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PROFILE TECHNOLOGIES INC  
Form 10KSB  
September 28, 2005

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-KSB  
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ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended:  
June 30, 2005

Commission File Number  
0-21151

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PROFILE TECHNOLOGIES, INC.  
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(Name of small business issuer in its charter)

DELAWARE  
-----  
(State or other jurisdiction of  
incorporation or organization)

91-1418002  
-----  
(I.R.S. Employer  
Identification Number)

2 Park Avenue, Suite 201  
MANHASSET, NY  
-----

11030  
-----  
(Zip Code)

(Address of Principal  
Executive Offices)

-----  
Issuer's telephone number: (516) 365-1909

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

Securities registered under Section 12(g) of the Act:

Common Stock, \$.001 Par Value

Title of Class  
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Check whether the issuer (1) has filed all reports required to be filed by  
Section 13 or 15(d) of the Exchange Act during the past 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 [X] No [ ]

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Check if there is no disclosure of delinquent filers pursuant to Item 405 of Regulation S-B is not contained in this form, and no disclosure will 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-KSB or any amendment to this Form 10-KSB.[X]

Issuer's revenues for the most recent fiscal year. \$0.

The aggregate market value of the voting stock held by non-affiliates of the registrant was \$7,501,000, computed by reference to the price at which the common stock last sold or the average bid and ask price as reported by the NASD'S Over the Counter Bulletin Board on September 15, 2005.

There were 8,334,44 5shares of common stock, \$.001 par value, outstanding as of September 15, 2005.

### DOCUMENTS INCORPORATED BY REFERENCE:

Part III incorporates certain information by reference from the Registrant's definitive proxy statement for its annual shareholder meeting to be held on December 12, 2005 to be filed pursuant to Regulation 14A.

Transitional Small Business Format (check one): Yes  No

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Preliminary Note Regarding Certain Risks

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and Forward-Looking Statements  
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This Annual Report on Form 10-KSB contains "forward-looking statements." These forward-looking statements can generally be identified as such because the context of the statement will include words such as the Company "believes," "anticipates," "expects" or words of similar import. Similarly, statements that describe the Company's projected future results, future plans, objectives or goals or future conditions or events are also forward-looking statements. Actual results are inherently difficult to predict. Any such forward-looking statements are subject to the risks and uncertainties that could cause actual results of operations, financial condition, acquisitions, financing transactions, operations, expenditures, expansion and other events to differ materially from those expressed or implied in such forward-looking statements. Any such forward-looking statements would be subject to a number of assumptions regarding, among other things, future economic, competitive and market conditions generally. Such assumptions would be based on facts and conditions as they exist at the time such statements are made as well as predictions as to future facts and conditions, the accurate prediction of which may be difficult and involve the assessment of events beyond the Company's control.

The forward-looking statements contained in this report are based on current expectations that involve a number of risks and uncertainties. Such forward-looking statements are based on assumptions that the Company will obtain or have access to adequate financing for each successive phase of its growth, that the Company will market and provide products and services on a timely basis, that there will be no material adverse competitive or technological change with respect to the Company's business, demand for the Company's products and services will significantly increase, that the Company's executive officers will remain employed as such by the Company, that the Company's forecast accurately anticipates market demand, and that there will be no material adverse change in the Company's operations, business or governmental regulation affecting the Company or its customers. The foregoing assumptions are based on judgments with respect to, among other things, future economic, competitive and

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market conditions and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond the Company's control. Although the Company believes the expectations reflected in the forward-looking statements are reasonable, the Company cannot guarantee future results, levels of activity, performance or achievements.

### PART I

#### Item 1. Description of Business.

##### Introduction

Profile Technologies, Inc. (the "Company"), a Delaware corporation, was incorporated in 1986 and commenced operations in fiscal year 1988. The Company is in the business of inspecting pipelines for corrosion and is in the final stages of researching and developing a patented, non-destructive and non-invasive, high speed scanning process using electro magnetic waves to remotely inspect buried, encased and insulated pipelines for corrosion (the "EMW Inspection"). The EMW Inspection process analyzes the waveforms of electrical impulses by extracting point-to-point information along a segment of pipeline to determine the integrity of the entire pipeline. During the EMW Inspection process electromagnetic pulses are directed along the length of a pipeline from either one ("Single-Pulse") or two ("Dual-Pulse") directions. In Dual-Pulse mode, the intersecting point of the two electro magnetic pulses is moved down the pipeline by computerized delays of one pulse and data received from these locations is analyzed to determine if an anomaly on the pipeline exists and whether such anomaly is likely to be identified as corrosion.

The EMW Inspection process provides a corrosion inspection method which does not require the inspector to physically remove the pipeline's insulation or otherwise dig up the pipeline to visually inspect for corrosion. In certain instances, limited access points to buried pipelines exist for reasons unrelated to corrosion inspection. As a result, corrosion inspection may be conducted at these access points. Where such access points are not already available, the EMW Inspection process permits the inspection of pipelines with a minimal amount of disturbance to the coating or insulation on the pipeline. In addition, the EMW Inspection process permits corrosion inspection over the entire pipeline, as opposed to other technologies, which only provide for spot point inspections. Such "spot inspections" are not necessarily accurate in indicating the overall condition of a pipeline.

Refineries, chemical plants, utilities, natural gas transmission companies and the petroleum industry have millions of miles of pipeline much of which may be exposed to harsh and severe environments subjecting such pipeline to higher incidence of corrosion. As a result of such environments these industries are continually challenged to ensure that the quality of its pipeline meets applicable standards established by relevant regulatory bodies to protect operating personnel and the environment.

During the summer of 1998, the Company completed work on its first commercial contract with ASCG Inspection, Inc. testing British Petroleum pipelines at approximately 100 road and caribou crossings located on the North Slope of Alaska. During the summer of 1999, the Company continued work testing pipelines under a contract with another large multi-national oil company related to the inspection of approximately 250 below-grade pipelines. During the summer of 2000, the Company expanded its Alaska efforts by testing a total of 372

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below-grade pipelines. In 2001, the Company completed the testing of approximately 441 pipelines in Alaska and in 2002 the Company inspected 364 pipelines.

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Based on estimates provided by its then current Alaska customers based on their recently completed road and caribou crossing inspections, the Company was expected to complete the inspection of approximately 400 to 500 below-grade pipelines in Alaska during the 2003 calendar year. However, the Company was able to successfully test only 250 below-grade pipelines during this time period as a result of lack of current budgeting for the remainder of such program.

The remainder of the inspection work is expected to be completed at some future date. In anticipation of this possibility, the Company designed, fabricated, and began testing new hardware for the inspection of direct-buried pipe in the lower-48 states. The new hardware has been designed with a view toward improving efficiency, ease of use, portability, accuracy of test data and customer acceptance.

More importantly, the new hardware provides a different pulse waveform specifically tailored to the buried pipe requirement. The improved waveform has increased low frequency energy content, which enables efficient wave propagation through sand, soil, and moist earth.

The new hardware was designed to be much smaller than the previous generation hardware used in Alaska. The entire test hardware package weighs less than 25 pounds including data acquisition digitizer and battery power supply. The new hardware can be hand-carried and operated by a single person and does not require the gasoline powered AC generator, utility trailer, and external computer data acquisition system which were necessary with the previous generation hardware. The portable system is designed to allow testing of both underground and above-grade pipelines with one test set.

The buried pipe inspection hardware is currently being tested at the Company's Ferndale, Washington pipe test facility. The new hardware has demonstrated good results in initial testing. Proper pulse waveforms have been transmitted through several hundred feet of pipe buried in moist earth. The hardware is now being optimized and evaluated for ability to detect various types of anomalies. This work is currently the focus of the research effort at Ferndale. When this work is successfully completed, the improved highly portable system will increase field productivity, reduce operator training time, and significantly reduce the cost of field operations. The new system will also be compatible with production in quantity and operation with minimal training, enabling licensing of the technology to the industry.

Although several important milestones have been achieved in the fabrication and testing of this new hardware, there can be no assurance that the remaining portion of the testing program can be funded or that the new hardware can be successfully tested and deployed on a commercial basis. Failure to do so could have a serious and material effect on the business and financial condition of the Company.

On December 15, 2003, the U.S Department of Transportation ("DOT") issued regulations under the Pipeline Safety Improvement Act of 2002 requiring regulated companies to gather baseline integrity data on pipelines in so-called "high consequence areas" ("HCA's") (e.g., populated areas) initially over a ten-year period and then every seven years thereafter. Based on consultations with industry representatives, the Company believes that its new buried pipe inspection hardware will provide such regulated companies with a superior tool

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for gathering required baseline integrity data.

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Pending the deployment of its new hardware and the receipt of new contracts, and in an effort to reduce its out-of-pocket expenses to the lowest practicable level, the Company has furloughed all of its field crews. If and when commercial contracts are obtained, the Company may re-hire former crew personnel or may hire and train new crews.

Throughout its development stage, the Company has filed and continues to file many patents in order to protect the proprietary nature of its technology.

### Pipeline Corrosion

A combination of federal state, and industry rules combine to regulate corrosion protection. The U.S. Department of Labor, operating through the Occupational Safety and Health Administration has jurisdiction over numerous plants and facilities containing corrosion protected pipeline that, if breached, could cause serious bodily injury or death to on-site workers. The U.S. Department of Transportation has jurisdiction over interstate natural gas and hazardous liquids pipelines. Counterpart state agencies have jurisdiction over intrastate natural gas and hazardous liquids pipelines. In addition, the American Petroleum Institute has promulgated a comprehensive Piping Inspection Code which requires that extensive corrosion testing be done by all members (which includes the vast majority of the petroleum and petrochemical industries). As a result of extensive regulation and testing requirements, the industry is faced with the requirement to engage in extensive testing for corrosion. In 1993, the American Petroleum Institute imposed even stricter test standards regarding the problem of corrosion under the insulation on pipelines. When pipeline is uninsulated and above ground, external corrosion can be identified visually. The petroleum and other related industries, however, insulate much of their piping to conserve energy and to prevent injury to personnel from high temperature levels on the pipelines. As soon as piping is insulated, a very complex situation is created. Corrosion can occur underneath the insulation due to moisture or corrosive products that find their way through broken or poorly sealed insulation. This corrosion under insulated pipelines is very difficult and costly to locate. In the past, testing for this problem had been on a limited sample basis and relied upon inspection processes that were very cumbersome and costly.

Two prevalent testing methods used to detect corrosion under insulated pipelines are X-ray and eddy current methods, which are methods of detecting defects in pipe by analyzing visual image and decay. After physically stripping away coating for visual inspection, depth gauges, ultrasonics and X-ray are then used to determine the severity of corrosion on questionable pipe. However, the stripping of insulation to determine corrosion is a costly testing method for the industry because it often involves the assembly of scaffolding for testing otherwise inaccessible above ground pipe (particularly in refineries and petrochemical plants) or an actual dig-up on below ground pipe. The Company's technology enables it to test pipe segments in a refinery setting for a distance up to three hundred feet and to use "cherry pickers" instead of costly scaffolding.

Corrosion under insulated pipelines presents a very complicated testing problem because corrosion cannot be easily identified by statistical sampling. If, for example, a segment of pipe has a small insulation part removed every ten feet and is visually inspected using eddy current or x-ray techniques, there is no statistical basis to assume that the external condition of the piping between

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the removed insulation parts is good or bad. The American Petroleum Institute testing standard adopted in 1993, in essence, mandates either stripping even larger amounts of coating or using an alternate system that will identify corrosion under the insulation without stripping the coating on suspected and unsuspected pipe. Because of the enormous cost involved in using the stripping and visual testing process, the Company believes that the industry will be receptive to an alternate testing system that is reliable and less costly. The Company believes that its EMW process provides an alternate testing system that could be widely accepted by the Industry. However, while the Company has obtained some commercial contracts and prospects for expanded commercial contracts in the future appear strong, there can be no assurance that such acceptance will continue to grow or that competitors will not develop newer and better technologies.

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### The Company's EMW Inspection Technology

The Company has developed two basic EMW inspection techniques, namely, Dual Pulse or Pulse Propagation Analyzer and Single-Pulse or Calibration Mark Z. For above-grade piping, the Company uses both the Dual-Pulse and CMZ to determine the condition of a given pipe segment in the open field as well as in a refinery, chemical plant or power plant. For below-grade piping under streets and road crossings, we use only the Dual Pulse technique. The results of our two basic techniques provide an assessment of the overall integrity of the pipe in question and the location and classification of electromagnetic anomalies which, in most instances, are related to external corrosion.

### The Single-Pulse Technique

The Single-Pulse technique requires fixing the source location on one end of the pipe segment in question and adjusting the signal receiver generally at an equal incremental distance from the source across the length of pipe segment. From the characteristics of the electromagnetic waves as a result of wave propagation, attenuation, and dispersion, we determine whether electromagnetic anomalies exist, as in the case of the Dual-Pulse techniques.

As simple as these concepts may appear, the Company believes that the EMW process is not intuitively obvious. The petroleum industry has spent significant funds trying to solve the problem of finding corrosion under insulation. Correlating pipeline corrosion information using the Company's technology requires a combination of state-of-the-art instrumentation plus an understanding of the physical phenomena that are being measured. Although the principles of the EMW process are simple to explain, management believes that the EMW measurement and analysis are on the leading edge of inspection technology.

The Company believes that its technology has at least two significant competitive advantages. First, its technology can inspect certain pipelines that are inaccessible to other testing methods. Second, with respect to insulated, coated, encased or buried facilities that are accessible to other inspection technologies, because the Company's technology does not require the removal of such insulation, coatings or encasements or pipeline excavation as a prerequisite to testing, it has a much lower cost of site preparation and, therefore, a significant cost advantage over other technologies. Research and development efforts will continue in the development of new applications for the Company's technology and to develop new products for the petroleum industry and other industries.

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### The Dual-Pulse Technique

The Dual-Pulse process extracts corrosion related information from segments of both accessible and inaccessible pipelines underneath the entire insulation barrier by analyzing the intersection of two electrical current pulses traveling in opposite directions along the pipeline. This corrosion related information is extracted without the need for removing the insulation protecting the pipeline. Through laboratory and field testing the Company established that the electrical response, called characteristic transfer function ("CTF"), of two intersecting

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pulses traveling along the pipeline is uniquely defined with location specific information that relates to the integrity of the pipeline at the point of intersection. Constructive interference occurs when the two current impulses run into and interfere with each other at the point of intersection on a pipeline. The CTF is determined, not only by the nature and characteristics of the original pulses, but by the physical characteristics of the pipeline segment in its environment at the point of intersection.

The EMW process was developed to evaluate the condition and integrity of pipelines. Electro-magnetic pulses are applied at both ends of the pipe segment being tested. Under computer control, the timing of the pulses is controlled so that the intersection point of the two pulses moves sequentially from one end of the pipe to the other end. A unique CTF is obtained for each intersection point of the pipeline segment being tested on some predetermined interval, such as, in one foot intervals. When this data is geophysically displayed, it provides a visual display of data related to the physical condition of the pipe at each point of intersection. Information can also be derived using the EMW process to determine the condition of the coating and the effectiveness of the existing corrosion protection system that is being used to protect each point of intersection. Where there are indications of problems, closer interval inspection can be performed and/or one of the other location specific processes used in the industry may be utilized before the insulation is removed to inspect the pipe condition.

### Sales and Marketing

The Company's sales and marketing strategy has been to position the Company's EMW inspection process as the method of choice to detect pipeline corrosion where the pipelines are either inaccessible to other inspection tools or much more costly to inspect with tools other than the Company's EMW technology. Pipelines are commonly found in refinery and chemical plants (such as insulated, overhead pipes), natural gas distribution systems (such as pipes buried in city streets), and natural gas transmission systems (such as road, bridge and stream crossings and concrete-encased pipes).

As described above, the Company has fabricated new buried pipe inspection hardware and is actively seeking industry and other financing sources in order to rigorously and scientifically test that hardware. In order to obtain additional revenue generating contracts, the Company intends to emphasize the reliability of its buried pipeline testing method, the flexibility of the method's application, and its cost effectiveness as compared to other methods. The Company intends to concentrate its fiscal year 2006 marketing efforts on the pipeline and utility buried pipe inspection markets in the lower-48 states, particularly in "high consequence areas" as defined in the federal Department of Transportation's regulations ("HCAs"). However, there can be no assurance that the Company will be successful in concentrating its marketing efforts for the



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EMW technology on natural gas utility and pipeline markets.

### Revenues

The Company derives revenue solely from the sale of the EMW inspection technology service. The Company relies solely upon several employees, including the Chief Executive Officer and the Chief Operating Officer to conduct the Company's sales activities.

The Company did not have revenues during the twelve months ended June 30, 2005. During the twelve months ended June 30, 2004, all of the Company's revenues were attributable to two customers. These customers individually accounted for 9% and 91% of revenues for the twelve months ended June 30, 2004.

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### Patents, Intellectual Property and Licensing

The Company pursues a policy of generally obtaining patent protection both in the United States and abroad for patentable subject matter in its proprietary technology. As of June 30, 2005, the Company had ten issued U.S. patents, five issued foreign patents, one U.S. patent application pending, and three foreign patents pending.

The Company's success depends in large part upon its ability to protect its process and technology under United States and international patent laws and other intellectual property laws. U.S. patents have a term of 17 years from date of issuance or, for more recently filed patent applications, 20 years from the filing of such applications, and patents in most foreign countries have a term of 20 years from the proprietary filing date of the patent application. The first U.S. patent was issued in 1990; three patents were issued in 1993; one patent was issued in 1998; two patents were issued in 2000, and one patent was issued in 2002.

The Company believes that it owns and has the right to use or license all proprietary technology necessary to license and market its EMW process under development. The Company is not aware of the issuance of any patents or the filing of any patent applications which relate to processes or products which utilize the Company's proprietary technology in a manner which could be similar to or competitive with the Company's products or processes. The Company has no knowledge that it is infringing on any existing patent such that it would be prevented from marketing or licensing products or services currently being developed by the Company.

The Company may decide for business reasons to retain a patentable invention as a trade secret. In such event or if patent protection is not available, the Company must rely upon trade secrets, internal knowledge and continuing technological innovation to develop and maintain its competitive position. The Company's employees and consultants have access to the Company's proprietary information and have signed confidentiality agreements. However, even inadvertent disclosure of such a trade secret without a promise of confidentiality could destroy trade secret protection. There can be no assurance that inadvertent disclosures might not occur. If the Company's proprietary information is disclosed to competitors, it may have a material adverse effect on the Company's business.

### Competition

Although a number of inspection technologies have been developed to aid in

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ascertaining the condition of piping throughout the pipeline corrosion control industry, information needed to determine the integrity of these critical systems is often difficult and costly to acquire. The Company has numerous indirect competitors, but the Company believes that its inspection services have significant competitive advantages over other services provided by competitors.

The Company's EMW inspection service is designed to help pipeline operators quickly and less expensively screen buried, insulated, or hard to-access piping for external corrosion. Although its technology does not provide pipeline and plant operators with all the data they will require to manage and remediate corrosion, when used as a "front-end" screening tool in combination with one or more spot inspection tools, it can dramatically lower the cost of acquiring all of the data necessary to manage corrosion risks to their piping systems. There can be no assurances, however, that the Company's competitors will not develop newer, more efficient and less costly technologies.

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### Employees and Consultants

As of June 30, 2005, the Company had five employees, one of which was part-time. In an effort to reduce its "burn rate" to the lowest practicable level, the Company furloughed all of its field crews during the quarter ended March 31, 2004. If and when revenue-generating contracts are obtained, the Company may re-hire former crew personnel or may hire and train new crews.

### Customers

The Company did not have revenues during the twelve months ended June 30, 2005 as it was engaged solely in the redevelopment of its testing hardware and software. The testing of that hardware and software is nearing completion. The Company now seeks funding required to pursue pipeline and utility customers in the U.S. lower-48 states. However, there can be no assurance that funding sufficient for this purpose can be obtained. For the twelve months ended June 30, 2004, the Company had two customers in Alaska that accounted for 100 percent of the Company's revenues.

### Supplier Relationships

Although there are other sources for EMW inspection equipment, the Company intends for the foreseeable future to purchase same from a single supplier on the basis of superior quality and performance.

### Government Regulation

Natural gas and hazardous liquids pipelines are extensively regulated. The Department of Transportation's Office of Pipeline Safety, and state public utility commissions applying federal regulations, monitor operator compliance with corrosion monitoring and other pipeline safety-related regulatory requirements. The President signed the Pipeline Safety Improvement Act of 2002 into law in December of 2002. The legislation would require much more active corrosion monitoring than is currently required and could generate significant interest in the Company's technology, particularly by natural gas transmission and hazardous liquids pipeline operators. In addition, there may be opportunities to demonstrate the technology, in light of this legislation, to industry and government pipeline safety advisory groups. However, eventually the Company's inspection method must be certified for use by the federal Department of Transportation if it is to satisfy customers' required inspection

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obligations. Nevertheless, the Company expects that many companies will find the Company's new methods useful and beneficial even prior to federal certification and may, indeed, sponsor the Company in the certification process.

### Research and Development Expenditures

During the last year, the Company has re-developed and improved the hardware and software it uses to detect corrosion on direct-buried pipe. As a result of such re-development and improvement, the Company believes that its technology is now ready to obtain broad acceptance in the U.S pipeline and utility industry segments. However, additional funding and certifications must be acquired to gain significant market share in the Company's target markets.

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### Item 2. Description of Properties.

The Company's executive offices are located at 2 Park Avenue, Suite 201, Manhasset, NY 11030. The Company leases on a month-to-month basis approximately 500 square feet of office space from a non-affiliate. The rental payment is approximately \$788 per month.

The Company's research and development facility is located in Ferndale, Washington. The Company leases 1,800 square feet of space from a non-affiliate at a monthly cost of approximately \$2,026, pursuant to a lease that expires on January 31, 2006.

The Company does not own any real estate.

### Item 3. Legal Proceedings.

The Company is not aware of any legal proceedings contemplated by any governmental authority or any other party involving the Company or its properties. As of the date of this report, no director, officer or affiliate is a party adverse to the Company in any legal proceeding or has an adverse interest to the Company in any legal proceedings. The Company is not aware of any other legal proceedings pending or that have been threatened against the Company or its properties.

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

No matters were submitted to a vote of the Company's security holders during the fourth quarter of the fiscal year ended June 30, 2005.

## PART II

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

#### Market Information

The Company's common stock traded on the NASDAQ Small Cap market from the date it began to be publicly traded in February 1997 until August 10, 2001 under the symbol PRTK. On August 13, 2001, the Company's common stock was delisted from the NASDAQ Small Cap market and began trading on the NASD's Over the Counter Bulletin Board (the "OTCBB") under the same symbol. The Company's common

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stock continues to be traded on the OTCBB.

The following table sets forth the high and low bid prices for the Company's common stock for each quarter within the past two fiscal years as reported by OTCBB. The quotations reflect inter-dealer prices, with retail mark-up, mark-down or commissions, and may not represent actual transactions.

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|                  | Range of<br>Sale Prices |        |
|------------------|-------------------------|--------|
|                  | High                    | Low    |
| Fiscal Year 2005 |                         |        |
| First Quarter    | \$0.90                  | \$0.35 |
| Second Quarter   | \$1.55                  | \$0.35 |
| Third Quarter    | \$1.15                  | \$0.60 |
| Fourth Quarter   | \$0.90                  | \$0.55 |
| Fiscal Year 2004 |                         |        |
| First Quarter    | \$0.51                  | \$0.17 |
| Second Quarter   | \$0.50                  | \$0.23 |
| Third Quarter    | \$1.00                  | \$0.27 |
| Fourth Quarter   | \$0.90                  | \$0.50 |

As of September 15, 2005, the Company had approximately 1,000 holders of record of the Company's common stock.

### Dividends

The payment of dividends by the Company is within the discretion of its Board of Directors and depends in part upon the Company's earnings, capital requirements, debt covenants and financial condition. Since its inception, the Company has not paid any dividends on its common stock and does not anticipate paying such dividends in the foreseeable future. The Company intends to retain earnings, if any, to finance its operations.

### Securities Authorized for Issuance Under Equity Compensation Plans

The following table sets forth certain information regarding the common stock that may be issued upon the exercise of options, warrants and other rights that have been or may be granted to employees, directors or consultants under all of the Company's existing equity compensation plans, as of June 30, 2005.

| Number of<br>securities to be<br>issued upon | Weighted-average<br>exercise price | Number of<br>securities<br>remaining<br>available for<br>future issuance<br>under equity<br>compensation |
|--|------------------------------------|--|

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|   | exercise of<br>outstanding<br>options, warrants<br>and rights | of outstanding<br>options,<br>warrants and<br>rights | plans (excluding<br>securities<br>reflected in<br>column (a)) |
|---|---|--|---|
|   | (a)   | (b)  | (c)   |
| Equity compensation plans approved by security holders (1)    | 2,275,000   | \$1.14   | 225,000   |
| Equity compensation plans not approved by security holders(2) | 1,182,500(3)  | \$2.41   | N/A   |
| Total   | 3,457,500   | \$1.57   | 225,000   |

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- (1) Consists of grants under the Company's 1999 Stock Plan. On February 9, 2005, the Board of Directors approved an increase in the number of shares of common stock that may be issued under the Plan from 500,000 to 2.5 million shares.
- (2) Consists of grants under individual compensation arrangements approved separately by the Board of Directors and are not part of any written or formal plan under which the Company will be obligated to issue equity compensation in the future.
- (3) Consists of the following compensatory warrants: (A) 15,000 warrants at \$0.55 per share, expiring on December 9, 2007, (B) 40,000 warrants at \$0.70 per share, expiring on December 16, 2008, (C) 12,500 warrants at \$0.75 per share, of which 8,000 expire on June 1, 2010 and 4,500 expire on June 17, 2010, (D) 50,000 warrants at \$1.00 per share, expiring on January 2, 2007, (E) 150,000 warrants at \$1.05 per share, expiring on March 18, 2007, (F) 305,000 warrants at \$1.125 per share, expiring on October 31, 2007, (G) 40,000 warrants at \$1.50 per share, expiring on October 31, 2007, (H) 235,000 warrants at \$3.00 per share, expiring on October 31, 2007, (I) 285,000 warrants at \$3.50 per share, expiring on October 31, 2007, (J) 30,000 warrants at \$7.20 per share, expiring on October 31, 2007, and (K) 20,000 warrants at \$13.50 per share, expiring on October 31, 2007.

Recent Sales of Unregistered Securities

On June 19, 2003, the Board of Directors approved the offering (the "2003 Offering") of \$1,000,000 in convertible debentures (the "Debentures"). The Debentures are convertible into that number of shares of the Company's common stock equal to the amount of the converted indebtedness divided by \$0.50 per share. The Debentures bear interest at a rate of 5% per annum, payable quarterly. Delinquent interest payments bear interest at a rate of 12% per annum. The Company is required to redeem each Debenture on the 5th anniversary of the date of the Debenture. The Company may, in its discretion, redeem any Debenture at any time prior to the mandatory redemption date of the Debenture by

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providing no less than 60 days' prior written notice to the holder of the Debenture. Certain events of default will result in the Debentures being redeemable by the Company upon demand of the holder.

Upon the purchase of, and for each \$0.50 of the Debenture's principal amount, the Company issued to each investor a warrant (the "Warrant") to purchase one (1) share of the Company's common stock at an exercise price of \$0.75 per share. The Warrants are exercisable at any time prior to the 5th anniversary date of the redemption of the Debenture. The 2003 Offering is exempt from registration under Section 4(2) of the Securities Act.

During the twelve months ended June 30, 2005, five investors exercised their conversion right in accordance with the terms of the 2003 Offering. As a result, 201,044 restricted shares of common stock were issued.

On January 19, 2005, the Board of Directors approved the offering (the "2005 Offering") of 2,000,000 units (the "Units") consisting of shares of common stock and attached warrants. The purchase price of one Unit is \$0.50. Each Unit consists of one share of common stock and a warrant to purchase one share of common stock at an exercise price of \$0.75. The warrants are exercisable at any time prior to the fifth anniversary from the date of grant. The 2005 Offering is exempt from registration under Section 4(2) of the Securities Act.

As of June 30, 2005, the Company had raised \$62,500 and issued 125,000 restricted shares of common stock and warrants to purchase up to 125,000 shares of restricted stock in accordance with the terms of the 2005 Offering.

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On February 9, 2005, the Board approved the issuance of options exercisable for 1,850,000 shares of common stock pursuant to the 1999 Stock Option Plan to certain directors, officers, an employee and two consultants of the Company. The Company granted the options on February 16, 2005. Directors, officers, and an employee were granted options exercisable for 1,600,000 shares of common stock and have a ten-year term. Options exercisable for the remaining 250,000 shares of common stock were granted to two of the Company's consultants and have a five-year term. The exercise price of the options are \$1.16, ten percent over the closing bid price of the Company's common stock as quoted on the Over the Counter Bulletin Board on the grant date, February 16, 2005. These securities were issued in reliance on exemptions from registration provided by Section 4(2) of the Securities Act.

During the twelve months ended June 30, 2005, the Company issued of 150,000 restricted shares of common stock to two consultants of the Company as compensation for rendering services related to fund raising strategies and business and financial planning. These shares are exempt from registration under Section 4(2) of the Securities Act.

### Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations.

#### Overview

The Company is currently focused on the buried pipe market in the United States. Accordingly, failure to complete, finance and deploy its new buried pipe hardware could have a material adverse effect on the business and financial condition of the Company.

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### Revenue

The Company derives revenue solely from the sale of the EMW inspection technology service. The Company relies solely upon several employees, including the Chief Executive Officer and the Chief Operating Officer to conduct the Company's sales activities.

The Company did not have revenues during the twelve months ended June 30, 2005. During the twelve months ended June 30, 2004, all of the Company's revenues were attributable to two customers. These customers individually accounted for 9% and 91% of revenues for the twelve months ended June 30, 2004.

### Sales and Marketing

The Company's sales and marketing strategy has been to position the Company's EMW inspection process as the method of choice to detect pipeline corrosion where the pipelines are either inaccessible to other inspection tools or much more costly to inspect with tools other than the Company's EMW technology. Pipelines are commonly found in refinery and chemical plants (such as insulated, overhead pipes), natural gas distribution systems (such as pipes buried in city streets), and natural gas transmission systems (such as road, bridge and stream crossings and concrete-encased pipes).

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As described above, the Company has fabricated new buried pipe inspection hardware and is actively seeking industry and other financing sources in order to rigorously and scientifically test that hardware. In order to obtain additional revenue generating contracts, the Company intends to emphasize the reliability of its buried pipeline testing method, the flexibility of the method's application, and its cost effectiveness as compared to other methods. The Company intends to concentrate its fiscal year 2006 marketing efforts on the pipeline and utility buried pipe inspection markets in the lower-48 states, particularly in "high consequence areas" as defined in the federal Department of Transportation's regulations ("HCAs"). However, there can be no assurance that the Company will be successful in concentrating its marketing efforts for the EMW technology on natural gas utility and pipeline markets.

### Critical Accounting Estimates and Policies

The discussion and analysis of financial condition and results of operations is based upon the Company's financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates, including contract revenue recognition and impairment of long-lived assets. The Company bases its estimates on historical experience and on various other assumptions that the Company believes to be reasonable under the circumstances, the results of which form its basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates under different assumptions and conditions, and such variations may be adverse.

The Company recognizes revenue from service contracts using the percentage-of-completion method of contract accounting. Contract revenues earned are measured using either the percentage-of-contract costs incurred to date to

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total estimated contract costs or, when the contract is based on measurable units of completion, revenue is based on the completion of such units. Anticipated losses on contracts, if any, are charged to earnings as soon as such losses can be estimated. Changes in estimated profits on contracts are recognized during the period in which the change in estimate is known. The Company records claims for additional compensation on contracts upon revision of the contract to include the amount to be received for the additional work performed. Contract costs include all direct material and labor costs and those indirect costs related to contract performance, such as indirect labor, supplies, tools and repairs, and depreciation costs. Selling, general, and administrative costs are charged to expense as incurred. Service contracts generally extend no more than six months.

The Company reviews long-lived assets and certain identifiable intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount which the carrying amount of the asset exceeds the fair value of the asset.

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The Company estimates the value of warrants and option grants using a Black-Scholes pricing model based on management assumptions regarding the expected volatility and risk free interest rates.

### Results of Operations

The Company's operating results depend exclusively on its ability to market its EMW inspection technology services. If the Company is not able to automate completely the EMW inspection process and fully implement its new technology, the Company may not be able to obtain future contracts to sell or license its EMW technology. Since the Company's revenues are derived solely from sales of its EMW technology, any failure to obtain future contracts will have a material adverse effect on the business and financial condition of the Company.

Revenues for the twelve months ended June 30, 2005 were \$0, as compared to \$222,579 for the twelve months ended June 30, 2004. The Company did not generate any revenues during the twelve months ended June 30, 2005 as the Company was engaged solely in the redevelopment and improvement of its testing hardware and software. During calendar year 2003, the Company's Alaska customers completed a five-year program of inspecting road-crossings and caribou crossings. Upon completion of this initial program, the inspections were not budgeted for. Revenues generated during the twelve months ended June 30, 2004 were derived from the work performed on the North Slope of Alaska under the initial program.

Cost of revenues for the twelve months ended June 30, 2005 were \$0, as compared to \$181,611 for the twelve months ended June 30, 2004. During the twelve months ended June 30, 2005 the Company did not have any employees working in the field because the Company did not have any revenue generating contracts during this period. Cost of revenues for the twelve months ended June 30, 2004 consists of depreciation and equipment rental expense related to field equipment and salaries related to the employees working in the field prior to the termination of the Alaska contracts.

The Company did not have a gross profit or loss for the twelve months ended June 30, 2005. The Company had a gross profit of \$40,968 for the twelve months



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ended June 30, 2004. The decrease in gross profit is due to the completion of the inspection program on the North Slope of Alaska during calendar year 2003.

Research and development expenses for the twelve months ended June 30, 2005 were \$261,617 as compared to \$200,406 for the twelve months ended June 30, 2004. The increase of \$61,211 for the twelve months ended June 30, 2005 as compared to the twelve months ended June 30, 2004 is substantially the result of recording \$174,000 for the fair value of the 200,000 options granted to a consultant during the quarter ended March 31, 2005, offset by a significant decrease in salary and other payroll related expenditures. The Company furloughed several key employees during the quarter ended March 31, 2004 who were previously spending time on research and development activities and revenue generating contracts. Payroll expenses related to these employees were previously classified as research and development expenses and cost of revenues.

General and administrative expenses for the twelve months ended June 30, 2005 were \$705,542 as compared to \$867,828 for the twelve months ended June 30, 2004. The decrease of \$162,286 for the twelve months ended June 30, 2005 as compared to the twelve months ended June 30, 2004 is the result of a general reduction of operating expenditures as the Company focuses on reducing its

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overall burn rate. Compensation and benefits expense decreased significantly for the twelve months ended June 30, 2005 as compared to the twelve months ended June 30, 2004 as a result of the Company furloughing certain employees during the quarter ended March 31, 2004. Additionally, amortization decreased by approximately \$61,000 for the twelve months ended June 30, 2005 as compared to the twelve months ended June 30, 2004 as a result of patents being fully amortized during the quarter ended June 30, 2004.

Loss from operations for the twelve months ended June 30, 2005 was \$967,159 as compared to \$1,027,266 for the twelve months ended June 30, 2004. The decrease of \$60,107, or 6%, is primarily due to overall reductions in compensation and benefit related expenses, depreciation and amortization and other operating expenses as discussed above.

Interest expense for the twelve months ended June 30, 2005 was \$179,857 as compared to \$139,081 for the twelve months ended June 30, 2004. The increase in interest expense of \$40,776 is in part the result of five investors who exercised their conversion right under the terms of the 2003 Offering during the twelve months ended June 30, 2005. The 2003 Offering includes a beneficial conversion feature. As such, the Company recorded interest expense of approximately \$101,500 during the twelve months ended June 30, 2005 to expense the unamortized debt discount remaining at the date of conversion. This increase is offset by a decrease from the twelve months ended June 30, 2004 in which the Company recorded a charge to interest expense of approximately \$82,000 to expense the unamortized convertible debt discount on the convertible debentures that were in default with respect to principal and interest at June 30, 2004. As a result of a larger aggregate principal balance outstanding on the Convertible Debentures during the twelve months ended June 30, 2005 as compared to the twelve months ended June 30, 2004, the Company recorded approximately \$14,200 more in interest expense related to the Convertible Debentures during the twelve months ended June 30, 2005 than during the same period in 2004. The Company also recorded approximately \$7,900 more interest expense on the notes payable to stockholders during the twelve months ended June 30, 2005 than during the same period in 2004 as a result of an increase in the outstanding principal balance. Also, contributing to the increase in interest expense for the twelve months ended June 30, 2005 as compared to the twelve months ended June 30, 2004 is

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amortization of deferred financing fees of \$5,200 related to the 2003 Offering.

### Recently Issued Accounting Standards

SFAS No. 151, *Inventory Costs*, is effective for fiscal years beginning after June 15, 2005. This statement amends the guidance in Accounting Research Bulletin No. 43, Chapter 4, *Inventory Pricing*, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). The adoption of SFAS No. 151 is expected to have no impact on the Company's financial statements.

SFAS No. 152, *Accounting for Real Estate Time-Sharing Transactions*, is effective for fiscal years beginning after June 15, 2005. This statement amends SFAS No. 66, *Accounting for Sales of Real Estate*, to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in American Institute of Certified Public Accountants Statement of Position 04-2, *Accounting for Real Estate Time-Sharing Transactions*. The adoption of SFAS No. 152 is expected to have no impact on the Company's financial statements.

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SFAS No. 123(R), *Share-Based Payment*, replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. This statement requires that the compensation cost relating to share-based payment transactions be recognized at fair value in the financial statements. The Company is required to apply this statement in the first interim period that begins after December 15, 2005. The Company is currently analyzing the requirements of the adoption of SFAS No. 123(R).

SFAS No. 153, *Exchanges of Nonmonetary Assets - an amendment of APB Opinion No. 29*, is effective for fiscal years beginning after June 15, 2005. This statement addresses the measurement of exchange of nonmonetary assets and eliminates the exception from fair-value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, and replaces it with an exception for exchanges that do not have commercial substance. The adoption of SFAS No. 153 is not expected to have a significant impact on the Company's financial statements.

Financial Accounting Standards Board Interpretation ("FIN") No. 46(R) revised FIN No. 46, *Consolidation of Variable Interest Entities*, requiring the consolidation by a business of variable interest entities in which it is the primary beneficiary. The adoption of FIN No. 46(R) did not have any impact on the Company's financial statements.

The Emerging Issues Task Force ("EITF") reached consensus on Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, which provides guidance on determining when an investment is considered impaired, whether that impairment is other than temporary and the measurement of an impairment loss. The FASB issued FSP EITF 03-1-1, *Effective Date of Paragraphs 10-20 of EITF Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, which delays the effective date for the measurement and recognition criteria contained in EITF 03-1 until final application guidance is issued. The adoption of this consensus or FSP is expected to have no impact on the Company's financial statements.

The EITF reached a consensus on Issue No. 04-8, *The Effect of Contingently*

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Convertible Debt on Diluted Earnings Per Share, which addresses when the dilutive effect of contingently convertible debt instruments should be included in diluted earnings (loss) per share. EITF 04-8 became effective for reporting periods ending after December 15, 2004. The adoption of EITF 04-8 did not have an impact on diluted earnings (loss) per share of the Company.

### Liquidity and Capital Resources

The accompanying financial statements have been prepared assuming the Company will continue as a going concern. The Company incurred cumulative losses of \$11,605,139 through June 30, 2005, and had negative working capital of \$2,349,380 as of June 30, 2005. Additionally, the Company has expended a significant amount of cash in developing its technology and patented processes. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management recognizes that in order to meet the Company's capital requirements, and continue to operate, additional financing, including seeking industry-partner investment through joint ventures or other possible arrangements, will be necessary. The Company is evaluating alternative sources of financing to improve its cash position and is undertaking efforts to raise capital. If the Company is unable to raise additional capital or secure additional revenue contracts and generate positive cash flow, it is unlikely

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that the Company will be able to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

### Deferred Wages and Accrued Professional Fees

To reduce cash outflows, certain of the Company's employees, officers and directors have agreed to defer a portion of their salaries and consulting fees until the Company has sufficient resources to pay the amounts owed or to exchange such deferred amounts into options as described below. At June 30, 2005, the Company has accrued \$807,276 related to the deferred payment of salaries and consulting fees of which \$639,126 is included under deferred wages and \$168,150 in accrued professional fees. On March 18, 2002, the Board approved a conversion right on all deferred wages and accrued professional fees deferred as of March 18, 2002. Pursuant to this conversion right, employees, officers, consultants, and directors may elect to convert \$1.00 of fees owed to them as of March 18, 2002 for an option to purchase two shares of the Company's common stock, at an exercise price of \$1.00 per share for a term of five years. Deferred salaries and fees as of March 18, 2002 were \$111,500, resulting in the potential issuance of 223,000 options under the terms mentioned above. No conversions have occurred to date. As there was no intrinsic value associated with these exchange rights, no additional compensation cost has been recorded.

### Long-term Convertible Debt

On June 19, 2003, the Board of Directors approved the offering (the "2003 Offering") of \$1,000,000 in convertible debentures (the "Debentures"). The Debentures are convertible into that number of shares of the Company's common stock equal to the amount of the converted indebtedness divided by \$0.50 per share. The Debentures bear interest at a rate of 5% per annum, payable quarterly. Delinquent interest payments bear interest at a rate of 12% per annum. The Company is required to redeem each Debenture on the 5th anniversary of the date of the Debenture. The Company may, in its discretion, redeem any Debenture at any time prior to the mandatory redemption date of the Debenture by providing no less than 60 days' prior written notice to the holder of the

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Debenture. Certain events of default will result in the Debentures being redeemable by the Company upon demand of the holder.

Upon the purchase of, and for each \$0.50 of the Debenture's principal amount, the Company issued to each investor a warrant (the "Warrant") to purchase one (1) share of the Company's common stock at an exercise price of \$0.75 per share. The Warrants are exercisable at any time prior to the 5th anniversary date of the redemption of the Debenture.

Warrants issued in connection with the 2003 Offering were recorded based on their relative fair value as compared to the fair value of the debt at issuance. The relative fair value of the warrants were recorded as paid-in capital, estimated at \$101,978 and \$185,868 for the years ended June 30, 2005 and 2004, respectively. The fair value of the warrants issued during the year ended June 30, 2005 were determined based on an option pricing model with the following assumptions: warrant lives of 10 years, risk free interest rates ranging from 4.14% to 4.30%, volatility of 120% and a zero dividend yield. The fair value of the warrants issued during the year ended June 30, 2004 were determined based on an option pricing model with the following assumptions: warrant lives of 10 years, risk free interest rates ranging from 3.74% to 4.72%, volatility of 120%, and a zero dividend yield. The intrinsic value of the Debentures results in a beneficial conversion feature that reduces the book value of the convertible debt to not less than zero. Accordingly, the Company recorded a discount of \$158,000 and \$293,023 during the years ended June 30, 2005 and 2004, respectively on the convertible debt issued under the 2003 Offering. The Company amortizes the discount using the effective interest method over the five-year life of the Debentures.

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During the quarter ended March 31, 2005, the Board of Directors terminated the 2003 Offering. As of the closing date of the 2003 Offering, the Company had raised \$503,000 from the 2003 Offering.

As of June 30, 2004, the Company was in default on the accrued interest on \$137,500 of the total face value of the Debentures. Due to the default status as of June 30, 2004 and the uncertainty regarding the Company's ability to remain in compliance with the terms of the Debentures, and thereby preventing a future default, the \$137,500 debt in default was classified as a current liability. Additionally, unamortized debt discount of \$81,559 and debt issuance costs of \$5,200 were written off and were included in interest expense and general and administrative expenses, respectively in the statement of operations for the twelve months ended June 30, 2004.

During the twelve months ended June 30, 2005, five investors exercised their conversion right under the terms of the Debentures. Accordingly, the carrying value of the convertible debt was reclassified as equity upon conversion. Since the convertible debt instruments include a beneficial conversion feature, the remaining unamortized discount of approximately \$100,000 at the conversion date was recognized as interest expense.

As of June 30, 2005, accrued interest on the Debentures was \$5,024. The Company recorded interest expense related to the accretion of the discount on the Debentures and amortization of the convertible debt discount of \$100,583 and \$85,523 for the twelve months ended June 30, 2005 and June 30, 2004, respectively. As of June 30, 2005 the carrying value of the long-term debt debenture was \$61, net of unamortized debt discount of \$265,439.

Common Stock

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On January 19, 2005, the Board of Directors approved the offering (the "2005 Offering") of 2,000,000 units (the "Units") consisting of shares of common stock and attached warrants. The purchase price of one Unit is \$0.50. Each Unit consists of one share of common stock and a warrant to purchase one share of common stock at an exercise price of \$0.75. The warrants are exercisable at any time prior to the fifth anniversary from the date of grant.

As of June 30, 2005, the Company had raised \$62,500 and issued 125,000 restricted shares of common stock and warrants to purchase up to 125,000 shares of restricted stock in accordance with the terms of the 2005 Offering.

The Company engaged a law firm to help in the fund raising efforts of the 2005 Offering. Pursuant to the terms of the agreement with the law firm, the Company will pay the law firm a ten percent cash commission on all funds that the law firm helps raise. Additionally, the Company will issue warrants to purchase restricted shares of common stock at \$0.75 per share equal to ten percent of the total warrants issued in connection with the 2005 Offering. The warrants may be exercised up to five years from the date of issuance, which is the date the proceeds are received under the 2005 Offering. As of June 30, 2005, the Company has incurred \$6,250 of fees to be paid in cash to the law firm and issued warrants to purchase 12,500 restricted shares of common stock. The Company recorded approximately \$7,000 as a reduction to paid-in capital for the fair value of the warrant grants. The fair value of the warrant grants were estimated using the Black-Scholes option pricing model with the following weighted average assumptions: expected volatility of ranging from 133% to 183%, risk-free interest rates ranging from 3.63% to 3.88%, expected lives of five years, and a 0% dividend yield.

### Other Commitments

The Company's other contractual obligations consist of commitments under deferred wages and accrued professional fees, payments under an operating lease, and repayment of loans payable to certain officers, directors and stockholders. As of June 30, 2005, deferred wages and accrued professional fees were \$807,276. The salaries and professional fees will continue to be deferred until the Company has sufficient resources to pay the amounts owed, or the employees, officers, or directors exchange such amounts as described above.

As of June 30, 2005, the Company had outstanding loans payable to certain officers, directors and stockholders with principal amounts, in the aggregate, equal to \$1,128,990. The terms of the various notes are described below under "Note 3: Related Parties: Notes Payable - Stockholders."

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As of June 30, 2005, the Company has future minimum lease payments of approximately \$14,000 under its operating lease.

Capital will be expended to support operations until the Company can generate sufficient cash flows from operations. In order for the Company to generate cash flows from operations, the Company must secure revenue generating contracts. Management is currently directing the Company's activities towards obtaining service contracts, which, if obtained, will necessitate the Company attracting, hiring, training and outfitting qualified technicians. If service contracts are obtained, additional field test equipment purchases will be necessary to provide the services. The Company intends to purchase such equipment for its field crews in the foreseeable future, at such time as the scope of operations require alternate sources of financing equipment. The Company expects that if additional contracts are secured, and revenues increase,

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working capital requirements will increase. There can be no assurance that the Company's process will gain widespread commercial acceptance within any particular time frame, or at all. The Company will incur additional expenses as it hires and trains field crews and support personnel related to the successful receipt of commercial contracts. Additionally, the Company anticipates that cash will be used to meet capital expenditure requirements necessary to develop infrastructure to support future growth. There can be no assurance that the Company will be able to secure additional revenue generating contracts to provide sufficient cash.

Pending the deployment of the Company's new hardware and software (as discussed in the "Introduction" section) and the receipt of new contracts, and in an effort to reduce its out-of-pocket expenses to the lowest practicable level, the Company has furloughed all of its field crews. If and when revenue-generating contracts are obtained, the Company will re-hire former crew personnel or may hire and train new crews. The Company was not obligated to make any severance payments for salaries, health benefits or accrued vacation and sick time related to the termination of any of its employees.

### Off-Balance Sheet Arrangements

The Company has no off-balance sheet arrangements that have had or are reasonably likely to have a material current or future effect on the Company's financial condition or financial statements.

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## Item 7. Financial Statements

Profile Technologies, Inc.

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Report of Independent Registered Public Accounting Firm

The Board of Directors  
Profile Technologies, Inc.:

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We have audited the accompanying balance sheet of Profile Technologies, Inc. as of June 30, 2005, and the related statements of operations, stockholders' deficit, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company has determined that it is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit 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 financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Profile Technologies, Inc. as of June 30, 2005, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States.

The accompanying financial statements have been prepared assuming the Company will continue as a going concern. As discussed in Note 8 to the financial statements, the Company has incurred cumulative losses and had negative working capital of \$2,349,380 at June 30, 2005. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plan regarding those matters is also described in Note 8. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Peterson Sullivan

Seattle, Washington  
September 9, 2005

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Report of Independent Registered Public Accounting Firm

The Board of Directors  
Profile Technologies, Inc.:

We have audited the accompanying statements of operations, stockholders' deficit, and cash flows of Profile Technologies, Inc. for the year ended June 30, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial

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statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the results of operations and the cash flows of Profile Technologies, Inc. for the year ended June 30, 2004, in conformity with U.S. generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in note 8 to the financial statements, the Company has incurred net losses since inception and has a working capital deficit at June 30, 2004 that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in note 8. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ KPMG LLP

Seattle, Washington  
October 11, 2004

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PROFILE TECHNOLOGIES, INC.  
Balance Sheet  
June 30, 2005

Assets

|   |    |        |
|---|----|--------|
| Current assets:   |    |        |
| Cash  | \$ | 27,045 |
| Prepaid expenses and other current assets               |    | 17,651 |
|   |    | -----  |
| Total current assets                                    |    | 44,696 |
| Equipment, net of accumulated depreciation of \$538,931 |    | 7,635  |
| Deferred financing fees                                 |    | 11,360 |
| Other assets  |    | 2,415  |
|   |    | -----  |
| Total assets  | \$ | 66,106 |
|   |    | =====  |

Liabilities and Stockholders' Deficit

Current Liabilities:



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|  |    |              |
|--|----|--------------|
| Accounts payable   | \$ | 196,364      |
| Notes payable to stockholders  |    | 1,128,990    |
| Current portion of convertible debt                                  |    | 137,500      |
| Deferred wages   |    | 639,126      |
| Accrued professional fees  |    | 168,150      |
| Accrued interest   |    | 103,352      |
| Other accrued expenses   |    | 20,594       |
|  |    | -----        |
| Total current liabilities  |    | 2,394,076    |
| Long-term convertible debt, net of unamortized discount of \$265,439 |    | 61           |
| Stockholders' deficit:   |    |              |
| Common stock, \$0.001 par value.                                     |    |              |
| Authorized 25,000,000 shares;  |    |              |
| issued and outstanding 5,925,705 shares                              |    | 5,926        |
| Common stock issuable; 45,000 shares                                 |    | 45           |
| Additional paid-in capital   |    | 9,271,137    |
| Accumulated deficit  |    | (11,605,139) |
|  |    | -----        |
| Total stockholders' deficit  |    | (2,328,031)  |
| Commitments, contingencies and subsequent events                     |    |              |
|  |    | -----        |
| Total liabilities and stockholders' deficit                          | \$ | 66,106       |
|  |    | =====        |

See accompanying notes to financial statements.

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PROFILE TECHNOLOGIES, INC.  
Statements of Operations  
For the years ended June 30, 2005 and 2004

|                            | 2005    | 2004       |
|----------------------------|---------|------------|
|                            | -----   | -----      |
| Revenue                    | \$ --   | \$ 222,579 |
| Cost of revenues           | --      | 181,611    |
|                            | -----   | -----      |
| Gross profit               | --      | 40,968     |
|                            | -----   | -----      |
| Operating expenses:        |         |            |
| Research and development   | 261,617 | 200,406    |
| General and administrative | 705,542 | 867,828    |
|                            | -----   | -----      |
| Total operating expenses   | 967,159 | 1,068,234  |
|                            | -----   | -----      |

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|  |                |                |
|--|----------------|----------------|
| Loss from operations   | (967,159)      | (1,027,266)    |
| Interest expense   | 179,857        | 139,081        |
| Other income   | --             | 1,762          |
|  | -----          | -----          |
| Net loss   | \$ (1,147,016) | \$ (1,164,585) |
|  | =====          | =====          |
| Basic and diluted net loss per share   | \$ (0.20)      | \$ (0.21)      |
| Weighted average shares outstanding<br>used to calculate basic and<br>diluted net loss per share | 5,744,371      | 5,472,710      |

See accompanying notes to financial statements.

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PROFILE TECHNOLOGIES, INC.  
Statements of Stockholders' Deficit  
For the years ended June 30, 2005 and 2004

|   | Common stock                     |                    |          | Additional<br>paid-in<br>capital |
|---|----------------------------------|--------------------|----------|----------------------------------|
|   | Shares issued<br>and outstanding | Shares<br>Issuable | Amount   |                                  |
|   | -----                            | -----              | -----    | -----                            |
| Balance at June 30, 2003  | 5,461,661                        | --                 | \$ 5,462 | \$ 8,349,7                       |
| Issuance of common stock for services                                     | 33,000                           | --                 | 33       | 9,0                              |
| Issuance of common stock warrants and<br>options for services             | --                               | --                 | --       | 17,6                             |
| Issuance of common stock warrants related<br>to the convertible debt      | --                               | --                 | --       | 185,8                            |
| Recording beneficial conversion feature<br>on convertible debt            | --                               | --                 | --       | 107,1                            |
| Net loss  | --                               | --                 | --       | --                               |
|   | -----                            | -----              | -----    | -----                            |
| Balance at June 30, 2004  | 5,494,661                        | --                 | 5,495    | \$ 8,669,3                       |
| Issuance of common stock for services                                     | 150,000                          | --                 | 150      | 69,8                             |
| Issuance of common stock warrants and<br>options for services             | --                               | --                 | --       | 224,5                            |
| Issuance of common stock warrants<br>related to<br>the convertible debt   | --                               | --                 | --       | 101,9                            |
| Recording beneficial conversion feature<br>on convertible debt            | --                               | --                 | --       | 56,0                             |
| Issuance of common stock upon conversion<br>of convertible debt to equity | 201,044                          | --                 | 201      | 100,3                            |
| Issuance of common stock warrants related<br>to the 2005 Offering         | --                               | --                 | --       | 33,0                             |
| Issuance of common stock related to the                                   |                                  |                    |          |                                  |

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|   |           |        |          |            |
|---|-----------|--------|----------|------------|
| 2005 Offering   | 80,000    | --     | 80       | 18,4       |
| Common stock issuance costs                           | --        | --     | --       | (13,2      |
| Common stock issuable related to<br>the 2005 Offering | --        | 45,000 | 45       | 10,8       |
| Net loss  | --        | --     | --       | --         |
|   | -----     | -----  | -----    | -----      |
| Balance at June 30, 2005                              | 5,925,705 | 45,000 | \$ 5,971 | \$ 9,271,1 |
|   | =====     | =====  | =====    | =====      |

See accompanying notes to financial statements.

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PROFILE TECHNOLOGIES, INC.  
Statements of Cash Flows  
For the years ended June 30, 2005 and 2004

Cash flows from operating activities:

Net loss

Adjustments to reconcile net loss to net cash used in operating activities:

Depreciation and amortization

Impairment loss of assets

Accreted discount on convertible debt

Amortization of convertible debt discount included in interest expense

Accrued interest on convertible debt converted to equity

Amortization of debt issuance costs

Equity issued for services

Changes in operating assets and liabilities:

Contract work-in progress

Prepaid expenses and other current assets

Accounts payable

Deferred wages

Accrued professional fees

Accrued interest

Other accrued expenses

Net cash used in operating activities

Cash flows from investing activities:

Purchases of equipment

Net cash used in investing activities

Cash flows from financing activities:

Allocated proceeds from issuance of convertible debt

Allocated proceeds from issuance of warrants attached to convertible debt

Convertible debt issuance costs

Common stock issuance costs

Allocated proceeds from issuance of common stock

Allocated proceeds from issuance of warrants attached to issuance of common stock

Proceeds from issuance of notes payable to stockholders

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Repayments of notes payable to stockholders

Net cash provided by financing activities

Increase (decrease) in cash

Cash at beginning of period

Cash at end of period

Supplemental disclosure of cash flow information:

Debt discount recorded for beneficial conversion feature

Cash paid for interest

Convertible debt converted into 201,044 shares of common stock

during the twelve months ended June 30, 2005

(no shares issued during the twelve months ended June 30, 2004)

See accompanying notes to financial statements.

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### Note 1: Description of Business

Profile Technologies, Inc. (the "Company"), was incorporated in 1986 and commenced operations in fiscal year 1988. The Company is in the business of inspecting pipelines for corrosion and is in the final stages of researching and developing a patented, non-destructive and non-invasive, high speed scanning process, using electro magnetic waves to remotely inspect buried, encased and insulated pipelines for corrosion.

### Note 2: Summary of Significant Accounting Policies

#### Contract Revenue Recognition

The Company recognizes revenue from service contracts using the percentage of completion method of accounting. Contract revenues earned are measured using either the percentage of contract costs incurred to date to total estimated contract costs or, when the contract is based on measurable units of completion, revenue is based on the completion of such units. This method is used because management considers total cost or measurable units of completion to be the best available measure of progress on contracts. Because of the inherent uncertainties in estimating costs, it is at least reasonably possible that the estimates used may change in the near term.

Anticipated losses on contracts, if any, are charged to earnings as soon as such losses can be estimated. Changes in estimated profits on contracts are recognized during the period in which the change in estimate is known.

Cost of revenues include contract costs incurred to date as well as any idle time incurred by personnel scheduled to work on customer contracts.

The Company records claims for additional compensation on contracts upon revision of the contract to include the amount to be received for the additional work performed. Contract costs include all direct material and labor costs and

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those indirect costs related to contract performance, such as indirect labor, supplies, tools and repairs, and depreciation costs. Selling, general, and administrative costs are charged to expense as incurred. Service contracts generally extend no more than six months.

### Research and Development

Research and development costs are expensed when incurred. During the twelve months ended June 30, 2005 and June 30, 2004, the Company incurred \$261,617 and \$200,406, respectively on research and development activities.

### Equipment

Equipment is stated at cost and is depreciated using the straight-line method over estimated useful lives of three to seven years.

### Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of

The Company reviews long-lived assets, such as equipment and purchased intangibles subject to amortization, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset.

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The Company did not generate any revenues during the last two quarters of the fiscal year ended June 30, 2004 and has not secured any future revenue generating contracts. Absent future cash flows give rise to the uncertainty of the recoverability of the Company's fixed assets and patents.

During the quarter ended June 30, 2004, the Company recorded an impairment charge of approximately \$64,000 for the write down of its patents and equipment based on management's assessment of fair value. Fair value was determined based on management's analysis of discounted future cash flows and approximate current market value of the assets. The impairment charge is reported in the line item titled, "General and administrative", in the Company's Statements of Operations.

### Valuation of Warrants and Options

The Company estimates the value of warrants and option grants using a Black-Scholes pricing model based on management assumptions regarding the warrant and option lives, expected volatility, and risk free interest rates.

### Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the

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enactment date. A valuation allowance is recorded for deferred tax assets when it is more likely than not that such deferred tax assets will not be realized.

### Major Customers

The Company did not have revenues during the twelve months ended June 30, 2005. During the twelve months ended June 30, 2004, all of the Company's revenues were attributable to two customers. These customers individually accounted for 9% and 91% of revenues for the twelve months ended June 30, 2004.

### Net Loss Per Share

Basic net loss per share is computed by dividing the net loss by the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing the net loss by the weighted average number of common and dilutive common equivalent shares outstanding during the period. As the Company had a net loss attributable to common shareholders in each of the periods presented, basic and diluted net loss per share are the same.

Excluded from the computation of diluted net loss per share for the twelve months ended June 30, 2005, because their effect would be antidilutive, are options and warrants to acquire 5,762,318 shares of common stock with a weighted-average exercise price of \$1.40 per share. Also excluded from the computation of diluted net loss per share for the twelve months ended June 30, 2005 are 806,000 shares of common stock that may be issued if investors exercise their conversion right under the Debentures related to the 2003 Offering as discussed in footnote 8 because their effect would be antidilutive.

Excluded from the computation of diluted net loss per share for the twelve months ended June 30, 2004, because their effect would be antidilutive, are options and warrants to acquire 3,578,818 shares of common stock with a weighted-average exercise price of \$1.58 per share. Also excluded from the computation of diluted net loss per share for the twelve months ended June 30, 2004 are 690,000 shares of common stock that may be issued if investors exercise their conversion right under the Debentures related to the 2003 Offering as discussed in footnote 8 because their effect would be antidilutive.

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For the twelve months ended June 30, 2005 and 2004, additional potential dilutive securities that were excluded from the diluted net loss per share computation are the exchange rights discussed in footnote 8 that could result in options to acquire up to 223,000 shares of common stock with an exercise price of \$1.00 per share at June 30, 2005 and 2004.

### Use of Estimates

The preparation of financial statements in conformity with U.S. 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. Actual results could differ from those estimates.

### Patents, Proprietary Technology, and Other Intellectual Property

The Company pursues a policy of generally obtaining patent protection both in the United States of America and abroad for patentable subject matter in its

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proprietary technology. The Company's success depends in a large part upon its ability to protect its products and technology under United States of America and international patent laws and other intellectual property laws. U.S. patents have a term of 17 years from date of issuance or, for more recently filed patent applications, 20 years from the filing of such applications, and patents in most foreign countries have a term of 20 years from the proprietary filing date of the patent application.

The Company believes that it owns and has the right to use or license all proprietary technology necessary to license and market its products under development. The Company is not aware of the issuance of any patents or the filing of any patent applications, which relate to processes or products which utilize the Company's proprietary technology in a manner which could be similar to or competitive with the Company's products or processes. The Company has no knowledge that it is infringing on any existing patent such that it would be prevented from marketing or licensing products or services currently being developed by the Company.

### Financial Instruments and Concentrations of Credit Risk

At June 30, 2005, the Company has the following financial instruments: notes payable to stockholders, convertible short-term and long-term debt, accounts payable and accrued expenses. The carrying value of these instruments, other than the convertible debt, approximate fair value based on their liquidity. The fair value of the convertible debt was determined as the excess of the proceeds over the fair value of the warrants. Credit is extended to customers based on an evaluation of their financial condition. The Company does not require any collateral.

### Stock-Based Compensation

The Company has elected to follow the measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for its employee stock options rather than the alternative fair value accounting provided for by Statements of Financial Accounting Standards No. 123 (SFAS No. 123), Accounting for Stock Based Compensation. Compensation cost for stock options issued to employees is

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measured as the excess, if any, of the fair market price of the Company's stock at the date of grant over the amount an employee must pay to acquire the stock. Had compensation cost for the Company's option awards been determined consistent with SFAS No. 123, the Company's net loss would have been increased to the proforma amounts indicated below:

|  | For the years end<br>June 30, |       |
|--|-------------------------------|-------|
|  | -----<br>2005<br>-----        | ----- |
| Net loss:  |                               |       |
| As reported  | \$ (1,147,016)                | \$ (  |
| Plus: stock-based employee compensation expense<br>included in reported net loss | --                            |       |

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|  |                |      |
|--|----------------|------|
| Less: stock based compensation expense determined under fair value based method for all employee rewards | (1,255,965)    |      |
|  | -----          |      |
| Pro forma net loss   | \$ (2,402,981) | \$ ( |
|  | -----          |      |
|  |                |      |
| Net loss per share   |                |      |
| Basic and diluted - as reported  | \$ (0.20)      | \$   |
| Basic and diluted - pro forma  | \$ (0.42)      | \$   |

The fair value of option and warrant grants is estimated using the Black-Scholes option pricing model with the following weighted average assumptions used for grants made during the year ended June 30, 2005: expected volatility of 163%, risk-free interest rate of 3.41%, expected lives of two years, and a 0% dividend yield. The weighted average assumptions used for grants made during the year ended June 30, 2004 were: expected volatility of 120%, risk free interest rate of 3.26%, expected lives of 5 years, and a 0% dividend yield.

The Company recognizes compensation cost, if any, related to fixed employee awards on an accelerated basis over the applicable vesting period using the methodology described in FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.

### Segment Reporting

The Company has one operating segment. Revenues consist almost entirely of fees generated from providing testing services. Expenses incurred to date are reported according to their expense category.

The Company's customers are located in the United States and various foreign countries. However, no revenue has been generated from contracts with customers in foreign countries during the years ended June 30, 2005 or 2004.

### Comprehensive Income (Loss)

Comprehensive income (loss) is equal to net income (loss) for the years ended June 30, 2005 and 2004.

### Recently Issued Accounting Pronouncements

SFAS No. 151, Inventory Costs, is effective for fiscal years beginning after June 15, 2005. This statement amends the guidance in Accounting Research Bulletin No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for

abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). The adoption of SFAS No. 151 is expected to have no impact on the Company's financial statements.

SFAS No. 152, Accounting for Real Estate Time-Sharing Transactions, is effective for fiscal years beginning after June 15, 2005. This statement amends SFAS No. 66, Accounting for Sales of Real Estate, to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in American Institute of Certified Public Accountants Statement of



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Position 04-2, Accounting for Real Estate Time-Sharing Transactions. The adoption of SFAS No. 152 is expected to have no impact on the Company's financial statements.

SFAS No. 123(R), Share-Based Payment, replaces SFAS No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. This statement requires that the compensation cost relating to share-based payment transactions be recognized at fair value in the financial statements. The Company is required to apply this statement in the first interim period that begins after December 15, 2005. The Company is currently analyzing the requirements of the adoption of SFAS No. 123(R).

SFAS No. 153, Exchanges of Nonmonetary Assets - an amendment of APB Opinion No. 29, is effective for fiscal years beginning after June 15, 2005. This statement addresses the measurement of exchange of nonmonetary assets and eliminates the exception from fair-value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, Accounting for Nonmonetary Transactions, and replaces it with an exception for exchanges that do not have commercial substance. The adoption of SFAS No. 153 is not expected to have a significant impact on the Company's financial statements.

Financial Accounting Standards Board Interpretation ("FIN") No. 46(R) revised FIN No. 46, Consolidation of Variable Interest Entities, requiring the consolidation by a business of variable interest entities in which it is the primary beneficiary. The adoption of FIN No. 46(R) did not have any impact on the Company's financial statements.

The Emerging Issues Task Force ("EITF") reached consensus on Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, which provides guidance on determining when an investment is considered impaired, whether that impairment is other than temporary and the measurement of an impairment loss. The FASB issued FSP EITF 03-1-1, Effective Date of Paragraphs 10-20 of EITF Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments, which delays the effective date for the measurement and recognition criteria contained in EITF 03-1 until final application guidance is issued. The adoption of this consensus or FSP is expected to have no impact on the Company's financial statements.

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The EITF reached a consensus on Issue No. 04-8, The Effect of Contingently Convertible Debt on Diluted Earnings Per Share, which addresses when the dilutive effect of contingently convertible debt instruments should be included in diluted earnings (loss) per share. EITF 04-8 became effective for reporting periods ending after December 15, 2004. The adoption of EITF 04-8 did not have an impact on diluted earnings (loss) per share of the Company.

### Note 3: Related Parties

#### Notes Payable - Stockholders

In April 2002, the Company issued a non-interest bearing bridge note payable to an officer of the Company in the amount of \$7,500. The note is payable in full when the Company determines it has sufficient working capital to do so. On September 29, 2002, the officer who was owed the \$7,500 died.

The Company has entered into various loan agreements with Murphy Evans,

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President, a director and stockholder of the Company. On March 6, 2003, the Company's Board of Directors approved the Loan Amendment and Promissory Note (the "Amended Evans Loan") between the Company and Murphy Evans. The Amended Evans Loan aggregates all previous debt and supercedes and replaces all of the terms of the previous loans with Mr. Evans, including any conversion features. The Amended Evans Loan bears interest on the aggregate principal balance at a rate of 5% per annum, payable on June 30 and December 31 of each year, with the principal balance due and payable in full on December 31, 2003. The Amended Evans Loan is exempt from registration under Section 4(2) of the Securities Act.

During the year ended June 30, 2005, Mr. Evans loaned the Company an additional \$278,500. Accrued interest and the outstanding principal balance of the Amended Evans Loan were \$98,328 and \$1,071,490, respectively as of June 30, 2005. Due to insufficient funds, the Company has not made the interest payments due on the Amended Evans Loan on June 30 and December 31 of each year and did not repay the outstanding principal balance. Corresponding interest expense related to the Amended Evans Loan was \$47,533 and \$37,734 for the twelve months ended June 30, 2005 and 2004, respectively. All advances from Mr. Evans are convertible into any debt or equity offerings made by the Company. Mr. Evans has not made any demand for payment, or exercised any of his remedies, under the Amended Evans Loan.

On May 9, 2002, the Company cancelled 150,000 warrants held by Mr. Evans with exercise prices ranging from \$3.00 per share to \$7.50 per share issued under the terms of a previous loan with Mr. Evans ("Old Warrants"), and issued to Mr. Evans 150,000 five-year warrants with an exercise price of \$1.05 per share, which expire on May 13, 2007.

The cancellation of the Old Warrants is an effective re-pricing and will be accounted for as a "variable plan" until such time as the warrants are exercised, expire or are forfeited. Variable plan accounting will result in intrinsic value associated with the warrants being adjusted to compensation expense based on each reporting period's ending stock value. As of June 30, 2005 and 2004, no intrinsic value had been recorded related to these warrants as the stock price was below the exercise price.

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In September 2002, the Company entered into two non-interest bearing bridge loans in the respective principal amounts of \$40,000 and \$10,000 (the "Stockholder Loans") payable to two stockholders of the Company. The terms of the Stockholder Loans provide for payment at such time as the Company determines it has sufficient working capital to repay the principal balances of the Stockholder Loans. The Stockholder Loans are convertible into 57,142 and 14,286 equity units, respectively, at any time prior to re-payment. Each equity unit is comprised of one share of the Company's common stock, with a detachable 5-year warrant to purchase one additional share at an exercise price of \$1.05 per share. Neither stockholder has converted either Stockholder Loan into equity units.

On June 19, 2003, the Board of Directors approved a promissory note (the "2003 Gemino Note") in the principal amount of \$34,047 payable to Henry E. Gemino, the Chief Executive Officer, Chief Financial Officer and a director and stockholder of the Company. The 2003 Gemino Note bears interest at the rate of 5% per annum, payable on June 30 and December 31 of each year. During the year ended June 30, 2005, the Company repaid the outstanding principal balance of \$48,270 and accrued interest to Mr. Gemino. Interest expense related to the 2003 Gemino Note was \$892 and \$2,765 for the twelve months ended June 30, 2005 and 2004, respectively.

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The following is a summary of notes payable to stockholders as of June 30, 2005.

|                       |             |
|-----------------------|-------------|
| Amended Evans Loan    | \$1,071,490 |
| 2003 Gemino Note      | --          |
| Deceased Officer Note | 7,500       |
| Stockholder Loans     | 50,000      |
|                       | -----       |
| Total                 | \$1,128,990 |
|                       | =====       |

### Royalty Arrangement

In September, 1988, at the time Gale D. Burnett, a beneficial shareholder of more than 10% of the Company's common stock, first transferred certain technology, know-how and patent rights to the Company, a royalty interest of 4% of all pre-tax profits derived from the technology and know-how transferred was granted to Northwood Enterprises, Inc., a family-owned company controlled by Mr. Burnett. Northwoods Enterprises subsequently assigned such royalty interest back to Mr. Burnett. On April 8, 1996, Mr. Burnett assigned 2% of this royalty interest to certain shareholders of the Company, 1 1/4% of which was assigned to Henry Gemino, currently the Chief Executive Officer and Chief Financial Officer, and a director of the Company. This royalty arrangement also applies to all future patent rights and technology developed by Mr. Burnett and assigned to the Company. To date, no royalty payments have been made or earned under the above described arrangement.

### Note 4: Income Taxes

Federal income taxes reported by the Company differ from the amount computed by applying the statutory rate due primarily to an increase in the valuation allowance for deferred tax assets.

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The tax effect of temporary differences that give rise to federal deferred tax assets are comprised of the following at June 30, 2005:

|  |             |
|--|-------------|
| Deferred tax assets.                           |             |
| Net operating loss carryforwards               | \$3,258,439 |
| Depreciation and amortization                  | 7,008       |
| Wages and professional fees                    | 236,564     |
| Stock compensation                             | 415,200     |
| Research and development credit carry forwards | 101,517     |
|  | -----       |
| Gross deferred tax assets                      | 4,018,728   |
| Less: valuation allowance                      | (4,018,728) |
| Net deferred tax assets                        | \$ --       |
|  | =====       |

The net increase in the valuation allowance for deferred tax assets was \$389,123 and \$335,605 for the years ended June 30, 2005 and 2004, respectively. The increases were primarily due to net operating loss carry forwards, the realization of which was uncertain.

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For federal income tax purposes, the Company has net operating loss carry forwards at June 30, 2005 available to offset future federal taxable income, if any, of approximately \$9,583,645 which begin to expire in 2005 through 2025. In addition, the Company has research and development tax credit carry forwards of approximately \$101,517 at June 30, 2005, which are available to offset federal income taxes and begin to expire during the year ended June 30, 2006.

The utilization of the tax net operating loss carry forwards may be limited due to ownership changes that have occurred as a result of sales of common stock.

The effects of state income taxes were insignificant for the years ended June 30, 2005 and 2004.

### Note 5: Common Stock

During the year ended June 30, 2005, the Company recorded stock compensation expense totaling \$70,000 for the fair market value of 150,000 shares of restricted common stock issued to third parties in exchange for services. The restricted common stock was valued based on the market price of the Company's common stock, as traded on the NASD's Over the Counter Bulletin Board, on the day of grant.

During the year ended June 30, 2005, five investors exercised their conversion right in accordance with the terms of the 2003 Offering. As a result, 201,044 restricted shares of common stock were issued. Additionally, pursuant to the terms of the 2005 Offering, the Company issued 125,000 restricted shares of common stock during the year ended June 30, 2005.

During the year ended June 30, 2004, the Company recorded stock compensation expense totaling \$9,050 for the fair market value of 33,000 shares

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of restricted common stock issued to third parties in exchange for services. The restricted common stock was valued based on the market price of the Company's common stock, as traded on the NASD's Over the Counter Bulletin Board, on the day of grant.

### Note 6: Stockholders' Equity

#### Stock Option Plan

The Company has granted stock options to compensate key employees, consultants, and board members for past and future services. During 1999, the Company adopted a stock option plan (the "Plan"). The Plan provides for both incentive and nonqualified stock options to be granted to employees, officers, directors, and consultants. In accordance with the Plan, the Company may grant options to purchase up to 500,000 shares of common stock. On February 9, 2005, the Board of Directors approved an increase in the number of shares of common stock that may be issued under the Plan from 500,000 to 2.5 million shares.

A summary of stock option-related activity follows:

Options outstanding  
-----

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|   | Shares<br>available for<br>granted | Number<br>of<br>shares | Weighted<br>average<br>exercise<br>price |
|---|------------------------------------|------------------------|--|
|   | -----                              | -----                  | -----                                    |
| Balance at June 30, 2003                | 135,000                            | 365,000                | \$ 2.70                                  |
| Grants                                  | (150,000)                          | 150,000                | 0.67                                     |
| Expirations                             | 25,000                             | (25,000)               | 10.50                                    |
|   | -----                              | -----                  |  |
| Balance at June 30, 2004                | 10,000                             | 490,000                | 1.68                                     |
|   |                                    |                        |  |
| Increase in options available for grant | 2,000,000                          |                        |  |
| Grants                                  | (1,850,000)                        | 1,850,000              | 1.16                                     |
| Cancellations                           | 15,000                             | (15,000)               | 5.00                                     |
| Expirations                             | 50,000                             | (50,000)               | 6.20                                     |
|   | -----                              | -----                  |  |
| Balance at June 30, 2005                | 225,000                            | 2,275,000              | 1.14                                     |
|   | =====                              | =====                  |  |

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The following is a summary of stock options outstanding, all of which are exercisable at June 30, 2005:

| Options outstanding |                       |   |  |
|---------------------|-----------------------|---|--|
| Exercise prices     | Number<br>outstanding | Weighted<br>average<br>remaining<br>contractual<br>life (years) | Weighted<br>average<br>exercise<br>price |
| -----               | -----                 | -----   | -----                                    |
| \$ 0.50             | 30,000                | 3.56  | \$ 0.50                                  |
| 0.55                | 90,000                | 2.75  | 0.55                                     |
| 0.70                | 130,000               | 3.46  | 0.70                                     |
| 1.00                | 135,000               | 1.38  | 1.00                                     |
| 1.16                | 1,850,000             | 8.96  | 1.16                                     |
| 2.00                | 5,000                 | 0.68  | 2.00                                     |
| 4.00                | 35,000                | 0.26  | 4.00                                     |
|                     | -----                 |   |  |
| \$ 0.50 - 4.00      | 2,275,000             | 7.73  | 1.14                                     |
|                     | =====                 |   |  |

The Company applies APB Opinion No. 25 and related interpretations in accounting for option grants to employees.

During the year ended June 30, 2005, the Company recorded stock compensation expense totaling \$217,500 for the fair market value of 250,000 options granted to third-parties in exchange for services. The options were valued using the Black-Scholes option pricing model with the following assumptions: Expected volatility of 120%, risk free interest rate of 3.78%, expected lives of five years, and a 0% dividend yield.

During the year ended June 30, 2004, the Company recorded stock compensation expense totaling \$10,400 for the fair market value of 30,000

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options granted to third-parties in exchange for services. The options were valued using the Black-Scholes option pricing model with the following assumptions: Expected volatility of 120%, risk free interest rates ranging from 3.26 % to 3.92%, expected lives of five years, and a 0% dividend yield.

The weighted average fair value per share of the option grants made during the years ended June 30, 2005 and June 30, 2004 were \$0.80 and \$0.21, respectively.

### Warrants

The Company has granted warrants to compensate key employees, consultants, and board members for past and future services, and as incentives during placements of stock and convertible debt.

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A summary of warrant-related activity follows:

|                              | Number of<br>warrants<br>outstanding | Weighted<br>average<br>exercise price |
|------------------------------|--------------------------------------|---------------------------------------|
|                              | -----                                | -----                                 |
| Outstanding at June 30, 2003 | 2,458,818                            | \$ 2.01                               |
| Grants                       | 730,000                              | 0.75                                  |
| Expirations                  | (100,000)                            | 6.50                                  |
|                              | -----                                |                                       |
| Outstanding at June 30, 2004 | 3,088,818                            | 1.57                                  |
| Grants                       | 453,500                              | 0.75                                  |
| Expirations                  | (55,000)                             | 5.31                                  |
|                              | -----                                |                                       |
| Outstanding at June 30, 2005 | 3,487,318                            | 1.57                                  |
|                              | =====                                |                                       |

The following is a summary of warrants outstanding, all of which are exercisable at June 30, 2005:

| Exercise prices | Number<br>outstanding | Weighted<br>average<br>remaining<br>contractual<br>life (years) | Weighted<br>average<br>exercise<br>price |
|-----------------|-----------------------|---|--|
| -----           | -----                 | -----   | -----                                    |
| \$ 0.55 - 0.75  | 1,198,500             | 8.19  | \$ 0.75                                  |
| 1.00 - 1.50     | 1,718,818             | 1.68  | 1.05                                     |
| 3.00 - 3.50     | 520,000               | 3.28  | 2.36                                     |
| 7.20            | 30,000                | 2.34  | 7.20                                     |
| 13.50           | 20,000                | 2.34  | 13.50                                    |
|                 | -----                 |   |  |
| \$ 0.55 -13.50  | 3,487,318             | 4.03  | 1.57                                     |
|                 | =====                 |   |  |

During the year ended June 30, 2005, the Company recorded expense related to warrants totaling \$7,025 for the fair market value of 12,500 warrants granted to a third-party in exchange for services. The warrants were valued using the

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Black-Scholes option pricing model with the following assumptions: expected volatility ranging from 133% to 183%, risk free interest rates ranging from 3.63% to 3.88%, expected lives of five years, and a 0% dividend yield.

During the year ended June 30, 2004, the Company recorded expense related to warrants totaling \$7,200 for the fair market value of 40,000 warrants granted to a third-party in exchange for services. The warrants were valued using the Black-Scholes option pricing model with the following assumptions: expected volatility of 120%, risk free interest rate of 3.26%, expected lives of five years, and a 0% dividend yield.

The weighted average fair value per share of the warrant grants made during the years ended June 30, 2005 and June 30, 2004 were \$0.31 and \$0.41, respectively.

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### Note 7: Operating Leases

The Company's research and development facility is located in Ferndale, Washington under a lease that renewed on January 31, 2003 for a one-year term. The lease automatically renews thereafter for one year-terms. The lease may be terminated upon ninety days written notice. The future minimum payments under the lease extension are at the same monthly rate of approximately \$2,026 per month as under the terms of the original lease.

The Company's executive office is located in Manhasset, New York under a lease agreement that is month to month.

The Company expects to continue to incur costs on leased properties, as the Company has extended such leases in the past or will use alternate facilities.

Total rent expense under operating leases with third parties was \$33,521 and \$34,407 during the years ended June 30, 2005 and 2004, respectively.

### Note 8: Liquidity

The accompanying financial statements have been prepared assuming the Company will continue as a going concern. The Company incurred cumulative losses of \$11,605,139 and \$10,458,123 through June 30, 2005 and June 30, 2004, respectively, and had negative working capital of \$2,349,380 and \$1,818,260 as of June 30, 2005 and June 30, 2004, respectively. Additionally, the Company has expended a significant amount of cash in developing its technology and patented processes. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management recognizes that in order to meet the Company's capital requirements, and continue to operate, additional financing, including seeking industry-partner investment through joint ventures or other possible arrangements, will be necessary. The Company is evaluating alternative sources of financing to improve its cash position and is undertaking efforts to raise capital. If the Company is unable to raise additional capital or secure additional revenue contracts and generate positive cash flow, it is unlikely that the Company will be able to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

### Deferred Wages and Accrued Professional Fees

To reduce cash outflows, certain of the Company's employees, officers and

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directors have agreed to defer a portion of their salaries and consulting fees until the Company has sufficient resources to pay the amounts owed or to exchange such deferred amounts into options as described below. At June 30, 2005, the Company has accrued \$807,276 related to the deferred payment of salaries and consulting fees of which \$639,126 is included under deferred wages and \$168,150 in accrued professional fees. On March 18, 2002, the Board approved a conversion right on all deferred wages and accrued professional fees deferred as of March 18, 2002. Pursuant to this conversion right, employees, officers, consultants, and directors may elect to convert \$1.00 of fees owed to them as of March 18, 2002 for an option to purchase two shares of the Company's common stock, at an exercise price of \$1.00 per share for a term of five years. Deferred salaries and fees as of March 18, 2002 were \$111,500, resulting in the potential issuance of 223,000 options under the terms mentioned above. No conversions have occurred to date. As there was no intrinsic value associated with these exchange rights, no additional compensation cost has been recorded.

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### Long-Term Convertible Debt

On June 19, 2003, the Board of Directors approved the offering (the "2003 Offering") of \$1,000,000 in convertible debentures (the "Debentures"). The Debentures are convertible into that number of shares of the Company's common stock equal to the amount of the converted indebtedness divided by \$0.50 per share. The Debentures bear interest at a rate of 5% per annum, payable quarterly. Delinquent interest payments bear interest at a rate of 12% per annum. The Company is required to redeem each Debenture on the 5th anniversary of the date of the Debenture. The Company may, in its discretion, redeem any Debenture at any time prior to the mandatory redemption date of the Debenture by providing no less than 60 days' prior written notice to the holder of the Debenture. Certain events of default will result in the Debentures being redeemable by the Company upon demand of the holder.

Upon the purchase of, and for each \$0.50 of the Debenture's principal amount, the Company issued to each investor a warrant (the "Warrant") to purchase one (1) share of the Company's common stock at an exercise price of \$0.75 per share. The Warrants are exercisable at any time prior to the 5th anniversary date of the redemption of the Debenture.

Warrants issued in connection with the 2003 Offering were recorded based on their relative fair value as compared to the fair value of the debt at issuance. The relative fair value of the warrants were recorded as paid-in capital, estimated at \$101,978 and \$185,868 for the years ended June 30, 2005 and 2004, respectively. The fair value of the warrants issued during the year ended June 30, 2005 were determined based on an option pricing model with the following assumptions: warrant lives of 10 years, risk free interest rates ranging from 4.14% to 4.30%, volatility of 120% and a zero dividend yield. The fair value of the warrants issued during the year ended June 30, 2004 were determined based on an option pricing model with the following assumptions: warrant lives of 10 years, risk free interest rates ranging from 3.74% to 4.72%, volatility of 120%, and a zero dividend yield. The intrinsic value of the Debentures results in a beneficial conversion feature that reduces the book value of the convertible debt to not less than zero. Accordingly, the Company recorded a discount of \$158,000 and \$293,023 during the years ended June 30, 2005 and 2004, respectively on the convertible debt issued under the 2003 Offering. The Company amortizes the discount using the effective interest method over the five-year life of the Debentures.

During the quarter ended March 31, 2005, the Board of Directors terminated



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the 2003 Offering. As of the closing date of the 2003 Offering, the Company had raised \$503,000 from the 2003 Offering.

As of June 30, 2004, the Company was in default on the accrued interest on \$137,500 of the total face value of the Debentures. Due to the default status as of June 30, 2004 and the uncertainty regarding the Company's ability to remain in compliance with the terms of the Debentures, and thereby preventing a future default, the \$137,500 debt in default was classified as a current liability. Additionally, unamortized debt discount of \$81,559 and debt issuance costs of \$5,200 were written off and were included in interest expense and general and administrative expenses, respectively in the statement of operations for the twelve months ended June 30, 2004.

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During the twelve months ended June 30, 2005, five investors exercised their conversion right under the terms of the Debentures. Accordingly, the carrying value of the convertible debt was reclassified as equity upon conversion. Since the convertible debt instruments include a beneficial conversion feature, the remaining unamortized discount of approximately \$100,000 at the conversion date was recognized as interest expense.

As of June 30, 2005, accrued interest on the Debentures was \$5,024. The Company recorded interest expense related to the accretion of the discount on the Debentures and amortization of the convertible debt discount of \$100,583 and \$85,523 for the twelve months ended June 30, 2005 and June 30, 2004, respectively. As of June 30, 2005 the carrying value of the long-term debt debenture was \$61, net of unamortized debt discount of \$265,439.

### Common Stock

On January 19, 2005, the Board of Directors approved the offering (the "2005 Offering") of 2,000,000 units (the "Units") consisting of shares of common stock and attached warrants. The purchase price of one Unit is \$0.50. Each Unit consists of one share of common stock and a warrant to purchase one share of common stock at an exercise price of \$0.75. The warrants are exercisable at any time prior to the fifth anniversary from the date of grant.

As of June 30, 2005, the Company had raised \$62,500 and issued 125,000 restricted shares of common stock and warrants to purchase up to 125,000 shares of restricted stock in accordance with the terms of the 2005 Offering.

The Company engaged a law firm to help in the fund raising efforts of the 2005 Offering. Pursuant to the terms of the agreement with the law firm, the Company will pay the law firm a ten percent cash commission on all funds that the law firm helps raise. Additionally, the Company will issue warrants to purchase restricted shares of common stock at \$0.75 per share equal to ten percent of the total warrants issued in connection with the 2005 Offering. The warrants may be exercised up to five years from the date of issuance, which is the date the proceeds are received under the 2005 Offering. As of June 30, 2005, the Company has incurred \$6,250 of fees to be paid in cash to the law firm and issued warrants to purchase 12,500 restricted shares of common stock. The Company recorded approximately \$7,000 as a reduction in paid-in capital for the fair value of the warrant grants. The fair value of the warrant grants were estimated using the Black-Scholes option pricing model with the following weighted average assumptions: expected volatility of ranging from 133% to 183%, risk-free interest rates ranging from 3.63% to 3.88%, expected lives of five years, and a 0% dividend yield.

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### Note 9: Subsequent Events

On August 9, 2005, Mr. Evans converted \$400,000 of his stockholder loan payable in accordance with the terms of the 2005 Offering. Accordingly, Mr. Evans was issued 800,000 shares of restricted common stock and warrants to purchase 800,000 shares of restricted common stock at an exercise price of \$0.75 per share.

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On September 1, 2005 Mr. Evans converted \$75,000 of his stockholder loan payable in accordance with the terms of the 2005 Offering. Accordingly, Mr. Evans was issued 150,000 shares of restricted common stock and warrants to purchase 150,000 shares of restricted common stock at an exercise price of \$0.75 per share.

Subsequent to June 30, 2005, four investors exercised their conversion right under the terms of the 2003 Offering. Accordingly, \$180,000 of principal was converted into 360,000 shares of restricted common stock.

Subsequent to June 30, 2005, the Company has raised \$548,000 and issued 1,096,000 restricted shares of common stock and warrants to purchase up to 1,096,000 shares of restricted stock in accordance with the terms of the 2005 Offering. Additionally, pursuant to an agreement with a law firm, the Company has incurred \$51,650 of commission related fees and issued warrants to purchase 1,033,000 restricted shares of common stock at \$0.75 per share.

### Item 8. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

#### (a) Previous independent accountant.

On November 4, 2004, the Company dismissed KPMG LLP ("KPMG") as its independent accountant. The decision to change independent accountant was approved by the Company's Audit Committee and Board of Directors.

During the audits of the Company's two most recent fiscal years ended June 30, 2004 and through the date of this report, the Company has had no disagreements with KPMG on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of KPMG, would have caused it to make reference to the subject matter of such disagreements in its report on the financial statements of the Company for such period. During the Company's two most recent fiscal years and through the date of this report, the Company has had no reportable events under Item 304(a)(1)(iv) of Regulation S-B, except as discussed in the next paragraph below.

During the audit for the year-ended June 30, 2004, KPMG advised the Company's audit committee that they identified one material weakness in the Company's internal controls. The material weakness identified related to the accounting and financial reporting for the non-payment of interest on the convertible debt, causing certain of the notes to be in default as of June 30, 2004. The accounting for this default is included in the Company's financial statements for the year-ended June 30, 2004. The Company has implemented processes and procedures to review debt agreements, on a quarterly basis, to ensure that the Company is in compliance with the terms of its debt instruments and covenants. In instances of non-compliance, the Company will take the

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necessary actions to remedy the non-compliance and consider the impact of any non-compliance in the reporting of the Company's financial statements.

The audit reports of KPMG on the financial statements of the Company as of and for each of the past two fiscal years ended June 30, 2004 and 2003 did not contain any adverse opinion or a disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope or accounting principles, except as follows:

KPMG's report on the financial statements of the Company as of and for the years ended June 30, 2004 and 2003, contained a separate paragraph stating that "the Company has incurred net losses since inception and has a working capital deficit at June 30, 2004 that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in note 7. The financial statements do not include any adjustments that might result from the outcome of this uncertainty."

The Company has requested KPMG to furnish it with a letter addressed to the Commission stating whether or not KPMG agrees with the above statements. A copy of such letter, dated November 9, 2004, is filed as Exhibit No. 16 to this report.

(b) New independent accountant.

The Company has engaged Peterson Sullivan PLLC ("Peterson Sullivan") as its new independent accountant as of November 4, 2004. During the Company's two most recent fiscal years and through the date of their engagement by the Company, the Company did not consult with Peterson Sullivan regarding the issues of the type described in Item 304(a)(2) of Regulation S-B.

Item 8A. Controls and Procedures.

Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in the Company's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. The Company's executive officers, including the Company's Chief Executive Officer, who also serves as Chief Financial Officer, and the Chief Operating Officer, are responsible for establishing and maintaining disclosure controls and procedures for the Company. These executives have designed such controls to ensure that all material information related to the Company is made known to them by others within the organization. As of June 30, 2005, the Company's Chief Executive Officer and Chief Operating Officer completed an evaluation of the Company's disclosure controls and procedures and have determined that such disclosure controls and procedures are functioning properly and effectively. They did not discover any significant deficiencies or

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material weaknesses within the controls and procedures that require modification. There were no changes in the Company's internal control over financial reporting identified in connection with the Company's evaluation that occurred during the Company's fourth fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART III

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Item 9. Directors and Executive Officers.

Directors, Executive Officers, Promoters and Control Persons

The information regarding directors contained under the caption "Proposal One: Election of Directors" in the Company's Proxy Statement for the 2005 Annual Meeting of Shareholders, which will be filed with the Commission not later than 120 days after the end of the fiscal year covered by this report, is incorporated herein by reference.

Executive Officers of the Company

In addition to Murphy Evans and Henry Gemino, who also serve as directors, the following constitutes the executive officer of the Company:

| Name            | Age | Positions Held and Principal Occupations During the Past 5 Years  |
|-----------------|-----|---|
| ----            | --- | -----   |
| Philip L. Jones | 63  | Mr. Jones has served as the Chief Operating Officer and Executive Vice President for the Company during the past five years. Previous to his employment with the Company, he provided energy consulting services to certain utility companies for a period of one year. Prior to that time, Mr. Jones held various executive positions with Consolidated Natural Gas Company before retiring in April 2000. |

Compliance with Section 16(a) of the Exchange Act

The information regarding reports required under Section 16(a) of the Securities Exchange Act of 1934, as amended, contained under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" in the Company's Proxy

Statement for the 2005 Annual Meeting of Shareholders, which will be filed with the Commission not later than 120 days after the end of the fiscal year covered by this report, is incorporated herein by reference.

Code of Ethics

The Company has adopted a Code of Ethics applicable to its chief executive officer, chief operating officer, chief financial officer, president and other finance leaders. A copy of the Code of Ethics may be obtained by any person without charge, upon request, by contacting the principle office of the Company.

Audit Committee

The information contained under the caption "Board of Directors and Committees" in the Company's Proxy Statement for the 2005 Annual Meeting of Shareholders, which will be filed with the Commission not later than 120 days after the end of the fiscal year covered by this report, is incorporated herein by reference.

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### Item 10. Executive Compensation.

The information contained under the caption "Executive Compensation" in the Company's Proxy Statement for the 2005 Annual Meeting of Shareholders, which will be filed with the Commission not later than 120 days after the end of the fiscal year covered by this report, is incorporated herein by reference.

### Item 11. Security Ownership of Certain Beneficial Owners and Management.

The information contained under the caption "Security Ownership of Certain Beneficial Owners and Management" in the Company's Proxy Statement for the 2005 Annual Meeting of Shareholders, which will be filed with the Commission not later than 120 days after the end of the fsical year covered by this report, is incorporated herein by reference.

### Item 12. Certain Relationships and Related Transactions.

The information contained under the caption "Certain Relationship and Related Transactions" in the Company's Proxy Statement for the 2005 Annual Meeting of Shareholders, which will be filed with the Commission not later than 120 days after the end of the fiscal year covered by this report, is incorporated herein by reference.

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### Item 13. Exhibits.

The following exhibits were filed with or incorporated by reference into this report.

| Exhibit No.<br>----- | Description of Exhibit<br>-----  |
|----------------------|--|
| Exhibit 3.i          | Articles of Incorporation (incorporated by reference to Exhibit 3.1 to the Company's Registration Statement on Form SB-2 filed with the Commission on May 10, 1996).   |
| Exhibit 3.ii         | Bylaws of the Company (incorporated by reference to Exhibit 3.3 to the Company's Registration Statement on Form SB-2 filed with the Commission on May 10, 1996).   |
| Exhibit 3.iii        | Amendment to Certificate of Incorporation (incorporated by reference to Exhibit A to the Company's Definitive Proxy Statement filed with the Commission on October 28, 2002).  |
| Exhibit 10.1         | Service Agreement dated as of August 16, 2001 between Profile Technologies, Inc. and BP Exploration (Alaska) Inc. (incorporated by reference to Exhibit 10.1 to the Company's Annual Report on Form 10-KSB filed with the Commission on September 28, 2001). |
| Exhibit 10.2         | Loan Agreement dated March 6, 2003, by and between the Company and Murphy Evans (incorporated by reference to Exhibit 4.1 to the Company's Quarterly Report on Form 10-QSB filed with the Commission on May 15, 2003).                                       |

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- Exhibit 10.3            Loan Amendment and Promissory Note dated March 6, 2003, by and between the Company and Murphy Evans (incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-QSB filed with the Commission on May 20, 2003).
- Exhibit 10.4            Lease Agreement dated January 26, 2001 by and between the Company and Fatum LLC. (incorporated by reference to Exhibit 10.4 to the Company's Annual Report on Form 10-KSB filed with the Commission on October 12, 2004).
- Exhibit 10.5            Lease Extension dated February 26, 2003 by and between the Company and Fatum LLC. (incorporated by reference to Exhibit 10.5 to the Company's Annual Report on Form 10-KSB filed with the Commission on October 12, 2004).
- Exhibit 10.6            Royalty Agreement (incorporated by reference to Exhibit 10.1 to the Company's Registration Statement on Form SB-2 filed with the Commission on May 10, 1996).
- Exhibit 10.7            Assignment of Patent Rights (incorporated by reference to Exhibit 10.2 to the Company's Registration Statement on Form SB-2 filed with the Commission on May 10, 1996).
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- Exhibit 10.8            ConocoPhillips Alaska, Inc., Contract No. AK 990156, Amendment No. 3 dated February 1, 2003, by and between the Company and ConocoPhillips Alaska, Inc. (incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-QSB filed with the Commission on May 20, 2003).
- Exhibit 10.9            1999 Stock Option Plan (incorporated by reference to Exhibit 10.9 to the Company's Annual Report on Form 10-KSB filed with the Commission on October 12, 2004).
- Exhibit 11.1            Code of Ethics (incorporated by reference to Exhibit 14 to the Company's Annual Report on Form 10-KSB filed with the Commission on October 12, 2004).
- Exhibit 23.1            Consent of Independent Registered Public Accounting Firm.
- Exhibit 23.2            Consent of Independent Registered Public Accounting Firm.
- Exhibit 31.1            Rule 13a-14(a)/15d-14(a) Certification of Henry E. Gemino, as Chief Executive Officer and Chief Financial Officer of the Company.
- Exhibit 31.2            Rule 13a-14(a)/15d-14(a) Certification of Philip L. Jones, as Chief Operating Officer and Executive Vice President of the Company.
- Exhibit 32.1            Certification under Section 906 of the Sarbanes-Oxley Act of 2002 by Henry E. Gemino, as Chief Executive Officer and Chief Financial Officer of the Company.

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Exhibit 32.2

Certification under Section 906 of the Sarbanes-Oxley Act of 2002 by Philip L. Jones, as Chief Operating Officer and Executive Vice President of the Company.

Item 14. Principal Accountant Fees and Services.

The information required by this item is incorporated by reference to the section entitled "Independent Public Accountants" in the Company's Proxy Statement for the 2005 Annual Meeting of Shareholders, which will be filed with the Commission not later than 120 days after the end of the fiscal year covered by this report, is incorporated herein by reference.

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SIGNATURES

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

PROFILE TECHNOLOGIES, INC.

By /s/ Henry E. Gemino

-----  
Henry E. Gemino  
Chief Executive Officer  
and Chief Financial Officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant in the capacities and as of the dates indicated:

| Signature<br>-----                                     | Title<br>----- | Date<br>----       |
|--|----------------|--------------------|
| /s/Charles Christenson<br>-----<br>Charles Christenson | Director       | September 27, 2005 |
| /s/Murphy Evans<br>-----<br>Murphy Evans               | Director       | September 27, 2005 |
| /s/Henry E. Gemino<br>-----<br>Henry E. Gemino         | Director       | September 27, 2005 |
| /s/William A. Krivsky<br>-----<br>William A. Krivsky   | Director       | September 27, 2005 |

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