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

FORM 10-QSB

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

For the quarterly period ended March 31, 2006

or

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

For the transition period from _____ to _____

Commission File Number 0-29185

SAVE THE WORLD AIR, INC.

(Exact name of registrant as specified in its charter)

Nevada

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

52-2088326

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

**5125 Lankershim Boulevard
North Hollywood, California 91601**

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

(818) 487-8000

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Exchange Act: None. Securities registered pursuant to Section 12(g) of the Exchange Act: Common Stock, \$0.001 par value.

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

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

The number of shares of the Registrant's Common Stock outstanding as of May 15, 2006 was 33,658,531 shares.

Transitional Small Business Disclosure Format (Check one): Yes No

SAVE THE WORLD AIR, INC.

FORM 10-QSB
INDEX

| | <u>Page</u> |
|--|-------------|
| <u>PART I</u> | 1 |
| <u>ITEM 1. Financial Statements</u> | 1 |
| <u>Condensed balance sheets</u> | 1 |
| <u>Condensed statements of operations (unaudited)</u> | 3 |
| <u>Condensed statements of changes in stockholders' deficiency (unaudited)</u> | 4 |
| <u>Condensed statements of cash flows (unaudited)</u> | 10 |
| <u>Notes to condensed financial statements (unaudited)</u> | 12 |
| <u>ITEM 2. Management's Discussion and Analysis or Plan of Operations</u> | 27 |
| <u>ITEM 3. Controls and Procedures</u> | 32 |
| <u>PART II</u> | 32 |
| <u>ITEM 1. Legal Proceedings</u> | 32 |
| <u>ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 35 |
| <u>ITEM 3. Defaults Upon Senior Securities</u> | 36 |
| <u>ITEM 4. Submission of Matters to a Vote of Security Holders</u> | 36 |
| <u>ITEM 5. Other Information</u> | 36 |
| <u>ITEM 6. Exhibits</u> | 37 |
| <u>SIGNATURES</u> | 38 |
| <u>EXHIBIT INDEX</u> | 39 |
| <u>Exhibit 10.1</u> | |
| <u>Exhibit 31.1</u> | |
| <u>Exhibit 31.2</u> | |
| <u>Exhibit 32</u> | |

PART I

Item 1. Financial Statements

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

**CONDENSED BALANCE SHEETS
MARCH 31, 2006 (UNAUDITED) AND DECEMBER 31, 2005**

| | <u>March 31, 2006</u> <u>(unaudited)</u> | <u>December 31,</u> <u>2005</u> |
|---|---|------------------------------------|
| ASSETS | | |
| Current assets | | |
| Cash | \$ 320,344 | \$ 279,821 |
| Other current assets | <u>8,740</u> | <u>9,009</u> |
| Total current assets | <u>329,084</u> | <u>288,830</u> |
| Property and equipment , net of accumulated depreciation | <u>314,203</u> | <u>295,374</u> |
| Other assets | <u>4,500</u> | <u>4,500</u> |
| | <u>\$ 647,787</u> | <u>\$ 588,704</u> |

See notes to condensed financial statements.

[Table of Contents](#)

SAVE THE WORLD AIR, INC.
(A DEVELOPMENT STAGE ENTERPRISE)
CONDENSED BALANCE SHEETS — Continued
MARCH 31, 2006 (UNAUDITED) AND DECEMBER 31, 2005

| | March 31, 2006 (unaudited) | December 31, 2005 |
|--|-------------------------------|----------------------|
| LIABILITIES AND STOCKHOLDERS' DEFICIENCY | | |
| Current liabilities | | |
| Accounts payable | \$ 128,423 | \$ 155,456 |
| Accrued expenses | 246,337 | 179,461 |
| Accrued research and development fees | 595,000 | 680,000 |
| Accrued professional fees | 523,970 | 450,555 |
| Payable to shareholder | — | 45,000 |
| Payable to related parties | 158,732 | 158,732 |
| Finders fees payable | 5,666 | 8,916 |
| Convertible debentures, net | <u>1,245,974</u> | <u>318,759</u> |
| Total current liabilities | <u>2,904,102</u> | <u>1,996,879</u> |
| Commitments and contingencies | | |
| Stockholders' deficiency | | |
| Common stock, \$.001 par value: 200,000,000 shares authorized, 32,343,967 and 31,387,418 shares issued and outstanding at March 31, 2006 and December 31, 2005, respectively | 32,344 | 31,387 |
| Common stock to be issued | 224,845 | 612,521 |
| Additional paid-in capital | 20,730,675 | 18,336,178 |
| Deferred compensation | — | (142,187) |
| Deficit accumulated during the development stage | <u>(23,244,179)</u> | <u>(20,246,074)</u> |
| Total stockholders' deficiency | <u>(2,256,315)</u> | <u>(1,408,175)</u> |
| | <u>\$ 647,787</u> | <u>\$ 588,704</u> |

See notes to condensed financial statements.

[Table of Contents](#)**SAVE THE WORLD AIR, INC.**
(A DEVELOPMENT STAGE ENTERPRISE)**CONDENSED STATEMENTS OF OPERATIONS (UNAUDITED)**
THREE MONTHS ENDED MARCH 31, 2006 AND 2005 AND FOR THE PERIOD FROM INCEPTION (FEBRUARY 18, 1998) TO MARCH 31, 2006

| | March 31, 2006 | March 31, 2005 | Cumulative since inception |
|--|-----------------------|-----------------------|----------------------------------|
| Net sales | \$ — | \$ — | \$ — |
| Operating expenses | 2,940,011 | 661,595 | 18,785,425 |
| Research and development expenses | 57,294 | 401,485 | 3,860,881 |
| Non-cash patent settlement cost | <u>—</u> | <u>—</u> | <u>1,610,066</u> |
| Loss before other income | (2,997,305) | (1,063,080) | (24,256,372) |
| Other income | | | |
| Interest income | — | — | 954 |
| Settlement of litigation and debt | <u>—</u> | <u>—</u> | <u>1,017,208</u> |
| Loss before provision for income taxes | (2,997,305) | (1,063,080) | (23,238,210) |
| Provision for income taxes | <u>800</u> | <u>1,976</u> | <u>5,969</u> |
| Net loss | <u>\$ (2,998,105)</u> | <u>\$ (1,065,056)</u> | <u>\$ (23,244,179)</u> |
| Net loss per common share, basic and diluted | <u>\$ (0.10)</u> | <u>\$ (0.03)</u> | |
| Weighted average common shares outstanding, basic and diluted | <u>31,468,333</u> | <u>38,036,260</u> | |

See notes to condensed financial statements.

| | | | | | | | | |
|--|------|--------|----|---|---------|---|---|---------|
| June 20, 2000 | 4.44 | 1,633 | 2 | — | 7,249 | — | — | 7,251 |
| Stock issued for professional services on June 26, 2000 | 5.31 | 1,257 | 1 | — | 6,674 | — | — | 6,675 |
| Stock issued for employee compensation on June 26, 2000 | 5.31 | 22,000 | 22 | — | 116,798 | — | — | 116,820 |
| Stock issued for consulting services on June 26, 2000 | 5.31 | 9,833 | 10 | — | 52,203 | — | — | 52,213 |
| Stock issued for promotional services on July 28, 2000 | 4.88 | 9,675 | 9 | — | 47,205 | — | — | 47,214 |
| Stock issued for consulting services on July 28, 2000 | 4.88 | 9,833 | 10 | — | 47,975 | — | — | 47,985 |
| Stock issued for consulting services on August 4, 2000 | 2.13 | 35,033 | 35 | — | 74,585 | — | — | 74,620 |
| Stock issued for promotional services on August 16, 2000 | 2.25 | 25,000 | 25 | — | 56,225 | — | — | 56,250 |
| Stock issued for consulting services on September 5, 2000 | 2.25 | 12,833 | 13 | — | 28,861 | — | — | 28,874 |
| Stock issued for consulting services on September 10, 2000 | 1.50 | 9,833 | 10 | — | 14,740 | — | — | 14,750 |
| Stock issued for consulting services on November 2, 2000 | 0.88 | 9,833 | 10 | — | 8,643 | — | — | 8,653 |

| | | | | | | | | |
|--|------|-----------|-------|---|---------|---|---|---------|
| April 4, 2001 | 0.25 | 7,040 | 7 | — | 1,753 | — | — | 1,760 |
| Stock issued for consulting services on April 5, 2001 | 0.25 | 132,600 | 132 | — | 33,018 | — | — | 33,150 |
| Stock issued for filing fees on April 30, 2001 | 1.65 | 1,233 | 1 | — | 2,033 | — | — | 2,034 |
| Stock issued for filing fees on September 19, 2001 | 0.85 | 2,678 | 2 | — | 2,274 | — | — | 2,276 |
| Stock issued for professional services on September 28, 2001 | 0.62 | 150,000 | 150 | — | 92,850 | — | — | 93,000 |
| Stock issued for directors services on October 5, 2001 | 0.60 | 100,000 | 100 | — | 59,900 | — | — | 60,000 |
| Stock issued for legal services on October 17, 2001 | 0.60 | 11,111 | 11 | — | 6,655 | — | — | 6,666 |
| Stock issued for consulting services on October 18, 2001 | 0.95 | 400,000 | 400 | — | 379,600 | — | — | 380,000 |
| Stock issued for consulting services on October 19, 2001 | 1.25 | 150,000 | 150 | — | 187,350 | — | — | 187,500 |
| Stock issued for exhibit fees on October 22, 2001 | 1.35 | 5,000 | 6 | — | 6,745 | — | — | 6,751 |
| Stock issued for directors services on November 2, 2001 | 0.95 | 1,000,000 | 1,000 | — | 949,000 | — | — | 950,000 |
| Stock issued for consulting services on November 7, 2001 | 0.85 | 20,000 | 20 | — | 16,980 | — | — | 17,000 |

[Table of Contents](#)

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

CONDENSED STATEMENTS OF STOCKHOLDERS' DEFICIENCY
FROM INCEPTION (FEBRUARY 18, 1998) TO MARCH 31, 2006

| | Price per share | Common Stock | | Common stock to be issued | Additional paid-in capital | Deferred compensation | Deficit accumulated during the development stage | Total stockholders' development stage deficiency |
|--|-----------------|-------------------|---------------|---------------------------|----------------------------|-----------------------|--|--|
| | | Shares | Amount | | | | | |
| Stock issued for consulting services on November 20, 2001 | 0.98 | 43,000 | 43 | — | 42,097 | — | — | 42,140 |
| Stock issued for consulting services on November 27, 2001 | 0.98 | 10,000 | 10 | — | 9,790 | — | — | 9,800 |
| Stock issued for consulting services on November 28, 2001 | 0.98 | 187,000 | 187 | — | 183,073 | — | — | 183,260 |
| Intrinsic value of options issued to employees | | — | — | — | 2,600,000 | (2,600,000) | — | — |
| Fair value of options issued to non-employees for services | | — | — | — | 142,318 | — | — | 142,318 |
| Amortization of deferred compensation | | — | — | — | — | 191,667 | — | 191,667 |
| Net loss | | — | — | — | — | — | (2,735,013) | (2,735,013) |
| Balance, December 31, 2001 | | 18,085,847 | 18,086 | — | 6,220,322 | (2,408,333) | (5,102,346) | (1,272,271) |
| Stock issued for directors services on December 10, 2002 | 0.40 | 2,150,000 | 2,150 | — | 857,850 | — | — | 860,000 |
| Common stock paid for, but not issued (2,305,000 shares) | 0.15-0.25 | — | — | 389,875 | — | — | — | 389,875 |
| Fair value of options issued to non-employees for services | | — | — | — | 54,909 | (54,909) | — | — |
| Amortization of deferred compensation | | — | — | — | — | 891,182 | — | 891,182 |
| Net loss for the year ended December 31, 2002 | | — | — | — | — | — | (2,749,199) | (2,749,199) |
| Balance, December 31, 2002 | | 20,235,847 | 20,236 | 389,875 | 7,133,081 | (1,572,060) | (7,851,545) | (1,880,413) |
| Common stock issued, previously paid for | 0.15 | 1,425,000 | 1,425 | (213,750) | 212,325 | — | — | — |

| | | | | | | | | |
|--|------|-----------|-------|-----------|---------|---|---|---------|
| Common stock issued, previously paid for | 0.25 | 880,000 | 880 | (220,000) | 219,120 | — | — | — |
| Stock issued for cash on March 20, 2003 | 0.25 | 670,000 | 670 | — | 166,830 | — | — | 167,500 |
| Stock issued for cash on April 4, 2003 | 0.25 | 900,000 | 900 | — | 224,062 | — | — | 224,962 |
| Stock issued for cash on April 8, 2003 | 0.25 | 100,000 | 100 | — | 24,900 | — | — | 25,000 |
| Stock issued for cash on May 8, 2003 | 0.25 | 1,150,000 | 1,150 | — | 286,330 | — | — | 287,480 |
| Stock issued for cash on June 16, 2003 | 0.25 | 475,000 | 475 | — | 118,275 | — | — | 118,750 |
| Stock issued for legal services on June 27, 2003 | 0.55 | 83,414 | 83 | — | 45,794 | — | — | 45,877 |
| Debt converted to stock on June 27, 2003 | 0.25 | 2,000,000 | 2,000 | — | 498,000 | — | — | 500,000 |
| Stock and warrants issued for cash on July 11, 2003 | 0.25 | 519,000 | 519 | — | 129,231 | — | — | 129,750 |
| Stock and warrants issued for cash on September 29, 2003 | 0.25 | 1,775,000 | 1,775 | — | 441,976 | — | — | 443,751 |
| Stock and warrants issued for cash on October 21, 2003 | 0.25 | 1,845,000 | 1,845 | — | 459,405 | — | — | 461,250 |
| Stock and warrants issued for cash on October 28, 2003 | 0.25 | 1,570,000 | 1,570 | — | 390,930 | — | — | 392,500 |
| Stock and warrants issued for cash on November 19, 2003 | 0.25 | 500,000 | 500 | — | 124,500 | — | — | 125,000 |

| | | | | | | | | |
|--|------|---------|-----|---------|----------|---|---|----------|
| cash on November 3, 2004 | 1.00 | 25,000 | 25 | — | 24,975 | — | — | 25,000 |
| Stock issued for cash on November 18, 2004 | 1.00 | 172,500 | 173 | — | 172,327 | — | — | 172,500 |
| Stock issued for cash on December 9, 2004 | 1.00 | 75,000 | 75 | — | 74,925 | — | — | 75,000 |
| Stock issued for cash on December 23, 2004 | 1.00 | 250,000 | 250 | — | 249,750 | — | — | 250,000 |
| Finders fees related to stock issuances | — | — | — | — | (88,384) | — | — | (88,384) |
| Common stock paid for, but not issued (119,000 shares) | — | — | — | 119,000 | — | — | — | 119,000 |

| | | | | | | | | |
|---|---|---|---|---------|-----------|-----------|---|-----------|
| 2005 | — | — | — | 555,429 | — | — | — | 555,429 |
| Finders fees related to stock issuances | — | — | — | — | (109,840) | — | — | (109,840) |
| Intrinsic value of options issued to employees | — | — | — | — | 243,750 | (243,750) | — | — |
| Fair value of options issued for settlement costs | — | — | — | — | 31,500 | — | — | 31,500 |
| Fair value of warrants issued for settlement costs | — | — | — | — | 4,957 | — | — | 4,957 |
| Fair value of warrants issued to non-employees for services | — | — | — | — | 13,505 | — | — | 13,505 |
| Amortization of deferred compensation | — | — | — | — | — | 177,631 | — | 177,631 |
| Warrants issued with convertible notes | — | — | — | — | 756,768 | — | — | 756,768 |

[Table of Contents](#)

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

**CONDENSED STATEMENTS OF STOCKHOLDERS' DEFICIENCY FROM
INCEPTION (FEBRUARY 18, 1998) TO MARCH 31, 2006**

| | Price per share | Common Stock | | Common stock to be issued | Additional paid-in capital | Deferred compensation | Deficit accumulated during the development stage | Total stockholders' development stage deficiency |
|--|-----------------|-------------------|-----------------|---------------------------|----------------------------|-----------------------|--|--|
| | | Shares | Amount | | | | | |
| Intrinsic value of beneficial conversion associated with convertible notes | — | — | — | — | 696,413 | — | — | 696,413 |
| Net loss for year ended December 31, 2005 | — | — | — | — | — | — | (3,115,186) | (3,115,186) |
| Balance, December 31, 2005 | | 31,387,418 | \$31,387 | \$ 612,521 | \$18,336,178 | \$(142,187) | \$(20,246,074) | \$ (1,408,175) |
| Stock issued, for previously settled payables | — | 846,549 | 847 | (612,521) | 611,674 | — | — | — |
| Stock issued upon exercise of warrants on March 23, 2006 | — | 25,000 | 25 | — | 37,475 | — | — | 37,500 |
| Stock issued upon exercise of warrants on March 27, 2006 | — | 75,000 | 75 | — | 87,425 | — | — | 87,500 |
| Stock issued upon exercise of warrants on March 30, 2006 | — | 10,000 | 10 | — | 9,990 | — | — | 10,000 |
| Common stock paid for, but not issued | — | — | — | 18,125 | — | — | — | 18,125 |
| Common stock for convertible notes converted to stock, but not issued | — | — | — | 206,720 | — | — | — | 206,720 |
| Fair value of options issued to employees and officers | — | — | — | — | 478,490 | — | — | 478,490 |
| Fair value of warrants issued for services | — | — | — | — | 401,130 | — | — | 401,130 |
| Write off of deferred compensation | — | — | — | — | (142,187) | 142,187 | — | — |
| Warrants issued with convertible notes | — | — | — | — | 620,252 | — | — | 620,252 |
| Intrinsic value of beneficial conversion associated with convertible notes | — | — | — | — | 290,248 | — | — | 290,248 |
| Net loss for three months ended March 31, 2006 | — | — | — | — | — | — | (2,998,105) | (2,998,105) |
| Balance, March 31, 2006 (unaudited) | | 32,343,967 | \$32,344 | \$ 224,845 | \$20,730,675 | \$ — | \$(23,244,179) | \$ (2,256,315) |

See Notes to condensed financial statements.

[Table of Contents](#)**SAVE THE WORLD AIR, INC.****(A DEVELOPMENT STAGE ENTERPRISE)****CONDENSED STATEMENTS OF CASH FLOWS (UNAUDITED)****THREE MONTHS ENDED MARCH 31, 2006 AND 2005 AND FOR THE PERIOD FROM INCEPTION (FEBRUARY 18, 1998) TO****MARCH 31, 2006**

| | <u>March 31,</u> <u>2006</u> | <u>March 31,</u> <u>2005</u> | <u>Cumulative</u> <u>since</u> <u>inception</u> |
|---|---------------------------------|---------------------------------|---|
| Cash flows from operating activities | | | |
| Net loss | \$(2,998,105) | \$(1,065,056) | \$(23,244,179) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | | |
| Write off of intangible assets | — | — | 505,000 |
| Settlement of litigation and debt | — | — | (1,017,208) |
| Fair value of options and warrants issued for services | 879,619 | — | 1,050,809 |
| Issuance of common stock for services | — | — | 4,668,102 |
| Issuance of options for legal settlement | — | — | 31,500 |
| Issuance of warrants for legal settlement | — | — | 4,957 |
| Issuance of warrants for services | — | — | 13,505 |
| Patent acquisition cost | — | — | 1,610,066 |
| Amortization of issuance costs | 1,133,935 | — | 1,452,694 |
| Amortization of deferred compensation | — | 76,068 | 3,060,744 |
| Depreciation | 23,312 | 2,268 | 57,074 |
| Changes in operating assets and liabilities: | | | |
| Prepaid expenses and other | 269 | (2,800) | (13,240) |
| Income taxes payable | — | 1,176 | — |
| Accounts payable and accrued expenses | 25,007 | 338,633 | 1,824,930 |
| Net cash used in operating activities | <u>(935,963)</u> | <u>(649,711)</u> | <u>(9,995,246)</u> |
| Cash flows from investing activities | | | |
| Purchase of property and equipment | <u>(42,141)</u> | <u>—</u> | <u>(367,727)</u> |
| Net cash used in investing activities | <u>(42,141)</u> | <u>—</u> | <u>(367,727)</u> |
| Cash flows from financing activities | | | |
| Increase (decrease) in payables to related parties and shareholder | — | 100,000 | 715,183 |
| Advances from founding executive officer | — | — | 517,208 |
| Net proceeds from convertible debentures | 865,500 | — | 2,318,683 |
| Issuance of common stock for cash | 135,002 | 530,800 | 7,114,118 |
| Common stock issuable | 18,125 | 25,000 | 18,125 |
| Net cash provided by financing activities | <u>1,018,627</u> | <u>655,800</u> | <u>10,683,317</u> |
| Net increase in cash | 40,523 | 6,089 | 320,344 |
| Cash, beginning of period | <u>279,821</u> | <u>84,826</u> | <u>—</u> |
| Cash, end of period | <u>\$ 320,344</u> | <u>\$ 90,915</u> | <u>\$ 320,344</u> |

See Notes to condensed financial statements.

[Table of Contents](#)**SAVE THE WORLD AIR, INC.****(A DEVELOPMENT STAGE ENTERPRISE)****CONDENSED STATEMENTS OF CASH FLOWS — Continued (UNAUDITED)****THREE MONTHS ENDED MARCH 31, 2006 AND 2005 AND FOR THE PERIOD FROM INCEPTION (FEBRUARY 18, 1998) TO****MARCH 31, 2006**

| | <u>March 31,</u> <u>2006</u> | <u>March 31,</u> <u>2005</u> | <u>Cumulative</u> <u>since</u> <u>inception</u> |
|---|---------------------------------|---------------------------------|---|
| Supplemental disclosures of cash flow information | | | |
| Cash paid during the year for | | | |
| Interest | \$ — | \$ — | \$ — |
| Income taxes | \$ 800 | \$ 800 | \$ 5,957 |
| Non-cash investing and financing activities | | | |
| Acquisition of intangible asset through advance from related party and issuance of common stock | \$ — | \$ — | \$ 505,000 |
| Deferred compensation for stock options issued for services | — | — | 3,202,931 |
| Purchase of property and equipment financed by advance from related party | — | — | 3,550 |
| Conversion of related party debt to equity | — | — | 515,000 |
| Issuance of common stock in settlement of payable | — | — | 113,981 |
| Common stock, previously paid for | — | 100,000 | — |
| Finders fees accrued for issuance of common stock | — | — | 510,806 |
| Value of warrants and beneficial conversion feature of convertible notes | 865,500 | — | 2,318,683 |
| Cancellation of stock | — | — | 8,047 |
| Conversion of accounts payable and accrued expenses to common stock issued | 612,521 | — | 612,521 |
| Conversion of related party debt to convertible debentures | 45,000 | — | 45,000 |
| Conversion of convertible debentures to common stock | 206,720 | — | 206,720 |
| Write off of deferred compensation | 142,187 | — | 142,187 |

See Notes to condensed financial statements.

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

**NOTES TO CONDENSED FINANCIAL STATEMENTS
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)**

1. Organization and basis of presentation

Basis of presentation

The accompanying interim condensed financial statements are unaudited, but in the opinion of management of Save the World Air, Inc. (the Company), contain all adjustments, which include normal recurring adjustments, necessary to present fairly the financial position at March 31, 2006, the results of operations for the three months ended March 31, 2006 and 2005, and cash flows for the three months ended March 31, 2006 and 2005. The balance sheet as of December 31, 2005 is derived from the Company's audited financial statements.

Certain information and footnote disclosures normally included in financial statements that have been prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission, although management of the Company believes that the disclosures contained in these financial statements are adequate to make the information presented therein not misleading. For further information, refer to the financial statements and the notes thereto included in the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2005, as filed with the Securities and Exchange Commission.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expense during the reporting period. Actual results could differ from those estimates. The results of operations for the three months ended March 31, 2006 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2006.

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

**NOTES TO CONDENSED FINANCIAL STATEMENTS — Continued
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)**

1. Organization and basis of presentation — Continued

Description of business

Save the World Air, Inc. (the "Company") was incorporated in Nevada on February 18, 1998 under the name Mandalay Capital Corp. The Company changed its name to Save the World Air, Inc. on February 11, 1999 following the purchase of the worldwide exclusive manufacturing, marketing and distribution rights for the ZEFS device. The ZEFS is a device, which is fitted to an internal combustion engine and is expected to reduce carbon monoxide hydrocarbons and nitrous oxide emissions. During the past three years, the Company has been acquiring new technologies, developing prototype products using the Company's technologies and conducting scientific tests regarding the technologies and prototype products. In 2003, the Company acquired worldwide intellectual property and patent rights to technologies which reduce carbon monoxide, hydrocarbons and nitrous oxide emissions in two- and four-stroke motorcycles, fuel-injection engines, generators and small engines. The Company has also developed prototype products and named them "CAT-MATE".

Development stage enterprise

The Company is a development stage enterprise as defined by Statement of Financial Accounting Standards (SFAS) No. 7, "Accounting and Reporting by Development Stage Enterprises." All losses accumulated since the inception of the Company have been considered as part of the Company's development stage activities.

The Company's focus is on research and development of proprietary devices that are designed to reduce harmful emissions, and improve fuel efficiency and engine performance on equipment and vehicles driven by internal combustion engines and has not yet generated any revenues. The prototype devices are called "ZEFS" and "CAT-MATE." The Company has put forth efforts to complete the design, the development of production models and the promotion of products in the market place worldwide. Expenses have been funded through the sale of company stock, debt and the exercise of warrants. The Company has taken actions to secure the intellectual property rights to the ZEFS and CAT-MATE devices. In addition, the Company has initiated marketing efforts to international governmental entities in cooperation with the United Nations Environmental Programme (UNEP) and various original equipment manufacturers (OEMs), to eventually sell or license the ZEFS and CAT-MATE products and technology.

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

**NOTES TO CONDENSED FINANCIAL STATEMENTS — Continued
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)**

2. Net loss per share

Basic earnings (loss) per share is computed by dividing net income (loss) available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflects the potential dilution, using the treasury stock method, that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Company. In computing diluted earnings per share, the treasury stock method assumes that outstanding options and warrants are exercised and the proceeds are used to purchase common stock at the average market price during the period. Options and warrants will have a dilutive effect under the treasury stock method only when the average market price of the common stock during the period exceeds the exercise price of the options and warrants. For the three months ended March 31, 2006 and 2005, the dilutive impact of outstanding stock options of 7,181,257 and 14,422,652 respectively, and outstanding warrants of 22,971,954 and 16,093,914 have been excluded because their impact on the loss per share is antidilutive.

3. Recent accounting pronouncements

On January 1, 2006, the Company adopted Statements of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company's fiscal year 2006. The Company's financial statements as of and for the three months ended March 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company's financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). There was no stock-based compensation expense related to employee or director stock options recognized during the three months ended March 31, 2005. Stock-based compensation expense recognized under SFAS 123(R) for employee and directors for the three months ended March 31, 2006 was \$478,490. Basic and diluted loss per share for the quarter ended March 31, 2006 would have been \$(0.08) per share, if the Company had not adopted SFAS 123(R), compared to reported basic and diluted loss per share of \$(0.10) per share.

[Table of Contents](#)**SAVE THE WORLD AIR, INC.
(A DEVELOPMENT STAGE ENTERPRISE)****NOTES TO CONDENSED FINANCIAL STATEMENTS — Continued
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)****3. Recent accounting pronouncements — Continued**

The following table illustrates the effect on net loss and loss per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based awards granted under the Company's stock option plans for the three months ended March 31, 2005. For purposes of this pro-forma disclosure, the fair value of the options is estimated using the Black-Scholes-Merton option-pricing formula ("Black-Scholes model") and amortized to expense over the options' requisite service periods (vesting periods).

| | |
|---|----------------------|
| Net loss as reported | \$(1,065,056) |
| Plus: Stock-based expense recognized in the Statement of Operations – intrinsic value | 60,938 |
| Less: Stock-based expense determined under fair-value based method (SFAS 123) | <u>(290,102)</u> |
| Pro forma net loss | <u>\$(1,294,220)</u> |
| Net loss per share | |
| As reported – basic and diluted | \$ (0.03) |
| Pro forma – basic and diluted | \$ (0.04) |

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards to employees and directors on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Statements of Operations. Stock-based compensation expense recognized in the Statements of Operations for the first quarter of fiscal 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of January 1, 2006 based on the grant date fair value estimated in accordance with the pro-forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to January 1, 2006 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). For stock-based awards issued to employees and directors, stock-based compensation is attributed to expense using the straight-line single option method, which is consistent with how the prior-period pro formas were provided. As stock-based compensation expense recognized in the Statements of Operations for the first quarter of fiscal 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In our pro-forma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred.

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

**NOTES TO CONDENSED FINANCIAL STATEMENTS — Continued
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)**

3. Recent accounting pronouncements — Continued

Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25. Under the intrinsic value method, the Company recognized share-based compensation equal to the award's intrinsic value at the time of grant over the requisite service periods using the straight-line method. Forfeitures were recognized as incurred.

The Company's determination of fair value of share-based payment awards to employees and directors on the date of grant using the Black-Scholes model, which is affected by the Company's stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to our expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors.

The Company has elected to adopt the detailed method provided in SFAS 123(R) for calculating the beginning balance of the additional paid-in capital pool ("APIC pool") related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R).

In May 2005, the FASB issued Statement No. 154 ("SFAS 154") "Accounting Changes and Error Corrections — a replacement of APB Opinion No. 20 and FASB Statement No. 3." SFAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle. APB Opinion 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects of the cumulative effect of the change. In the event of such impracticality, SFAS 154 provides for other means of application. In the event the Company changes accounting principles, it will evaluate the impact of SFAS 154.

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

**NOTES TO CONDENSED FINANCIAL STATEMENTS — Continued
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)**

4. Certain relationships and related transactions

Advances from founding executive officer

All of the marketing and manufacturing rights for the ZEFS were acquired from Mr. Muller, for 5,000,000 shares of common stock, \$500,000 and a \$10 royalty for each unit sold (see discussion below), pursuant to the Agreement entered into in December 1998, by and between the Company and Mr. Muller. Working capital advances in the amount of \$517,208 and payment in the amount of \$500,000 for marketing and distribution rights of the ZEFS are due to Mr. Muller. Such amounts are interest free and do not have any due dates for payment.

In January 2000, the Company entered into an agreement offering Mr. Muller and Lynne Muller, Mr. Muller's wife, the option to purchase 5,000,000 shares each at \$0.10 per share as consideration for work performed for the Company. Mrs. Muller subsequently transferred her option to Mr. Muller.

In connection with the Company's legal proceedings against Mr. Muller (see Note 9). The Company has canceled (i) the 8,047,403 shares of its common stock held by Mr. Muller and/or his affiliates, (ii) the options to acquire an additional 10,000,000 shares of the Company's common stock held by Mr. Muller personally and (iii) the \$1,017,208 of debt which Mr. Muller claimed was owed to him by the Company.

Loans from related parties

Masry & Vititoe, a law firm in which Edward Masry, the Company's former Chief Executive Officer, was a partner, has advanced \$158,732 and \$136,478 as of March 31, 2006 and 2005, respectively, to the Company for working capital purposes. Advances by Masry and Vititoe are unsecured, non-interest bearing, and are due on demand.

In 2005, Eugene Eichler, the Company's Chief Executive Officer, advanced \$45,000 to the Company for working capital purposes. These advances are unsecured, bear interest at 6% per annum and are due on demand. In February 2006, these advances were converted into a convertible note (Note 5).

Lease agreement

In January 2006, the Company entered into a new sublease of a portion of a building in North Hollywood, California from an entity that is owned by a director of the Company. The lease term is from January 1, 2006 through July 31, 2007 and carries an option to renew for two additional years with a 10 percent increase in the rental rate. Monthly rent is \$6,208 per month under this lease.

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

**NOTES TO CONDENSED FINANCIAL STATEMENTS — Continued
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)**

5. Convertible debentures and warrants

During the year ended December 31, 2005, the Company completed the first part of a private offering of its 9% Convertible Notes due at dates ranging between May 31, 2006 and July 31, 2006 (the "Notes") and Warrants to purchase shares of the Company's common stock which expire between August 31, 2007 and December 28, 2007 (the "Warrants"). The Notes are convertible at \$0.70 per share of common stock and the Warrants entitle the holder to purchase a number of shares of the Company's common stock equal to 150% of the number of shares of common stock into which the Note is convertible. The Warrants are exercisable at a price of \$1.00 per share.

During the year ended December 31, 2005, the Company issued Notes totaling \$1,576,378 and paid related transaction fees of \$123,196, resulting in net proceeds to the Company of \$1,453,182. In addition to the cash paid for transaction fees, 166,126 additional Warrants were issued to certain placement agents. These Warrants expire between August 31, 2007 and December 28, 2007 and are exercisable at a price of \$1.00 per share.

The aggregate value of the Warrants issued in connection with the offering and to the finder were valued at \$696,413 using the Black-Scholes option valuation model with the following assumptions; risk-free interest rate of 4.02% to 4.45%; dividend yield of 0%; volatility factors of the expected market price of common stock of 83.59%; and an expected life of two years. The company also determined that the notes contained a beneficial conversion feature of \$756,768.

The value of the Warrants of \$696,413, the conversion option of \$756,768, and the transaction fees of \$123,196 are considered as debt discount and are being amortized over the life of the Notes.

During the three months ended March 31, 2006, the Company issued additional Notes totaling \$1,000,000 which included the conversion of \$45,000 of debt owed to the Company's Chief Financial Officer. The Company paid related transaction fees of \$89,500 resulting in net proceeds to the Company of \$865,500. In addition to the cash paid for transaction fees, 117,857 additional Warrants were issued to certain placement agents. These Warrants expire between August 31, 2007 and February 9, 2008 and are exercisable at a price of \$1.00 per share.

The aggregate value of the Warrants issued in connection with the offering and to the finder were valued at \$620,252 using the Black-Scholes option valuation model with the following assumptions; risk-free interest rate of 4.35% to 4.66%; dividend yield of 0%; volatility factors of the expected market price of common stock of 130.61%; and an expected life of two years. The company also determined that the notes contained a beneficial conversion feature of \$290,248.

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

**NOTES TO CONDENSED FINANCIAL STATEMENTS — Continued
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)**

5. Convertible debentures and warrants — Continued

The value of the Warrants of \$620,252, the conversion option of \$290,248, and the transaction fees of \$89,500 are considered as debt discount and are being amortized over the life of the Notes.

For the three months ended March 31, 2006, \$1,053,266 of the total discount has been amortized and included in the accompanying statement of operations. The remaining unamortized debt discount of \$1,123,684 has been netted against the \$2,369,658 Convertible Notes in the accompanying March 31, 2006 Balance Sheet.

During the three months ended March 31, 2006, \$206,720 of the Notes were converted to 295,314 shares of stock at \$0.70 per share.

6. Capital stock

Sale of equity securities

As of March 31, 2006, the Company has authorized 200,000,000 shares of its common stock, of which 32,343,967 shares were issued and outstanding.

During the year ended December 31, 2005, the Company issued 1,599,500 units of common stock, which consisted of one share of common stock and one warrant to acquire a share of common stock at an exercise price of \$1.50 per share, for net proceeds of \$1,490,660. The 1,599,500 warrants were issued to investors as part of an equity agreement and were not ascribed any value in the accompanying financial statements. Of the 1,599,500 shares issued, the Company issued 69,000 shares of common stock for which payment was previously received. The Company also issued 50,500 shares for the exercise of warrants, 50,000 of which payment was previously received.

The warrants issued above were part of a private offering of 2,892,000 units that began July 29, 2004 and concluded on July 22, 2005. The expiration date of each of the warrants was previously extended by one hundred eighty (180) days from its original expiration date. On February 6, 2006, the Company extended the expiration date for each of the warrants by an additional one hundred eighty-five (185) days, for a total extension of one year from its original expiration date.

During the year ended December 31, 2005, the Company agreed to issue 846,548 shares in settlement of accrued expenses of \$612,521. These shares are reflected as common stock to be issued in the accompanying December 31, 2005 financial statements.

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

**NOTES TO CONDENSED FINANCIAL STATEMENTS — Continued
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)**

6. Capital stock — Continued

Sale of equity securities — Continued

During the three months ended March 31, 2006, individuals exercised outstanding warrants to purchase 146,250 shares of common stock for net proceeds of \$153,125. Subsequent to the end of the three-month period ended March 31, 2006 and through May 12, 2006, individuals exercised outstanding warrants, at various exercise prices, to purchase an additional 1,550,000 shares of common stock for gross and net proceeds of \$900,000.

Warrants

During the year ended December 31, 2005, the Company issued 10,000 warrants to an individual for settlement of a claim. The Company also issued 25,000 warrants to an individual in exchange for consulting services rendered. The warrants were valued at an aggregate amount of \$18,462 using the Black Scholes pricing model using 3-year and 5-year respective terms (statutory terms), 58.69% volatility, no annual dividends, and a discount rate of 3.55% and 4.13%, respectively.

During February 2006, the Company issued 250,000 performance based warrants to an outside consultant. These warrants are to be exercisable at \$.40 per share, are fully vested and exercisable immediately. These warrants were valued at \$401,130 using the Black-Scholes option valuation model with the following assumptions; risk-free interest rate of 4.59%; dividends yield of 0%; volatility factors of the expected market price common of 130.61%; and an expected life of five years.

Intrinsic value of employee options

During the years ended December 31, 2004 and prior, certain employee options were granted with exercise prices less than fair market value of the Company's stock at the date of grant. As the grants were to employees, the intrinsic value method, as allowed under APB No. 25, was used to calculate the related compensation expense. \$76,068 of deferred compensation costs were amortized and recognized as expense in the three months ended March 31, 2005. In January 2006, the Company adopted SFAS 123R. Under SFAS 123R, deferred compensation of \$142,187 was written off against additional paid in capital. The unvested options outstanding were previously valued for pro forma disclosure purposes using the Black-Scholes pricing model, using a 3.0 to 5.5 year expected term, 83.59% volatility, no annual dividends, and a discount rate of 4.06% to 4.12%. Total compensation expense recognized for the three months ended March 31, 2006 was \$290,102.

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

NOTES TO CONDENSED FINANCIAL STATEMENTS — Continued
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)

6. Capital stock — Continued

Black-Scholes value of employee options

During the three months ended March 31, 2006, the Company granted 1,163,605 options to certain employees, exercisable at amounts ranging from \$0.85 to \$1.69, vested over one year with a ten year life. The options were valued at an aggregate amount of \$1,809,518 using the Black Scholes pricing model, as required under SFAS 123R, using a 5.5 year expected term, 130.61% volatility, no annual dividends, and a discount rate of 4.59%. The total compensation expense recognized for the three months ended March 31, 2006 was \$188,388.

The Company issues stock options to employees, directors and consultants under the 2004 Stock Option Plan (the "Plan"). Employee options vest according to the terms of the specific grant and expire from 5 to 10 years from date of grant. Non-employee option grants to date are vested upon issuance.

In February, 2006, the board approved an amendment to the 2004 Plan, increasing by 2,000,000 shares, from 5,000,000 to 7,000,000 shares, the total number of shares subject to options that can be granted under the 2004 Plan.

The weighted average exercise prices, remaining contractual lives and aggregate intrinsic values for options and warrants granted, exercisable, and expected to vest under the Plan as of December 31, 2005 were as follows:

| | Number of shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (Years) | Intrinsic Value |
|---------------------------------|------------------------|--|--|--------------------|
| <i>As of December 31, 2005:</i> | | | | |
| Outstanding | 6,508,561 | \$ 0.27 | 5.26 | \$2,600,000 |
| Expected to Vest | 6,017,652 | \$ 0.43 | 5.31 | \$2,600,000 |
| Exercisable | 4,422,652 | \$ 0.52 | 3.62 | \$2,600,000 |

Aggregate intrinsic value excludes those options and warrants that are "not-in-the-money" as of December 31, 2005. Awards that are expected to vest take into consideration estimate forfeitures for awards not yet vested.

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

**NOTES TO CONDENSED FINANCIAL STATEMENTS — Continued
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)**

6. Capital stock — Continued

Black-Scholes value of employee options — Continued

For the year ended December 31, 2005, no options were exercised.

As of December 31, 2005, there was \$142,187 of total unrecognized compensation costs related to non-vested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over the weighted-average period of one year.

7. Research and development

The Company has research and development facilities in Morgan Hill, California and Queensland, Australia. The Company has expanded research and development to include application of the technologies utilized by the ZEFS and CAT-MATE device for diesel engines, motorbikes, boats, generators, lawnmowers and other small engines. The Company has purchased test vehicles, test engines and testing equipment. The Company has completed testing on ZEFS and CAT-MATE devices for multiple automobiles, trucks, motorcycles, off-road vehicles and stationary engines, the results of which have been provided to RAND Corporation (RAND) for evaluation. RAND oversees the research and development facilities. The Company also uses third party research and development facilities in Los Angeles, California for the development of the ZEFS and CAT-MATE devices. The Company spent \$57,294 and \$401,485 for the three months ended March 31, 2006 and 2005, respectively.

8. Going concern

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. As reflected in the accompanying financial statements, the Company had a net loss of \$2,998,105 and a negative cash flow from operations of \$953,963 for the three months ended March 31, 2006, and had a working capital deficiency of \$2,575,017 and a stockholders' deficiency of \$2,256,314 at March 31, 2006. These factors raise substantial doubt about its ability to continue as a going concern. The ability of the Company to continue as a going concern is dependent upon the Company's ability to raise additional funds and implement its business plan. The financial statements do not include any adjustments that might be necessary if the Company is unable to continue as a going concern.

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

**NOTES TO CONDENSED FINANCIAL STATEMENTS — Continued
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)**

9. Commitments and contingencies

Legal matters

On December 19, 2001, the SEC filed civil charges in the United States Federal District Court, Southern District of New York, against us, the Company's former President and then sole director Jeffrey A. Muller, and others, alleging that the Company and the other defendants were engaged in a fraudulent scheme to promote our stock. The SEC complaint alleged the existence of a promotional campaign using press releases, Internet postings, an elaborate website, and televised media events to disseminate false and materially misleading information as part of a fraudulent scheme to manipulate the market for stock in the corporation, which was then controlled by Mr. Muller. On March 22, 2002, the Company signed a consent to final judgment of permanent injunction and other relief in settlement of this action as against the corporation only, which the court approved on July 2, 2002. Under this settlement, the Company was not required to admit fault and did not pay any fines or restitution. The SEC's charges of fraud and stock manipulation continue against Mr. Muller and others.

On July 2, 2002, after an investigation by the Company's newly constituted board of directors, the Company filed a cross-complaint in the SEC action against Mr. Muller and others seeking injunctive relief, disgorgement of monies and stock and financial restitution for a variety of acts and omissions in connection with sales of the Company's stock and other transactions occurring between 1998 and 2002. Among other things, the Company alleged that Mr. Muller and certain others sold company stock without providing adequate consideration to the Company; sold insider shares without making proper disclosures and failed to make necessary filings required under federal securities laws; engaged in self-dealing and entered into various undisclosed related-party transactions; misappropriated for their own use proceeds from sales of the Company's stock; and entered into various undisclosed arrangements regarding the control, voting and disposition of their stock. The Company contends that it is entitled to a judgment canceling all of the approximately 8,716,710 shares of the Company's common stock that were previously obtained and controlled, directly or indirectly, by Mr. Muller; divesting and preventing any subsequent holders of the right to exercise options previously held by Mr. Muller for 10,000,000 shares of the Company's common stock, conversion of an existing preliminary injunction to a permanent injunction to prevent Mr. Muller from any involvement with the Company and a monetary judgment against Mr. Muller and others in the amount of several million dollars.

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

**NOTES TO CONDENSED FINANCIAL STATEMENTS — Continued
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)**

9. Commitments and contingencies — Continued

Legal matters — Continued

In the course of the litigation, the Company has obtained ownership control over Mr. Muller's claimed patent rights to the ZEFS device. Under a Buy-Sell Agreement between Mr. Muller and the Company dated December 29, 1998, Mr. Muller, who was listed on the ZEFS device patent application as the inventor of the ZEFS device, purported to grant us all international marketing, manufacturing and distribution rights to the ZEFS device. Those rights were disputed because an original inventor of the ZEFS device contested Mr. Muller's legal ability to have conveyed those rights.

In Australia, Mr. Muller entered into a bankruptcy action seeking to overcome the Company's claims for ownership of the ZEFS device. In conjunction with these litigation proceedings, a settlement agreement was reached whereby the \$10 per unit royalty previously due to Mr. Muller under his contested Buy-Sell Agreement was terminated and replaced with a \$.20 per unit royalty payable to the bankruptcy trustee. On November 7, 2002, under a settlement agreement executed with the Mr. Muller's bankruptcy trustee, the trustee transferred to the Company all ownership and legal rights to this international patent application for the ZEFS device.

Both the SEC and the Company have filed Motions for Summary Judgment contending that there are no material issues of fact in contention and as a matter of law, the Court should grant a judgment against Mr. Muller and the cross-defendants. Mr. Muller has filed a response contending the motions are without merit or substance.

Mr. Muller and several of the defendants filed a Motion to Dismiss the complaint filed by the Company and moved for summary judgment in their favor. On December 21, 2004, Judge George B. Daniels denied the cross-defendants' motion to dismiss the Company's cross-complaint, denied the request to vacate the July 2, 2002 preliminary injunction and denied the request for damages against the Company. The court also refused to grant a summary judgment in favor of the cross-defendants and dismissed Mr. Muller's claims against the Company for indemnification for his legal costs and for damages resulting from the litigation. Neither Mr. Muller nor any of the cross-defendants have filed any cross-claims against the Company and the Company is not exposed to any liability as a result of the litigation, except for possibly incurring legal fees and expenses should the Company lose the litigation.

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

**NOTES TO CONDENSED FINANCIAL STATEMENTS — Continued
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)**

9. Commitments and contingencies — Continued

Legal matters — Continued

On November 16, 2005, the Court granted the SEC's motion for summary judgment. In granting the motion, the Court has barred Mr. Muller from serving as an officer or director of a public company for a period of 20 years, ordered Mr. Muller to disgorge any shares of our stock that he still owns and directed the Company to cancel any issued and outstanding shares of our stock still owned by Mr. Muller. Mr. Muller was also ordered to disgorge to the SEC unlawful profits in the amount of \$7.5 million and a pay a civil penalty in the amount of \$100,000. Acting in accordance with the Court's order, the Company has canceled (i) 8,047,403 shares of its common stock held by Mr. Muller and/or his affiliates, (ii) options to acquire an additional 10,000,000 shares of the Company's common stock held by Mr. Muller personally and (iii) \$1,017,208 of debt which Mr. Muller claimed was owed to him by the Company.

In response to the November 16, 2005 decision by the Court, Muller filed a motion seeking to set aside the decision and order of the Court. On March 31, 2006, the Court issued a decision and order denying Muller's motion to set aside the decision on summary judgment issued against Muller on November 16, 2005.

A final decision on the motion for summary judgment filed by the Company, which potentially would terminate the ongoing litigation, is still pending. Should the Court not grant summary judgment in favor of the Company, the case will be scheduled for final disposition in a trial. Although the outcome of this litigation cannot be predicted with any degree of certainty, the Company is optimistic that, based upon previous developments in the litigation and the Court's granting of the SEC's motion for summary judgment, the Court's ruling on the motion for summary judgment will either significantly narrow the issues for any later trial or will result in a final disposition of the case in a manner favorable to the Company.

In April 2005, Jeffrey A. Muller, the Company's former sole director and executive officer, filed a lawsuit in the Federal District Court for the Central District of California, seeking declaratory and injunctive relief and alleging unfair competition in connection with a claimed prior patent interest in the ZEFS device and stock option rights. In seeking declaratory relief, Mr. Muller is seeking to have the patent rights in the ZEFS device that were previously transferred to the Company by Mr. Muller's bankruptcy trustee declared null and void.

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

**NOTES TO CONDENSED FINANCIAL STATEMENTS — Continued
THREE MONTHS ENDED MARCH 31, 2006 (UNAUDITED)**

9. Commitments and contingencies — Continued

Legal matters — Continued

This recent lawsuit brought by Mr. Muller arises out of the same claims that are the subject of ongoing litigation in the Federal District Court for the Southern District of New York, in which the Company has previously obtained a preliminary injunction against Mr. Muller barring him from any involvement with the Company and preventing Mr. Muller, his agents or assigns, from exercising any claimed rights to the Company's assets or stock. Mr. Muller previously filed the same complaint in the Federal District Court for the Southern District of New York, which claim is pending dismissal. On December 28, 2004, Federal District Court Judge George B. Daniels issued a decision dismissing motions filed by Mr. Muller against the Company's cross-claims. The dismissal of those motions involved similar causes of action as those contained in Mr. Muller's recent lawsuit commenced in the Federal District Court for the Central District of California. Since the case in New York is still pending, the filing of the new lawsuit in California is subject to various defenses which should result in the dismissal of the new lawsuit.

On January 25, 2006, Mr. Muller's complaint, filed in the California District Court and transferred to the Federal Court in the Southern District of New York, was assigned to Judge George B. Daniels. It is expected that the Court will consolidate that complaint with the already pending claims encompassed within the Company's Motion for Summary Judgment. While the Company believes that it will have valid claims and defenses, there can be no assurance that an adverse result or outcome on the pending motions or a trial of this case would not have a material adverse effect on the Company's financial position or cash flow.

[Table of Contents](#)

Item 2. Management's Discussion and Analysis or Plan of Operations

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

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

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

Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth under the heading "Risk Factors" in our Annual Report on Form 10-KSB for the year ended December 31, 2005. All forward-looking statements included in this document are based on information available to us on the date hereof. We assume no obligation to update any forward-looking statements.

Overview

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the Financial Statements and notes thereto included in Part I, Item 1 of this Form 10-QSB and the Financial Statements and notes thereto contained in our Annual Report on Form 10-KSB for the fiscal year ended December 31, 2005.

We are a development stage company that is transitioning to operations. We have not yet generated revenues. Much of our focus remains on research and development of our proprietary and patented devices that are designed to reduce harmful emissions, and improve fuel efficiency and overall performance on equipment and vehicles driven by internal combustion engines.

Our devices are called "ZEFS" and "CAT-MATE." Historically, we have devoted the bulk of our efforts to the completion of the design, the development of our production models and the promotion of our products in the marketplace worldwide. We have taken actions to secure our intellectual property rights to the ZEFS and CAT-MATE devices.

Table of Contents

During 2005 and continuing in the three-month period ended March 31, 2006, we also began to focus on the initial marketing of our devices. We entered into the first agreements for the distribution of our products in late 2005 and early 2006. Our first two US distributorship agreements with Team Phantom of Alaska and Motorcycle Products Consulting of California, provides for the sale of our ZEFS devices in the North American OEM and after-market for motorcycles through the distributors to certain named prospective purchasers.

In January 2006, we entered into our first international distributorship agreement, with Golden Allied Enterprises (Group) Co., Ltd. ("GAE"). The agreement provides that GAE will serve as our exclusive distributor for our ZEFS and CAT-MATE devices in the People's Republic of China. The agreement with GAE is conditioned upon our ZEFS device achieving EURO2 standards in tests to be conducted in Shanghai. These tests were conducted and passed in April 2006.

We anticipate that we will begin delivering devices under these agreements commencing in the third quarter of 2006 and we currently believe that we will begin to generate revenue during the third quarter of 2006.

In addition, we are continuing our marketing efforts to international governmental entities in cooperation with the United Nations Environmental Programme (UNEP) and various original equipment manufacturers (OEMs), and the aftermarket to sell or license our ZEFS and CAT-MATE devices and technology. We anticipate that these efforts will continue during the remainder of 2006.

Since February 2, 2006, our common stock has been quoted on the Over-the-Counter Bulletin Board under the symbol "ZERO.OB".

Expenses have been funded primarily through the sale of stock and convertible debt. We have raised capital in 2006 and will need to raise additional capital in 2006, and possibly beyond, to fund our sales and marketing efforts, continuing research and development, and certain other expenses, until our revenue base grows sufficiently.

Results of Operations

To date, we have not generated any revenues and our business continues in the development stage. We have focused our efforts on verifying and developing our technologies and devices and commencing marketing efforts for their license or sale. We expect to begin generating revenue in the third quarter of 2006.

General and administrative expenses were \$2,940,011 for the three-month period ended March 31, 2006, compared to \$661,595 for the three-month period ended March 31, 2005, an increase of \$2,278,416. This increase is primarily attributable to an increase in non-cash expenses in the amount of \$2,007,888. These non-cash items are made up of accounting valuation and amortization of warrant values associated with convertible debt financing totaling \$1,183,293, revaluation of options and warrants using the Black- Scholes option pricing model amounting to \$803,551, and depreciation of \$21,044. Increases in cash expenses were \$270,528 and were made up of Salaries, Benefits and Consulting Fees of \$164,994; Corporate Expenses of \$30,541; Professional Fees of \$50,250; and Rent and Utilities and Office Expenses of \$24,743.

[Table of Contents](#)

Research and development expenses were \$57,294 for the three-month period ended March 31, 2006, compared to \$401,485 for the three-month period ended March 31, 2005, a decrease of \$344,191. This decrease is primarily attributable to a decrease in research by RAND Corporation of \$380,032, offset in part by an increase in product research, testing and prototype expenses of \$35,841.

We expect our operating costs to increase during the balance of fiscal year 2006, primarily as a result of anticipated increases in product development expenses, general and administrative expenses and marketing expenses, as we continue production and sales activities during 2006.

We had a net loss of \$2,998,105 or \$.10 per share for the three-month period ended March 31, 2006, compared to a net loss of \$1,065,056 or \$.03 per share for the three-month period ended March 31, 2005. We expect to incur additional net loss in the fiscal year ending December 31, 2006, primarily attributable to continued general and administrative expenses and marketing-related expenditures without the benefit of any significant revenue for the remainder of the year.

Liquidity and Capital Resources

We have incurred negative cash flow from operations in the development stage since our inception in 1998. As of March 31, 2006, we had cash of \$320,344 and an accumulated deficit of \$23,244,179. Our negative operating cash flow since inception has been funded primarily through the sale of common stock, issuance of convertible notes, and, to a lesser degree, by proceeds we received from the exercise of options and warrants.

The financial statements accompanying this Report have been prepared on a going concern basis, which contemplates the realization of assets and settlement of liabilities and commitments in the normal course of our business. As reflected in the accompanying financial statements, we had a net loss of \$2,998,105 and negative cash flow from operations of \$953,963 for the three-month period ended March 31, 2006 and a stockholders' deficiency of \$2,256,314 as of March 31, 2006. These factors raise substantial doubt about our ability to continue as a going concern. Our ability to continue as a going concern is dependent on our ability to raise additional funds and implement our business plan. The financial statements do not include any adjustments that might be necessary if we are unable to continue as a going concern.

As of March 31, 2006, our expenses ran, and are expected to continue to run, at a "burn rate" of approximately \$350,000 per month. Our current capital resources will be sufficient to fund operations only through July 2006, and we will require additional capital in order to operate beyond this date.

We issued an aggregate \$1,075,000 principal amount of our 9% convertible subordinated notes to investors in late 2005 and early 2006 (the "Bridge Notes"). Net proceeds to us from the sale of the Bridge Notes were \$935,250. Of this amount, \$550,000 principal amount was issued in the three-month period ended March 31, 2006, resulting in net proceeds to the Company of \$487,500. The Bridge Notes mature on the

Table of Contents

earlier of May 31, 2006 or the successful completion of an offering of our securities of at least \$5,000,000 gross proceeds.

In addition, during 2005 and early 2006, we also issued an aggregate of \$1,501,378 principal amount of our 9% convertible subordinated notes (the "Investor Notes") due July 31, 2006 to certain investors. Of this amount, \$450,000 principal amount was issued in the three-month period ended March 31, 2006, resulting in net proceeds to the Company of \$432,000. The Company may, at its option, require that the Investor Notes be converted into shares of our Common Stock if we raise at least \$5,000,000 gross proceeds in one or more offerings of our securities prior to such date.

In 2006, we have raised capital through the sale of our common stock and are continuing to raise capital through the sale of our common stock, to provide the funds necessary to continue to execute on our business plan and repay the Bridge Notes and Investor Notes as they mature. Subsequent to the end of the three-month period ended March 31, 2006, we conducted an offering of shares of our common stock to two overseas investors, in which we raised \$737,881 gross proceeds (\$667,783 net proceeds).

Also subsequent to the end of the three-month period ended March 31, 2006, we commenced an offering (the "PIPE Offering") of shares of up to \$2,000,000 (subject to a 20% over-allotment option) of our common stock and warrants through our exclusive placement agent, Spencer Clarke LLC of New York. Prior to the filing of this Report, we raised \$1,334,000 gross proceeds (\$1,160,579 net proceeds) in the PIPE Offering. The PIPE Offering is ongoing at the time of the filing of this Report.

During the three-month period ended March 31, 2006, we have also raised \$153,125 through the exercises of outstanding warrants. Subsequent to the end of the three-month period ended March 31, 2006 and through May 12, 2006, we raised an additional \$900,000 through the exercise of outstanding warrants.

We believe that exercises of in-the-money options and warrants, together with sales of our securities in the PIPE Offering and other financings we have undertaken and may undertake, will provide most of the proceeds needed to meet our capital requirements on a going forward basis. However, there can be no assurance that additional equity or debt financing will be available or available on terms favorable to us. If we are unable to obtain additional financing, we may be required to delay, reduce the scope of, or eliminate, our ongoing research and development programs, reduce our marketing and sales activities, or relinquish rights to technologies that we might otherwise seek to develop or commercialize.

Critical Accounting Policies and Estimates

Our discussion and analysis of financial condition and results of operations is based upon our Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these Financial Statements and related disclosures requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, expenses, and related disclosure of contingent assets and liabilities. We evaluate, on an on-going basis, our estimates and judgments, including those related to the useful life of the assets. We base our estimates on historical experience and assumptions that we believe to be reasonable under the

[Table of Contents](#)

circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The methods, estimates and judgments we use in applying our most critical accounting policies have a significant impact on the results that we report in our Financial Statements. The SEC considers an entity's most critical accounting policies to be those policies that are both most important to the portrayal of a company's financial condition and results of operations and those that require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about matters that are inherently uncertain at the time of estimation. We believe the following critical accounting policies, among others, require significant judgments and estimates used in the preparation of our Financial Statements:

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

Stock-Based Compensation

On January 1, 2006, we adopted Statements of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123R"), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. SFAS 123R supersedes our previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123R. We have applied the provisions of SAB 107 in our adoption of SFAS 123R.

We adopted SFAS 123R using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of our 2006 fiscal year.

Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 151, "Inventory Costs". This Statement amends the guidance in ARB No. 43 Chapter 4 Inventory Pricing, to require items such as idle facility costs, excessive spoilage, double freight and rehandling costs to be expensed in the current period, regardless if they are abnormal amounts or not. This Statement will become effective for us in the first quarter of 2006. The adoption of SFAS No. 151 is not expected to have a material impact on our financial condition, results of operations, or cash flows.

[Table of Contents](#)

In May 2005, the FASB issued Statement No. 154, "Accounting Changes and Error Corrections — a replacement of APB Opinion No. 20 and FASB Statement No. 3" ("SFAS No. 154"). SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. APB Opinion 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS No. 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects of the cumulative effect of the change. In the event of such impracticability, SFAS No. 154 provides for other means of application. In the event the Company changes accounting principles, it will evaluate the impact of SFAS No. 154.

Item 3. Controls and Procedures

(a) *Evaluation of disclosure controls and procedures:* Our management evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-QSB. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)) are not adequate to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. We have developed, and have partially implemented, a plan to ensure that all information will be recorded, processed, summarized and reported on a timely basis. This plan is dependent, in part, upon reallocation of responsibilities among various personnel, hiring additional personnel and additional funding. We began to implement this plan during 2005, including the hiring in August 2005 of a Controller who is a Certified Public Accountant. It should also be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

(b) *Changes in internal control over financial reporting:* There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-QSB that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II

Item 1. Legal Proceedings

On December 19, 2001, the SEC filed civil charges in the United States Federal District Court, Southern District of New York, against us, our former President and then sole director Jeffrey A. Muller, and others, alleging that we and the other defendants were engaged in a fraudulent scheme to promote our stock. The SEC complaint alleged the existence of a promotional campaign using press releases, Internet postings, an elaborate website, and televised media events to disseminate false and materially misleading

Table of Contents

information as part of a fraudulent scheme to manipulate the market for stock in our corporation, which was then controlled by Mr. Muller. On March 22, 2002, we signed a Consent to Final Judgment of Permanent Injunction and Other Relief in settlement of this action as against the corporation only, which the court approved on July 2, 2002. Under this settlement, we were not required to admit fault and did not pay any fines or restitution. The SEC's charges of fraud and stock manipulation continue against Mr. Muller and others.

On July 2, 2002, after an investigation by our newly constituted board of directors, we filed a cross-complaint in the SEC action against Mr. Muller and others seeking injunctive relief, disgorgement of monies and stock and financial restitution for a variety of acts and omissions in connection with sales of our stock and other transactions occurring between 1998 and 2002. Among other things, we alleged that Mr. Muller and certain others sold Company stock without providing adequate consideration to us; sold insider shares without making proper disclosures and failed to make necessary filing required under federal securities laws; engaged in self-dealing and entered into various undisclosed related-party transactions; misappropriated for their own use proceeds from sales of our stock; and entered into various undisclosed arrangement regarding the control, voting and disposition of their stock. On July 30, 2002, the U.S. Federal District Court, Southern District of New York, granted our application for a preliminary injunction against Mr. Muller and others, which prevented Mr. Muller and other cross-defendants from selling, transferring, or encumbering any assets and property previously acquired from us, from selling or transferring any of our stock that they may own or control, or from taking any action to injure us or our business and from having any direct contact with our shareholders. The injunctive order also prevents Mr. Muller from engaging in any effort to exercise control over our corporation and from serving as an officer or director of our company. While we believe that we have valid claims, there can be no assurance that an adverse result or settlement would not have a material adverse effect on our financial position or cash flow.

In the course of the litigation, we have obtained ownership control over Mr. Muller's claimed patent rights to the ZEFS device. Under a Buy-Sell Agreement between Mr. Muller and dated December 29, 1998, Mr. Muller, who was listed on the ZEFS devise patent application as the inventor of the ZEFS device, purported to grant us all international marketing, manufacturing and distribution rights to the ZEFS device. Those rights were disputed because an original inventor of the ZEFS device contested Mr. Muller's legal ability to have conveyed those rights.

In Australia, Mr. Muller entered into a bankruptcy action seeking to overcome our claims for ownership of the ZEFS device. In conjunction with these litigation proceedings, a settlement agreement was reached with the bankruptcy trustee whereby the \$10 per unit royalty previously due to Mr. Muller under his contested Buy-Sell Agreement was terminated and replaced with a \$.20 per unit royalty payable to the bankruptcy trustee. On November 7, 2002, under a settlement agreement executed with Mr. Muller's bankruptcy trustee, the trustee transferred to us all ownership and legal rights to this international patent application for the ZEFS device.

[Table of Contents](#)

Both the SEC and we filed Motions for Summary Judgment contending that there are no material issues of fact in contention and as a matter of law, the Court should grant a judgment against Mr. Muller and the cross-defendants.

Mr. Muller and several of the defendants filed a Motion to Dismiss the complaint filed by us and moved for summary judgment in their favor. On December 28, 2004, Judge George B. Daniels, denied the cross-defendants' motion to dismiss our cross-complaint, denied the defendants' request to vacate the July 2, 2002 preliminary injunction and denied their request for damages against us. The court also refused to grant a summary judgment in favor of the cross-defendants and dismissed Mr. Muller's claims against us for indemnification for his legal costs and for damages resulting from the litigation. Neither Mr. Muller nor any of the cross-defendants have filed any cross-claims against us and we are not exposed to any liability as a result of the litigation, except for possibly incurring legal fees and expenses should we lose the litigation.

On November 16, 2005, the Court granted the SEC's motion for summary judgment. In granting the motion, the Court has barred Mr. Muller from serving as an officer or director of a public company for a period of 20 years, ordered Mr. Muller to disgorge any shares of our stock that he still owns and directed the Company to cancel any issued and outstanding shares of our stock still owned by Mr. Muller. Mr. Muller was also ordered to disgorge to the SEC unlawful profits in the amount of \$7.5 million and a pay a civil penalty in the amount of \$100,000. Acting in accordance with the ruling and decision of the Court, we have canceled (i) 8,047,403 shares of its common stock held by Mr. Muller and/or his affiliates, (ii) options to acquire an additional 10,000,000 shares of our common stock held by Mr. Muller personally and (iii) \$1,017,208 of debt which Mr. Muller claimed was owed to him by the Company.

In response to the November 16, 2005 decision by the Court, Muller filed a motion seeking to set aside the Decision and Order of the Court. On March 31, 2006, the Court issued a Decision and Order denying Muller's Motion to set aside the Decision on Summary Judgment issued against Muller on November 16, 2005.

A final decision on the motion for summary judgment filed by us, which potentially would terminate the ongoing litigation, is still pending. Should the Court not grant summary judgment in our favor, the case will be scheduled for final disposition in a trial. Although the outcome of this litigation cannot be predicted with any degree of certainty, we are optimistic that, based upon previous developments in the litigation and the Court's granting of the SEC's motion for summary judgment, the Court's ruling on our motion for summary judgment will either significantly narrow the issues for any later trial or will result in a final disposition of the case in a manner favorable to us.

In April 2005, Jeffrey A. Muller, the Company's former sole director and executive officer, filed a complaint against us in the Federal District Court for the Central District of California, seeking declaratory and injunctive relief and alleging unfair competition in connection with a claimed prior patent interest in the ZEFS device and stock option rights. In seeking declaratory relief, Mr. Muller is seeking to have the patent rights in the ZEFS device that were previously transferred to us by Mr. Muller's bankruptcy trustee declared null and void.

[Table of Contents](#)

This recent lawsuit brought by Mr. Muller arose out of the same claims that are the subject of ongoing litigation in the Federal District Court for the Southern District of New York, in which we have previously obtained a preliminary injunction against Mr. Muller barring him from any involvement with the Company and preventing Mr. Muller, his agents or assigns, from exercising any claimed rights to our assets or stock. Mr. Muller previously filed the same complaint in the Federal District Court for the Southern District of New York, which claim is still pending. On December 28, 2004, Federal District Court Judge George B. Daniels issued a decision dismissing motions filed by Mr. Muller against our cross-claims. The dismissal of those motions involved similar causes of action as those contained in Mr. Muller's recent lawsuit commenced in the Federal District Court for the Central District of California. Since the case in New York is still pending, we believe that the filing of the new lawsuit in California is subject to various defenses which should result in the dismissal of the new lawsuit.

On January 25, 2006, Mr. Muller's complaint, filed in the California District Court and transferred to the Federal Court in the Southern District of New York, was assigned to Judge George B. Daniels. It is expected that the Court will consolidate that complaint with the already pending claims encompassed within our Motion for Summary Judgment. While we believe that we have valid claims and defenses, there can be no assurance that an adverse result or outcome on the pending motions or a trial of this case would not have a material adverse effect on our financial position or cash flow.

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

During the three-month period ended March 31, 2006, the Company sold an aggregate \$450,000 principal amount of Investor Notes and warrants to purchase 964,286 additional shares of common stock at \$1.00 share, to one investor. Net proceeds to the Company were \$432,000. The issuance of the convertible notes and warrants described above were made in reliance on the exemptions from registration set forth in Section 4(2) of the Securities Act of 1933, as amended, or Regulations D promulgated thereunder.

During the three-month period ended March 31, 2006, the Company also sold an aggregate \$550,000 principal amount of Bridge Notes and warrants to purchase 1,178,571 additional shares of common stock at \$1.00 per share, to 15 investors, as part of the Company's Bridge Financing. In addition, warrants exercisable for 117,857 shares of the Company's common stock were issued to the Company's placement agent. Net proceeds to the Company in connection with these issuances were \$487,500. The issuances of the convertible notes and warrants described above were made in reliance on the exemptions from registration set forth in Section 4(2) of the Securities Act of 1933, as amended, or Regulations D or S promulgated thereunder.

Additionally, during the three-month period ended March 31, 2006, individuals exercised outstanding warrants to purchase 146,250 shares of our common stock for an aggregate \$153,125 gross and net proceeds. Subsequent to the end of the three-month period ended March 31, 2006 and through May 12, 2006, individuals exercised outstanding warrants, at various exercise prices, to purchase an additional 1,550,000 shares for an aggregate \$900,000 gross and net proceeds. The issuances of the shares of common stock upon exercise of the warrants described above were made in reliance on the

[Table of Contents](#)

exemptions from registration set forth in Section 4(2) of the Securities Act of 1933, as amended, or Regulations D promulgated thereunder.

In April 2006, subsequent to the end of the three-month period ended March 31, 2006, the Company sold an aggregate 473,000 shares of common stock and warrants to purchase 118,250 additional shares of common stock at \$2.60 per share, to two investors. In addition, warrants exercisable for 11,825 shares of the Company's common stock were issued to the Company's placement agent. Gross proceeds to the Company in connection with these issuances were \$737,881 and net proceeds were \$667,783. This offering was made to individuals who are not "U.S. persons" as that term is defined in Rule 902 of Regulation S promulgated under the Securities Act of 1933, as amended.

Item 3. Defaults Upon Senior Securities

None

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

None

Item 5. Other Information

Our principal executive offices consist of leased space in North Hollywood, California. We lease this space from KZ Golf, Inc. ("KZG"), pursuant to a lease we originally entered into on October 16, 2003 and which expired on October 16, 2005. We exercised an option to renew the lease, which renewal term was due to expire on October 15, 2007. Through October 16, 2005, the rent was \$3,400 per month for approximately 1,225 square feet, and for comprehensive office support services, including reception, parking and conference facilities. During the extended lease term, the rent was \$3,740 per month.

In connection with our need to acquire additional office space and expanded services as our business activities grow, we entered into a new lease dated as of January 1, 2006 with KZG, replacing the prior lease and the terms applicable under the extended term thereof. The new lease is for a term of 19 months, expiring July 31, 2007. The new rent is \$6,208 per month for approximately 1,700 square feet of office space, and for additional common area use, expanded office support services, including a computer network, and additional parking spaces. We have the right to renew the lease for an additional term of two years at a 10% increase over the then-current rent.

Bruce H. McKinnon, our President and a director, is an owner of KZG. Management believes that the terms of the lease with KZG are no less favorable than what we would have had to pay for equivalent space and comparable services with an unaffiliated party.

[Table of Contents](#)

Item 6. Exhibits

| <u>Exhibit No.</u> | <u>Description</u> |
|--------------------|---|
| 10.1 | Commercial Sublease dated as of January 1, 2006 between KZG and the Company |
| 31.1 | Certification of Chief Executive Officer of Quarterly Report Pursuant to Rule 13(a)-15(e) or Rule 15(d)-15(e) |
| 31.2 | Certification of Chief Financial Officer of Quarterly Report Pursuant to 18 U.S.C. Section 1350 |
| 32 | Certification of Chief Executive Officer and Chief Financial Officer of Quarterly Report pursuant to Rule 13(a)-15(e) or Rule 15(d)-15(e) |

SIGNATURES

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

Date: May 17, 2006

SAVE THE WORLD AIR, INC.

By: /s/ EUGENE E. EICHLER

Eugene E. Eichler

Chief Executive Officer

EXHIBIT INDEX

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COMMERCIAL SUBLEASE

This sublease is made between KZG (hereinafter "Sublessor") and Save the World Air, Inc. (hereinafter "Sublessee").

Sublessee hereby leases from Sublessor the following premises on the following terms and conditions.

1. Description of Sublet Property.

Sublessor sublets the following premises:

- a. Five Offices including the use of the receptionist, conference room, kitchen and all common areas (see Exhibit 1, attached. Five offices #1-5 in yellow; common areas in pink) in the building located at 5125 Lankershim Blvd., North Hollywood, CA 91601.
- b. Use of 7 parking spaces for automobiles.

2. Term and Rent.

Sublessor demises the above premises for a term of nineteen (19) months, commencing January 1, 2006 and terminating July 31, 2007 at the annual rental of seventy four thousand four hundred ninety six dollars (\$74,496) payable in equal installments in advance on the first day of each month in the sum of \$6,208 during the term of this sublease.

3. Use.

Sublessee shall use and occupy the premises for the purpose of general administration of its business.

4. Care and Maintenance and Services.

Sublessor shall provide the maintenance, cleaning and care of the premises and shall maintain the premises in good order and repair. Sublessor shall also provide telephone receptionist to answer Sublessee's phones during normal business hours.

5. Alterations.

Sublessee shall not, without first obtaining the written consent of Sublessor, make any alterations, additions, or improvements, in, to or about the premises.

6. Ordinances and Statutes.

Sublessee shall comply with all statutes, ordinances, and requirements of all municipal, state and federal authorities now in force, or which may hereafter be in force, pertaining to the premises, occasioned by or affecting the use thereof by Sublessee.

7. Assignment and Subletting.

Lessee shall not assign this sublease or sublet any portion of the premises without prior written consent of the Sublessor, which shall not be unreasonably withheld. Any such assignment or subletting without consent shall be void and at the option of the Sublessor, may terminate this Sublease.

8. Utilities.

Sublessor shall pay all utilities except telephone and fax which expenses shall be Sublessee's expense.

9. Indemnification of Sublessor.

Sublessor shall not be liable for any damage or injury to Sublessee or any other person (on the premises at the request of or for the benefit of Sublessee) or to any property, occurring on the demised premises or any part thereof, and Sublessee agrees to hold Sublessor harmless from any claims for damages, no matter how caused.

10. Insurance.

Sublessee, at its expense, shall maintain public liability insurance including bodily injury and property damage insuring Sublessee and Sublessor with minimum coverage as follows:

Sublessee shall provide Sublessor with a Certificate of Insurance showing Sublessor as an additional insured. The Certificate shall provide for a ten-day written notice to Sublessor in the event of cancellation or material change of coverage. To the maximum extent permitted by insurance policies which may be owned by Sublessor or Sublessee, Sublessee and Sublessor, for the benefit of each other, waive any and all rights of subrogation which might otherwise exist.

11. Late Charges.

Sublessee hereby acknowledges that late payment by Sublessee will cause Sublessor to incur costs not contemplated by this Sublease. Accordingly if any rent shall not be received by Sublessor within ten (10) days after such amount shall be due, Sublessor shall immediately pay to Sublessor a late charge of One hundred dollars per day until all past due payments including late payments are paid in full.

12. Eminent Domain

If the premises or any part thereof or any estate therein, or any other part of the building materially affecting Sublessee's use of the premises, shall be taken by eminent domain, this lease shall terminate on the date when title vest pursuant to such taking.

13. Destruction of Premises.

In the event of partial destruction of the premises during the term hereof, from any cause, Sublessor shall forthwith repair the same, provided that such repairs can be made within sixty (60) days under existing governmental laws and regulations, but such partial destruction shall not terminate this Sublease, except that Sublessee shall be entitled to a proportionate reduction of rent during repairs based on the extent the repairs interfere with the business of Sublessee on the premises. If repairs cannot be made within sixty (60) days, Sublessor at its option may terminate this Sublease.

14. Sublessor's Remedies on Default.

If Sublessee defaults in the payment of rent, or any additional rent, or defaults in the performance of any of the other covenants or conditions hereof, Sublessor may give Sublessee notice of such default and if Sublessee does not cure any such default within three (3) business days, Sublessor at its sole option may terminate the Sublease and Sublessee shall quit and surrender the premises to Sublessor, without extinguishing Sublessee's liability. If this Sublease shall have been so terminated by Sublessor, Sublessor may at any time thereafter resume possession of the premises by any lawful means and remove Sublessee or other occupants and their effects. No failure to enforce any term shall be deemed a waiver.

15. Attorneys fees.

In case suit should be brought for recovery of the premises, or for any sum due hereunder, or because of any act which may arise out of the possession of the premises by either party, the prevailing party shall be entitled to all costs incurred in connection with such action, including reasonable attorneys fees.

16. Waiver.

No failure of Sublessor to enforce any term hereof shall be deemed to be a waiver.

17. Notices.

Any notice which either party may or is required to give, shall be given by e-mail and shall be considered given on the day the e-mail is sent.

18. Heirs, Assigns, Successors.

This Sublease is binding upon and inures to the benefit of the heirs, assigns and successors in interest to the parties.

19. Options for change in leased areas.

In the event that Bruce McKinnon is no longer an officer of STWA his office (marked office #1 on Exhibit 1) shall revert back to Sublessor. In the event Gene Eichler is no

longer with STWA his office (marked office #2 on Exhibit 1) shall revert back to Sublessor. STWA may take additional space as available in the building. All additions or subtractions from the square footage shall effect the lease amount on a pro rata basis.

19. Option to Renew.

Provided that Sublessee is not in default in the performance of this Sublease, Sublessee shall have the option to renew the Sublease for an additional term of two years commencing at the expiration of the initial lease term. All of the terms and conditions of the Sublease shall apply during the renewal term except that the Sublease payment shall be 10% greater than the current Sublease. The option shall be exercised by a written notice given to Sublessor not less than sixty (60) days prior to the expiration of the initial Sublease term. If notice is not timely given, this option will expire.

20. No Right To Hold Over.

Sublessee has no right to retain possession of the premise or any part thereof beyond the expiration or termination of this Sublease. In the event Sublessee holds over, then the base rent shall be increased to 150% of the base rent applicable immediately preceding the expiration or termination. Nothing contained herein shall be construed as consent by Sublessor to any holding over by Sublessee.

21. Radon Gas Disclosure.

As required by law, Sublessor makes the following disclosure: "Radon Gas" is a naturally occurring radioactive gas that, when it has accumulated in a building in sufficient quantities, may present health risks to persons who are exposed to it over time. Levels of radon that exceed federal and state guidelines have been found in buildings in California. Additional information regarding radon and radon testing may be obtained from your county public health unit.

22. Entire Agreement.

The foregoing constitutes the entire agreement between the parties and may be modified only by a writing signed by both parties.

This Sublease shall be deemed to have been signed on the 1st day of January, 2006 in North Hollywood, California:

SAVE THE WORLD AIR, INC.

KZG

/s/ Eugene E. Eichler

/s/ Jennifer King

By: Gene Eichler

By: Jennifer King

Title: CEO

Title: President

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002
AND RULES 13A-14 AND 15D-14 UNDER THE SECURITIES EXCHANGE ACT OF 1934

I, Eugene E. Eichler, certify that:

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

Date: May 17, 2006

/s/ EUGENE E. EICHLER

Eugene E. Eichler
Chief Executive Officer

CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002
AND RULES 13A-14 AND 15D-14 UNDER THE SECURITIES EXCHANGE ACT OF 1934

I, Eugene E. Eichler, certify that:

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

Date: May 17, 2006

/s/ EUGENE E. EICHLER

Eugene E. Eichler
Chief Financial Officer

CERTIFICATION OF PERIODIC FINANCIAL REPORT BY THE CHIEF EXECUTIVE OFFICER
AND CHIEF FINANCIAL OFFICER PURSUANT TO SECTION 906 OF THE
SARBANES-OXLEY ACT OF 2002

Solely for the purposes of complying with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, we, the undersigned Chief Executive Officer and Chief Financial Officer of Save the World Air, Inc. (the "Company"), hereby certify, based on our knowledge, that the Quarterly Report on Form 10-QSB of the Company for the quarter ended March 31, 2006 (the "Report") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and that the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: May 17, 2006

/s/ EUGENE E. EICHLER

Eugene E. Eichler
Chief Executive Officer

Date: May 17, 2006

/s/ EUGENE E. EICHLER

Eugene E. Eichler
Chief Financial Officer