
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 June 30, 2007

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.)*

235 Tennant Avenue

Morgan Hill, California 95037

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

(408) 778-0101

(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 June 29, 2007 was 41,962,178 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>	
<u>ITEM 1. Financial Statements</u>	1
<u>Condensed consolidated balance sheets</u>	1
<u>Condensed consolidated statements of operations (unaudited)</u>	3
<u>Condensed consolidated statements of changes in stockholders' deficiency (unaudited)</u>	4
<u>Condensed consolidated statements of cash flows (unaudited)</u>	13
<u>Notes to condensed consolidated financial statements (unaudited)</u>	15
<u>ITEM 2. Management's Discussion and Analysis or Plan of Operations</u>	41
<u>ITEM 3. Controls and Procedures</u>	53
<u>PART II</u>	
<u>ITEM 1. Legal Proceedings</u>	54
<u>ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	56
<u>ITEM 3. Defaults Upon Senior Securities</u>	57
<u>ITEM 4. Submission of Matters to a Vote of Security Holders</u>	57
<u>ITEM 5. Other Information</u>	57
<u>ITEM 6. Exhibits</u>	59
<u>SIGNATURES</u>	60
<u>EXHIBIT INDEX</u>	
EXHIBIT 10.1	
EXHIBIT 31.1	
EXHIBIT 31.2	
EXHIBIT 32	
<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. AND SUBSIDIARY
(A DEVELOPMENT STAGE ENTERPRISE)
CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2007 (unaudited)	December 31, 2006
ASSETS		
Current assets		
Cash	\$ 223,882	\$ 244,228
Inventory	41,193	21,314
Other current assets	<u>73,282</u>	<u>81,232</u>
Total current assets	<u>338,357</u>	<u>346,774</u>
Property and equipment , net of accumulated depreciation	<u>257,701</u>	<u>322,023</u>
Other assets	<u>4,500</u>	<u>4,500</u>
Total assets	<u>\$ 600,558</u>	<u>\$ 673,297</u>

See notes to condensed consolidated financial statements.

SAVE THE WORLD AIR, INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE ENTERPRISE)
CONDENSED CONSOLIDATED BALANCE SHEETS — Continued

	<u>June 30, 2007</u> <u>(unaudited)</u>	<u>December 31,</u> <u>2006</u>
LIABILITIES AND STOCKHOLDERS' DEFICIENCY		
Current liabilities		
Accounts payable	\$ 708,145	\$ 233,707
Accrued expenses	587,985	468,413
Accrued research and development fees	95,000	95,000
Accrued professional fees	489,407	594,945
Convertible debentures, net	<u>1,247,098</u>	<u>177,926</u>
Total current liabilities	<u>3,127,635</u>	<u>1,569,991</u>
Commitments and contingencies		
Stockholders' deficiency		
Common stock, \$.001 par value: 200,000,000 shares authorized, 41,962,178 and 40,081,758 shares issued and outstanding at June 30, 2007 and December 31, 2006, respectively	41,963	40,082
Common stock to be issued	60,000	60,000
Additional paid-in capital	31,240,901	29,430,821
Deficit accumulated during the development stage	<u>(33,869,941)</u>	<u>(30,427,597)</u>
Total stockholders' deficiency	<u>(2,527,077)</u>	<u>(896,694)</u>
Total liabilities and stockholders' deficiency	<u>\$ 600,558</u>	<u>\$ 673,297</u>

See notes to condensed consolidated financial statements.

SAVE THE WORLD AIR, INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE ENTERPRISE)
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	For the Three months ended June 30,		For the Six months ended June 30,		For the Period From February 18, 1998 (Date of Inception) through June 30, 2007
	2007	2006	2007	2006	
Net sales	\$ —	\$ —	\$ 22,000	\$ —	\$ 52,000
Cost of goods sold	—	—	5,360	—	18,760
Gross profit	—	—	16,640	—	33,240
Operating expenses	1,023,787	1,852,870	2,303,562	3,607,840	25,206,538
Research and development expenses	100,731	121,111	441,183	178,873	4,646,597
Non-cash patent settlement costs	—	—	—	—	1,610,066
Loss before other income (expense)	<u>(1,124,518)</u>	<u>(1,973,981)</u>	<u>(2,728,105)</u>	<u>(3,786,713)</u>	<u>(31,429,961)</u>
Other income (expense)					
Other income	90	125	177	125	302
Interest income	33	6,976	50	6,976	16,301
Interest expense	(265,996)	(1,025,345)	(473,668)	(2,209,918)	(3,229,511)
Financing fees	—	—	(47,104)	—	(47,104)
Placement fee	(6,000)	—	(48,000)	—	(48,000)
Loss on valuation of warrants	(131,792)	—	(144,894)	—	(144,894)
Settlement of litigation and debt	—	—	—	—	1,017,208
Total other income (expense)	<u>(403,665)</u>	<u>(1,018,244)</u>	<u>(713,439)</u>	<u>(2,202,817)</u>	<u>(2,435,698)</u>
Loss before provision for income taxes	(1,528,183)	(2,992,225)	(3,441,544)	(5,989,530)	(33,865,659)
Provision for income taxes	—	—	800	800	4,282
Net loss	<u>\$ (1,528,183)</u>	<u>\$ (2,992,225)</u>	<u>\$ (3,442,344)</u>	<u>\$ (5,990,330)</u>	<u>\$ (33,869,941)</u>
Net loss per share, basic and diluted	<u>\$ (0.04)</u>	<u>\$ (0.09)</u>	<u>\$ (0.09)</u>	<u>\$ (0.18)</u>	
Weighted average shares outstanding, basic and diluted	<u>39,746,015</u>	<u>33,661,360</u>	<u>37,297,407</u>	<u>32,816,890</u>	

See notes to condensed consolidated financial statements.

[Table of Contents](#)

SAVE THE WORLD AIR, INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE ENTERPRISE)
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIENCY
FEBRUARY 18, 1998 (DATE OF INCEPTION) TO JUNE 30, 2007

	<u>Common Stock</u>		<u>Common stock to be issued</u>	<u>Additional paid-in capital</u>	<u>Deferred compensation</u>	<u>Deficit accumulated during the development stage</u>	<u>Total stockholders' development stage deficiency</u>
	<u>Shares</u>	<u>Amount</u>					
Balance, February 18, 1998							
(date of inception)	—	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Issuance of common stock on April 18, 1998	10,030,000	10,030	—	14,270	—	—	24,300
Net loss	—	—	—	—	—	(21,307)	(21,307)
Balance, December 31, 1998	10,030,000	10,030		14,270	—	(21,307)	2,993
Issuance of common stock on May 18, 1999	198,003	198	—	516,738	—	—	516,936
Issuance of common stock for ZEFS on September 14, 1999	5,000,000	5,000	—	—	—	—	5,000
Stock issued for professional services on May 18, 1999	69,122	69	—	49,444	—	—	49,513
Net loss	—	—	—	—	—	(1,075,264)	(1,075,264)
Balance, December 31, 1999	15,297,125	15,297	—	580,452	—	(1,096,571)	(500,822)
Stock issued for employee compensation on February 8, 2000	20,000	20	—	20,580	—	—	20,600
Stock issued for consulting services on February 8, 2000	100,000	100	—	102,900	—	—	103,000
Stock issued for professional services on April 18, 2000	27,000	27	—	91,233	—	—	91,260
Stock issued for directors fees on April 18, 2000	50,000	50	—	168,950	—	—	169,000
Stock issued for professional services on May 19, 2000	5,000	5	—	20,295	—	—	20,300
Stock issued for directors fees on June 20, 2000	6,000	6	—	26,634	—	—	26,640
Stock issued for							

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

[Table of Contents](#)

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

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIENCY — Continued
FEBRUARY 18, 1998 (DATE OF INCEPTION) TO JUNE 30, 2007

	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 4, 2000	9,833	10	—	8,643	—	—	8,653
Stock issued for consulting services on December 20, 2000	19,082	19	—	9,522	—	—	9,541
Stock issued for filing services on December 20, 2000	5,172	5	—	2,581	—	—	2,586
Stock issued for professional services on December 26, 2000	12,960	13	—	4,912	—	—	4,925
Other stock issuance on August 24, 2000	2,000	2	—	4,258	—	—	4,260
Common shares cancelled	(55,000)	(55)	—	(64,245)	—	—	(64,300)
Net loss	—	—	—	—	—	(1,270,762)	(1,270,762)
Balance, December 31, 2000	15,645,935	15,646	—	1,437,873	—	(2,367,333)	(913,814)
Stock issued for consulting services on January 8, 2001	9,833	10	—	3,038	—	—	3,048
Stock issued for consulting services on February 1, 2001	9,833	10	—	3,235	—	—	3,245
Stock issued for consulting services on March 1, 2001	9,833	10	—	2,743	—	—	2,753
Stock issued for legal services on March 13, 2001	150,000	150	—	47,850	—	—	48,000
Stock issued for consulting services on April 3, 2001	9,833	10	—	2,448	—	—	2,458
Stock issued for legal services on April 4, 2001	30,918	31	—	7,699	—	—	7,730
Stock issued for							

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

[Table of Contents](#)

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

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIENCY — Continued
FEBRUARY 18, 1998 (DATE OF INCEPTION) TO JUNE 30, 2007

	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	43,000	43	—	42,097	—	—	42,140
Stock issued for consulting services on November 27, 2001	10,000	10	—	9,790	—	—	9,800
Stock issued for consulting services on November 28, 2001	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	2,150,000	2,150	—	857,850	—	—	860,000
Common stock paid for, but not issued (2,305,000 shares)	—	—	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	1,425,000	1,425	(213,750)	212,325	—	—	—
Common stock issued, previously paid for	880,000	880	(220,000)	219,120	—	—	—
Stock issued for cash on March 20, 2003	670,000	670	—	166,830	—	—	167,500
Stock issued for cash on April 4, 2003	900,000	900	—	224,062	—	—	224,962
Stock issued for cash on April 8, 2003	100,000	100	—	24,900	—	—	25,000
Stock issued for cash on May 8, 2003	1,150,000	1,150	—	286,330	—	—	287,480
Stock issued for cash on June 16, 2003	475,000	475	—	118,275	—	—	118,750
Stock issued for legal services on June 27, 2003	83,414	83	—	45,794	—	—	45,877
Debt converted to stock on June 27, 2003	2,000,000	2,000	—	498,000	—	—	500,000
Stock and warrants issued for cash on July 11, 2003	519,000	519	—	129,231	—	—	129,750
Stock and warrants issued for cash on September 29, 2003	1,775,000	1,775	—	441,976	—	—	443,751
Stock and warrants issued for cash on October 21, 2003	1,845,000	1,845	—	459,405	—	—	461,250
Stock and warrants issued for cash on October 28, 2003	1,570,000	1,570	—	390,930	—	—	392,500
Stock and warrants issued for cash on November 19, 2003	500,000	500	—	124,500	—	—	125,000

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

**CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIENCY — Continued
FEBRUARY 18, 1998 (DATE OF INCEPTION) TO JUNE 30, 2007**

	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					
Finders' fees related to stock issuances	—	—	43,875	(312,582)	—	—	(268,707)
Common stock paid for, but not issued (25,000 shares)	—	—	6,250	—	—	—	6,250
Amortization of deferred comp	—	—	—	—	863,727	—	863,727
Net loss for year ended December 31, 2003	—	—	—	—	—	(2,476,063)	(2,476,063)
Balance, December 31, 2003	34,128,261	34,128	6,250	10,162,177	(708,333)	(10,327,608)	(833,386)
Common stock issued, previously paid for	25,000	25	(6,250)	6,225	—	—	—
Stock issued for director services on March 31, 2004	50,000	50	—	74,950	—	—	75,000
Stock issued for finders fees on March 31, 2004	82,500	82	—	12,293	—	—	12,375
Stock issued for finders fees on March 31, 2004	406,060	407	—	101,199	—	—	101,606
Stock issued for services on April 2, 2004	65,000	65	—	99,385	—	—	99,450
Debt converted to stock on April 2, 2004	60,000	60	—	91,740	—	—	91,800
Stock issued upon exercise of warrants on May 21, 2004	950,000	950	—	189,050	—	—	190,000
Stock issued for directors services on June 8, 2004	600,000	600	—	1,019,400	—	—	1,020,000
Stock issued for cash on August 25, 2004	550,000	550	—	549,450	—	—	550,000
Stock issued upon exercise of options on August 30, 2004	4,000	4	—	1,596	—	—	1,600
Stock issued for cash on September 8, 2004	25,000	25	—	24,975	—	—	25,000
Stock issued for consulting services on September 15, 2004	50,000	49	—	65,451	—	—	65,500
Stock issued for patent settlement on September 22, 2004	20,000	20	—	24,780	—	—	24,800
Stock issued for research and development on October 6, 2004	65,000	65	—	90,935	—	—	91,000
Stock issued for cash on October 6, 2004	25,000	25	—	24,975	—	—	25,000
Stock issued for cash on October 15, 2004	150,000	150	—	149,850	—	—	150,000
Stock issued upon exercise of stock options on October 21, 2004	6,500	6	—	2,594	—	—	2,600
Stock issued for cash on November 3, 2004	25,000	25	—	24,975	—	—	25,000
Stock issued for cash on November 18, 2004	172,500	173	—	172,327	—	—	172,500
Stock issued for cash on December 9, 2004	75,000	75	—	74,925	—	—	75,000
Stock issued for cash on December 23, 2004	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
Intrinsic value of options issued to employees	—	—	—	248,891	(248,891)	—	—

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

**CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIENCY — Continued
FEBRUARY 18, 1998 (DATE OF INCEPTION) TO JUNE 30, 2007**

	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					
Fair value of options issued to non-employees for services	—	—	—	55,381	(55,381)	—	—
Fair value of warrants issued for settlement costs	—	—	—	1,585,266	—	—	1,585,266
Fair value of warrants issued to non-employees for services	—	—	—	28,872	—	—	28,872
Amortization of deferred compensation	—	—	—	—	936,537	—	936,537
Net loss for year ended December 31, 2004	—	—	—	—	—	(6,803,280)	(6,803,280)
Balance, December 31, 2004	37,784,821	37,784	119,000	15,043,028	(76,068)	(17,130,888)	(2,007,144)
Common stock issued, previously paid for	69,000	69	(69,000)	68,931	—	—	—
Stock issued upon exercise of warrants, previously paid for	50,000	50	(50,000)	49,950	—	—	—
Stock issued for cash on January 20, 2005	25,000	25	—	24,975	—	—	25,000
Stock issued upon exercise of warrants on January 31, 2005	500	1	—	199	—	—	200
Stock issued for cash on February 17, 2005	325,000	325	—	324,675	—	—	325,000
Stock issued for cash on March 31, 2005	215,000	215	—	214,785	—	—	215,000
Stock issued for cash on May 17, 2005	5,000	5	—	4,995	—	—	5,000
Stock issued for cash on June 7, 2005	300,000	300	—	299,700	—	—	300,000
Stock issued for cash on August 5, 2005	480,500	480	—	480,020	—	—	480,500
Stock issued for cash on August 9, 2005	100,000	100	—	99,900	—	—	100,000
Stock issued for cash on October 27, 2005	80,000	80	—	79,920	—	—	80,000
Common stock cancelled on December 7, 2005	(8,047,403)	(8,047)	—	8,047	—	—	—
Stock issued for settlement of payables on December 21, 2005	—	—	57,092	—	—	—	57,092
Stock issued for settlement of payables on December 31, 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
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)

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

**CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIENCY — Continued
FEBRUARY 18, 1998 (DATE OF INCEPTION) TO JUNE 30, 2007**

	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					
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	1.50	25,000	25	—	37,475	—	37,500
Stock issued upon exercise of warrants on March 27, 2006	1.50	50,000	50	—	74,950	—	75,000
Stock issued upon exercise of warrants on March 27, 2006	0.50	25,000	25	—	12,475	—	12,500
Stock issued upon exercise of warrants on March 30, 2006	1.00	10,000	10	—	9,990	—	10,000
Stock issued upon exercise of warrants on April 10, 2006	0.50	36,250	36	—	18,089	—	18,125
Common stock issued for convertible debt on April 10, 2006	0.70	269,600	270	—	188,450	—	188,720
Stock issued for cash on April 24, 2006	1.56	473,000	473	—	737,408	—	737,881
Stock issued upon exercise of warrants on April 26, 2006	0.50	125,000	125	—	62,375	—	62,500
Stock issued upon exercise of warrants on April 26, 2006	1.50	100,000	100	—	149,900	—	150,000
Common stock issued for convertible debt on April 26, 2006	0.70	35,714	36	—	24,964	—	25,000
Stock issued upon exercise of warrants on May 6, 2006	0.50	200,000	200	—	99,800	—	100,000
Stock issued upon exercise of warrants on May 15, 2006	1.50	25,000	25	—	37,475	—	37,500
Stock issued upon exercise of warrants on May 15, 2006	0.50	50,000	50	—	24,950	—	25,000
Stock issued for cash on June 7, 2006	1.89	873,018	872	—	1,649,136	—	1,650,008
Common stock issued for convertible debt on June 7, 2006	0.70	1,535,716	1,536	—	1,073,464	—	1,075,000
Stock issued upon exercise of warrants on June 8, 2006	0.50	900,000	900	—	449,100	—	450,000
Stock issued upon exercise of warrants on June 9, 2006	0.50	9,000	9	—	4,491	—	4,500
Stock issued upon exercise of warrants on June 23, 2006	0.50	150,000	150	—	74,850	—	75,000
Stock issued upon exercise of warrants on June 23, 2006	1.50	15,000	15	—	22,485	—	22,500
Common stock issued for convertible debt on June 30, 2006	0.70	219,104	219	—	153,155	—	153,374
Common stock issued for convertible debt on July 11, 2006	0.70	14,603	15	—	10,207	—	10,222
Common stock issued for convertible debt on August 7, 2006	0.70	1,540,160	1,540	—	1,076,572	—	1,078,112
Common stock issued upon exercise of warrants on August 7, 2006	1.50	175,000	175	—	262,325	—	262,500
Common stock issued upon exercise of warrants on August 21, 2006	1.50	50,000	50	—	74,950	—	75,000

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

**CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIENCY — Continued
FEBRUARY 18, 1998 (DATE OF INCEPTION) TO JUNE 30, 2007**

		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					
Common stock issued for cash on August 22, 2006	1.00	14,519	15	—	14,504	—	—	14,519
Common stock issued upon exercise of warrants on August 23, 2006	1.00	3,683	4	—	3,679	—	—	3,683
Common stock issued upon exercise of warrants on August 28, 2006	1.50	5,000	5	—	7,495	—	—	7,500
Common stock issued for convertible debt on September 13, 2006	0.70	4,286	4	—	2,996	—	—	3,000
Common stock issued upon exercise of warrants on September 13, 2006	0.50	150,000	150	—	74,850	—	—	75,000
Common stock issued for convertible debt on October 16, 2006	0.70	66,654	67	—	46,591	—	—	46,658
Common stock issued upon exercise of warrants on November 3, 2006	0.50	210,000	210	—	104,790	—	—	105,000
Common stock issued for put on equity line of credit on November 7, 2006	1.22	94,470	94	—	115,368	—	—	115,462
Common stock issued for put on equity line of credit on November 14, 2006	1.14	7,300	7	—	8,349	—	—	8,356
Common stock issued for put on equity line of credit on November 27, 2006	0.83	27,500	28	—	22,913	—	—	22,941
Common stock issued for put on equity line of credit on November 28, 2006	0.82	36,500	36	—	30,059	—	—	30,095
Common stock issued for put on equity line of credit on December 6, 2006	0.78	73,863	74	—	57,244	—	—	57,318
Common stock issued for put on equity line of credit on December 26, 2006	0.55	18,800	19	—	10,377	—	—	10,396
Common stock issued for put on equity line of credit on December 31, 2006	0.59	229,050	229	—	135,300	—	—	135,529
Common stock paid for, but not issued	—	—	—	60,000	—	—	—	60,000
Fair value of options issued to employees and officers	—	—	—	—	2,253,263	—	—	2,253,263
Fair value of warrants issued for services	—	—	—	—	401,130	—	—	401,130
Write off of deferred compensation	—	—	—	—	(142,187)	142,187	—	—
Warrants issued for consulting services	—	—	—	—	62,497	—	—	62,497
Warrants issued with convertible notes	—	—	—	—	408,596	—	—	408,596
Intrinsic value of beneficial conversion associated with convertible notes	—	—	—	—	851,100	—	—	851,100
Finders fees related to stock issuances	—	—	—	—	(284,579)	—	—	(284,579)
Fees paid on equity line of credit	—	—	—	—	(30,402)	—	—	(30,402)
Net loss for year ended December 31, 2006	—	—	—	—	—	—	(10,181,523)	(10,181,523)

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

**CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIENCY — Continued
FEBRUARY 18, 1998 (DATE OF INCEPTION) TO JUNE 30, 2007**

	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						
Balance, December 31, 2006	40,081,757	\$ 40,082	\$ 60,000	\$ 29,430,821	\$ —	\$ (30,427,597)	\$ (896,694)	
Common stock issued for put on equity line of credit on January 11, 2007	—	63,000	63	—	39,659	—	—	39,722
Common stock issued for put on equity line of credit on January 22, 2007	—	58,150	58	—	42,246	—	—	42,304
Common stock issued for put on equity line of credit on February 9, 2007	—	35,800	36	—	26,009	—	—	26,045
Common stock issued for put on equity line of credit on February 16, 2007	—	162,000	162	—	112,979	—	—	113,141
Common stock issued for put on equity line of credit on February 26, 2007	—	71,000	71	—	46,761	—	—	46,832
Common stock issued for put on equity line of credit on March 5, 2007	—	42,600	43	—	28,056	—	—	28,099
Common stock issued for put on equity line of credit on March 12, 2007	—	92,900	93	—	62,085	—	—	62,178
Common stock issued for put on equity line of credit on March 19, 2007	—	47,500	48	—	30,362	—	—	30,410
Common stock issued for put on equity line of credit on March 26, 2007	—	7,500	7	—	4,722	—	—	4,729
Common stock issued for put on equity line of credit on March 31, 2007	—	25,500	25	—	15,558	—	—	15,583
Fees paid on equity line of credit	—	—	—	—	(32,723)	—	—	(32,723)
Warrants issued with convertible notes	—	—	—	—	291,936	—	—	291,936
Intrinsic value of beneficial conversion associated with convertible notes	—	—	—	—	274,312	—	—	274,312
Fair value of warrants issued to non-employee for services	—	—	—	—	47,104	—	—	47,104
Fair value of options issued to an officer	—	—	—	—	16,302	—	—	16,302
Common stock issued for put on equity line of credit on April 9, 2007	—	56,300	56	—	35,441	—	—	35,497
Common stock issued for put on equity line of credit on April 17, 2007	—	73,835	74	—	41,466	—	—	41,540
Common stock issued for put on equity line of credit on April 24, 2007	—	122,857	123	—	68,996	—	—	69,119
Common stock issued for put on equity line of credit on May 1, 2007	—	226,081	226	—	124,774	—	—	125,000
Common stock issued for put on equity line of credit on May 8, 2007	—	29,400	29	—	19,363	—	—	19,392
Common stock issued for put on equity line of credit on May 15, 2007	—	403,502	404	—	171,811	—	—	172,215
Common stock issued for put on equity line of credit on May 22, 2007	—	119,800	120	—	46,362	—	—	46,482

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

**CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIENCY — Continued
FEBRUARY 18, 1998 (DATE OF INCEPTION) TO JUNE 30, 2007**

	<u>Common Stock</u>		<u>Common stock to be issued</u>	<u>Additional paid-in capital</u>	<u>Deferred compensation</u>	<u>Deficit accumulated during the development stage</u>	<u>Total stockholders' development stage deficiency</u>
	<u>Shares</u>	<u>Amount</u>					
Common stock issued for put on equity line of credit on May 30, 2007	80,996	81	—	26,631	—	—	26,712
Common stock issued for put on equity line of credit on June 6, 2007	54,700	55	—	17,454	—	—	17,509
Common stock issued for put on equity line of credit on June 15, 2007	94,500	95	—	25,571	—	—	25,666
Common stock issued for put on equity line of credit on June 21, 2007	12,500	12	—	3,868	—	—	3,880
Fees paid on equity line of credit	—	—	—	(46,641)	—	—	(46,641)
Warrants issued with convertible notes	—	—	—	260,718	—	—	260,718
Fair value of options issued to an officer	—	—	—	8,898	—	—	8,898
Net loss for six months ended June 30, 2007	—	—	—	—	—	(3,442,344)	(3,442,344)
Balance, June 30, 2007 (unaudited)	<u>41,962,178</u>	<u>41,963</u>	<u>60,000</u>	<u>31,240,901</u>	<u>\$ —</u>	<u>(33,869,941)</u>	<u>(2,527,077)</u>

SAVE THE WORLD AIR, INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE ENTERPRISE)
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	<u>For the Six months ended June 30,</u>		<u>For the Period</u>
	<u>2007</u>	<u>2006</u>	<u>From February 18,</u> <u>1998 (Date of</u> <u>Inception) through</u> <u>June 30, 2007</u>
Cash flows from operating activities			
Net loss	\$ (3,442,344)	\$ (5,990,330)	\$ (33,869,941)
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)
Stock based compensation expense	25,200	1,659,565	2,926,784
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 financing fees	47,104	—	47,104
Loss on valuation of warrants	144,894	—	144,894
Patent acquisition cost	—	—	1,610,066
Amortization of interest on debt discount	3,500	—	3,500
Amortization of issuance costs and original issue debt	463,994	2,113,825	3,263,299
Amortization of deferred compensation	—	—	3,060,744
Depreciation	110,035	57,217	298,254
Changes in operating assets and liabilities:			
Inventory	(19,879)	(3,719)	(41,193)
Prepaid expenses and other	7,950	(113,579)	(73,282)
Other assets	—	—	(4,500)
Accounts payable and accrued expenses	457,068	(172,872)	2,689,182
Net cash used in operating activities	<u>(2,202,478)</u>	<u>(2,449,893)</u>	<u>(15,752,738)</u>
Cash flows from investing activities			
Purchase of property and equipment	<u>(45,713)</u>	<u>(129,115)</u>	<u>(552,405)</u>
Net cash used in investing activities	<u>(45,713)</u>	<u>(129,115)</u>	<u>(552,405)</u>
Cash flows from financing activities			
Net proceeds under equity line of credit	912,691	—	1,262,386
Increase (decrease) in payables to related parties and shareholder	31,404	(158,732)	542,854
Advances from founding executive officer	—	—	517,208
Net proceeds from issuance of convertible notes and warrants	1,310,000	865,500	3,977,878
Repayment of convertible notes	(26,250)	—	(26,250)
Net proceeds from issuance of common stock and common stock issuable	<u>—</u>	<u>3,220,936</u>	<u>10,254,949</u>
Net cash provided by financing activities	<u>2,227,845</u>	<u>3,927,704</u>	<u>16,529,025</u>
Net increase (decrease) in cash	(20,346)	1,348,696	223,882
Cash, beginning of period	<u>244,228</u>	<u>279,821</u>	<u>—</u>
Cash, end of period	<u>\$ 223,882</u>	<u>\$ 1,628,517</u>	<u>\$ 223,882</u>

See notes to condensed consolidated financial statements.

SAVE THE WORLD AIR, INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE ENTERPRISE)
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	<u>For the Six months ended June 30,</u>		<u>For the Period</u> <u>From February 18,</u> <u>1998 (Date of</u> <u>Inception)</u> <u>through</u> <u>June 30, 2007</u>
	<u>2007</u>	<u>2006</u>	
Supplemental disclosures of cash flow information			
Cash paid during the period for			
Interest	<u>\$ 7,674</u>	<u>\$ 93,688</u>	<u>\$ 149,153</u>
Income taxes	<u>\$ 800</u>	<u>\$ 800</u>	<u>\$ 4,282</u>
Non-cash investing and financing activities			
Acquisition of intangible asset through advance from related party and issuance of common stock	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 505,000</u>
Deferred compensation for stock options issued for services	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 3,202,931</u>
Purchase of property and equipment financed by advance from related party	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 3,550</u>
Conversion of related party debt to equity	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 515,000</u>
Issuance of common stock in settlement of payable	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 113,981</u>
Cancellation of stock	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 8,047</u>
Conversion of accounts payable and accrued expenses to common stock issued	<u>\$ —</u>	<u>\$ 612,521</u>	<u>\$ 612,521</u>
Conversion of related party debt to convertible debentures	<u>\$ —</u>	<u>\$ 45,000</u>	<u>\$ 45,000</u>
Conversion of convertible debentures to common stock	<u>\$ —</u>	<u>\$ 1,452,319</u>	<u>\$ 2,580,086</u>
Write off of deferred compensation	<u>\$ —</u>	<u>\$ 142,187</u>	<u>\$ 142,187</u>
Consulting fee for issuance of stock options	<u>\$ 25,200</u>	<u>\$ —</u>	<u>\$ 25,200</u>
Financing fee for issuance of warrants	<u>\$ 47,104</u>	<u>\$ —</u>	<u>\$ 47,104</u>

See notes to condensed consolidated financial statements.

**SAVE THE WORLD AIR, INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE ENTERPRISE)
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

1. Organization and basis of presentation

Basis of presentation

The accompanying interim condensed consolidated 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 June 30, 2007, the results of operations for the three months and six months ended June 30, 2007 and 2006, and cash flows for the six months ended June 30, 2007 and 2006. The balance sheet as of December 31, 2006 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 condensed consolidated financial statements are adequate to make the information presented therein not misleading. For further information, refer to the condensed consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2006, 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 consolidated results of operations for the six months ended June 30, 2007 are not necessarily indicative of the consolidated results of operations to be expected for the full fiscal year ending December 31, 2007.

Going Concern

The accompanying condensed consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. As reflected in the accompanying condensed consolidated financial statements, the Company had a net loss of \$3,442,344 and a negative cash flow from operations of \$2,202,478 for the six months ended June 30, 2007, and had a working capital deficiency of \$2,789,278 and a stockholders' deficiency of \$2,527,077 at June 30, 2007. These factors raise substantial doubt about the Company's ability to continue as a going concern. The ability of the Company to continue as a going concern is dependent upon the Company's ability to raise additional funds and implement its business plan. The condensed consolidated 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. AND SUBSIDIARY
(A DEVELOPMENT STAGE ENTERPRISE)**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

Description of business

Save the World Air, Inc. (the "Company") is a green technology company that leverages a suite of patented, patent-pending and licensed intellectual properties related to the treatment of fuels. These technologies utilize either magnetic or uniform electrical fields to alter physical characteristics of fuels and are designed to create a cleaner combustion. Cleaner combustion has been shown to improve performance, enhance fuel economy and/or reduce harmful emissions in laboratory testing.

The Company was incorporated 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 technology.

During the past several 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. The Company's ECO ChargR™ and MAG ChargR™ products, use fixed magnetic fields to alter some physical properties of fuel, by incorporating our patented and patent-pending ZEFS, MK IV technologies. When fitted to an internal combustion engine, these products are expected to increase power and improve mileage and may also reduce carbon monoxide, hydrocarbons and nitrous oxide emissions and to. The Company also has developed certain products incorporating its CAT-MATE technology, although at this time the Company does not intend to devote significant effort to the commercialization of products incorporating the CAT-MATE technology.

The Company has obtained licenses from Temple University for their patent-pending uniform electric field technology, tentatively called ELEKTRA™. The ELEKTRA technology consists of passing fuel through a specific strong electrical field. Although ELEKTRA has a similar effect on fuels as the Company's ZEFS and MK IV technologies, ELEKTRA incorporates a uniform electrical field principle. Based on the Company's early research and product development, the Company believes that ELEKTRA carries certain advantages over the Company's ZEFS and MK IV technologies, primarily not requiring as many variations for products incorporating the ELEKTRA technology compared to products incorporating the ZEFS or MK IV technologies. When it is developed, the Company intends to market ELEKTRA products primarily to the transportation industry, oil refineries and pipelines, and OEMs.

The accompanying condensed consolidated financial statements of Save the World Air, Inc. and Subsidiary include the accounts of Save the World Air, Inc. and its wholly-owned subsidiary STWA Asia Pte. Limited, incorporated on January 17, 2006. As of June 30, 2007, the subsidiary held \$7,386 in cash and had operating expenses of \$7,595. Intercompany transactions and balances have been eliminated in consolidation.

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

2. 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 product development and marketing 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 meaningful revenues. The technologies are called "ZEFS", "MK IV", "ELEKTRA" and "CAT-MATE". The Company is currently marketing its ECO and MAG ChargR products incorporating ZEFS and MK IV technologies in the United States and certain countries in Asia; and the Company is in the early stages of developing ELEKTRA products. Expenses have been funded primarily through the sale of company stock, convertible notes and the exercise of warrants.

The Company has taken actions to secure the intellectual property rights to the ZEFS, MK IV and CAT-MATE devices and is the worldwide exclusive licensee for patent-pending technologies associated with the development of ELEKTRA.

3. Significant Accounting Policies

Revenue Recognition

The Company has adopted Staff Accounting Bulletin 104, "Revenue Recognition", and therefore recognizes revenue based upon meeting four criteria:

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

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

Inventories

Inventories are valued at the lower of cost (first-in, first-out) or market and consist of finished goods.

**SAVE THE WORLD AIR, INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE ENTERPRISE)**
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)

Estimates

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

Stock-based compensation

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 and six months ended June 30, 2007 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). Stock-based compensation expense recognized under SFAS 123(R) for employee and directors for the six months ended June 30, 2007 was \$25,200.

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 uses 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.

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

The Company accounts for stock option and warrant grants issued to non-employees for goods and services using the guidance of SFAS No. 123 and Emerging Issues Task Force (“EITF”) No. 96-18: “Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services,” whereby the fair value of such option and warrant grants is determined using the Black-Scholes option pricing model at the earlier of the date at which the non-employee’s performance is completed or a performance commitment is reached.

4. Recent Accounting Pronouncements

Management does not believe that there are any other recently-issued accounting pronouncements, but not yet effective accounting standards, which could have a material effect on the accompanying condensed consolidated financial statements.

Statement No. 157

In September 2006, the Financial Accounting Standards Board (the “FASB”) issued Statement No. 157, “Fair Value Measurements” (“SFAS 157”), SFAS 157 establishes a formal framework for measuring fair value under GAAP. It defines and codifies the many definitions of fair value included among various other authoritative literature, clarifies and, in some instances, expands on the guidance for implementing fair value measurements, and increases the level of disclosure required for fair value measurements. Although SFAS 157 applies to and amends the provisions of existing FASB and AICPA pronouncements, it does not, of itself, require any new fair value measurements, nor does it establish valuation standards. SFAS 157 applies to all other accounting pronouncements requiring or permitting fair value measurements, except for; SFAS 123R, share-based payment and related pronouncements, the practicability exceptions to fair value determinations allowed by various other authoritative pronouncements, and AICPA Statements of Position 97-2 and 98-9 that deal with software revenue recognition. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Management is currently evaluating the effect of this pronouncement on the Company’s financial statements.

Statement No. 159

In February 2007, the FASB issued Statement No. 159, “The Fair Value Option for Financial Assets and Liabilities”. This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

shall report unrealized gains and losses on items for which the fair value option has been elected in earnings (or another performance indicator if the business entity does not report earnings) at each subsequent reporting date. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. We do not believe that the adoption of SFAS 159 will have a material affect on our financial statements.

Interpretation No. 48

Effective January 1, 2007, the Company adopted Financial Accounting Standards Board Interpretation No 48, "Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No 109, "Accounting for Income Taxes ("FIN 48")." FIN 48 addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures. At the date of adoption, and as of June 30, 2007, the Company does not have a liability for unrecognized tax benefits.

The Company files income tax returns in the U.S. federal jurisdiction and the state of California. The Company is subject to U.S. federal or state income tax examinations by tax authorities for years after 2002. During the periods open to examination, the Company has net operating loss and tax credit carry forwards for U.S. federal and state tax purposes that have attributes from closed periods. Since these net operating losses and tax credit carry forwards may be utilized in future periods, they remain subject to examination. The Company's policy is to record interest and penalties on uncertain tax provisions as income tax expense. As of June 30, 2007, The Company has no accrued interest or penalties related to uncertain tax positions. The Company believes that it has not taken any uncertain tax positions that would impact its condensed consolidated financial statements as of June 30, 2007. Also as of the date of adoption, and as of June 30, 2007, the Company does not have a liability for unrecognized tax benefits.

EITF 00-19-2

Effective in the first quarter of 2007 the Company adopted FASB Staff Position No. EITF 00-19-2, "Accounting for Registration Payment Arrangements" issued on December 21, 2006 ("FSP 00-19-2"). FSP 00-19-2 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, "Accounting for

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

Contingencies.” For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to the issuance of EITF 00-19-2, this guidance is effective for financial statements issued for fiscal years beginning after December 15, 2006 and interim periods within those fiscal years.

5. 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 may have a dilutive effect under the treasury stock method only when the average market price of the common stock during the period exceeds the exercise price of the options and warrants. For the six months ended June 30, 2007 and 2006, the dilutive impact of outstanding stock options of 4,039,559 and 7,181,257 respectively, and outstanding warrants of 21,631,197 and 22,050,058 have been excluded because their impact on the loss per share is anti-dilutive.

6. Certain relationships and related transactions

Advances from founding executive officer

All of the marketing and manufacturing rights for the ZEFS were acquired from founding officer Jeffery A. 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 12), 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

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

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

Interest expense recognized under related-party loans was immaterial for all periods presented. Interest expense recognized under related-party loans for the period from February 18, 1998 (date of inception) through June 30, 2007 was \$327.

Lease agreement

During 2003, the Company entered into a sublease agreement with an entity to lease office space in North Hollywood, California for its principal executive offices. Bruce H. McKinnon, the Chief Executive Officer and a director of the Company, is an owner of the lessor.

In August 2005, the Company amended this sublease agreement. The original lease term was from November 1, 2003 through October 16, 2005 and carried an option to renew for two additional years with a 10 percent increase in the rental rate. Monthly rent under this lease is \$3,740 per month under this lease. The Company exercised its option to renew the lease through October 15, 2007.

In January 2006, the Company further amended this sublease agreement, as a result of taking more space and obtaining expanded support services. The term of the sublease was amended to 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 amended sublease agreement. Additionally, the Company began leasing two additional office spaces for \$964 per month beginning July 2006 on a month-to-month basis.

During the three months ended June 30, 2007 and 2006, rent expense under the sublease was \$30,615 and \$18,624, respectively. The amount for the three months ended June 30, 2007 includes \$9,100 with respect to a late penalty of \$100 per day since April 1, 2007, in addition to amounts previously accrued and discussed in the next paragraph. The Company does not admit that it owes this amount.

During the six months ended June 30, 2007 and 2006, rent expense under the sublease was \$97,630 and \$37,248, respectively. The amount for the six months ended June 30, 2007 includes \$54,600 with respect to a late penalty of \$100 per day since January 1, 2006. The Company does not admit that it owes this amount.

Marketing and promotional services agreement

In July 2006, the Company entered into an agreement with SS Sales and Marketing Group ("SS Sales"), to provide exclusive marketing and promotional services in the western United States and western Canada (the "Territory") for the Company's products. SS Sales will also provide advice, assistance and information on marketing the Company's products in the automotive after-market, and will seek to recruit and establish a market with distributors,

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

wholesalers and others. SS Sales will be paid a commission equal to 5% of the gross amount actually collected on contracts the Company entered into during the term of the agreement for existing or future customers introduced by SS Sales in the Territory. The agreement has a term of five years unless sooner terminated by either party on 30 days' notice. In the event of termination, SS Sales will be entitled to receive all commissions payable through the date of termination. No amount was due or paid under this agreement as of June 30, 2007. SS Sales is owned by Nathan Shelton, who has served as one of the directors of the Company since February 12, 2007.

7. Equity line of credit

In September 2006, the Company entered into what is sometimes termed an equity line of credit arrangement. Under the line of credit the Company may, but is not obligated to, put shares of common stock from time to time over a 36-month period, at a purchase price calculated at 97% of the lowest best closing bid for the Company's common stock for the five trading days following the put notice. The Company may draw up to \$10,000,000 under the line of credit. Because the price of the common stock fluctuates and the number of shares of common stock, if any, that the Company may issue, should exercise the put rights under the equity line of credit, will vary, the Company does not know how many shares, if any, will actually issue under the equity line of credit. As of June 30, 2007 the Company has registered and made available 7,000,000 shares of common stock for possible future draws under the line of credit.

As of June 30, 2007 the Company has drawn down \$1,372,150 (\$1,262,384 net of closing costs) of this commitment and issued 2,367,905 shares of common stock, leaving 4,632,095 shares of common stock still available under the equity line of credit.

8. Convertible debentures

During the year ended December 31, 2006, the Company issued notes (the "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 warrants (the "Warrants") were issued to certain placement agents. The 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 placement agent 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 (statutory term). The company also determined that the notes contained a beneficial conversion feature of \$290,248.

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

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.

During the year ended December 31, 2006, convertible notes in the amount of \$2,576,379 of the Notes were converted to 3,680,540 shares of stock at \$0.70 per share. In addition, \$3,707 of accrued interest was converted to 5,296 shares at \$0.70 per share. For the year ended December 31, 2006, \$2,257,620 of the total discount has been amortized and included in the accompanying consolidated statement of operations.

On December 5, 2006, the Company entered into a Note Purchase Agreement (the "Agreement") with Morale Orchards, LLC, a limited liability company formed under the laws of the State of Oregon ("Morale"). The entire equity interest in Morale is beneficially owned by Leodis Matthews who provides legal services to the Company. The Agreement provides that Morale will purchase the Company's one year Convertible Promissory Notes in the aggregate face amount of \$1,225,000 (the "Morale Notes"), and five-year Warrants (the "Morale Warrants") to purchase shares of the Company's common stock (the "Common Stock"). The aggregate purchase price for the Notes and Warrants is \$1,000,000. Therefore, while the stated interest on the Notes is 0%, the effective interest rate is 22.5% because the Notes are being purchased at a discount from their face amount.

Each of the Morale Notes is convertible into shares of the Company's Common Stock at a per share conversion price initially equal to the closing price of a share of the Company's Common Stock on the trading day prior to the date of issuance of such Note. The conversion right is exercisable during the period commencing 90 days prior to the maturity of each Note. Concurrently with the issuance of a Note, for no additional consideration, Morale will acquire Warrants to purchase a number of shares of Common Stock equal to 50% of the number of shares of Common Stock initially issuable on conversion of the associated Note. The Morale Warrants become exercisable 180 days after the date of their issuance. The Note purchased by Morale on December 5, 2006 is convertible at the rate of \$0.85 per share into 720,588 shares of the Company's Common Stock and the Morale Warrants are exercisable at the same per share price for 360,294 shares of the Company's Common Stock.

Repayment of each Note is to be made monthly, at an amount equal to at least \$3,750 for each Note. Additional payments may be made prior to maturity with no prepayment penalties. In the event the Company has not repaid each Note in full by the anniversary date of its issuance, the remaining balance shall be increased by 10% as an initial penalty, and the Company shall pay additional interest of 2.5% per month, compounded daily, for each month until such Note is paid in full.

Morale has piggyback registration rights pursuant to which Morale may require the Company to include the shares of the Company's Common Stock issuable upon conversion of the Morale Notes and exercise of the Morale Warrants in certain future registration statements the Company may elect to file, subject to the right of the Company and/or its

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

underwriters to reduce the number of shares to be included in such a registration in good faith based on market or other conditions.

During the year ended December 31, 2006, the Company issued Morale Notes totaling \$612,500 discounted by \$112,500, resulting in net proceeds to the Company of \$500,000. In addition to the discount, 360,264 additional warrants were issued to Morale. These warrants expire December 5, 2011 and are exercisable at a price of \$0.85 per share.

The aggregate value of the Morale Warrants issued in connection with the offering and to the finder were valued at \$118,348 using the Black-Scholes option valuation model with the following assumptions; risk-free interest rate of 4.39%; dividend yield of 0%; volatility factors of the expected market price of common stock of 110.21%; and an expected life of five years (statutory term) and vest over 180 days. The Company also determined that the notes contained a beneficial conversion feature of \$230,848.

The value of the Morale Warrants of \$118,348, the conversion option of \$230,848, and the transaction fees of \$112,500 are considered as debt discount and are being amortized over the life of the Note.

During the six months ended June 30, 2007, the Company issued Morale Notes totaling \$612,500 discounted by \$112,500, resulting in net proceeds to the Company of \$500,000. In addition to the discount, 437,500 warrants were issued to Morale. These warrants expire January 10, 2011 and are exercisable at \$0.70 per share. The note is convertible at the rate of \$0.70 per share into 875,000 shares of the Company's Common Stock.

The aggregate value of the Morale Warrants issued in connection with the offering were valued at \$118,955 the Black-Scholes option valuation model with the following assumptions; risk-free interest rate of 4.68%; dividend yield of 0%; volatility factors of the expected market price of common stock of 245%; and an expected life of five years (statutory term) and vest over 180 days. The Company also determined that the notes contained a beneficial conversion feature of \$231,455.

The value of the Morale Warrants of \$118,955, the conversion option of \$231,455 and the transaction fees of \$112,500 are considered as debt discount and being amortized over the life of the note.

During the six months ended June 30, 2007, the Company conducted an offering (the "2007 PIPE Offering"), through Spencer Clarke LLC, as exclusive placement agent, of up to \$2,000,000 principal amount of its 10% convertible notes (the "2007 PIPE Notes"). Interest on the 2007 PIPE Notes, at a rate of 10% per annum, is payable quarterly. The Notes are due nine months from date of issuance. The 2007 PIPE Notes are convertible into shares of Common Stock at an initial conversion price of \$0.70 per share (the "Conversion Shares").

The Company has the right to redeem any or all of the outstanding 2007 PIPE Notes in its sole discretion anytime after the termination of the 2007 PIPE Offering and prior to the maturity date of the 2007 PIPE Notes. The redemption price shall be the face amount of the

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

redeemed 2007 PIPE Notes plus accrued and unpaid interest thereon. Subject to the following sentence, at any time prior to the maturity date of the 2007 PIPE Notes, for each additional \$1,000,000 of gross proceeds raised from one or more offerings of the Company's equity or quasi-equity securities, the Company shall redeem 2007 PIPE Notes with a minimum face value of \$500,000 together with accrued and unpaid interest, until the entire outstanding 2007 PIPE Note is redeemed. Certain financings that the Company may conduct outside of North America are exempt from this provision to redeem the 2007 PIPE Notes in whole or in part.

Investors in the 2007 PIPE Offering received, for no additional consideration, a warrant (the "2007 PIPE Warrant"), entitling 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 2007 PIPE Notes are convertible (the "Warrant Shares"). The 2007 PIPE Warrant will be exercisable on a cash basis only and will have registration rights. The 2007 PIPE Warrant is exercisable at an initial price of \$1.00 per share, and is exercisable immediately upon issuance and for a period of three years from the date of issuance.

Promptly, but no later than 90 days following the closing date of the 2007 PIPE Offering, the Company is required to file a registration statement with the SEC to register the Conversion Shares and the Warrant Shares. The Company shall use its best efforts to ensure that such registration statement is declared effective within 120 days after filing.

During the six months ended June 30, 2007, the Company issued \$400,000 of the PIPE Notes and 2007 PIPE Warrants to purchase 857,144 shares of the Company's common stock. The Company had related transaction fees of \$48,000, resulting in net proceeds to the Company of \$352,000. In addition to the transaction fees, warrants to purchase 75,000 shares of the Company's common stock were issued to Spencer Clarke LLC, the Company's exclusive placement agent for the 2006 Spring Offering. These warrants expire March 1, 2010 and are exercisable at a price of \$1.00 per share.

The aggregate value of the 2007 PIPE Warrants issued in connection with the offerings and the warrants issued to the placement agent were valued at \$256,533 using the Black-Scholes option valuation model with the following assumptions; risk-free interest rate of 4.40% to 5.16%; dividend yield of 0%; volatility factors of the expected market price of common stock of 100.28% to 114.98%; and an expected life of two years (statutory term). The company also determined that the notes contained a beneficial conversion feature of \$62,857.

The value of the 2007 PIPE Warrants of \$256,533, the conversion option of \$62,857 and the transaction fees of \$48,000 are considered as debt discount and are being amortized over the life of the 2007 PIPE Notes.

During the six months ended June 30, 2007, no 2007 PIPE Notes were converted to shares of stock.

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

From June 13, 2007 through June 26, 2007, the Company conducted a private offering (the "Spring 2007 Offering") of up to \$550,000 aggregate face amount of its convertible notes (the "Spring 2007 Notes") with a small number of accredited investors. Of this amount, \$451,000 aggregate face amount of the Spring 2007 Notes were sold for an aggregate purchase price of \$410,000. Therefore, while the stated interest rate on the Spring 2007 Notes is 0%, the actual interest rate on the Spring 2007 Notes is 10%. The Spring 2007 Notes mature on the first anniversary of their date of issuance. The Spring 2007 Notes are convertible, at the option of the noteholder, into shares of common stock of the Company (the "Conversion Shares") at an initial conversion price equal to the average of the closing bid price of the Company's Common Stock for the five trading days preceding the closing dates of the Spring 2007 Offering (the "Conversion Prices"). Up to 1,210,489 Conversion Shares are initially issuable at Conversion Prices of either \$0.34 or \$0.53 per share, depending upon which of the two closing dates of the Spring 2007 Offering the Spring 2007 Notes were sold.

Each of the investors in the Spring 2007 Offering received, for no additional consideration, a warrant (the "Spring 2007 Warrants"), entitling the holder to purchase a number of shares of the Company's common stock equal to 50% of the number of shares of common stock into which the Spring 2007 Notes are convertible (the "Warrant Shares"). Each Spring 2007 Warrant is exercisable on a cash basis only at an initial price of \$0.50 per share, and is exercisable immediately upon issuance and for a period of two years from the date of issuance. Up to 605,242 Warrant Shares are initially issuable on exercise of the Spring 2007 Warrants.

The Company received \$410,000 gross and net proceeds in the 2007 Spring Offering. The proceeds of the Spring 2007 Offering were used for general corporate purposes and working capital.

9. Capital stock

As of June 30, 2007, the Company has authorized 200,000,000 shares of its common stock, of which 41,962,178 shares were issued and outstanding.

During the year ended December 31, 2005, the Company issued 1,599,500 shares of common stock and 1,599,500 warrants, each 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 of common stock issued, the Company issued 69,000 shares of common stock for which payment was previously received. The Company also issued 50,500 shares of common stock for the exercise of warrants, 50,000 of which payment was previously received.

The warrants issued above were part of a private offering of 2,872,000 shares of common stock and warrants 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

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

(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 of common stock in settlement of accrued expenses of \$612,521. These shares were reflected as common stock to be issued in the accompanying December 31, 2005 financial statements, and were subsequently issued in 2006.

In late 2005 and early 2006, the Company conducted an offering (the "Bridge Offering") and sold an aggregate \$1,075,000 principal amount of its 9% convertible subordinated notes (the "Bridge Notes") and issued warrants ("Bridge Warrants") to purchase up to 2,303,568 shares of the Company's common stock at \$1.00 per share, to certain investors. Net proceeds to the Company from the sale of the Bridge Notes were \$935,250. All of the Bridge Notes were converted voluntarily by the holders of the Bridge Notes into 1,535,715 shares of the Company's common stock (the "Bridge Shares"), at a conversion price of \$0.70 per share, on or prior to the maturity date of the Bridge Notes on May 31, 2006.

In April 2006, the Company conducted an offering (the "Overseas Offering") and sold 473,000 shares of the Company's common stock at \$1.56 per share and issued warrants to purchase up to 118,250 shares of our common stock at an exercise price of \$2.60 per share, to two overseas investors. The Company raised \$737,881 gross proceeds (\$667,803 net proceeds) in this offering.

In May 2006, the Company conducted an offering (the "2006 PIPE Offering") and sold 873,018 shares of the Company's common stock (the "2006 PIPE Shares") at \$1.89 per share and issued warrants (the "2006 PIPE Warrants") to purchase up to 436,511 shares of the Company's common stock at \$2.70 per share, through the Company's exclusive placement agent, Spencer Clarke LLC ("Spencer Clarke"). The Company raised \$1,650,009 gross proceeds (\$1,435,508 net proceeds) in the 2006 PIPE Offering.

On June 28, 2006, the Company filed a registration statement to register the Bridge Shares and the 2006 PIPE Shares, and the shares of the Company's common stock issuable upon exercise of the Bridge Warrants, the 2006 PIPE Warrants and warrants issued to Spencer Clarke for various investment banking and other related services, including services in connection with the Bridge Offering, the Overseas Offering and the 2006 PIPE Offering. The registration statement was declared effective by the SEC on July 24, 2006.

During the year ended December 31, 2006, convertible notes in the amount of \$2,576,379 of the Company's previously issued and outstanding Investor Notes were converted to 3,680,540 shares of common stock, at a conversion rate of \$0.70 per share. In addition, \$3,707 of accrued interest was converted to 5,296 shares of common stock, at a conversion rate of \$0.70 per share. The Company did not receive any proceeds in connection with the conversion of the Investor Notes.

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

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)

During the year ended December 31, 2006, individuals exercised outstanding warrants to purchase 2,328,452 shares of common stock for gross and net proceeds of \$1,623,327.

During the six months ended June 30, 2007 the Company issued 1,880,421 shares of common stock in connection with its equity line of credit (see note 7).

10. Stock options and warrants

The Company currently issues stock options to employees, directors and consultants under the 2004 Stock Plan (the "Plan"). As of December 31, 2005, the Company could issue options under the Plan to acquire up to 5,000,000 shares of common stock. In February 2006, the board approved an amendment to the Plan, increasing the authorized shares by 2,000,000 shares to 7,000,000 shares. At June 30, 2007, 2,980,441 shares of common stock were available to be granted under the Plan. Prior to 2004, the Company granted to officers of the Company outside the Plan options to purchase 3,250,000 shares of common stock, which options are still outstanding.

Employee options vest according to the terms of the specific grant and expire from 5 to 10 years from date of grant. Non-employee option grants to date are vested upon issuance. The weighted-average, remaining contractual life of employee options outstanding at June 30, 2007 and December 31, 2006 was 7.43 years and 5.53 years, respectively. Stock option activity for the six months ended June 30, 2007 and the year ended December 31, 2006 was as follows, which includes 3,250,000 options granted outside the Plan:

	<u>Weighted Avg. Options</u>	<u>Weighted Avg. Exercise Price</u>
Options, December 31, 2005	6,508,561	0.53
Options granted	1,313,605	1.21
Options exercised	(2,860,000)	0.10
Options forfeited	(962,607)	0.84
Options cancelled	—	—
	<hr/>	<hr/>
Options, December 31, 2006	3,999,559	0.99
Options granted (unaudited)	40,000	0.85
Options exercised (unaudited)	—	—
Options forfeited (unaudited)	—	—
Options cancelled (unaudited)	—	—
	<hr/>	<hr/>
Options, June 30, 2007 (unaudited)	<u>4,039,559</u>	<u>\$ 0.99</u>

During the six months ended June 30, 2007, the Company granted an option for 40,000 shares to an officer. The options were valued at \$25,200, using the Black-Scholes pricing model, with the following average assumptions:

Expected life (years)	5.00
Risk free interest rate	4.42%
Volatility	117.64%
Expected dividend yield	0.00%

[Table of Contents](#)

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

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)

Options outstanding at June 30, 2007 and the related weighted average exercise price and remaining life information is as follows: (unaudited)

Exercise prices	Total options outstanding	Weighted average remaining life in years	Total weighted average exercise price	Options exercisable	Exercisable weighted Average exercise price
0.40	250,000	4.55	0.40	250,000	0.40
0.85	2,115,000	8.34	0.85	2,115,000	0.85
0.98	650,000	6.16	0.98	650,000	0.98
1.00	370,000	8.23	1.00	370,000	1.00
1.15	193,912	6.93	1.15	193,912	1.15
1.69	310,647	8.90	1.69	310,647	1.69
2.26	150,000	3.56	2.26	30,000	2.26
<u>\$ 0.40-\$2.26</u>	<u>4,039,559</u>	<u>7.43</u>	<u>\$ 0.99</u>	<u>3,919,559</u>	<u>\$ 0.95</u>

Black-Scholes value of employee options

During the six-month period ended June 30, 2007, the Company valued employee options at the grant date using the Black-Scholes pricing model with the following average assumptions:

Expected life (years)	5.00
Risk free interest rate	4.42%
Volatility	117.64%
Expected dividend yield	0.00%

Stock-based compensation during the six-month period ended June 30, 2007 was \$25,200, compared to \$1,659,565 for the six-month period ended June 30, 2006.

Warrants

The following table summarizes certain information about the Company's stock purchase warrants:

SAVE THE WORLD AIR, INC. AND SUBSIDIARY
(A DEVELOPMENT STAGE ENTERPRISE)
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)

	<u>Warrants</u>	<u>Weighted Avg. Exercise Price</u>
Warrants outstanding, December 31, 2005	20,792,488	0.75
Warrants granted	3,624,894	1.28
Warrants exercised	(2,328,452)	0.68
Warrants cancelled	(1,191,619)	1.46
Warrants outstanding, December 31, 2006	20,897,311	0.81
Warrants granted (unaudited)	1,974,886	0.79
Warrants exercised (unaudited)		
Warrants cancelled (unaudited)	(1,241,000)	1.50
Warrants outstanding, June 30, 2007 (unaudited)	<u>21,631,197</u>	<u>0.76</u>

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.

In April 2006, the Company entered into a one-year agreement with an outside consultant to provide public relations services. The terms of the agreement calls for monthly payments of \$7,000. Additionally, the Company issued a five-year warrant to the consultant. The warrant is exercisable for up to 100,000 shares of common stock at an exercise price of \$2.30 per share and vests as to 8,333 shares per month commencing April 30, 2006. The shares issuable upon exercise of the warrant have piggyback registration rights. In August 2006 the Company terminated the agreement. The consultant earned warrants to purchase 41,665 shares and the remaining balance of the warrants to purchase 58,335 shares was forfeited.

During the six months ended June 30, 2007, the Company did not issue any warrants for services other than what is stated in Note 8.

11. 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 ZEFS, MK IV and CAT-MATE technologies 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

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

products incorporating its ZEFS, MK IV and CAT-MATE technologies 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 \$441,183 and \$178,873 for the six months ended June 30, 2007 and 2006, respectively.

12. Commitments and contingencies

Legal matters

Litigation Involving Jeffrey A. Muller

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 our 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 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 the Company's 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 the Company's 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 the Company, from selling or transferring any of the Company's stock that they may own or control, or from taking any action to injure the Company or the Company's business and from having any direct contact with the

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

Company's shareholders. The injunctive order also prevents Mr. Muller from engaging in any effort to exercise control over the Company's corporation and from serving as an officer or director of the Company. While the Company believes that the Company has valid claims, there can be no assurance that an adverse result or settlement would not have a material adverse effect on the Company's financial position or cash flow..

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 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 28, 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.

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 pay a civil penalty in the amount of \$100,000. Acting in accordance with the Court's order, the Company has canceled

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

(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.

Mr. Muller subsequently filed a Notice of Appeal from the Judgment resulting from this decision to the Second Circuit Court of Appeals in New York. The clerk of the Court recently issued an Order dismissing this appeal.

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.

On October 27, 2006, Magistrate Judge Frank Maas, Federal District Court of the Southern District of New York, issued an order granting summary judgment in favor of the Company. The ruling provided that all shares, options and any other obligations allegedly owed by the Company to Jeffrey A. Muller, its former Chairman, were to be disgorged. The ruling also confirmed an earlier decision issued on November 16, 2005 in favor of the SEC holding Mr. Muller liable for \$7.5 million in actual damages, imposing a \$100,000 fine and barring Muller from any involvement with a publicly traded company for 20 years. With prejudgment interest, this ruling brings the actual damages against Muller to over \$9 million. Additionally, the Court further clarified that the scope of its previous disgorgement order required the disgorgement of any shares of the Company's stock that Mr. Muller or any of his nominees directly or indirectly own or control. The Company has taken action to cancel over 3.6 million shares which had been issued to the offshore companies.

The Court also confirmed the appropriateness of an action previously taken by the Company to acquire the patent rights and to consolidate the manufacturing, marketing and distribution rights with its ownership of all rights to the existing patents.

Finally, the Court ruled that Mr. Muller had no claim to an alleged \$500,000 debt owed to him while the damages of over \$9 million remain unpaid. The Court also ruled that other assets that were transferred by Mr. Muller to members of his family through various offshore corporations were also to be disgorged. Because the Court left unresolved an issue concerning claims against one Muller family member, the Company sought a modification of the Order. On February 8, 2007, Judge Maas issued an Amended Order, which concluded that all of the STWA shares of Muller or any of his nominees directly or indirectly owned or controlled were to be recaptured by STWA and were subject to disgorgement and forfeiture. With this modification of the October 27, 2007 ruling, this order provides the complete relief requested by the Company in its motion for summary judgment.

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

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

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.

This 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. That Complaint is currently pending, however, the issues raised in this Complaint arise from the same claims already decided by the Court in its February 8, 2007 Amended Order. The Company plans to file a request to dismiss the pending Complaint on several grounds, including that the claims sought to be litigated in this latter complaint has been included within the Summary Judgment Motions decided against Muller, his nominees and assignees. While the Company believes that the Company has 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.

Litigation Involving Sublessor of Former Corporate Offices

On July 19, 2007, Scottish Glen Golf Company, Inc. doing business as KZG ("KZG") sued the Company in Los Angeles Superior Court, alleging unlawful detainer by the Company of its then-leased corporate offices at 5125 Lankershim Boulevard, North Hollywood, California, and failure to pay past due rent and penalties in the aggregate amount of \$104,413. In its complaint, KZG also seeks attorney fees. Bruce H. McKinnon, the Company's former President and Chief Executive Officer, and an incumbent director, is, the Company believe, the Chairman and an owner of KZG. Mr. McKinnon's wife is the President of KZG.

On July 25, 2007, the parties entered into an agreement pursuant to which KZG would dismiss the eviction action. However, KZG reserved the right to amend their complaint to include a demand for past due rent and penalties. The Company agreed to vacate the premises and KZG agreed not to further prosecute its eviction action. The Company

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

vacated the premises on July 25, 2007. The Company is currently awaiting a decision by KZG to amend its complaint and thereafter the Company will formulate its response to the suit.

While the Company believes that it has valid claims and defenses, given the inherent uncertainties of litigation, the Company cannot predict the outcome of this matter. Accordingly, there can be no assurance that an adverse result or outcome of this matter would not have a material adverse effect on the Company's financial position or cash flow.

Employment agreements

In July 2005, the Company entered into an employment agreement with an individual to serve as a Vice President of Operations for the Company. The agreement expired December 31, 2005, with an automatic one-year extension and provided for annual base salary of not less than \$120,000 per year. Effective February 21, 2006, the individual was promoted to Executive Vice President, his annual base salary was increased from \$120,000 per year to \$150,000 per year and the term of his employment agreement was extended to December 31, 2007. Effective August 8, 2006, the individual was promoted to Chief Operating Officer and his annual base salary was increased from \$150,000 per year to \$200,000 per year. During the employment term, the individual is eligible to participate in certain incentive plans, stock option plans and similar arrangements in accordance with the Company's recommendations at award levels consistent and commensurate with the position and duties hereunder.

On November 9, 2006, the individual who served as the Company's Chief Executive Officer and Chief Financial Officer resigned, due to a medical disability. His resignation as Chief Executive Officer took effect on November 20, 2006 and his resignation as Chief Financial Officer took effect on January 8, 2007. He will continue to serve as a director of the Company.

Under the terms of the separation agreement as an officer of the Company, he is entitled to be paid out the remainder of the cash portion of his employment agreement through December 31, 2007, in accordance with the Company's normal pay policies. Options granted to him in February 2006 have been accelerated, fully vested on November 20, 2006 and were recalculated under 123R. Additionally, the former officer will have until November 20, 2007 to exercise such options. He is also entitled to receive a stock option grant in 2007 equal to the lesser of (i) the number of stock options he was granted in 2006 or (ii) the highest number of options granted to any of the then Chief Executive Officer, President or Chief Financial Officer on an annualized basis, on terms no less favorable as granted to such person; provided, however, that such options to be granted to the former officer shall be fully vested upon grant and shall be exercisable for one year from the date of grant. The Company and the former officer have waived any claims they may have against each other and have agreed to mutual indemnification. The Company expensed \$345,000 for the remaining term of his employment agreement and benefits for the year ended December 31, 2006.

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

Minimum guaranteed compensation, including those agreements entered into prior to 2006, payments under employment agreements, as amended, amounts to \$647,000 for the balance of the year 2007. Previously, \$10,000 was shown for the year 2008 in respect of an officer of the Company and has been eliminated in this Report due to the resignation of that officer.

During the six months ended June 30, 2007, approximately \$177,000 was paid for employment agreements.

Consulting agreements

In April 2006, the Company entered into a one-year agreement with an outside consultant to provide public relations services. The terms of the agreement calls for monthly payments of \$7,000. Additionally, the Company issued a five-year warrant to the consultant. The warrant is exercisable for up to 100,000 shares of common stock at an exercise price of \$2.30 per share and vests as to 8,333 shares per month commencing April 30, 2006. The shares issuable upon exercise of the warrant have piggyback registration rights. In August 2006 the Company terminated the agreement. The consultant earned warrants to purchase 41,665 shares of common stock and warrants to purchase the balance of 58,335 shares of common stock were forfeited.

Leases

During 2003, the Company entered into a sublease agreement with an entity to lease office space in North Hollywood, California for its principal executive offices. Bruce H. McKinnon, the Company's former President and Chief Executive Officer, and an incumbent director, is an owner of the sublessor. Mr. McKinnon's wife is the President of the sublessor and the Company believes that Mr. McKinnon is presently the Chairman of the sublessor. See Note 13, "Subsequent Events."

In August 2005, the Company amended this sublease agreement. The original lease term was from November 1, 2003 through October 16, 2005 and carried an option to renew for two additional years with a 10 percent increase in the rental rate. Monthly rent under this lease is \$3,740 per month under this lease. The Company exercised its option to renew the lease through October 15, 2007.

In January 2006, the Company further amended this sublease agreement, as a result of taking more space and obtaining expanded support services. The term of the sublease was amended to July 31, 2007 and carried an option to renew for two additional years with a 10 percent increase in the rental rate. Monthly rent was \$6,208 per month under this amended sublease agreement. Additionally, the Company began leasing two additional office spaces for \$964 per month beginning July 2006 on a month-to-month basis. The Company did not exercise its option to renew the sublease and vacated the premises on July 25, 2007.

In November 2003, the Company entered into a lease for a research and development facility located in Queensland, Australia. The term of the lease is from November 15, 2003

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

through March 15, 2006 and carries an option to renew for two additional years each with an increase of the greater of 5% or the increase in the then current Australian Consumer Price Index. Monthly rent is AUD \$1,292 (approximately US \$1,000) per month under this lease. In March 2006, the Company entered into a new lease for this facility for a term of two years commencing March 15, 2006. Monthly rent is AUD \$1,462 (approximately US \$1,100) per month.

In September 2005, the Company entered into a lease for a testing facility located in Morgan Hill, California. The term of the lease is from September 1, 2005 through August 31, 2007 and carries an option to renew for two additional years at the then prevailing market rate. Monthly rent is \$2,240 per month under this lease. The lease was amended in February 2006 for additional space. Monthly rate under the amended lease is \$4,640 per month. The Company renewed this lease on August 9, 2007 for an additional two-year term. The rent is \$4,640 per month for the first six months of the new term of the lease and \$5,480 per month for the remaining 18 months of the new term of the lease.

Total rent expense under these leases for the six-months periods ended June 30, 2007 and 2006, is \$128,333 and \$68,535, respectively. The amount for the six months ended June 30, 2007 includes \$54,600 with respect to a late penalty of \$100 per day since January 1, 2006. The Company does not admit that it owes this amount.

The following is a schedule by years of future minimum rental payments required under the non-cancelable operating leases as of June 30, 2007.

Years Ending December 31,	
2007	\$ 44,952
2008	69,270
2009	44,800
Total	<u>\$159,022</u>

13. Subsequent events

On July 12, 2007, KZ Golf, Inc. (“KZG”), the Company’s landlord, presented to the Company a Three-Day Notice to Pay or Quit, demanding payment of unpaid rent, additional rent and penalties, in the aggregate amount of \$104,413 as of such date. In addition to the unpaid rent during 2007, it is apparently KZG’s position that there is a discrepancy in the calculation of base rent as far back as April 1, 2004 and that a penalty of \$100 per day should be imposed continuously since January 1, 2006 under the terms of a certain provision of the sublease between the Company and KZG (the “2006 Sublease”). As of June 30, 2007, the Company recorded a contingent liability in the amount of \$91,422. The Company does not admit that it owes either the entire amount claimed by KZG or the entire amount recorded by it as a contingent liability. The Company did not exercise its option to renew the 2006 Sublease.

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

On June 15, 2007, the Company and Bruce H. McKinnon agreed and entered into an agreement that Mr. McKinnon would resign as Chief Executive Officer of the Company effective on the first to occur of (i) the appointment of a new Chief Executive Officer by the Board of Directors and (ii) July 31, 2007. At the time of the filing of the Current Report on Form 8-K announcing such matter (the "Form 8-K"), and as stated therein, it was intended that Mr. McKinnon would continue to serve as President of the Company and would continue to receive the compensation provided for in accordance with the provisions of the employment agreement dated as of October 5, 2005 between the Company and Mr. McKinnon, through December 31, 2007, the end of the term of that agreement. Additionally, as stated in the Form 8-K, Mr. McKinnon will continue to serve as a director of the Company, until he has resigned, been removed by the stockholders or not been re-elected to the Board. The Company and Mr. McKinnon have waived any claims they may have against each other and have agreed to mutual indemnification.

On July 18, 2007, Bruce H. McKinnon was removed by the Board of Directors as President and Chief Executive Officer of the Company and its wholly-owned subsidiary, STWA Asia, effective immediately. Mr. McKinnon also was removed by the Board of Directors as a director of STWA Asia, effective immediately. Mr. McKinnon will continue to serve as a director of the Company, until he has resigned, been removed by the stockholders or not been re-elected to the Board.

Also on July 18, 2007, the Board of Directors of the Company appointed Charles Blum as President and Chief Executive Officer of the Company. Mr. Blum will assume his positions on July 25, 2007. Mr. Blum was also appointed to the Board of Directors to fill the vacancy created by the resignation on June 5, 2007 of Maj. Gen. Dennis M. Kenneally (Ret.), such appointment took effect upon Mr. Blum's joining the Company as President and Chief Executive Officer.

Effective July 18, 2007, the Company entered into an employment agreement with Mr. Blum (the "Blum Employment Agreement"), pursuant to which Mr. Blum will serve as the Company's President and Chief Executive Officer. Pursuant to the Blum Employment Agreement, Mr. Blum's employment is for a one-year term, subject to automatic one-year extensions and provides for annual base compensation of \$200,000 per year, subject to periodic review and adjustment. In addition, Mr. Blum will receive an automobile allowance of \$900 per month and four weeks of paid vacation annually. Mr. Blum is entitled to participate in all employee benefit plans that the Company makes available to its employees generally; provided that if Mr. Blum elects not to participate in the Company's group medical insurance plan, he will be reimbursed in an amount equal to the lesser of (i) the premium the Company would have paid to include him as a participant in that group health insurance plan and (ii) the sums paid by him in connection with maintaining his private health insurance. The Company will also reimburse Mr. Blum the reasonable costs paid by him for maintaining DSL Internet access and other direct costs of maintaining an office at his home, but only until such time as the Company shall provide him with an office at a location reasonably acceptable to him.

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — Continued
SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)**

As an interim matter, on July 18, 2007, the Board of Directors appointed incumbent director and former President Chief Executive Officer of the Company Eugene E. Eichler as Acting President and Chief Executive Officer of the Company. Mr. Eichler served without compensation and resigned on July 25, 2007 at which time Mr. Blum assumed the positions of President and Chief Executive Officer.

On July 25, 2007, the Company vacated the offices in North Hollywood, California, and temporarily relocated its corporate offices to the Company's existing facility located at 235 Tennant Avenue, Morgan Hill, California 95037.

On August 9, 2007, the Company renewed the lease for its facility at Morgan Hill, California, which facility now also serves as the Company's corporate offices. The renewed lease is for 24 months and expires on August 15, 2009. The new rent is \$4,760 per month for the first six months of the lease and \$5,600 per month for the balance of the renewal term. The Company has the option to renew the lease for an additional two-year period at the end of the renewal term.

On August 1, 2007, a former officer and incumbent director of the Company loaned \$50,000 to the Company so that it could pay certain operating expenses. This amount will be repaid in the future.

In August 2007, the Company commenced a private offering (the "2007 Summer Offering") of up to \$300,000 principal amount of convertible notes, on substantially similar terms as the 2007 Spring Offering, to a limited number of accredited investors, in order to raise additional working capital for the Company. As of August 17, 2007, the Company received \$116,000 gross and net proceeds in the 2007 Summer Offering, which is ongoing as of the date of the filing of this Report.

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

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

Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth under the heading "Risk Factors" in our Annual Report on Form 10-KSB for the year ended December 31, 2006. 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 consolidated financial condition and consolidated results of operations should be read in conjunction with the condensed consolidated financial statements and notes thereto included in Part I, Item 1 of this Form 10-QSB and the consolidated financial statements and notes thereto contained in our Annual Report on Form 10-KSB for the fiscal year ended December 31, 2006.

We are a development stage company that generated our first revenues in the fourth quarter of 2006. Our focus is on research and development, and initial sales and marketing, of products incorporating our proprietary and patented technology, which is designed to reduce harmful emissions, and/or improve fuel efficiency and engine performance on equipment and vehicles driven by internal combustion engines. We have devoted the bulk of our efforts to the completion of the design, the development of our production models, testing of devices and the promotion of our products in the marketplace. We anticipate that these efforts will continue during 2007, subject to our ability to finance such efforts.

We face significant challenges in generating revenue and maintaining adequate working capital during the remainder of 2007 as a result of several factors. Among other things, to date our distributors, primarily located in Asia, have placed fewer orders than we had expected them to place under the terms of our distribution agreements with them. This resulted in our having less revenue and therefore less working capital available for the further development of our business at a time when the operating costs of our

[Table of Contents](#)

business have been increasing. Additionally, certain long-term financing transactions that we were negotiating earlier this year have not materialized. In turn, this lack of adequate working capital has put additional pressures on our ability to meet our obligations as they come due, including without limitation, being able to order and pay for the tooling and manufacture of products from third parties for sale to our distributors, being able to pay for shipment and freight duties in connection with such sales, being able to make our filings with the Securities and Exchange Commission (the "SEC") in a timely manner, being able to prepare and file our proxy statement and schedule our 2007 annual meeting of stockholders, and being able to pay our trade creditors, professional advisors and others in a timely manner. We will require significant additional outside capital during the remainder of 2007 in order to meet all of our obligations, produce products for sale and ship such products.

Given our current circumstances, we anticipate that revenue will remain nominal for at least the next few quarters, and unless and until we can simultaneously raise capital, reduce our expenses and generate more meaningful revenue from the sale of our products. See "Results of Operations" and "Liquidity and Capital Resources" below.

We are in the process of reviewing certain terms of our distribution agreement with Golden Allied Enterprises (Group) Co., Ltd. ("GAE"), our distributor in China. Among other things, we currently expect that we will again defer certain of GAE's order deadlines, including GAE's revised obligation to order 100,000 units by July 31, 2007 (previously extended from July 31, 2006), by up to one additional year until July 31, 2008, and we would like GAE to become a non-exclusive distributor (rather than an exclusive distributor) for our ECO ChargR, MAG ChargR and ELEKTRA products in China, while maintaining its exclusivity for the distribution of ZEFS and CAT-MATE products in China. These negotiations have not concluded and therefore are subject to change. Additionally, we have informally modified the terms of our distribution agreements with each of our distributors in China, Indonesia and Vietnam, so that none of these distributors is required to post letters of credit prior to or at the time that they place any further orders with us. These modifications may increase somewhat our exposure in terms of being paid in a timely fashion for products we ship to these distributors.

Our expenses to date have been funded primarily through the sale of stock and convertible debt, as well as proceeds from the exercise of stock purchase warrants. We raised capital in the three-month period ended June 30, 2007 and subsequent to the end of the three-month period ended June 30, 2007, and we will need to raise substantial additional capital during 2007, and possibly beyond, to fund our sales and marketing efforts, the manufacture of products to our distributors, continuing research and development, and certain other expenses, unless and until our revenue base grows sufficiently.

Results of Operations

We did not generate any revenue for the three-month periods ended June 30, 2007 and 2006. We generated revenue of \$22,000 and incurred cost of goods sold of \$5,360 for the six-month period ended June 30, 2007, compared to \$-0- and \$-0-, respectively, for the six-month period ended June 30, 2006.

Operating expenses were \$1,023,787 for the three-month period ended June 30, 2007, compared to \$1,852,870 for the three-month period ended June 30, 2006, a decrease of \$829,083. This decrease is attributable to decreases in non-cash expenses of \$748,749 and cash expenses of \$80,334. Specifically, the non-cash decrease is attributable to the revaluation of options and warrants given to employees and consultants (\$771,047), partially offset by an increase in depreciation (\$22,298). Decreases in cash expenses are attributable to decreases in travel expenses (\$72,164), corporate expenses (\$35,211), and salaries and benefits (\$3,279), partially offset by increases in consulting and professional fees (\$15,274), exhibits and trade shows (\$8,666), and office and other expenses (\$6,380).

Operating expenses were \$2,303,562 for the six-month period ended June 30, 2007, compared to \$3,607,840 for the six-month period ended June 30, 2006, a decrease of \$1,304,278. This decrease is attributable to a decrease in non-cash expenses of \$1,581,546, offset by an increase in cash expenses of \$277,268. Specifically, the non-cash decrease is attributable to the revaluation of options and warrants given to employees and consultant (\$1,634,364), partially offset by an increase in depreciation (\$52,818). Increases in cash expenses are attributable to increases in consulting and professional fees (\$188,907), office and other expenses (\$75,024), exhibits and trade shows (\$33,228), and salaries and benefits (\$30,859), partially offset by decreases in travel expenses (\$31,607) and corporate expenses (\$19,143).

Table of Contents

Research and development expenses were \$100,731 for the three-month period ended June 30, 2007, compared to \$121,111 for the three-month period ended June 30, 2006, a decrease of \$20,380. This decrease is attributable to decreases in consulting fees (\$31,740), and travel and related expenses (\$11,211), partially offset by an increase in product testing, research and supplies (\$22,571).

Research and development expenses were \$441,183 for the six-month period ended June 30, 2007, compared to \$178,873 for the six-month period ended June 30, 2006, an increase of \$262,310. This increase is attributable to an increase in product testing, research and supplies (\$351,676), partially offset by decreases in consulting fees (\$63,423) and travel and related expenses (\$25,943).

Other expense for the three-month period ended June 30, 2007 were \$403,665, compared to \$1,018,244 for the three-month period ended June 30, 2006, a decrease of \$614,579. This decrease is attributable to decreases in non-cash interest expense (\$720,488) and cash interest expense (\$38,860), partially offset by an increase in financing costs (\$137,791) and a decrease in interest and other income (\$6,978).

Other expense for the six-month period ended June 30, 2007 were \$713,439, compared to \$2,202,817 for the six-month period ended June 30, 2006, a decrease of \$1,489,378. This decrease is attributable to decreases in non-cash interest expense (\$1,649,831) and cash interest expense (\$86,419), partially offset by an increase in financing cost (\$239,998) and a decrease in interest and other income (\$6,874).

We had a net loss of \$1,528,183, or \$0.04 per share, for the three-month period ended June 30, 2007, compared to a net loss of \$2,992,225, or \$0.09 per share, for the three-month period ended June 30, 2006. We had a net loss of \$3,442,344, or \$0.09 per share, for the six-month period ended June 30, 2007, compared to a net loss of \$5,990,330, or \$0.18 per share, for the six-month period ended June 30, 2006. We expect to incur additional net loss in the fiscal year ending December 31, 2007, primarily attributable to continued operating and marketing-related expenditures without the benefit of any significant revenue for the remainder of the year.

Liquidity and Capital Resources

General

We have incurred negative cash flow from operations in the developmental stage since our inception in 1998. As of June 30, 2007, we had cash of \$223,882 and an accumulated deficit of \$33,869,941. Our negative operating cash flow in the six-month period ended June 30, 2007 was funded primarily through the sale of convertible notes, as well as sales of our stock by Dutchess Private Equity Fund, LLP ("Dutchess") under our equity line of credit.

The condensed consolidated financial statements accompanying this Quarterly Report 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 our business. As reflected in the accompanying condensed consolidated financial statements, we had a net loss of \$1,528,183 and a negative cash flow from operations of \$881,953 for the three-month period ended June 30, 2007, a net loss of \$3,442,344 and a negative cash flow from operations of \$2,202,478 for the six-month period ended June 30, 2007 and a stockholders' deficiency of \$2,527,077 as of June 30, 2007. 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, generate revenue 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.

Our current liabilities greatly exceed our assets and we are unable to meet our obligations as they become due. Additionally, we have been unable to make certain payments to various parties for amounts currently owed to them.

We face significant challenges in generating revenue and maintaining adequate working capital during the remainder of 2007 as a result of several factors. Among other things, to date our distributors, primarily located in Asia, have placed fewer orders than we had expected them to place under the terms of our distribution agreements with them. This resulted in our having less revenue and therefore less working capital available for the further development of our business at a time when the operating costs of our

[Table of Contents](#)

business have been increasing. Additionally, certain long-term financing transactions that we were negotiating earlier this year have not materialized. In turn, this lack of adequate working capital has put additional pressures on our ability to meet our obligations as they come due, including without limitation, being able to order and pay for the tooling and manufacture of products from third parties for sale to our distributors, being able to pay for shipment and freight duties in connection with such sales, being able to make our filings with the SEC in a timely manner, being able to prepare and file our proxy statement and schedule our 2007 annual meeting of stockholders, and being able to pay our professional advisors and outside consultants in a timely manner. We will require significant additional outside capital during 2007 in order to meet all of our obligations, produce products for sale and ship such products.

During the three-month period ended June 30, 2007, we raised an aggregate \$1,043,012 gross proceeds (\$990,371 net proceeds) from the sale of our stock and the issuance of debt, as follows:

- Gross proceeds of \$50,000 (net proceeds of \$44,000) from the issuance of notes and related warrants in a private offering (the "2007 PIPE Offering") conducted by Spencer Clarke, LLC ("Spencer Clarke"), as exclusive placement agent, that began in January 2007 and was completed on April 27, 2007.
- Gross proceeds of \$583,012 (net proceeds of \$536,371) from the issuance of stock under our equity line of credit from Dutchess.
- Gross and net proceeds of \$410,000 from the issuance of convertible notes and related warrants in a private offering (the "Spring 2007 Offering").

In addition, in June 2007, Eugene E. Eichler, our former Chief Executive Officer and an incumbent director, and Cecil Kyte, an incumbent director, each personally loaned the Company \$5,000 to meet certain expenses. These loans were repaid to Messrs. Eichler and Kyte from the proceeds of the 2007 Spring Offering (defined and discussed below).

Subsequent to end of the three-month period ended June 30, 2007, Mr. Eichler personally loaned the Company an additional \$50,000 in order to meet certain expenses. This loan is outstanding as of the date of the filing of this Report.

In August 2007, we commenced another private offering (the "2007 Summer Offering") of up to \$300,000 principal amount of convertible notes, on substantially similar terms as the 2007 Spring Offering, to a limited number of accredited investors, in order to raise additional working capital for the Company. See "Details of Recent Financing Transactions — 2007 Spring Offering" below. Through August 17, 2007, we received \$116,000 gross and net proceeds in the 2007 Summer Offering, which is ongoing as of the date of the filing of this Report.

Details of Recent Financing Transactions

Equity Line of Credit. In September 2006, to address our longer-term capital needs, we entered into what is sometimes referred to as an equity line of credit arrangement with Dutchess. Specifically, we entered into an investment agreement, pursuant to which Dutchess is committed to purchase up to \$10,000,000 of our common stock over the 36-month term of the investment agreement. We are not obligated to request any portion of the \$10,000,000.

In connection with the equity line of credit, we filed a Registration Statement with the SEC (the "Dutchess Registration Statement") on October 6, 2006 to register 7,000,000 shares of Common Stock that we may issue under the equity line of credit and the Dutchess Registration Statement was declared effective by the SEC on October 30, 2006.

Under the line of credit we may, but are not obligated to, put shares of our stock to Dutchess from time to time over a 36-month period, at a purchase price calculated at 97% of the lowest best closing bid for our common stock for the five trading days following our put notice to Dutchess. Because the price of our common stock fluctuates and the number of shares of our common stock, if any, that we may issue, should we exercise our put rights under the equity line of credit, will vary, we do not know how many shares, if

[Table of Contents](#)

any, we will actually issue under the equity line of credit. If we put more than the amount that would require us to issue the 7,000,000 shares that we have registered with the SEC, we would be required to file a new registration statement with regard to the excess number of shares and have it declared effective by the SEC, before we could make further puts under the equity line of credit.

The actual number of shares that we may issue pursuant to the equity line of credit is not determinable as it is based on the market price of our common stock from time to time and the number of shares we desire to put to Dutchess. Under the terms of the equity line of credit, Dutchess may not own more than 4.99% of our issued and outstanding stock at any one time.

As we draw down on the equity line of credit, more shares will be sold into the market by Dutchess. These additional shares could cause our stock price to drop. In turn, if the stock price drops and we make more drawdowns on the equity line of credit, more shares will come into the market, which could cause a further drop in the stock price. You should be aware that there is an inverse relationship between our stock price and the number of shares to be issued pursuant to the equity line of credit. If our stock price declines, we will be required to issue a greater number of shares under the equity line of credit. We have no obligation to utilize the full amount available under the equity line of credit.

For purposes of the Dutchess Registration Statement, we assumed that we would put \$9,913,400, or all 7,000,000 shares, based on a closing price of our common stock on September 20, 2006 of \$1.46 per share, less the 3% discount applicable to the price per share that Dutchess would pay under the terms of the equity line of credit. However, this may not in fact be the case. We would only be able to put a total of approximately \$5,908,000 for the same 7,000,000 shares, based on a more current closing price of our Common Stock on January 11, 2007 of \$0.87 per share, less the 3% discount applicable to the price per share that Dutchess would pay under the terms of the equity line of credit.

In part because of the drop of our stock price since the establishment of the equity line of credit, we have not used the maximum amount of the equity line of credit to date that we could have used. Additionally, our capital requirements are expected to increase for various reasons discussed in this report and other filings we make from time to time with the SEC.

2007 PIPE Offering. From January 13 through April 27, 2007, the Company conducted an offering (the "2007 PIPE Offering"), through Spencer Clarke, as exclusive placement agent, of up to \$2,000,000 principal amount of its 10% convertible notes (the "2007 PIPE Notes"). Interest on the 2007 PIPE Notes, at a rate of 10% per annum, is payable quarterly. The Notes are due nine months from date of issuance. The Notes are convertible into shares of Common Stock at an initial conversion price of \$0.70 per share (the "Conversion Shares"). The Company raised \$400,000 gross proceeds (\$352,000 net proceeds) in the 2007 PIPE Offering. The per share price of the Company's common stock on the Pink Sheets during this period ranged from a low bid price (intraday) of \$0.58 to a high bid price (intraday) of \$1.03.

The Company has the right to redeem any or all of the outstanding 2007 PIPE Notes in its sole discretion anytime after the termination of the 2007 PIPE Offering and prior to the maturity date of the 2007 PIPE Notes. The redemption price shall be the face amount of the redeemed Notes plus accrued and unpaid interest thereon. Subject to the following sentence, at any time prior to the maturity date of the 2007 PIPE Notes, for each additional \$1,000,000 of gross proceeds raised from one or more offerings of the Company's equity or quasi-equity securities, the Company shall redeem 2007 PIPE Notes with a minimum face value of \$500,000 together with accrued and unpaid interest, until the entire outstanding 2007 PIPE Note is redeemed. Certain financings that the Company may conduct outside of North America and only up to a maximum of UK £15,000,000 in the aggregate, are exempt from this provision to redeem the 2007 PIPE Notes in whole or in part.

Investors in the 2007 PIPE Offering received, for no additional consideration, a warrant (the "2007 PIPE Warrant"), entitling 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 2007 PIPE Notes are convertible (the "Warrant Shares"). The 2007 PIPE Warrant will be exercisable on a cash basis only and will have registration rights. The 2007 PIPE Warrant is exercisable at an initial price of \$1.00 per share, and is exercisable immediately upon issuance and for a period of three years from the date of issuance.

Table of Contents

Promptly, but no later than 90 days following the closing date of the 2007 PIPE Offering, the Company is required to file a registration statement with the SEC to register the Conversion Shares and the Warrant Shares. The Company shall use its best efforts to ensure that such registration statement is declared effective within 120 days after filing. Due to the Company's current cash flow and liquidity difficulties, including its inability to file all of its reports with the SEC in a timely manner, the Company was unable to meet its obligations to file the registration statement required under the terms of the 2007 PIPE Offering in a timely manner, the deadline for which was June 27, 2007. The Company has begun discussions with Spencer Clarke, on behalf of the holders of the 2007 PIPE Notes, for an extension of time to file the registration statement, but it is not known what, if any, arrangements will be made in this matter.

2007 Spring Offering. From June 13, 2007 through June 26, 2007, the Company conducted a private offering (the "Spring 2007 Offering") of up to \$550,000 aggregate face amount of its convertible notes (the "Spring 2007 Notes") with a small number of accredited investors. Of this amount, \$451,000 aggregate face amount of the Spring 2007 Notes were sold for an aggregate purchase price of \$410,000. Therefore, while the stated interest rate on the Spring 2007 Notes is 0%, the actual interest rate on the Spring 2007 Notes is 10%. The Spring 2007 Notes mature on the first anniversary of their date of issuance. The Spring 2007 Notes are convertible, at the option of the noteholders, into shares of common stock of the Company (the "Conversion Shares") at an initial conversion price equal to the average of the closing bid price of the Company's Common Stock for the five trading days preceding the closing dates of the Spring 2007 Offering (the "Conversion Prices"). Up to 1,210,489 Conversion Shares are initially issuable at Conversion Prices of either \$0.34 or \$0.53 per share, depending upon which of the two closing dates of the Spring 2007 Offering the Spring 2007 Notes were sold. The per share price of the Company's common stock on the Pink Sheets during this period ranged from a low bid price (intraday) of \$0.35 to a high bid price (intraday) of \$0.59.

Each of the investors in the Spring 2007 Offering received, for no additional consideration, a warrant (the "Spring 2007 Warrants"), entitling the holder to purchase a number of shares of the Company's common stock equal to 50% of the number of shares of common stock into which the Spring 2007 Notes are convertible (the "Warrant Shares"). Each Spring 2007 Warrant is exercisable on a cash basis only at an initial price of \$0.50 per share, and is exercisable immediately upon issuance and for a period of two years from the date of issuance. Up to 605,242 Warrant Shares are initially issuable on exercise of the Spring 2007 Warrants.

The Company received \$410,000 gross and net proceeds in the 2007 Spring Offering. The proceeds of the Spring 2007 Offering were used for general corporate purposes and working capital and have been exhausted.

With the exception of some of the proceeds of the Spring 2007 Offering and some recent draw-downs under our equity line of credit, the net proceeds of all of the offerings discussed above are largely exhausted and we have cash on hand to meet expenses only for a short period of time. In order to fund our capital needs for the foreseeable future, including the operations of our business, and the repayment of our outstanding Bridge Notes and our 2007 PIPE Notes, both of which series of notes are due by the end of 2007, and the Morale Orchards Notes, which are due in December 2007 and January 2008, as well as the Spring 2007 Notes, which are due in June 2008, we must raise substantial additional funds, in addition to the funds required to continue to operate our business, including without limitation the expenses we will incur in connection with the license and research and development agreements with Temple University, costs associated with product development and commercialization of the ELEKTRA technology, costs to manufacture and ship our products, costs to design and implement an effective system of internal controls and disclosure controls and procedures, costs of maintaining our status as a public company by filing periodic reports with the SEC, and costs required to protect our intellectual property. In addition, as discussed below, we have substantial contractual commitments, including without limitation salaries to our executive officers pursuant to employment agreements, certain severance payments to a former officer and consulting fees, during the remainder of 2007 and beyond.

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

[Table of Contents](#)

distributors, reductions in research and development and product development of ELEKTRA products, and reductions of certain other expenses. We intend to review these measures on an ongoing basis and make additional decisions as may be required.

We may continue to use our equity line of credit for some of our additional requirements for 2007. However, even if we continued to use our equity line of credit, it will not be sufficient to meet all of our current liabilities and other obligations in 2007. Among other things, the thin trading of our common stock may limit our ability to use the equity line of credit without adversely affecting the price of our common stock. Therefore, in addition to the recently-completed 2007 Spring Offering and the current 2007 Summer Offering, the Company is actively pursuing additional financing alternatives, but no commitments have been received and, accordingly, no assurance can be given that any financing will be available or, if available, that it will be on terms that are satisfactory to the Company. At present, we have relatively few financing options available to us.

Contractual Obligations

The following table discloses our contractual commitments for future periods. Long-term commitments are comprised operating leases and minimum guaranteed compensation payments under employment and other agreements. See Note 12 to Notes to Condensed Consolidated Financial Statements.

Year ending December 31,	Operating Leases(1)	Guaranteed Payments
2007	\$ 136,376(1)	\$ 1,501,667(3)
2008	\$ 69,270	\$ 439,030(4)
2009	\$ 44,800(2)	\$ 75,000(5)
Total	\$ 250,446	\$ 2,015,697

- (1) This amount includes, with respect to the North Hollywood facility: (i) unpaid base rent from February 2007 through July 2007, in the aggregate amount of \$43,032; (ii) \$963 with respect to partially unpaid rent for January 2007; and (iii) a \$100 per day penalty from January 1, 2006 through July 31, 2007, in the aggregate amount of \$57,700, for unpaid rent and/or unpaid late fees claimed by the landlord, for which the landlord claims we are liable pursuant to a certain provision of the sublease. We believe that there are numerous reasons why we should not be liable for most, or all, of any such penalties; however, no assurance can be given that we would not be liable for any or all of such penalties. We did not renew the sublease for our corporate offices at North Hollywood, California, and vacated the premises prior to the expiration of the sublease on July 31, 2007. See Part II, Item 5, "Other Information" and Notes 12 and 13 to Notes to Condensed Consolidated Financial Statements, for additional information regarding this matter. We have renewed the lease for our engineering, production and testing facility at Morgan Hill, California, which facility now also serves as our corporate offices, for an additional two-year period, expiring on August 15, 2009.
- (2) Does not include rent for our engineering, production and testing facility at Morgan Hill, California beyond August 31, 2009, which are the expiration dates of the respective renewal terms for those two leases.
- (3) Consists of an aggregate \$462,617 in total compensation, including base salary and certain contractually-provided benefits to one present and one former executive officer pursuant to employment agreements that expire on December 31, 2007 and to one new executive officer pursuant to an employment agreement that expires on July 17, 2008; \$385,000 in licensing fees to Temple University; \$287,300 in severance payments to a former officer; \$240,000 in consulting fees to Spencer Clarke; \$80,000 to RAND Corporation; and \$47,750 in fees to a consultant.
- (4) Consists of licensing fees in the amount of \$290,000 due to Temple University; base salary and certain contractually-provided benefits in the amount of \$120,683 to an officer pursuant to an employment agreement that expires on July 17, 2008; and \$28,347 to RAND Corporation. Does not include compensation to one present and one former executive officer, whose employment agreements expire

Table of Contents

on December 31, 2007.

- (5) Consists of licensing fees due to Temple University. Does not include compensation to our two executive officers, whose employment agreements expire on December 31, 2007.

Licensing Fees to Temple University. We have obtained a license from Temple University for their patent-pending uniform electric field technology, tentatively called ELEKTRA™. The ELEKTRA technology consists of passing fuel through a specific strong electrical field.

We have entered into two license agreements with Temple University, one covering Temple University's current patent application concerning certain electric field effects on gasoline, kerosene and diesel fuel particle size distribution, and the other covering Temple University's current patent application concerning electric field effects on crude oil viscosity, and any and all United States and foreign patents issuing in respect of the technologies described in such applications (individually, a "License Agreement" and collectively, the "License Agreements"). Initially, the License Agreements are exclusive and the territory licensed to the Company is worldwide. Pursuant to the License Agreements, the Company will pay Temple University (i) license fees in the aggregate amount of \$250,000.00, payable in three installments of \$100,000.00, the first installment of which was paid in March 2007, and \$75,000.00 on each of February 2, 2008 and February 2, 2009, respectively; and (ii) annual maintenance fees of \$125,000 annually commencing January 1, 2008. In addition, each License Agreement separately provides that the Company will pay royalties to Temple University on net sales of products incorporating the technology licensed under that License Agreement in an amount equal to 7% of the first \$20 million of net sales, 6% of the next \$20 million of net sales and 5% of net sales in excess of \$40 million. Sales under the two License Agreements are not aggregated for purposes of calculating the royalties payable to Temple University. In addition, the Company has agreed to bear all costs of obtaining and maintaining patents in any jurisdiction where the Company directs Temple University to pursue a patent for either of the licensed technologies. Should the Company not wish to pursue a patent in a particular jurisdiction, that jurisdiction would not be included in the territory licensed to the Company.

We have also entered into a research and development agreement ("R&D Agreement") with Temple University to conduct further research on the ELEKTRA technology. Under the R&D Agreement, Temple University will conduct a 24-month research project towards expanding the scope of, and developing products utilizing, the technologies covered under the License Agreements, including design and manufacture of prototypes utilizing electric fields to improve diesel, gasoline and kerosene fuel injection in engines using such fuels and a device utilizing a magnetic field to reduce crude oil viscosity for crude oil (paraffin and mixed base) flow in pipelines. Pursuant to the R&D Agreement, we will make payments to Temple University in the aggregate amount of \$500,000.00, payable in eight non-refundable installments commencing with \$123,750, which was paid in March 2007, and \$53,750 every three months thereafter until paid in full. If the research project yields results within the scope of the technologies licensed pursuant to the License Agreements, those results will be deemed included as rights licensed to the Company pursuant to the License Agreements. If the research project yields results outside of the scope of the technologies covered by the License Agreements, the Company has a six-month right of first negotiation to enter into a new worldwide, exclusive license agreement with Temple University for the intellectual property covered by those results.

A payment of \$53,750 with respect to the R&D Agreement, which was due in June 2007, has not yet been made to Temple University.

Severance Payments to Former Officers. On November 9, 2006, Eugene E. Eichler resigned as our Chief Executive Officer and Chief Financial Officer, due to a medical disability. Mr. Eichler's resignation as Chief Executive Officer took effect on November 20, 2006 and his resignation as Chief Financial Officer took effect on the appointment of his successor on January 8, 2007.

Under the terms of Mr. Eichler's separation as an officer of the Company, he is entitled to be paid out the remainder of the cash portion of his employment agreement, at a rate of \$300,000 per annum, through December 31, 2007, in accordance with the Company's normal pay policies. Options granted to him in February 2006 have been accelerated and fully vested on November 20, 2006; additionally, Mr. Eichler will have until November 20, 2007 to exercise such options. Mr. Eichler is also entitled to receive a stock option grant in 2007 equal to the lesser of (i) the number of stock options Mr. Eichler was granted in 2006

[Table of Contents](#)

or (ii) the highest number of options granted to any of the then Chief Executive Officer, President or Chief Financial Officer on an annualized basis, on terms no less favorable as granted to such person; provided, however, that such options to be granted to Mr. Eichler shall be fully vested upon grant and shall be exercisable for one year from the date of grant. The Company and Mr. Eichler have waived any claims they may have against each other and have agreed to mutual indemnification.

Of the payments we are required to make under this arrangement, we have paid \$25,000 for January 2007 and have accrued but not yet paid \$125,000 through June 30, 2007, by agreement between the Company and Mr. Eichler.

On June 15, 2007, the Company and Bruce H. McKinnon entered into an agreement (the "McKinnon Separation Agreement") which provided that Mr. McKinnon would resign as Chief Executive Officer of the Company effective on the first to occur of (i) the appointment of a new Chief Executive Officer by the Board of Directors and (ii) July 31, 2007. Under the terms of the McKinnon Separation Agreement, Mr. McKinnon would have continued to serve as President of the Company and receive the compensation provided for in accordance with the provisions of the Employment Agreement between Mr. McKinnon and the Company dated as of October 5, 2005 (the "McKinnon Employment Agreement") through December 31, 2007, the end of the term of that agreement. In addition Mr. McKinnon will continue to serve as a Director of the Company, until he has resigned, been removed by the stockholders or not been re-elected to the Board. The Company and Mr. McKinnon have waived any claims they may have against each other and have agreed to mutual indemnification.

On July 18, 2007, Bruce H. McKinnon was removed by the Board of Directors as President and Chief Executive Officer of the Company and its wholly-owned subsidiary, STWA Asia Pte. Limited ("STWA Asia"), effective immediately. The Company is currently reviewing its rights and responsibilities with respect to the McKinnon Employment Agreement, the McKinnon Separation Agreement and other matters pertaining to Mr. McKinnon's tenure as President and Chief Executive Officer of the Company. See Part II, Item 1, "Legal Proceedings" and Item 5, "Other Information".

Of the payments provided for under the McKinnon Employment Agreement, we have paid \$20,000 for January 2007 and have accrued but not yet paid \$100,000 through June 30, 2007. We have not made any payments to Mr. McKinnon under the McKinnon Separation Agreement.

Transactions with Spencer Clarke. Spencer Clarke has served as our exclusive placement agent in recent offerings of our securities. We also have retained Spencer Clarke as a consultant to the Company, for which it will be separately compensated.

We entered into a consulting agreement dated January 4, 2007 with Spencer Clarke (the "Consulting Agreement"), pursuant to which Spencer Clarke has agreed that for a twelve-month period beginning January 15, 2007, Spencer Clarke will provide us with financial consulting services (including but not limited to executive search, strategic partnerships, research on new markets, strategic visibility, etc) to help further develop our strategic business plan.

For Spencer Clarke's services, we have agreed to pay Spencer Clarke a non-refundable fee of \$20,000 per month, payable in advance. The first payment, in the amount of \$60,000 and covering three months, was payable by us on March 15, 2007. We will also reimburse Spencer Clarke for expenses they incur in connection with the performance of their services under the Consulting Agreement, provided that expenses in excess of \$2,000 require our prior approval before they may be incurred by Spencer Clarke.

We have agreed to indemnify Spencer Clarke against any losses, claims, damages or liabilities to which Spencer Clarke may become subject arising out of or in connection with the services they render under the Consulting Agreement, unless it is finally judicially determined that such losses, claims, damages or liabilities arose primarily out of the gross negligence or bad faith of Spencer Clarke. We have also agreed to reimburse Spencer Clarke immediately for any legal or other expenses they reasonably incur in connection with investigating, preparing to defend or defending any lawsuits or other proceedings arising out of or in connection with their rendering of services under the Consulting Agreement; provided, however, that in the event of a final judicial determination that the alleged losses, claims, damages or liabilities arose primarily out of the gross negligence or bad faith of Spencer Clarke, Spencer Clarke will remit to us any amounts reimbursed, but the amount which Spencer Clarke must remit in such event is limited to the fee payable by us to Spencer Clarke under the Consulting Agreement.

[Table of Contents](#)

To date, we have not made any payments under the Consulting Agreement and have accrued \$120,000 through June 30, 2007 with respect to this obligation.

Critical Accounting Policies and Estimates

Our discussion and analysis of our consolidated 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 condensed consolidated financial statements and related disclosures requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, expenses, and related disclosure of contingent assets and liabilities. We evaluate, on an on-going basis, our estimates and judgments, including those related to the useful life of the assets. We base our estimates on historical experience and assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The methods, estimates and judgments we use in applying our most critical accounting policies have a significant impact on the consolidated 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.. For a more detailed discussion of the accounting policies of the Company, see Note 2 of Notes to the condensed consolidated financial statements.

We believe the following critical accounting policies, among others, require significant judgments and estimates used in the preparation of our condensed consolidated 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 condensed consolidated financial statements as described in Note 1 to Notes to condensed consolidated financial statements. Actual results could differ from those estimates.

Revenue Recognition

The Company has adopted Staff Accounting Bulletin 104, "Revenue Recognition" and therefore recognizes revenue based upon meeting four criteria:

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

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

Long-lived assets

The Company accounts for the impairment and disposition of long-lived assets in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." In accordance with SFAS No. 144, long-lived assets to be held are reviewed for events or changes in circumstances that

[Table of Contents](#)

indicate that their carrying value may not be recoverable. The Company periodically reviews the carrying values of long-lived assets to determine whether or not an impairment to such value has occurred. No impairments were recorded for the year ended December 31, 2006. The Company recorded an impairment of approximately \$505,000 during the period from inception (February 18, 1998) through December 31, 2006.

Stock-Based Compensation

On January 1, 2006, the Company 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 the Company's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees", for periods beginning in fiscal 2006. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123R. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123R.

The Company 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 the Company's fiscal year 2006. The Company's financial statements as of and for the year ended December 31, 2006 reflect the impact of SFAS 123R. 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 123R. Stock-based compensation expense recognized under SFAS 123R for employee and directors for the year ended December 31, 2006 was \$2,253,263. Basic and diluted loss per share for the year ended December 31, 2006 would have been (\$0.21) per share, if the Company had not adopted SFAS 123R, compared to reported basic and diluted loss per share of (\$0.28) per share.

SFAS 123R 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 year ended December 31, 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 Statements of Financial Accounting Standards No. 123, "Share-Based Payment" ("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 123R. 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 second quarter of fiscal 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123R 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.

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-Merton option-pricing formula ("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 123R 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 123R.

The Company accounts for stock option and warrant grants issued to non-employees for goods and services using the guidance of SFAS 123 and Emerging Issues Task Force ("EITF") No. 96-18:

[Table of Contents](#)

“Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services,” whereby the fair value of such option and warrant grants is determined using the Black-Scholes model at the earlier of the date at which the non-employee’s performance is completed or a performance commitment is reached.

Recent Accounting Pronouncements

Statement No. 157

In September 2006, the FASB issued Statement No. 157, “Fair Value Measurements” (“SFAS 157”), SFAS 157 establishes a formal framework for measuring fair value under GAAP. It defines and codifies the many definitions of fair value included among various other authoritative literature, clarifies and, in some instances, expands on the guidance for implementing fair value measurements, and increases the level of disclosure required for fair value measurements. Although SFAS 157 applies to and amends the provisions of existing FASB and AICPA pronouncements, it does not, of itself, require any new fair value measurements, nor does it establish valuation standards. SFAS 157 applies to all other accounting pronouncements requiring or permitting fair value measurements, except for; SFAS 123R, share-based payment and related pronouncements, the practicability exceptions to fair value determinations allowed by various other authoritative pronouncements, and AICPA Statements of Position 97-2 and 98-9 that deal with software revenue recognition. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years.

Statement No. 159

In February 2007, the FASB issued Statement No. 159, “The Fair Value Option for Financial Assets and Liabilities”. This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings (or another performance indicator if the business entity does not report earnings) at each subsequent reporting date. This Statement is effective as of the beginning of an entity’s first fiscal year that begins after November 15, 2007. We do not believe that the adoption of SFAS 159 will have a material affect on our financial statements.

Interpretation No. 48

Effective January 1, 2007, the Company adopted Financial Accounting Standards Board Interpretation No 48, “Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No 109, “Accounting for Income Taxes (“FIN 48”).” FIN 48 addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN 48, the Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. FIN 48 also provides guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures. At the date of adoption, and as of June 30, 2007, the Company does not have a liability for unrecognized tax benefits.

The Company files income tax returns in the U.S. federal jurisdiction and the state of California. The Company is subject to U.S. federal or state income tax examinations by tax authorities for years after 2002. During the periods open to examination, the Company has net operating loss and tax credit carry forwards for U.S. federal and state tax purposes that have attributes from closed periods. Since these net operating losses and tax credit carry forwards may be utilized in future periods, they remain subject to examination. The Company’s policy is to record interest and penalties on uncertain tax provisions as income tax expense. As of June 30, 2007, The Company has no accrued interest or penalties related to uncertain tax positions.

[Table of Contents](#)

The Company believes that it has not taken any uncertain tax positions that would impact its condensed consolidated financial statements as of June 30, 2007. Also as of the date of adoption, and as of June 30, 2007, the Company does not have a liability for unrecognized tax benefits.

EITF 00-19-2

Effective in the first quarter of 2007 the Company adopted FASB Staff Position No. EITF 00-19-2, "Accounting for Registration Payment Arrangements" issued on December 21, 2006 ("FSP 00-19-2"). FSP 00-19-2 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, "Accounting for Contingencies." For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to the issuance of EITF 00-19-2, this guidance is effective for financial statements issued for fiscal years beginning after December 15, 2006 and interim periods within those fiscal years.

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. These matters persist despite our having developed and partially implemented a plan to ensure that all information will be recorded accurately, processed effectively, summarized promptly and reported on a timely basis. Our plan to date has involved, in part, reallocation of responsibilities among officers, various other personnel and some of our directors, and hiring additional personnel. We began to implement this plan during 2005, including the hiring in August 2005 of a Controller who is a Certified Public Accountant. However, the implementation of this plan has been affected by several factors. In December 2006 our Controller retired, and in January 2007 our Chief Financial Officer retired, although our former Controller still provides certain financial consulting services for us. We have hired a new part-time Chief Financial Officer and a full-time Controller, although the latter is not a Certified Public Accountant. In July 2007, our Board of Directors terminated our President and Chief Executive Officer, and also in July 2007, we hired a new President and Chief Executive Officer from outside the Company. One of several specific additional steps that the Company believes it must undertake is to retain a consulting firm to, among other things, design and implement adequate systems of accounting and financial statement disclosure controls during the current fiscal year to comply with the requirements of the SEC. We believe that the ultimate success of our plan to improve our disclosure controls and procedures will require a combination of additional financial resources, outside consulting services, legal advice, additional personnel, further reallocation of responsibility among various persons, and substantial additional training of those of our officers, personnel and others, including certain of our directors such as our Chairman of the Board and committee chairs, who are charged with implementing and/or carrying out our plan. The Company does not presently have sufficient capital to move forward on the full implementation of this plan. It should also be noted that the design of any system of controls and procedures is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

(b) Changes in internal control over financial reporting. Except for those changes discussed above, there were no changes 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

Litigation Involving Jeffrey A. Muller

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 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 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 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.

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

[Table of Contents](#)

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.

Muller subsequently filed a Notice of Appeal from the Judgment resulting from this decision to the Second Circuit Court of Appeals in New York. The clerk of the Court recently issued an Order dismissing this appeal.

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.

On October 27, 2006, Magistrate Judge Frank Maas, Federal District Court of the Southern District of New York, issued an order granting summary judgment in favor of the Company. The ruling provided that all shares, options and any other obligations allegedly owed by the Company to Jeffrey A. Muller, its former Chairman, were to be disgorged. The ruling also confirmed an earlier decision issued on November 16, 2005 in favor of the SEC holding Mr. Muller liable for \$7.5 million in actual damages, imposing a \$100,000 fine and barring Muller from any involvement with a publicly traded company for 20 years. With prejudgment interest, this ruling brings the actual damages against Muller to over \$9 million. Additionally, the Court further clarified that the scope of its previous disgorgement order required the disgorgement of any shares of the Company's stock that Mr. Muller or any of his nominees directly or indirectly own or control. The Company has taken action to cancel over 3.6 million shares which had been issued to the offshore companies.

The Court also confirmed the appropriateness of an action previously taken by the Company to acquire the patent rights and to consolidate the manufacturing, marketing and distribution rights with its ownership of all rights to the existing patents.

Finally, the Court ruled that Mr. Muller had no claim to an alleged \$500,000 debt owed to him while the damages of over \$9 million remain unpaid. The Court also ruled that other assets that were transferred by Mr. Muller to members of his family through various offshore corporations were also to be disgorged. Because the Court left unresolved an issue concerning claims against one Muller family member, the Company sought a modification of the Order. On February 8, 2007, Judge Maas issued an Amended Order, which concluded that all of the STWA shares of Muller or any of his nominees directly or indirectly owned or controlled were to be recaptured by STWA and were subject to disgorgement and forfeiture. With this modification of the October 27, 2007 ruling, this order provides the complete relief requested by the Company in its motion for summary judgment.

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.

This 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

[Table of Contents](#)

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. That Complaint is currently pending, however, the issues raised in this Complaint arise from the same claims already decided by the Court in its February 8, 2007 Amended Order. The Company plans to file a request to dismiss the pending Complaint on several grounds, including that the claims sought to be litigated in this latter complaint has been included within the Summary Judgment Motions decided against Muller, his nominees and assignees. 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.

Litigation Involving Sublessor of Former Corporate Offices

On July 19, 2007, Scottish Glen Golf Company, Inc. doing business as KZG ("KZG") sued us in Los Angeles Superior Court, alleging unlawful detainer by us of our then-leased corporate offices at 5125 Lankershim Boulevard, North Hollywood, California, and failure to pay past due rent and penalties in the aggregate amount of \$104,413. In its complaint, KZG also seeks attorney fees. Bruce H. McKinnon, the Company's former President and Chief Executive Officer, and an incumbent director, is, we believe, the Chairman and an owner of KZG. Mr. McKinnon's wife is the President of KZG.

On July 25, 2007, the parties entered into an agreement pursuant to which KZG would dismiss the eviction action. However, KZG reserved the right to amend its complaint to include a demand for past due rent and penalties. We agreed to vacate the premises and KZG agreed not to further prosecute their eviction action. We vacated the premises on July 25, 2007. We are currently awaiting a decision by KZG to amend its complaint and thereafter we will formulate our response to the suit.

We strongly disagree with the apparent position of KZG that there is a discrepancy in the calculation of base rent as far back as April 1, 2004 and that a penalty of \$100 per day should be imposed continuously since January 1, 2006 under the terms of a certain provision of the current sublease with KZG. There may also be other aspects of KZG's positions or apparent positions with which we strongly disagree. We may also have counterclaims against KZG and its officers and directors.

While we believe that we have valid claims and defenses, given the inherent uncertainties of litigation, we cannot predict the outcome of this matter. Accordingly, there can be no assurance that an adverse result or outcome of this matter would not have a material adverse effect on our financial position or cash flow. Please also see Part II, Item 5, "Other Information" for additional information regarding this matter.

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

During the three-month period ended June 30, 2007, we sold \$50,000 aggregate principal amount of our 2007 PIPE Notes and warrants to purchase an aggregate 107,143 shares of our common stock at \$1.00 per share.

Also during the three-month period ended June 30, 2007, we sold \$451,000 aggregate face amount of the Spring 2007 Notes, convertible into shares of our common stock at either \$0.34 or \$0.53 per share, and warrants to purchase an aggregate 1,815,731 shares of our common stock at \$0.50 per share. Because the 2007 Spring Notes were issued at a discount to their face amount, gross and net proceeds to the Company were \$410,000.

[Table of Contents](#)

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

Item 3. Defaults Upon Senior Securities

None

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

None

Item 5. Other Information

The Company's former principal executive offices consisted of leased space in North Hollywood, California. The Company subleased this space from KZG. Bruce H. McKinnon, the Company's former President and Chief Executive Officer, and an incumbent director, is an owner of KZG. Mr. McKinnon's wife is the President of KZG and the Company believes that Mr. McKinnon is presently the Chairman of KZG.

The Company originally entered into a sublease with KZG on October 16, 2003, which sublease expired on October 16, 2005. The Company exercised an option to renew the sublease, 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 the Company's need to acquire additional office space and expanded services as its business activities were then growing, the Company entered into a new sublease dated as of January 1, 2006 with KZG (the "2006 Sublease"), replacing the original sublease and the terms applicable under the extended term thereof. The 2006 Sublease is for a term of 19 months, expiring July 31, 2007. The new rent under the 2006 Sublease 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. The Company has the right to renew the 2006 Sublease for an additional term of two years at a 10% increase over the then-current rent.

Thereafter, in July 2006, the Company acquired two additional offices comprising approximately 250 square feet, and additional parking spaces, for which the Company pays KZG \$964 per month in additional rent on a month-to-month basis, or a total of \$7,172 per month.

Due to the Company's current cash flow difficulties, it has not been able to make most of its payments to KZG commencing January 2007. On July 12, 2007, KZG presented to the Company a Three-Day Notice to Pay or Quit, demanding payment of unpaid rent, additional rent and penalties, in the aggregate amount of \$104,413 as of such date. In addition to the unpaid rent during 2007, it is apparently KZG's position, taken for the first time, that there is a discrepancy in the calculation of base rent as far back as April 1, 2004 and that a penalty of \$100 per day should be imposed continuously since January 1, 2006 under the terms of a certain provision of the 2006 Sublease.

For numerous reasons, the Company strongly disagrees with the apparent position of KZG that there is a discrepancy in the calculation of base rent as far back as April 1, 2004 and that a penalty of \$100 per day should be imposed continuously since January 1, 2006 under the terms of a certain provision of the 2006 Sublease. There may also be other aspects of KZG's positions or apparent positions with which the Company strongly disagrees. The Company intends to fully assess the situation, closely monitor all developments, continue discussions with KZG and take any and all such action as may be necessary or appropriate. The Company did not exercise its option to renew the 2006 Sublease.

As previously announced in a Current Report on Form 8-K filed with the SEC on June 15, 2007 (the "Form 8-K"), on June 15, 2007, the Company and Bruce H. McKinnon agreed and entered into the McKinnon Separation Agreement, which provided that Mr. McKinnon would resign as Chief Executive Officer of the Company effective on the first to occur of (i) the appointment of a new Chief Executive Officer by the Board of Directors and (ii) July 31, 2007. At the time of the filing of the Form 8-K and as

Table of Contents

stated therein, it was intended that Mr. McKinnon would continue to serve as President of the Company and would continue to receive the compensation provided for in accordance with the provisions of the McKinnon Employment Agreement, through December 31, 2007, the end of the term of that agreement. Additionally, as stated in the Form 8-K, Mr. McKinnon will continue to serve as a director of the Company, until he has resigned, been removed by the stockholders or not been re-elected to the Board. The Company and Mr. McKinnon have waived any claims they may have against each other and have agreed to mutual indemnification.

On July 18, 2007, Bruce H. McKinnon was removed by the Board of Directors as President and Chief Executive Officer of the Company and its wholly-owned subsidiary, STWA Asia, effective immediately. Mr. McKinnon also was removed by the Board of Directors as a director of STWA Asia, effective immediately. Mr. McKinnon will continue to serve as a director of the Company, until he has resigned, been removed by the stockholders or not been re-elected to the Board.

Also on July 18, 2007, the Board of Directors of the Company appointed Charles R. Blum as President and Chief Executive Officer of the Company. Mr. Blum assumed his positions on June 25, 2007. Mr. Blum was also appointed to the Board of Directors to fill the vacancy created by the resignation on June 5, 2007 of Maj. Gen. Dennis M. Kenneally (Ret.), which appointment took effect upon Mr. Blum's joining the Company as President and Chief Executive Officer.

Effective July 18, 2007, the Company entered into an employment agreement with Mr. Blum (the "Blum Employment Agreement"), pursuant to which Mr. Blum will serve as the Company's President and Chief Executive Officer, commencing on a mutually agreed date but not later than August 1, 2007. Pursuant to the Blum Employment Agreement, Mr. Blum's employment is for a one-year term, subject to automatic one-year extensions and provides for annual base compensation of \$200,000 per year, subject to periodic review and adjustment. In addition, Mr. Blum will receive an automobile allowance of \$900 per month and four weeks of paid vacation annually. Mr. Blum is entitled to participate in all employee benefit plans that the Company makes available to its employees generally; provided that if Mr. Blum elects not to participate in the Company's group medical insurance plan, he will be reimbursed in an amount equal to the lesser of (i) the premium the Company would have paid to include him as a participant in that group health insurance plan and (ii) the sums paid by him in connection with maintaining his private health insurance. The Company will also reimburse Mr. Blum the reasonable costs paid by him for maintaining DSL Internet access and other direct costs of maintaining an office at his home, but only until such time as the Company shall provide him with an office at a location reasonably acceptable to him.

Mr. Blum is eligible to receive stock option grants under the Company's stock option plan and will receive an initial grant of options to purchase a number of shares of the Company's common stock equal to the result of 100,000 divided by the closing price of a share of the Company's common stock (the "Closing Price") on the date Mr. Blum assumes his position as Chief Executive Officer and President of the Company (the "Effective Date"). The options will vest on the first anniversary of the Effective Date and will be exercisable at the Closing Price for 10 years from the Effective Date.

Additionally, on the first anniversary of the Effective Date, Mr. Blum is eligible to receive a stock option grant under the Company's stock option plan to purchase a number of shares of the Company's common stock equal to the result of 100,000 divided by the Closing Price on the first anniversary of the Effective Date. These options will vest on the second anniversary of the Effective Date and will be exercisable at the Closing Price on the first anniversary of the Effective Date for 10 years from the date of grant.

Mr. Blum is eligible to receive an annual cash bonus in an amount equal to 2% of the Company's net profit, if any, for its most recently completed fiscal year, computed in accordance with generally accepted accounting principles applied consistently with prior periods. The bonus shall be payable, if at all, on the anniversary date of employment of each year of the term if Mr. Blum continues to be employed by the Company on the relevant payment date.

The Blum Employment Agreement also contains terms and conditions customary in agreements of this kind, including provisions relating to protection of the Company's intellectual property, non-disclosure and non-solicitation. The Blum Employment Agreement also provides, among other things, that if Mr. Blum's employment should terminate by reason of a change of control of the Company he is entitled to

Table of Contents

continue to receive compensation and participate in the Company's employee benefit plans for a period of 12 months following such termination.

As an interim matter, on July 18, 2007, the Board of Directors appointed incumbent director and former President and Chief Executive Officer Eugene E. Eichler as Acting President and Acting Chief Executive Officer of the Company. Mr. Eichler served in these capacities, without compensation, from July 18, 2007 through July 24, 2007.

On July 19, 2007, KZG sued the Company in Los Angeles Superior Court (the "KZG Litigation"), alleging unlawful detainer by the Company of our then-leased corporate offices at 5125 Lankershim Boulevard, North Hollywood, California, and failure to pay past due rent and penalties in the aggregate amount of \$104,413. See Part II, Item 1, "Legal Proceedings — Litigation Involving Sublessor of Former Corporate Offices".

The Company is currently reviewing its rights and responsibilities with respect to the McKinnon Employment Agreement, the McKinnon Separation Agreement, other matters pertaining to Mr. McKinnon's tenure as President and Chief Executive Officer of the Company and the KZG Litigation.

On July 25, 2007, the Company vacated the premises in North Hollywood, California. On August 9, 2007, the Company renewed the lease for its facility at 235 Tennant Avenue, Morgan Hill, California, which facility now also serves as the Company's corporate offices. The renewed lease is for a term of 24 months and expires on August 15, 2009. The new rent is \$4,640 per month for the first six months of the lease and \$5,480 per month for the balance of the renewal term. The Company has the option to renew the lease for an additional two-year period at the end of the renewal term.

Item 6. Exhibits

<u>Exhibit No.</u>	<u>Description</u>
10.1	Addendum to Lease Agreement dated August 15, 2005 regarding 235 Tennant Avenue, Morgan Hill, California
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.

SAVE THE WORLD AIR, INC.

Date: August 20, 2007

By: /s/ CHARLES K. DARGAN II

Charles K. Dargan II

Chief Financial Officer

EXHIBIT INDEX

<u>Exhibit No.</u>	<u>Description</u>
10.1	Addendum to Lease Agreement dated August 15, 2005 regarding 235 Tennant Avenue, Morgan Hill, California
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)

ADDENDUM

THIS IS AN ADDENDUM TO THE LEASE AGREEMENT DATED AUGUST 15, 2005 WHEREIN IS REFERRED TO AS "LESSOR" AND IS REFERRED AS "LESSEE" FOR THE PROPERTY COMMONLY KNOWN AS 235 TENNANT AVENUE, #5, MORGAN HILL CALIFORNIA

The provisions of this Addendum shall amend and supersede the Provisions if the Lease Agreement where inconsistent. In all other aspects the Terms and Conditions contained in the Lease Agreement shall remain in full force and effect.

1. RENT SCHEDULE

Months 01-06	\$4640.00
Months 07-24	\$5480.00

2. TERM OF LEASE

Two years from August 15, 2007 with one additional 2 year optional term.

READ AND APPROVED

Lessee: Save The World Air, Inc.

Lessor: Tom Jackson

By: /s/ Charles R. Blum

By: /s/ Tom Jackson

Date: 8-14-07

Date: 8-10-07

**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, Charles R. Blum, 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: August 20, 2007

/s/ CHARLES R. BLUM

Charles R. Blum
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, Charles K. Dargan II, 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: August 20, 2007

/s/ CHARLES K. DARGAN II

Charles K. Dargan II
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 the 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 June 30, 2007 (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: August 20, 2007

/s/ CHARLES R. BLUM

Charles R. Blum
Chief Executive Officer

Date: August 20, 2007

/s/ CHARLES K. DARGAN II

Charles K. Dargan II
Chief Financial Officer