in connection with the October 31, 2008 closing were valued at \$53,320 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of 4.68%; dividend yield of 0%; volatility factors of the expected market price of common stock of 145.98%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$126,880. The value of the Fall 2008 Offering Warrants, the beneficial conversion feature, and the transaction fees of \$18,020 are considered as debt discount and were amortized over the life of the Note.

As of December 31, 2010, investors have converted \$198,220 of the Convertible Notes into 1,367,773 shares of the Company’s common stock, which included 46,307 shares issued for late penalty and interest. At December 31, 2010, there was no outstanding balance.

### ***2008 Winter Offering***

From November 24, 2008 to December 5, 2008, the Company conducted an offering (the “2008 Winter Offering”) of up to \$500,000 aggregate face amount of its Convertible Notes. A total of \$524,700 aggregate face amount of the 2008 Winter Notes were sold for an aggregate purchase price of \$477,000 net proceeds. Therefore, while the stated interest on the 2008 Winter Notes is 0%, the implied interest rate on the 2008 Winter Notes is 10%. The 2008 Winter Notes will mature on the first anniversary of the date of issuance. The 2008 Winter Notes are convertible, at the option of the noteholders, into shares of common stock of the Company (the “Conversion Shares”) at a conversion price equal to the average of the closing bid price of the Company’s common stock for the five trading days preceding the closing date of the 2008 Winter Offering (the “Conversion Price”). Up to 3,086,470

Conversion Shares are issuable at a Conversion Price of \$0.17 per share.

Each of the investors in the 2008 Winter Offering received, for no additional consideration, a warrant (the “2008 Winter Warrants”), entitling the holder to purchase a number of shares of the Company’s common stock equal to 50% of the number of shares of common stock into which the (2008 Winter Notes) are convertible (the “2008 Winter Warrant Shares”). Each 2008 Winter Warrant is exercisable on a cash basis only at a price of \$0.30 per share, and is exercisable for a period of two years from the date of issuance. Up to 1,543,235 2008 Winter Warrant Shares are initially issuable upon exercise of the 2008 Winter Warrants.

The aggregate value of the Winter 2008 Offering Warrants issued in connection with the December 5, 2008 closing were valued at \$168,925 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of 3.42%; dividend yield of 0%; volatility factors of the expected market price of common stock of 153.56%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$308,075. The value of the Winter 2008 Offering Warrants, the beneficial conversion feature, and the transaction fees of \$47,700 are considered as debt discount and were amortized over the life of the Note.

As of December 31, 2010, investors have converted \$519,200 of the Convertible Notes into 3,054,117 shares of the Company’s common stock. As of December 31, 2010, one note for \$5,500 was in default and outstanding (\$6,697 in total including \$1,197 in penalties and interest).

### ***2009 Winter Offering #1***

From January 13, 2009 to January 26, 2009, the Company conducted and concluded a private offering (the “Winter 2009 Offering I”) of up to \$250,000 aggregate face amount of its convertible notes (the “Winter 2009 Notes”) with 8 accredited investors. A total of \$250,000 aggregate face amount of the Winter 2009 Notes were sold for an aggregate purchase price of \$250,000. The Winter 2009 Notes bear interest at 10% per annum, payable at maturity. The Winter 2009 Notes mature three months from their date of issuance. The Winter 2009 Notes are convertible, at the option of the noteholder, into shares of common stock of the Company (the “Conversion Shares”) at an initial conversion price equal to the average of the closing bid price of the Company’s common stock for the five trading days preceding the closing dates of the Winter 2009 Offering (the “Conversion Price”). Up to 694,444 Conversion Shares are initially issuable at a Conversion Price of \$0.36 per share.

Each of the investors in the Winter 2009 Offering received, for no additional consideration, a warrant (the “Winter 2009 Warrants”), entitling the holder to purchase a number of shares of the Company’s common stock equal to 50% of the number of shares of common stock into which the Winter 2009 Notes are convertible (the “Warrant Shares”). Each Winter 2009 Warrant is exercisable on a cash basis only at an initial price of \$0.50 per share, and is exercisable immediately upon issuance and for a period of two (2) years from the date of issuance. Up to 347,722 Warrant Shares are initially issuable on exercise of the Winter 2009 Warrants.

The aggregate value of the Winter 2009 Offering Warrants issued in connection with the January 26, 2009 closing were valued at \$66,178 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of 0.85%; dividend yield of 0%; volatility factors of the expected market price of common stock of 151.42%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$183,822. The value of the Winter 2009 Offering Warrants and the beneficial conversion feature are considered as debt discount and were amortized over the life of the notes.

As of December 31, 2010 investors have converted \$200,000 of the Convertible Notes plus \$39,761 of penalty and interest into 780,307 shares of the Company’s common stock. In addition, the Company has paid \$50,000 plus penalty and interest as a redemption of one of the defaulted convertible notes. There was no outstanding balance at December 31, 2010.

### ***2009 Winter Offering #2***

From February 4, 2009 to March 12, 2009, the Company conducted and concluded a private offering (the “Winter 2009 Offering II”) of up to \$250,000 aggregate face amount of its convertible notes (the “Winter 2009 #2 Notes”) with 17 accredited investors. A total of \$247,302 aggregate face amount of the Winter 2009 #2 Notes were sold for an aggregate purchase price of \$224,820. While the stated interest rate on the Winter 2009#2 Notes is 0%, the implied interest rate on the Winter 2009 #2 Notes is 10% per annum. The Winter 2009 #2 Notes mature on the first anniversary of their date of issuance. The Winter 2009 #2 Notes are convertible, at the option of the noteholder, into shares of common stock of the Company (the “Conversion Shares”) at an initial conversion price equal to the average of the closing bid price of the Company’s common stock for the five trading days preceding the closing dates of the Winter 2009 #2 Offering (the “Conversion Price”). Up to 772,818 Conversion Shares are initially issuable at a Conversion Price of \$0.32 per share.

Each of the investors in the Winter 2009 #2 Offering received, for no additional consideration, a warrant (the “Winter 2009 #2 Warrants”), entitling the holder to purchase a number of shares of the Company’s common stock equal to 50% of the number of shares of common stock into which the Winter 2009 #2 Notes are convertible (the “Warrant Shares”). Each Winter 2009 #2 Warrant is exercisable on a cash basis only at an initial price of \$0.50 per share, and is exercisable immediately upon issuance and for a period of two (2) years from the date of issuance. Up to 386,409 Warrant Shares are initially issuable on exercise of the Winter 2009 #2 Warrants.

The Company received \$224,820 in net proceeds in the Winter 2009 #2 Offering which was used for general corporate purposes and working capital. The aggregate value of the Winter 2009 #2 Offering Warrants issued in connection with the January 26, 2009 closing were valued at \$62,028 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of 1.03%; dividend yield of 0%; volatility factors of the expected market price of common stock of 156%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$161,791. The value of the Winter 2009 #2 Offering Warrants, the beneficial conversion feature, and the transaction fees of \$22,482 are considered as debt discount and were amortized over the life of the Note.

As of December 31, 2010, investors have converted \$247,302 of the Convertible Notes plus \$6,876 in penalty and interest into 794,306 shares of the Company’s common stock. There is no outstanding balance at December 31, 2010.

### ***2009 Spring Offering***

From March 17, 2009 to April 30, 2009, the Company conducted and concluded a private offering (the “Spring 2009 Offering”) of up to \$300,000 aggregate face amount of its convertible notes (the “Spring 2009 Notes”) with 11 accredited investors. A total of \$181,500 aggregate face amount of the Spring 2009 Notes were sold for an aggregate purchase price of \$165,000. The Spring 2009 Notes mature on the first anniversary of their date of issuance, are convertible, at the option of the noteholder, into up to 672,222 shares of common stock of the Company at a conversion price of \$0.27 per share.

Each of the investors in the Spring 2009 Offering received, for no additional consideration, a warrant (the “Spring 2009 Warrants”), entitling the holder to purchase a number of shares of the Company’s common stock equal to 50% of the number of shares of common stock into which the Spring 2009 Notes are convertible (the “Warrant Shares”). Each Spring 2009 Warrant is exercisable on a cash basis only at an initial price of \$0.50 per share, and is exercisable for a period of two years. Up to 336,111 Warrant Shares are initially issuable on exercise of the Spring 2009 Warrants.

The Company received \$165,000 in net proceeds in the Spring 2009 Offering which was used for general corporate purposes and working capital. The aggregate value of the Spring 2009 Offering Warrants issued in connection with the April 30, 2009 closing were valued at \$39,994 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of 0.94%; dividend yield of 0%; volatility factors of the expected market price of common stock of 156.39%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$96,827. The value of the Spring 2009 Offering Warrants, the beneficial conversion feature, and the transaction fees of \$16,500 are considered as debt discount and were amortized over the life of the Note.

As of December 31, 2010, investors have converted \$176,000 of the Convertible Notes plus penalty and interest of \$7,538 into 679,768 shares of the Company’s common stock. As of December 31, 2010 one note in the amount of \$5,500 was in default and outstanding (\$6,455 in total which includes \$955 of penalty and interest).

### ***2009 Summer Offering***

From June 9, 2009 to September 28, 2009, the Company conducted and concluded a private offering (the “Summer 2009 Offering”) of up to \$500,000 aggregate face amount of its convertible notes (the “Summer 2009 Notes”) with interest compounded quarterly at the annual rate of seven percent (7%) payable at maturity. A total of \$467,500 Summer 2009 Notes were sold to 17 accredited investors. The Summer 2009 Notes mature on the second anniversary of the closing of this offering and will be convertible, at the option of the noteholder, into up to 1,870,000 shares of our common stock at a conversion price of \$0.25 per share.

Each of the investors in the Summer 2009 Offering will receive, for no additional consideration, a warrant (the “Summer 2009 Warrants”), entitling the holder to purchase a number of shares of our common stock equal to 100% of the number of shares of common stock into which the Summer 2009 Notes are convertible (the “Warrant Shares”). Each Summer 2009 Warrant is exercisable on a cash basis only at an initial price of \$0.30 per share, and is exercisable for a period of thirty six months. Up to 1,870,000 Warrant Shares are initially issuable on exercise of the Summer 2009 Warrants.

Each of the warrant agreements included an anti-dilution provision that allowed for the automatic reset of the exercise price upon any future sale of common stock or warrants at or below the current exercise price. The Company considered the current Financial Accounting Standards Board guidance of “Determining Whether an Instrument Indexed to an Entity’s Own Stock” which indicates that any adjustment to the fixed amount (either conversion price or number of shares) of the instrument regardless of the probability or whether or not within the issuers’ control, means the instrument is not indexed to the issuers own stock. Accordingly, the Company determined that as the strike price of these warrants contain exercise prices that may fluctuate based on the occurrence of future offerings or events, and as such is not a fixed amount.. As a result, the Company determined that these warrants are not considered indexed to the Company’s own stock and characterized the fair value of these warrants as derivative liabilities upon issuance.

The Company determined that the fair value of the warrant liability at issuance on September 28, 2009 to be \$668,525 based upon a weighted average Black-Sholes-Merton calculation. The Company recorded the full value of the derivative as a liability at issuance with an offset to valuation discount. As the fair value of the liability of \$668,525 exceeded the note value of \$467,500, the excess of the liability over the note amount of \$201,025 was considered as a cost of the private placement and recorded as such in 2009. The fair value of the warrant liability as of December 31, 2010 was \$804,100 (see Note 7).

As of December 31, 2010, investors have converted \$467,500 of the Convertible Notes plus \$5,002 of penalties and interest into 1,891,564 shares of the Company’s common stock. There was no outstanding balance at December 31, 2010.

### ***2009 Wellfleet Offering***

On November 20, 2009, the Company completed a private financing of \$75,000 principal amount of 7% Convertible Promissory Notes (the “Notes”) and 300,000 Common Stock Purchase Warrants exercisable at \$.30 per share (the “Warrants”), pursuant to a Securities Purchase Agreement (the “Purchase Agreement”) with 3 accredited investors (the “Note Offering”), through Sandgrain Securities, Inc., as placement agent.

The Notes are initially convertible into the Company’s common stock at a price of \$.25 per share and accrue interest at 7% per year with a default rate of 10%, payable quarterly in cash. Interest payments are payable in stock at the sole discretion of the Note holders, or, in the event that shares issuable thereon are registered under the Securities Act of 1933, as amended (the “Act”), or otherwise freely tradable pursuant to Rule 144, at the discretion of the Company as well. The Notes and any unpaid interest are due and fully payable on September 28, 2012. The conversion price of the Notes is adjustable for corporate events such as merger, reclassification or stock splits.

Pursuant to the terms of the Purchase Agreement, and among other terms, in the event the Company conducts any subsequent financings (each, a “Follow On Offering”) of any kind other than an offering of securities substantially similar to the Notes and Warrants or certain other exempted issuances enumerated in the Notes, the Notes may, at the discretion of each holder thereof, be exchanged in whole or in part to the extent of outstanding principal and/or interest in such Note, into the securities offered in the Follow On Offering, by applying and exchanging the outstanding principal and interest of such Notes towards the purchase price of the securities offered in such Follow On Offering, at the same price and terms of the Follow On Offering.

The Company paid a placement agent fee of (i) \$6,000 in cash, (ii) 24,000 shares of Common Stock constituting 8% of the number of Conversion Shares initially issuable upon exercise of the Notes, and (iii) 24,000 warrants, substantially similar to the Warrants sold to investors (the “Placement Agent Warrants”), in connection with the Note Offering, in addition to legal fees.

Each of the warrant agreements included an anti-dilution provision that allowed for the automatic reset of the exercise price upon any future sale of common stock or warrants at or below the current exercise price. The Company considered the current Financial Accounting Standards Board guidance of “Determining Whether an Instrument Indexed to an Entity’s Own Stock” which indicates that any adjustment to the fixed amount (either conversion price or number of shares) of the instrument regardless of the probability or whether or not within the issuers’ control, means the instrument is not indexed to the issuers own stock. Accordingly, the Company determined that as the strike price of these warrants contain exercise prices that may fluctuate based on the occurrence of future offerings or events, and as such is not a fixed amount. As a result, the Company determined that these warrants are not considered indexed to the Company’s own stock and characterized the fair value of these warrants as derivative liabilities upon issuance.

The Company determined that the fair value of the warrant liability at issuance on November 20, 2009 to be \$75,000 based upon a weighted average Black-Sholes-Merton calculation. The Company recorded the full value of the derivative as a liability at issuance with an offset to valuation discount. The fair value of the warrant liability as of December 31, 2010 was \$129,000 (see Note 7).

As of December 31, 2010 investors have converted \$50,000 of the Convertible Notes plus \$1,750 of accrued interest into 207,000 shares of the Company's common stock. The outstanding balance at December 31, 2010 was \$27,011 which includes \$2,011 of accrued interest.

### ***2009 Fall Offering***

From October 2, 2009 to January 15, 2010, the Company conducted and completed a private offering (the "Fall 2009 Offering") consisting of an aggregate of \$1,588,125 of 7% Convertible Promissory Notes (the "Notes") with interest compounded quarterly at the annual rate of 7% payable at maturity, and warrants to purchase an aggregate of 6,352,500 shares of our common stock (the "Fall 2009 Warrants"). The Company received \$1,284,425 net proceeds, of which \$344,500 was received as of December 31, 2009. The Fall 2009 Notes mature on the second anniversary of the closing of this offering and will be convertible, at the option of the noteholder, into up to 6,352,500 shares of our common stock at a conversion price of \$0.25 per share. The Fall 2009 Warrants are for a term of three years at an exercise price of \$0.30 per share.

Each of the warrant agreements included an anti-dilution provision that allowed for the automatic reset of the exercise price upon any future sale of common stock or warrants at or below the current exercise price. The Company considered the current Financial Accounting Standards Board guidance of "Determining Whether an Instrument Indexed to an Entity's Own Stock" which indicates that any adjustment to the fixed amount (either conversion price or number of shares) of the instrument regardless of the probability or whether or not within the issuers' control, means the instrument is not indexed to the issuers own stock. Accordingly, the Company determined that as the strike price of these warrants contain exercise prices that may fluctuate based on the occurrence of future offerings or events, and as such is not a fixed amount. As a result, the Company determined that these warrants are not considered indexed to the Company's own stock and characterized the fair value of these warrants as derivative liabilities upon issuance.

The Company determined that the fair value of the warrant liability at issuances to be \$3,027,815 based upon a weighted average Black-Scholes-Merton calculation (See Note 8), of which, \$654,978 was recorded on December 31, 2009 and \$2,372,837 was recorded on January 15, 2010. The Company recorded the full value of the derivative of \$2,372,837 as a liability at issuance with an offset to valuation discount. As the fair value of the liability of \$2,372,837 exceeded the note value of \$1,243,625, the excess of the liability over the note amount of \$1,129,212 was considered to be cost of the private placement and was recorded during the period. The fair value of the warrant liability as of December 31, 2010 was \$2,731,575 (see Note 7).

As of December 31, 2010, investors have converted \$1,553,125 of the Convertible Notes plus interest of \$9,781 into 6,251,623 shares of the Company's common stock. The outstanding balance at December 31, 2010 was \$37,409 which includes \$3,739 in accrued interest.

### ***2010 Winter Offering***

From February 15, 2010 to March 31, 2010, the Company conducted a private offering (the "Winter 2010 Offering") consisting of an aggregate of \$885,863 face amount of its Convertible Promissory Notes (the "Winter 2010 Notes") have been sold for an aggregate purchase price of \$805,330. While the stated interest rate on the Winter 2010 Notes is 0%, the implied interest rate on the Winter 2010 Notes is 10% per annum. The Winter 2010 Notes mature on the first anniversary of their date of issuance. The Winter 2010 Notes are convertible, at the option of the noteholder, into 2,214,657 shares of common stock of the Company (the "Conversion Shares") at an initial conversion price of \$0.40 per share (the "Conversion Price").

Each of the investors in the Winter 2010 Offering received, for no additional consideration, a warrant (the "Winter 2010 Warrants"), entitling the holder to purchase a number of shares of the Company's common stock equal to 100% of the number of shares of common stock into which the Winter 2010 Notes are convertible (the "Warrant Shares"). Each Winter 2010 Warrant is exercisable on a cash basis only at an initial price of \$0.40 per share, and is exercisable immediately upon issuance and for a period of two (2) years from the date of issuance. Up to 2,214,657 Warrant Shares are initially issuable to date on exercise of the Winter 2010 Warrants.

The Company received \$805,330 in net proceeds in the Winter 2010 Offering which was used for general corporate purposes and working capital. The aggregate value of the Winter 2010 Offering Warrants issued were valued at \$476,268 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of 1.02; dividend yield of 0%; volatility factors of the expected market price of common stock of 135%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$329,062. As of December 31, 2010, the aggregate value of the Winter 2010 Offering Warrants, the beneficial conversion feature and the transaction fees of \$80,533 are considered as debt discount and were fully amortized in conjunction with the conversion of the notes.

As of December 31, 2010, investors have converted \$885,863 of the Convertible Notes into 2,214,657 shares of the Company's common stock. There was no outstanding balance at December 31, 2010.

### ***2010 Spring Offering***

From April 15, 2010 to April 30, 2010, the Company conducted a private offering (the "Spring 2010 Offering") consisting of an aggregate of \$143,000 face amount of its Convertible Promissory Notes (the "Spring 2010 Notes") have been sold for an aggregate purchase price of \$130,000. While the stated interest rate on the Spring 2010 Notes is 0%, the actual interest rate on the Spring 2010 Notes is 10% per annum. The Spring 2010 Notes mature on the first anniversary of their date of issuance. The Spring 2010 Notes are convertible, at the option of the noteholder, into 357,500 shares of common stock of the Company (the "Conversion Shares") at an initial conversion price of \$0.40 per share (the "Conversion Price").

Each of the investors in the Spring 2010 Offering received, for no additional consideration, a warrant (the "Spring 2010 Warrants"), entitling the holder to purchase a number of shares of the Company's common stock equal to 100% of the number of shares of common stock into which the Spring 2010 Notes are convertible (the "Warrant Shares"). Each Spring 2010 Warrant is exercisable on a cash basis only at an initial price of \$0.40 per share, and is exercisable immediately upon issuance and for a period of two (2) years from the date of issuance. Up to 357,500 Warrant Shares are initially issuable to date on exercise of the Spring 2010 Warrants.

The Company received \$130,000 in net proceeds in the Spring 2010 Offering which was used for general corporate purposes and working capital. The aggregate value of the Spring 2010 Offering Warrants issued were valued at \$62,730 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of .41; dividend yield of 0%; volatility factors of the expected market price of common stock of 110%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$67,270. As of December 31, 2010, the aggregate value of the Spring 2010 Offering Warrants, the beneficial conversion feature and the transaction fees of \$13,000 are considered as debt discount and were fully amortized in conjunction with the conversion of the notes.

As of December 31, 2010, investors have converted \$143,000 of the Convertible Notes into 357,000 shares of the Company's common stock. There was no outstanding balance at December 31, 2010.

### ***2010 Summer Offering***

From June 14, 2010 to July 31, 2010, the Company conducted and concluded a private offering (the "Summer 2010 Offering") consisting of up to \$500,000 aggregate face amount of its convertible notes (the "Summer 2010 Notes"). A total of \$392,150 Summer 2010 Notes were sold to twenty six accredited investors for an aggregate purchase price of \$334,000. While the stated interest rate on the Summer 2010 Notes is 0%, the actual interest rate on the Summer 2010 Notes is 10% per annum. The Summer 2010 Notes mature on the first anniversary of the closing of this offering and will be convertible, at the option of the noteholder, into up to 1,568,600 shares of our common stock at a conversion price of \$0.25 per share (the "Conversion Price").

Each of the investors in the Summer 2010 Offering will receive, for no additional consideration, a warrant (the "Summer 2010 Warrants"), entitling the holder to purchase a number of shares of our common stock equal to 100% of the number of shares of common stock into which the Summer 2010 Notes are convertible (the "Warrant Shares"). Each Summer 2010 Warrant is exercisable on a cash basis only at an initial price of \$0.30 per share, and is exercisable for a period of twenty four months. Up to 1,568,600 Warrant Shares are initially issuable on exercise of the Summer 2010 Warrants.

The Company received \$334,000 in net proceeds in the Summer 2010 Offering which was used for general corporate purposes and working capital. The aggregate value of the Summer 2010 Offering Warrants issued were valued at \$209,512 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of .55; dividend yield of 0%; volatility factors of the expected market price of common stock of 132%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$146,988. As of December 31, 2010, the aggregate value of the Summer 2010 Offering Warrants, the beneficial conversion feature and the transaction fees of \$35,650 are considered as debt discount and were fully amortized in conjunction with the conversion of the notes.

As of December 31, 2010, investors have converted \$392,150 of the Convertible Notes into 1,568,600 shares of the Company's common stock. There was no outstanding balance at December 31, 2010.

### ***2010 Fall Offering***

From August 10, 2010 to September 30, 2010, the Company conducted and concluded a private offering (the "Fall 2010 Offering") consisting of up to \$600,000 aggregate face amount of its convertible notes (the "Fall 2010 Notes"). A total of \$174,482 Fall 2010 Notes were sold to ten accredited investors for an aggregate purchase



price of \$158,620. While the stated interest rate on the Fall 2010 Notes is 0%, the actual interest rate on the Fall 2010 Notes is 10% per annum. The Fall 2010 Notes mature on the first anniversary of the closing of this offering and will be convertible, at the option of the noteholder into 697,928 shares of the Company's common stock at a conversion price of \$0.25 per share (the "Conversion Price").

Each of the investors in the Fall 2010 Offering will receive, for no additional consideration, a warrant (the "Fall 2010 Warrants"), entitling the holder to purchase a number of shares of our common stock equal to 100% of the number of shares of common stock into which the Fall 2010 Notes are convertible (the "Warrant Shares"). Each Fall 2010 Warrant is exercisable on a cash basis only at an initial price of \$0.30 per share, and is exercisable for a period of twenty four months. Up to 697,928 Warrant Shares are initially issuable on exercise of the Fall 2010 Warrants.

The Company received \$158,620 in net proceeds in the Fall 2010 Offering which was used for general corporate purposes and working capital. The aggregate value of the Fall 2010 Offering Warrants issued were valued at \$88,113 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of .42; dividend yield of 0%; volatility factors of the expected market price of common stock of 135%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$70,507. As of December 31, 2010, the aggregate value of the Fall 2010 Offering Warrants, the beneficial conversion feature and the transaction fees of \$15,862 are considered as debt discount and were fully amortized in conjunction with the conversion of the notes.

As of December 31, 2010, investors have converted \$174,482 of the Convertible Notes into 697,928 shares of the Company's common stock. There was no outstanding balance at December 31, 2010.

### ***2010 Fall Offering #2***

From October 4, 2010 to November 30, 2010, the Company conducted and concluded a private offering (the "Fall 2010 Offering #2") consisting of up to \$3,000,000 aggregate face amount of its convertible notes (the "Fall 2010 Notes"). A total of \$940,347 Fall 2010 #2 Notes were sold to ten accredited investors for an aggregate purchase price of \$849,861. While the stated interest rate on the Fall 2010 #2 Notes is 0%, the actual interest rate on the Fall 2010 #2 Notes is 10% per annum. The Fall 2010 #2 Notes mature on the first anniversary of the closing of this offering and will be convertible, at the option of the noteholder into 3,761,386 shares of the Company's common stock at a conversion price of \$0.25 per share (the "Conversion Price").

Each of the investors in the Fall 2010 #2 Offering will receive, for no additional consideration, a warrant (the "Fall 2010 #2 Warrants"), entitling the holder to purchase a number of shares of our common stock equal to 100% of the number of shares of common stock into which the Fall 2010 #2 Notes are convertible (the "Warrant Shares"). Each Fall 2010 Warrant is exercisable on a cash basis only at an initial price of \$0.30 per share, and is exercisable for a period of twenty four months. Up to 3,761,386 Warrant Shares are initially issuable on exercise of the Fall 2010 #2 Warrants.

The Company received \$849,861 in net proceeds in the Fall 2010 #2 Offering which was used for general corporate purposes and working capital. The aggregate value of the Fall 2010 #2 Offering Warrants issued were valued at \$436,986 using the Black-Scholes-Merton option valuation model with the following assumptions; risk-free interest rate of .27; dividend yield of 0%; volatility factors of the expected market price of common stock of 121%; and an expected life of two years (statutory term) and vest immediately upon issuance. The Company also determined that the notes contained a beneficial conversion feature of \$417,875. As of December 31, 2010, the aggregate value of the Fall 2010 #2 Offering Warrants, the beneficial conversion feature and the transaction fees of \$85,486 are considered as debt discount and will be amortized over the life of the notes.

As of December 31, 2010, investors have converted \$553,587 of the Convertible Notes into 2,214,346 shares of the Company's common stock. The outstanding balance at December 31, 2010 was \$386,760.

## **6. Research and Development**

The Company has research and development facilities in Morgan Hill, California. The Company has tested products incorporating our ZEFS, MK IV and ELEKTRA technologies for multiple makes and models diesel engines, motorbikes, boats, generators, lawnmowers and other small engines. The Company has purchased test vehicles, test engines and testing equipment. The Company incurred expenses of \$427,982 and \$428,139 for the years ended December 30, 2010 and 2009, respectively, on its research and development activities, and \$6,314,714 from February 18, 1998 (inception) to December 31, 2010.

### ***Temple University License Agreements***

The Company has entered into a research and development agreement (R&D Agreement) with Temple University to conduct further research on the ELEKTRA technology. Under the R&D Agreement Temple University

will conduct a 24-month research project towards expanding the scope of, and developing products utilizing, the technologies covered under the License Agreements, including design and manufacture of prototypes utilizing electric fields to improve diesel, gasoline and kerosene fuel injection in engines using such fuels and a device utilizing a magnetic field to reduce crude oil viscosity for crude oil (paraffin and mixed base) and edible oil flow in pipelines. If the research project yields results within the scope of the technologies licensed pursuant to the License Agreements, those results will be deemed included as rights licensed to the Company pursuant to the License Agreements. If the research project yields results outside of the scope of the technologies covered by the License Agreements, the Company has a six-month right of first negotiation to enter into a new worldwide, exclusive license agreement with Temple University for the intellectual property covered by those results. Pursuant to the R & D Agreement, the Company will make payments to Temple University in the aggregate amount of \$500,000. At December 31, 2010 the Company has completed payment in full of \$500,000 under the R & D Agreement.

The Company has entered into three License Agreements with Temple University covering Temple University's current patent applications concerning certain electric field effects on gasoline, kerosene and diesel fuel particle size distribution, and concerning electric field effects on crude oil and edible oil viscosity. Initially, the License Agreements are exclusive and the territory licensed to the Company is worldwide. Pursuant to the License Agreements, the Company will pay to Temple University license fees in the aggregate amount of \$300,000. A payment of \$50,000 was due on November 1, 2006; a payment of \$100,000 was due on March 2, 2007; a payment of \$75,000 was due on February 2, 2008 and the final payment was due on February 2, 2009. Annual maintenance fees of \$25,000 for the first license were due on November 1, 2007, November 1, 2008. Annual maintenance payments of \$150,000 for two of the licenses were due January 1, 2010 and January 1, 2010. In addition, each License Agreement separately provides that the Company will pay royalties to Temple University on net sales of products incorporating the technology licensed under that License Agreement in an amount equal to 7% of the first \$20 million of net sales, 6% of the next \$20 million of net sales and 5% of net sales in excess of \$40 million. Sales under the three License Agreements are not aggregated for purposes of calculating the royalties payable to Temple University. In addition, the Company has agreed to bear all costs of obtaining and maintaining patents in any jurisdiction where the Company directs Temple University to pursue a patent for either of the licensed technologies. Should the Company not wish to pursue a patent in a particular jurisdiction, that jurisdiction would not be included in the territory licensed to the Company.

On November 10, 2008, the Company received written notice from Temple University of a material breach relating to required payments under the License Agreements. The notice provides the Company with 60 days' notice to cure the material breach. The Company's failure to cure could result in a termination of the License Agreements. Under the License Agreements the Company is subject to a penalty of 1% per month of the amounts due and unpaid under the License Agreements. As of December 31, 2010, the Company was in default in the total amount of \$721,785 which includes \$256,785 of penalty interest and the Company has accrued this in the accompanying financial statements. On March 28, 2011, the Company completed its final adjusted payment to Temple University for all obligations outstanding on the License Agreements and the R&D Agreement. (See "Note 12 Subsequent events").

The Company has provided for all past due amounts in the financial statements at December 31, 2010, which is included in accounts payable-Temple University License Agreement. During the twelve months ended December 31, 2010 and December 31, 2009, the Company recorded \$276,651, and \$389,884, respectively fees due to Temple University. Amounts due Temple University as of December 31, 2010 and 2009 were \$721,785 and \$1,006,384, respectively. (See "Note 12, Subsequent Events")

#### Other

In 2010, the company formed a relationship with Colfax Corporation to assist in the product development of commercial prototypes of the AOT technology. The initial prototype has been constructed and is being used for testing by the U.S. Department of Energy.

In 2010, the Company was approved for testing by the US Department of Energy for testing its new technology at the US DOE Rocky Mountain Oilfield Testing Center, at the US Naval Petroleum Reserve #3 near Casper, Wyoming.

In 2010, the Company contracted with Pipeline Research Council International (PRCI) for testing of the Company's AOT technology.

In 2010, Dr. RongjiaTao of Temple University confirmed the AOT technology's effects at nano-scale level using a neutron-scattering beam at the US National Institute of Standards and Technology (NIST).

In 2010, the Company satisfied its R&D Agreement obligations with Temple University.

The Company is also working with Temple and several domestic and international corporations to develop the AOT (Applied Oil Technology) product line for oil refineries and pipelines. The AOT product line uses the same dynamically-controlled strong electrical field concepts to reduce viscosity as ELEKTRA but is designed for pipeline applications that use thicker, more viscous fuels than the ELEKTRA market. The AOT product is intended to improve the speed of highly viscous fluids such as crude oil traveling through pipelines.

## 7. Derivative liability

In June 2010, the FASB issued authoritative guidance on determining whether an instrument (or embedded feature) is indexed to an entity's own stock. Under the authoritative guidance, effective January 1, 2010, instruments which do not have fixed settlement provisions are deemed to be derivative instruments. The strike price of the warrants issued by the Company, in connection with certain convertible note offerings made during 2009 and 2010, in the aggregate of 8,522,500 warrants, exercisable at \$.30 per share, contain exercise prices that may fluctuate based on the occurrence of future offerings or events. As a result, these warrants are not considered indexed to the Company's own stock. The Company characterized the fair value of these warrants as derivative liabilities upon issuance. The FASB's guidance requires the fair value of these liabilities be re-measured at the end of every reporting period with the change in value reported in the statement of operations.

The derivative liabilities were valued using a probability weighted average series of Black-Scholes-Merton models as a valuation technique with the following assumptions:

	No. of Warrants	Fair Value of Warrants		
		December 31, 2009	2010 Issuance	December 31, 2010
Risk-free interest rate		1.18%	1.44%	0.61%
Expected volatility		142% - 147%	137%	120%
Expected life (in years)		2.75 - 3	3	1.75 - 2.00
Expected dividend yield		0%	0%	0%
Fair Value:				
2009 Summer Warrants	1,870,000	\$ 906,015	—	\$ 804,100
2009 Wellfleet Warrants	300,000	145,350	—	129,000
2009 Fall Warrants	6,352,500	654,978	\$ 2,372,837	2,731,575
Total Fair Value	8,522,500	\$ 1,706,343	\$ 2,372,837	\$ 3,664,675

The risk-free interest rate is based on the yield available on U.S. Treasury securities. The Company estimates volatility based on the historical volatility of its common stock. The expected life warrants are based on the expiration date of the related warrants. The expected dividend yield was based on the fact that the Company has not paid dividends to common shareholders in the past and does not expect to pay dividends to common shareholders in the future.

The Company measured the fair value of the warrants issued during the year as of the date of issuance as \$2,372,837. As of December 31, 2010, The Company re-measured the derivative liabilities and determined the fair value to be \$3,664,675. For the year ended December 31, 2010, the Company recorded an income on the change in the fair value of derivatives of \$414,505.

## 8. Common Stock Transactions

### Issuances of Common Stock-2010

During the year ended December 31, 2010 the Company issued an aggregate of 20,163,798 shares of its common stock as follows:

- During 2010, the Company issued 3,710,099 shares of its common stock for services valued in the aggregate at \$1,385,137. The Company valued the shares at prices ranging from \$0.43 to \$0.48 per share.
- During 2010, the Company issued 170,000 shares of its common stock to its employees as compensation valued in the aggregate \$91,700. The Company valued the shares at prices ranging from \$0.52 to \$0.55 per share.
- During 2010, the Company issued 12,121 shares of its common stock to settle \$4,121 of outstanding accounts payable. The Company valued the shares at \$0.34 per share.
- During 2010, the Company issued 16,076,023 shares of its common stock (including 224,751 shares issued to induce conversion of certain notes valued at \$119,118) in exchange for conversion

of \$4,417,417 of Convertible Notes. The Company valued the shares at prices ranging from \$0.15 to \$0.50.

- During 2010, the Company issued 195,555 shares of its common stock for exercised options valued at \$.027.

### Issuances of Common Stock-2009

During the year ended December 31, 2009, the Company issued an aggregate of 8,348,505 shares of its common stock as follows:

- During 2009, the Company issued 1,482,000 shares of its common stock for services valued in the aggregate at \$596,920. The Company valued the shares at prices ranging from \$0.33 to \$0.51 per share.
- During 2009, the Company issued 495,615 shares of its common stock to settle \$129,481 of outstanding accounts payable. The Company valued the shares at prices ranging from \$0.20 to \$0.38 per share.
- During 2009, the Company issued 6,287,557 shares of its common stock in exchange for conversion of \$1,436,886 of Convertible Notes. The Company valued the shares at prices ranging from \$0.15 to \$0.50.
- During 2009, the Company issued 83,333 shares of its common stock for exercised options valued at \$.027.

### 9. Stock options and warrants

The Company currently issues stock options to employees, directors and consultants under the 2004 Stock Option Plan (the Plan). The Company could issue options under the Plan to acquire up to 5,000,000 shares of common stock. In February 2006, the board approved an amendment to the Plan (approved by the Shareholders in May 2006), increasing the authorized shares by 2,000,000 shares to 7,000,000 shares. At December 31, 2010, 2,412,512 were available to be granted under the Plan. Prior to 2004, the Company granted 3,250,000 options outside the Plan to officers of the Company of which 250,000 are still outstanding.

Employee options vest according to the terms of the specific grant and expire from 5 to 10 years from date of grant. Non-employee option grants to date are vested upon issuance. The weighted-average, remaining contractual life of employee options outstanding at December 31, 2010 was 6.37 years. Stock option activity for the years ended December 31, 2010 and 2009, which includes 3,250,000 options granted outside and prior to the adoption of the Plan, was as follows:

	Weighted Avg. Options	Weighted Avg. Exercise Price
Options, January 1, 2004	13,250,000	\$ 0.11
Options granted	1,172,652	1.03
Options exercised	—	—
Options cancelled	—	—
Options, December 31, 2004	14,422,652	0.18
Options granted	2,085,909	0.92
Options exercised	—	—
Options cancelled	(10,000,000)	0.10
Options, December 31, 2005	6,508,561	0.53
Options granted	1,313,605	1.21
Options exercised	(2,860,000)	0.10
Options forfeited	(962,607)	0.84
Options cancelled	—	—
Options, December 31, 2006	3,999,559	0.99
Options granted	238,679	0.55
Options exercised	—	—
Options forfeited	(49,793)	1.96
Options cancelled	—	—
Options, December 31, 2007	4,188,445	\$ 0.95
Options granted	2,700,000	0.28

Options exercised	—	—
Options forfeited	(2,287,220)	1.00
Options cancelled	—	—
Options, December 31, 2008	4,601,225	\$ 0.53
Options granted	333,333	0.30
Options exercised	(83,333)	0.27
Options forfeited	—	—
Options cancelled	—	—
Options, December 31, 2009	4,851,225	\$ 0.52
Options granted	181,818	0.55
Options exercised	(195,555)	0.27
Options forfeited	—	—
Options cancelled	—	—
Options, December 31, 2010	4,837,488	\$ 0.53

The weighted average exercise prices, remaining contractual lives for options granted, exercisable, and expected to vest under the Plan as of December 31, 2010 were as follows:

Option Exercise Price Per Share	Outstanding Options			Exercisable Options	
	Shares	Life (Years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
\$0.21 - \$0.99	4,449,942	6.6	\$ 0.46	4,268,124	\$ 0.45
\$1.00 - \$1.99	327,546	4.4	\$ 1.25	327,546	\$ 1.25
\$2.00 - \$2.26	60,000	0.6	\$ 2.26	60,000	\$ 2.26
	4,837,488		\$ 0.53	4,655,670	\$ 0.53

As of December 31, 2010 the market price of the Company's stock was \$0.54 per share. Future compensation expense on the options which were not exercisable at December 31, 2010 is \$8,058. At December 31, 2010 the aggregate intrinsic value of the options outstanding was \$741,087.

#### ***Black-Scholes value of options***

During the years ended December 31, 2010 and 2009, the Company valued options for pro-forma purposes at the grant date using the Black-Scholes pricing model with the following average assumptions:

	2010	2009
Expected life (years)	5.50	5.50
Risk free interest rate	3.63%	2.57%
Volatility	129.95%	129.49%
Expected dividend yield	0.00%	0.00%

The weighted average fair value for options granted in 2010 and 2009 were \$0.53 and \$0.26, respectively.

During the year ended December 31, 2010, the Company granted 181,818 options exercisable at \$0.55, vesting in one year with a ten year life. The options were valued at \$96,681 or \$0.53 per share using the Black Scholes pricing model using a 5.5 year expected term, 130% volatility, no annual dividends, and a discount rate of 3.63%. During the year ended December 31, 2010, the Company recognized compensation expense of \$88,623 relating to the vesting of these options. As of December 31, 2010, there was unamortized compensation of \$8,058 that will be amortized as compensation cost in 2011.

#### ***Warrants***

The following table summarizes certain information about the Company's stock purchase warrants (including the warrants discussed in Note 9).

	Warrants	Weighted Avg. Exercise Price
Warrants outstanding, January 1, 2004	14,252,414	0.48
Warrants granted	2,372,500	1.27
Warrants exercised	(960,500)	0.20
Warrants cancelled	—	—
Warrants outstanding, December 31, 2004	15,664,414	0.62
Warrants granted	5,198,574	1.16
Warrants exercised	(50,500)	0.99

Warrants cancelled	(20,000)	1.50
Warrants outstanding, December 31, 2005	20,792,488	0.75
Warrants granted	3,624,894	1.28
Warrants exercised	(2,328,452)	0.68
Warrants cancelled	(1,191,619)	1.46
Warrants outstanding, December 31, 2006	20,897,311	\$ 0.81
Warrants granted	3,602,701	0.64
Warrants exercised	—	—
Warrants cancelled	(6,580,984)	1.06
Warrants outstanding, December 31, 2007	17,919,028	\$ 0.67
Warrants granted	3,931,708	0.42
Warrants exercised	(1,064,650)	0.50
Warrants cancelled	(10,386,083)	0.56
Warrants outstanding, December 31, 2008	10,400,003	\$ 0.70
Warrants granted	5,247,276	0.36
Warrants exercised	—	—
Warrants cancelled	(2,300,515)	0.95
Warrants outstanding, December 31, 2009	13,346,764	\$ 0.52
Warrants granted	14,058,032	0.32
Warrants exercised	—	—
Warrants cancelled	(4,425,728)	0.53
Warrants outstanding, December 31, 2010	22,979,068	\$ 0.40

During the year ended December 31, 2010, the Company issued 13,758,042 warrants to acquire shares of its common stock in connection with the issuance of its convertible notes, and issued 300,000 warrants valued at \$126,000 for services provided. The warrants were valued using a Black Scholes option pricing model.

At December 31, 2010 the price of the Company's common stock was \$0.54 per share and the aggregate intrinsic value of the warrants outstanding was \$4,215,160.

Warrant Exercise Price Per Share	Outstanding Warrants			Exercisable Warrants	
	Shares	Life (Years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
\$0.30 - \$0.99	21,756,396	1.6	\$ 0.36	21,756,396	\$ 0.36
\$1.00 - \$1.99	1,135,370	2.2	\$ 1.00	1,135,370	\$ 1.00
\$2.00 - \$2.70	87,302	0.4	\$ 2.70	87,302	\$ 2.70
	<u>22,979,068</u>		<u>\$ 0.40</u>	<u>22,979,068</u>	<u>\$ 0.40</u>

Included in the table above are 8,522,500 warrants at an exercise price of \$.30 per share. Based upon these warrant agreements, the exercise price may be reduced if the Company sells equity to any person or entity at a price per share or conversion price or exercise price per share which shall be less than the Warrant exercise price in respect of the Warrant Shares then in effect. The reset of the warrant exercise price gives rise to the characterization of these instruments as derivative liabilities. (See note 7).

## 10. Commitments and contingencies

### *Legal matters*

We have concluded our litigation in previous matters involving the Company's prior Chairman and Chief Executive, Jeffrey Muller and all related matters and are of the current opinion that the Company no longer faces litigation liability in connection with those cases. We are continuing to ensure the Company's obligations are fully in compliance with a previous injunction order entered by a Federal District Court over six years ago to timely file all of the Company's financial and related reports. The Company will shortly be petitioning the Federal District Court to dissolve the compliance injunction on the basis that for more than a six-year period, under the Company's new administrative and executive leadership, it has been in full compliance with the Company's SEC financial and reporting obligations. We can provide no assurance that such action to dissolve the injunction would be successful.

There is no other litigation of any significance with the exception of the matters that have arisen under, and are being handled in, the normal course of business.

### ***Litigation Involving Former Executive Officer***

As previously reported, on April 7, 2010, Bruce McKinnon, the former CEO of the Company, and the Company entered into an Agreement Re: Collection on Judgment (“Judgment”) (the “Settlement Agreement”), wherein McKinnon, among other things, agreed to cease further collection efforts on the Judgment, and the Company, among other things, agreed to satisfy the Judgment for, and McKinnon agreed to accept as full and final satisfaction of the Judgment, subject to certain payment waivers described below, a total amount of \$360,000, plus interest of ten percent (10%) per annum from March 15, 2010, on the unpaid balance until paid, payable as follows: \$30,000 on April 7, 2010; \$85,000 on or before April 15, 2010; and, \$15,000 per month commencing on June 1, 2010, until paid. As of December 31, 2010, all payments have been made on time and the balance due is \$155,270. The Settlement Agreement also provides that if the Company makes all payments thereunder, on a timely basis, McKinnon will waive final payments due him in the amount of \$35,000.

### ***Employment agreements***

#### ***Agreement with Cecil Bond Kyte***

On January 30, 2009, the Company entered into an employment agreement with Cecil Bond Kyte, pursuant to which he serves as our Chief Executive Officer. The initial term of the agreement became effective on January 30, 2009 and expires on January 30, 2010 and renews automatically for additional one-year periods unless either party has given notice of non-extension prior to October 30, 2010. The agreement provides for a base compensation of \$200,000 per year. Mr. Kyte is eligible to participate in the Company’s incentive and benefit plans, including eligibility to receive grants of stock options under the 2004 plan.

Mr. Kyte shall be eligible to receive an annual cash bonus in an amount equal to 2% of the Company’s net profit, if any, for its most recently completed fiscal year, computed in accordance with generally accepted accounting principles applied consistently with prior periods. The bonus shall be payable, if at all, on the anniversary date of employment each year of the term; provided that no bonus shall be paid if the Executive is not, on such payment date, in the employ of the Company.

Mr. Kyte shall also receive an option (the “Option”) to purchase a number of shares (the “Option Shares”) of the Company’s common stock equal to the result of (A) 100,000 divided by (B) the closing price per share of the Company’s Common Stock on the first anniversary of the Effective Date. The Option shall be an incentive stock option, shall be exercisable at the closing price per share on the first anniversary of the Effective Date, shall be exercisable for ten years from the date of grant and shall vest on the second anniversary of the Effective Date.

Termination of Mr. Kyte’s contract will terminate upon his death or disability and may be terminated by the Company with or without cause and may be voluntarily terminated by Mr. Kyte. Termination of Mr. Kyte’s employment for any reason shall be effective upon the Date of Termination and he shall only be entitled to receive the compensation accrued through the Date of Termination. In the event of Involuntary Termination, involving merger, consolidation or sale or disposition of all of the Company’s assets, Mr. Kyte shall be entitled to receive (i) all compensation that has accrued through the date of termination, plus, (ii) a severance payment equal to one year’s compensation, plus he shall be entitled to continue to participate in the Company’s employee benefit programs offered to other senior management employees of the Company for a period of 12 months following the date of termination, provided that if at any time while the Company is required to pay severance to Mr. Kyte, his death or disability would cause the severance payments to terminate.

### ***Leases***

In March 2009, the Company entered into a sublease agreement for its executive offices in Santa Barbara, California. The term of the lease was for \$3,520 per month from April 1, 2010 through December 31, 2010 and \$3,630 per month from January 1, 2011 to December 31, 2010.

In November 2010, the Company entered into a lease agreement for its executive offices in Santa Barbara, California. The term of the lease was for \$5,830 per month from January 1, 2011 to December 31, 2013.

Total rent expense under this lease and other operating leases in effect during the years ended December 31, 2010 and 2009, was \$112,320 and \$112,440, respectively. The following is a schedule by years of future minimum rental payments required under the non-cancellable operating leases as of December 31, 2010.

**Years Ending December 31,**

2011	\$ 69,960
2012	69,960
2013	<u>69,960</u>
Total	<u>\$ 209,880</u>

**11. Income taxes**

The Company did not record an income tax provision for 2010 and 2009, other than \$800 for the minimum state tax provision. A reconciliation of income taxes with the amounts computed at the statutory federal rate follows:

	<b>December 31,</b>	
	<b>2010</b>	<b>2009</b>
Computed tax provision (benefit) at federal statutory rate (34%)	\$ (1,918,000)	\$ (2,160,000)
State income taxes, net of federal benefit	(170,000)	(260,000)
Permanent items	0	820,000
Valuation allowance	<u>2,088,800</u>	<u>1,600,800</u>
Income tax provision	<u>\$ 800</u>	<u>\$ 800</u>

The deferred tax assets and deferred tax liabilities recorded on the balance sheet are as follows:

	<b>December 31, 2010</b>	<b>December 31, 2009</b>
Net operating loss carry forwards	12,200,000	13,800,000
Valuation allowance	<u>(12,200,000)</u>	<u>(13,800,000)</u>
Total deferred taxes net of valuation allowance	<u>\$ —</u>	<u>\$ —</u>

As of December 31, 2010, the Company had net operating losses available for carry forward for federal tax purposes of approximately \$29.8 million expiring beginning in 2019. These carryforward benefits may be subject to annual limitations due to the ownership change limitations imposed by the Internal Revenue Code and similar state provisions. The annual limitation, if imposed, may result in the expiration of net operating losses before utilization.

As of December 31, 2010, the Company has recorded a \$12,200,000 valuation allowance against a portion of its deferred tax assets, since at that time it was believed that such assets did not meet the more likely than not criteria to be recoverable through projected future profitable operations in the foreseeable future.

Effective January 1, 2007, the Company adopted FASB guidance that addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under this guidance, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The FASB also provides guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures. As of December 31, 2009 and 2008, the Company does not have a liability for unrecognized tax benefits.

The Company files income tax returns in the U.S. federal jurisdiction and the state of California. The Company is subject to U.S. federal or state income tax examinations by tax authorities for years after 2002. During the periods open to examination, the Company has net operating loss and tax credit carry forwards for U.S. federal and state tax purposes that have attributes from closed periods. Since these net operating losses and tax credit carry forwards may be utilized in future periods, they remain subject to examination. The Company's policy is to record interest and penalties on uncertain tax provisions as income tax expense. As of December 31, 2010, the Company has no accrued interest or penalties related to uncertain tax positions. The Company believes that it has not taken any uncertain tax positions that would impact its consolidated financial statements as of December 31, 2010 or 2009.



## **12. Subsequent events**

### **2011 Winter Offering**

From December 13, 2010 through February 28, 2011, the Company conducted a private offering (the “Winter 2011 Offering”) of up to \$3,000,000 aggregate face amount of its convertible notes (the “Winter 2011 Notes”). A total of \$2,588,422 aggregate face amount of the Winter 2011 Notes were sold for an aggregate purchase price of \$2,353,111. While the stated interest rate on the Winter 2011 Notes is 0%, the actual interest rate on the Winter 2011 Notes is 10% per annum. The Winter 2011 Notes mature on the first anniversary of their date of issuance. The Winter 2011 Notes are convertible, at the option of the noteholder, into 10,353,688 shares of common stock of the Company (the “Conversion Shares”) at an initial conversion price of \$0.25 per share (the “Conversion Price”).

Each of the investors in the Winter 2011 Offering received, for no additional consideration, a warrant (the “Winter 2011 Warrants”), entitling the holder to purchase a number of shares of the Company’s common stock equal to 100% of the number of shares of common stock into which the Winter 2011 Notes are convertible (the “Warrant Shares”). Each Winter 2011 Warrant is exercisable on a cash basis only at an initial price of \$0.30 per share, and is exercisable immediately upon issuance and for a period of two (2) years from the date of issuance. Up to 10,353,688 Warrant Shares are initially issuable to date on exercise of the Winter 2011 Warrants.

### **Increase in Outstanding Shares**

During the period from January 1, 2011 through March 15, 2011, the Company issued 1,768,722 shares of its common stock. This was comprised of the following:

The Company issued 1,609,924 shares of its common stock upon conversion of \$402,481 of debt to its existing convertible note holders.

The Company issued 81,020 shares of its common stock upon exercise of cashless warrants.

The Company issued 77,778 shares of its common stock upon exercise of outstanding options at \$0.27 per share.

### ***Temple University.***

On March 28, 2011, the Company completed its final adjusted payment to Temple University for all obligations outstanding on the License Agreements and the R&D Agreement. This included previously made payments of \$577,837 in 2010 and \$677,422 of payments in the first three months of 2011. We are in current negotiations with Temple to execute new License Agreements to reflect updated technologies. All of these outlays have been made possible through proceeds raised in connection with our recent private investment offerings.

### ***Amendment to Employment Agreement of Chief Executive Officer***

***Amendment to Employment Agreement with Cecil Bond Kyte.*** On March 1, 2011, the Board of Directors (the “Board”) of Save The World Air, Inc. (the “Company”) approved an amendment (the “Amendment”) to the employment agreement between the Company and the Company’s Chief Executive Officer, Cecil Bond Kyte (“Kyte”), dated January 30, 2009 (the “Employment Agreement”).

The initial term of the Kyte Employment Agreement was for one (1) year, renewable for successive one (1) year periods, unless Kyte or the Company provided written notice to the other, no later than October 31<sup>st</sup> of the then current year of the term, that the Employment Agreement would not be renewed;

As early as April 2010, Kyte requested the Board to re-negotiate certain of the non-cash compensation provisions under the Employment Agreement; notwithstanding Kyte’s request in the foregoing regard, the Compensation Committee of the Board did not take any action to re-negotiate or change the Employment Agreement; nonetheless, Kyte elected not to terminate the Employment Agreement on October 31, 2010; thus, under provisions of the Employment Agreement, the Employment Agreement is in full force and effect and the term thereof has been extended to January 29, 2012;

1. Kyte, pursuant to provisions of the Employment Agreement, has indicated his intention not to renew the Employment Agreement, by giving notice of such non-renewal on a date no later than October 31, 2011;

2. The Board recognized Kyte’s skills, judgment, abilities, contributions and outstanding performance as the Company’s Chief Executive Officer (“CEO”), and determined that it is in the Company’s best interest for Kyte to remain and continue to serve as the Company’s CEO and for Kyte not to terminate the Employment Agreement;

3. Kyte has determined to waive his right, under Section 1 of the Employment Agreement, to terminate the Employment Agreement from March 1, 2011, through October 31, 2015, meaning that the Employment Agreement would remain in full force and effect through at least January 29, 2016, unless the Company determines to terminate the Employment Agreement earlier in accordance with provisions thereunder;

4. Kyte has also determined to waive his right to claim or receive any vested or unvested stock option grants or other benefits under Section 3.7 (Stock Option Grant) of the Employment Agreement, and has agreed to the cancellation of 181,818 stock option grants previously issued to Kyte under Section 3.7 of the Employment Agreement;

5. Kyte and the Board have determined that all terms and conditions set forth in the Employment Agreement shall remain in full force and effect, except for the changes identified in paragraphs 5. and 6., above, and the changes set forth in paragraph 10., below;

6. Kyte has agreed to continue to serve in the role of CEO of the Company through at least January 29, 2016;

7. Kyte has determined more fully to align his interests with the interests of the shareholders of the Company, and, in furtherance thereof, the Company and Kyte have agreed to an amendment of the Employment Agreement, providing for non-cash performance compensation in the form of nonqualified stock options as set forth below in paragraph 10.

8. In furtherance and consideration of the foregoing, the Board determined to amend the Employment Agreement and grant Kyte nonqualified stock options to acquire shares of common stock of the Company (the "Shares"), under the following terms and conditions:

- (i) Stock Option Grant (the "Option"): 17,600,000 Shares;
- (ii) Exercise Price: \$0.25 per share;
- (iii) Term: The Option shall expire ten (10) years from the Effective Date, defined in (iv) below;
- (iv) Effective Date: January 30, 2011;
- (v) Vesting: Twenty percent (20%) of the Option shall vest on the first anniversary of the Effective Date; twenty percent (20%) on the second anniversary of the Effective Date; twenty percent (20%) on the third anniversary of the Effective Date; twenty percent (20%) on the fourth anniversary of the Effective Date; and, twenty percent (20%) on the fifth anniversary of the Effective Date;
- (vi) Accelerated Vesting: In the event of a Change of Control, as defined in the Employment Agreement, all unvested options shall automatically vest on the effective date of such Change of Control. In the event the Company achieves net profit of no less than \$20,000,000, computed in accordance with generally accepted accounting principles, on a cumulative basis during the five (5) year vesting period, all unvested options shall automatically vest;
- (vii) If Kyte's employment with the Company is terminated with or without cause, voluntarily or involuntarily, as such terms are defined in the Employment Agreement, except for a Change of Control, all unvested Options shall terminate and be of no force or effect;
- (viii) The Options and Shares underlying the Options shall not be registered with the Securities and Exchange Commission, and shall be deemed "restricted" securities;
- (ix) The Options shall be nonqualified.



# SAVE THE WORLD AIR, INC.

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## **OFFICERS**

Cecil Bond Kyte, Chief Executive Officer  
Charles R. Blum, President  
Eugene E. Eichler, Interim Chief Financial Officer  
Jerry Joves, Controller and Corporate Secretary

## **ANNUAL REPORT ON FORM 10-K**

Our audited financial statements and the notes thereto, and other information required to be furnished to stockholders, are included in our Annual Report on Form 10-K, which forms a part of this Annual Report to Stockholders.

## **ADDITIONAL INFORMATION**

We file periodic reports with the Securities and Exchange Commission that contain additional information about our Company. You may find copies of these reports at the SEC website, [www.sec.gov](http://www.sec.gov).

## **PRESS RELEASES**

Copies of our press releases may be obtained through our Corporate Secretary at (805-845-3581)

## **WEBSITE**

You can also find copies of our SEC filings, press releases and Corporate governance documents on our website at [www.stwa.com](http://www.stwa.com)

## **ANNUAL MEETING OF SHAREHOLDERS**

Friday, May 13, 2011 at 10:00 a.m.  
Canary Hotel  
31 West Carrillo  
Santa Barbara, CA 93101

## **DIRECTORS**

Cecil Bond Kyte, Chairman  
Charles R. Blum  
Nathan Shelton

## **CORPORATE HEADQUARTERS**

735 State Street, Suite 500  
Santa Barbara, CA 93101  
(805) 845-3581

## **R&D AND TESTING CENTER**

235 Tennant Avenue  
Morgan Hill, CA 95037

## **COMMON STOCK**

Stock Symbol: ZERO  
Quotation: OTC Bulletin Board

## **TRANSFER AGENT**

Nevada Agency and Transfer Company  
50 West Liberty Street, Suite 880  
Reno, NV 89501  
(775) 322-0626  
Email: [info@natco.org](mailto:info@natco.org)

## **INDEPENDENT ACCOUNTANTS**

Weinberg & Co., P.A.  
1925 Century Park East, Suite 1120  
Los Angeles, CA 90067