

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

Form 10-KSB

(Mark One)

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

For the fiscal year ended June 30, 2005

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

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

Commission File No. 0-18958

**Groen Brothers Aviation, Inc.**

(Name of small business issuer in its charter)

**Utah**

(State or other jurisdiction of incorporation or  
organization)

**87-0489865**

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

**2640 W. California Ave., Suite A  
Salt Lake City, Utah 84104-4593**

(Address of principal executive offices) (Zip Code)

Issuer's telephone number, including area code: **(801) 973-0177**

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

Securities registered pursuant to Section 12(g) of the Act:

**Common Stock, No Par Value**

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

Check if no disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Issuer's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

The issuer's revenues for its most recent fiscal year were \$864,000.

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

The aggregate market value of the voting stock, consisting solely of common stock, held by non-affiliates of the issuer computed by reference to the closing price of such stock was \$21,699,000 as of September 15, 2005.

The number of shares outstanding of the Issuer's no par value Common Stock as of September 15, 2005 was 133,902,136.

**Documents Incorporated by Reference**

None

**Groen Brothers Aviation, Inc.**  
**Annual Report on Form 10-KSB**  
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## PART I

### Item 1. Description of Business

#### *Background*

Groen Brothers Aviation, Inc. (the "Company") or ("GBA") was originally incorporated in the State of Utah on July 28, 1980 as New Wave Energy. Separately, on March 21, 1986, Segro Tool, Inc. was incorporated by brothers Jay and David Groen in order to enter the gyroplane business. On September 18, 1990, the Groen brothers exchanged 100% of the common stock of Segro Tool, Inc. for 80% of the stock of New Wave Energy, an action that was in effect a reverse acquisition of New Wave by the owners of Segro Tool. On October 23, 1990, the name of New Wave Energy was changed to Groen Brothers Aviation, Inc., and under this name, the Company became a fully reporting public corporation (stock symbol "GNBA") to facilitate the raising of capital and to give minority shareholders the flexibility of owning publicly traded stock. Hereafter, the "Company" refers to the small business issuer, Groen Brothers Aviation, Inc. ("GBA") and its wholly-owned subsidiaries, Groen Brothers Aviation USA, Inc. ("GBA USA") and, from December 2002 through November 2004, American Autogyro, Inc. ("AAI"). Effective November 1, 2004, the Company merged AAI into GBA USA. Unless otherwise stated, the financial activities described herein are those of GBA USA, which is the sole operating entity of the Company.

The initial objective of the Company, primarily through GBA USA was to develop and market an easy-to-fly and cost-efficient gyroplane<sup>1</sup> that could compete effectively in the general aviation market. Initially, personal funds of the Groen brothers were used to build a proof-of-concept aircraft incorporating a design for the first collective pitch controlled semi-rigid teetering rotor system for a gyroplane. This first prototype aircraft flew successfully in 1987, and as a result, the Company was able to obtain the support of private investors to next begin the development of its second prototype gyroplane, the one-seat Hawk 1.

Following the successful flight of the Hawk 1 in 1992, the Company proceeded with the design of its third prototype, the two-seat Hawk 2X, which first flew in February 1997, incorporating a unique airfoil design enabling a smooth vertical takeoff at a world record-breaking density altitude for gyroplanes. At this point, management recognized that the opportunities for gyroplanes, and for the Company, extended well beyond the original general aviation market objective, and had broad potential for commercial, governmental and military applications. The Company's focus was thus reoriented to the design of a larger four-seat gyroplane, the Hawk 4, intended for Federal Aviation Administration ("FAA") certification for a wide range of commercial and public use applications.

During the first quarter of fiscal year 2003, the Company suspended its flight testing of the Hawk 4 due to lack of financial resources, and further development toward commercial certification of the Hawk 4 has been deferred pending the receipt of required funding. The Company's business plan for the Hawk 4 is now oriented in its immediate priorities toward offering this aircraft in its already well tested form to the US government, and to governments of friendly countries. This would give the Company the opportunity to receive revenues ahead of FAA certification, and as a result, to reduce the

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<sup>1</sup> Descriptions of the characteristics of a gyroplane and its derivative, the gyrodyne, and a history of the development of these two aircraft types are provided at the end of Item 1.

need for funding to permit the start of production of the Hawk 4. Consistent with this objective, the Company has been presenting the case for the Hawk 4's utility in this role to members of Congress, appropriate Federal Agencies, and to State and local agencies across the nation for Public Use applications, particularly Homeland Defense, and is seeking orders within the Federal 2006 Budget. The Company is also currently in discussions with foreign investors relating to potential funding of Hawk 4 certification. There is no assurance that the Company will reach an acceptable agreement with these foreign entities, and therefore no assurance that the Company will be able to soon fund the completion of the Hawk 4 business plan or be able to sell its gyroplanes to government entities.

The Company has also designed, and now manufactures and sells SparrowHawk gyroplane kits for the home-built market. In addition, the Company developed and sells modification kits designed to improve in-flight stability and safety for another manufacturer's kit gyroplane. Through June 30, 2005, over 60 initial orders for SparrowHawk gyroplane kits have been received, with 39 complete kits delivered.

### ***Gyroplane and Gyrodyne Technology***

Autorotative flight was developed in 1919 by Spanish aviator, Juan de la Cierva, with the objective of eliminating the risk of stalling inherent in all fixed wing aircraft when forward speed dropped below a critical speed. De la Cierva named and trademarked his invention as the "autogiro," which means "self turning" or "autorotation." The rotary wing of a gyroplane<sup>2</sup>, powered in flight only by the onrushing air, much like a windmill, will not stall, however, because a reduction in forward speed with the rotor blades in autorotation will not result in any sudden loss of lift. As speed decreases, a gyroplane will begin to descend, right side up and controllable as its rotating wing continues to provide lift with the upward flow of air driving the rotor. This provides the gyroplane with an inherent safety advantage over a conventional airplane for activities requiring low altitude and low speed operations.

For such low, slow flying missions, a gyroplane has a similar safety advantage over a helicopter. The helicopter obtains its lift from its engine-powered rotor blades pulling the air downwards, creating an upward force on the rotor, enabling the helicopter to hover. This, however, also makes the aircraft unstable, and difficult to fly, since a loss of power to a helicopter rotor will cause an immediate loss of lift. Only with sufficient forward speed or altitude will a skilled pilot have sufficient time to be able to put a helicopter into autorotation, and thus make a controlled landing operating as a gyroplane, although without the benefit of rotor blades optimized for gyroplane flight. A helicopter is also more mechanically complex than a gyroplane, requiring additional safety-critical systems, notably a transmission between engine and main rotor and a tail rotor with its transmission needed to offset the torque in the system created by the powering of the rotor in flight. For these reasons, a gyroplane is inherently safer, simpler, quieter, easier to operate while much less expensive to maintain than a helicopter.

The one material advantage of a helicopter over a gyroplane is its ability to hover, which is necessary in some situations such as sea rescue, sling-load work, or landing in uneven terrain. The percentage of today's helicopter market that requires hovering is, however, quite small, perhaps no more than 10 percent. For air surveillance and point-to-point flying, the inability to hover is not a

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<sup>2</sup> Gyroplane is an official term now designated by the FAA to describe an aircraft that gets its lift from rotor blades and its thrust from an engine-driven propeller either in front, the tractor configuration, or at the rear, the pusher configuration.

disadvantage. Helicopters at low altitude, out of ground effect, whenever possible, will avoid hovering because of the danger inherent in doing so. In a low level surveillance roll, such as law enforcement, border patrol, traffic control, etc., proper procedure for all rotorcraft is to circle in a slow orbit, something the Hawk 4 and SparrowHawk can do efficiently and safely.

In summary, gyroplanes in flight, being in constant autorotation, are much safer in low and slow flight than either airplanes or helicopters. Airplanes flying low and slow risk a stall/spin crash, which cannot happen in a gyroplane. If power fails in a gyroplane, the autorotation continues and the aircraft can be guided softly to the ground from any altitude. When power fails in a helicopter, the pilot must convert from powered flight to autorotative flight to keep the rotor blades turning. This is an unforgiving process, requiring split second reaction by the pilot, and requiring a minimum altitude and/or airspeed. If a helicopter is operating with insufficient altitude or speed when a power failure occurs, or beneath a line known as the “dead man’s curve” shown on graphs in the helicopter’s flight manual, the pilot will not be able to avoid a crash landing.

The gyrodyne is a derivative of the gyroplane that, as the name implies, has a powered rotor that enables the gyrodyne to hover and to takeoff and land vertically. Gyrodynes differ from helicopters in that their rotors are powered, not by the main engine, but by tipjets normally used only for takeoff, landing and hovering. In forward flight the tipjets are turned off and the aircraft operates as a gyroplane with the attendant advantages of safety, reliability and economy. Since the rotor is not driven by torque from the main engine located in the aircraft fuselage, a gyrodyne does not require a tail rotor with its complexity and maintenance requirements.

### **Interrupted History of the Gyroplane**

In the 1920s and 1930s, following the successful flights of Cierva, in America, Harold Pitcairn and his colleague Walter Kellett, under license from Cierva, designed and built a series of gyroplanes, which eventually made vertical takeoffs and landings. Their efforts resulted in the autogiro concept proving commercially successful in many applications during the 1930s and early 1940s. An outstanding example was its use by the U.S. Postal Service for nearly ten years to deliver mail from the roofs of post offices. Thousands of flights carrying millions of pieces of mail were performed by Kellett and Pitcairn gyroplanes flying in Camden, Philadelphia, Chicago, New Orleans, Washington, D.C., and other cities.

By the early 1940s the private aircraft market had collapsed in the Great Depression and the build up toward World War II, when the main source of investment in aviation came from the U.S. military. At the time, Igor Sikorsky, who was an important designer of transport airplanes for the government, recognized the potential of a helicopter to the military. After licensing rotor technology from Pitcairn, he convinced the U.S. military to invest in the helicopter as the next logical step in the evolution of rotorcraft, promising more versatility for military purposes than the gyroplane.

The commitment to the helicopter effectively ended government funding for technical development of the gyroplane. After World War II, however, there was a brief and modest resurgence as investors enabled three two-seat commercial gyroplanes to be developed and FAA certified by private companies: the Umbaugh (later the Air & Space 18A), the Avian (a Canadian design of that same period that reached FAA certification, but was never produced), and the McCulloch J-2. In each case, as an expedient to FAA certification, the designers adapted helicopter rotors and blades, and thus did not fully use the gyroplane technology created by their 1930s predecessors. As a result, none of these gyroplanes performed well and the companies failed. More significantly, during the 1950s, Igor

Benson, a colleague of Sikorsky, developed a home-built open-frame gyroplane kit for amateurs, which he called the “gyrocopter.” Stemming from this initiative, home-built kits, mostly seating one person, became popular with enthusiasts and more than a dozen small manufacturers have produced and sold several thousand kits.

The technical development of the helicopter necessary to achieve the potential of helicopter flight was, however, much more difficult and took far longer than the military expected. Real utility was not fully attained until the middle of the Vietnam War, and then only after billions of dollars had been spent developing turbine-powered helicopters with sufficient payload to move large numbers of troops and equipment into and out of the jungle. While the Vietnam War clearly demonstrated the versatility of vertical flight, it also demonstrated that the helicopter was too expensive to purchase and to operate for widespread civilian use.

Large aviation companies capable of developing and bringing a commercial-sized gyroplane to market have thus found that the civilian side of helicopter production has not been highly profitable. Nevertheless, companies such as Boeing and Bell, that have committed large capital outlays toward helicopter and tilt-rotor technology for military applications, recognize vertical takeoff and landing has substantial commercial potential. These companies continue to look for civilian use of that technology as evidenced by their investment into the development of aircraft targeted for commercial use, including a civilian tilt-rotor.

### ***Company Products***

#### **GBA Hawk 4 Gyroplane**

The first pre-production piston-engine version of the four-seat Hawk 4 flew in September 1999, followed by the turbine-engine version in July 2000. This latter aircraft, powered by a Rolls-Royce Model 250 420shp turboprop engine, was developed to become the Company’s first major production aircraft. It incorporates rotor blades optimized for autorotative flight and the Company’s patented rotor head with infinitely variable collective pitch control. This enables the pilot to optimize the rotor blade pitch to the existing conditions and attain a smoothly controlled ultra-short ground roll for both take-off and landing. The turbine engine further contributes to the reliability, maintainability and low operating cost characteristics of the aircraft. The Company has flown the Hawk 4 in several hundred incident-free sorties, hundreds of hours of flight time in its pre-certification flight-test program.

The Company believes that the safety, reliability, maneuverability and low operating cost of the Hawk 4 will permit it to perform competitively with helicopters (and airplanes) for many missions requiring low, slow flight, but without the requirement for a runway for take-off or landing. Potential customers include the following:

1. Law enforcement (police, sheriff, border patrol, customs, and drug interdiction).
2. Public service agencies (fire patrol, medical transport, wildlife and land management).
3. Military (courier, armed surveillance, VIP transport, forward artillery control, ground attack, unmanned aerial vehicle).
4. Commercial (oil, gas, and power line patrol and inspection, land survey, aerial photography, crop spraying, herd management, air taxi service, corporate transport, and flight training).

5. Private (commuting, sport flying, training).

Although certification of the Hawk 4 has not been completed, it has required significant capital and will continue to require significant capital to complete it. In consequence of the adverse affects on the venture capital market of the spring 2000 decline of the stock market and the September 11, 2001 terrorist attacks, the Company cut back its operations very substantially in October 2001, and reoriented its immediate priorities toward offering the Hawk 4 Gyroplane in its already well-tested form to the US government in roles similar to those outlined above that would not require commercial certification.

As operation in the United States by Federal, State or Local Government agencies is exempted from commercial certification requirements under Public Use laws, each of these opportunities would give the Company the opportunity to begin receiving revenues ahead of FAA certification. This would, as a result, reduce the need for funding to permit the start of production of the Hawk 4. Consistent with this objective, the Company has continued to present the case for the Hawk 4's utility in this role to members of Congress, appropriate Federal Agencies, and to State and local agencies across the nation as well as to those of foreign governments.

While the Company continues to believe that the initial market for the Hawk 4 will be for government use, it continues to seek opportunities to raise funding for FAA certification of the aircraft. In fiscal year 2004, technical representatives of a mid-size European aerospace company visited GBA to review the Hawk 4 certification program and reported positively on its merits. The Company was subsequently advised that the Board of the company concerned had concluded that in light of the overall state of the global aerospace market it would not be making any further investments in aerospace until conditions improved. However, during fiscal year 2005, the Company was advised that independent investors in that country, knowledgeable of the favorable technical report on the Hawk 4 and recognizing market opportunities in the region, might consider funding the certification program in return for certain marketing and production rights. The Company has provided information requested by those parties and continues detailed discussions on the subject into fiscal year 2006. While the Company can make no assurance that these preliminary discussions will lead to such funding, the Company is convinced that the potential investors have the capability to fund such a project and, in the opinion of management, that they are likely to have access to a significant market for the Hawk 4.

The Company recently announced that in exchange for a minimum equity investment of \$1 million, the Company has granted a Chinese investment group a six-month period in which to bring to the Company a funding/partnering package sufficient to fund the completion of the Hawk 4 Gyroplane program up through FAA certification and production. In addition, during this same period, the Company has granted this investment group the right to bring a funding/partnering package for the development of larger commercial GBA GyroLiner gyrodynes of the Company's design. Since then, the Company has hired the head of that group, Mr. Jason Chen, as Vice President of Business Development in Asia, who is now leading the Company's efforts in Asia. This essentially brought "in-house" the Company's relationship to the investment group, thereby removing the middle layer between the Company and government and commercial interests in China, and permitting the six-month window for investment from this group to expire without losing the contemplated opportunities. This group has nearly doubled its investment in the Company since reaching its first million dollar mark, and continues to invest in the Company.

As a result of this agreement and the hiring of Mr. Chen, executive officers and employees of the Company have traveled to China to meet with government officials and aerospace executives. These high level meetings were arranged by this investment group, executives of which accompanied Company

officials during the visits. In these meetings, Company representatives made presentations covering the application of the Company's gyroplane and gyrodyne technologies to China's commercial needs. The presentations were well received and resulted in the Company being invited back to China to discuss specific proposals for joint ventures or cooperation. Marketing activities in China continued in fiscal year 2006, with the Company participating in the Aviation Expo/China 2005 in Beijing in September 2005. In addition to its booth staffed with Chinese-speaking employees, the Company hosted a technical seminar designed to broaden the understanding of the concepts of gyroplanes and gyroplane technology and their considerable merits for the Chinese commercial markets. The Company believes that China represents a very large market for its products, from the SparrowHawk size gyroplanes, to the Hawk 4 gyroplane and its variants, to the varying sizes of tip-jet powered gyrodynes in commuter airline and transport category aircraft. In addition, the Company believes that these types of safe, economical, high performance Ultra-Short and Vertical Takeoff and Landing (USTOL and VTOL) aircraft can be very important in helping solve the transportation needs of China's burgeoning economy.

### **SparrowHawk Gyroplane**

In fiscal year 2003, the Company noted that the general aviation kit-plane market still lacked the safe, economical, easy-to-fly gyroplane that it originally intended to produce and that, in the opinion of management, this market could expand significantly as a result of likely new less restrictive FAA regulations. Although thousands of kit-built small gyroplanes have been produced by a variety of manufacturers over many years, for the most part, the Company believes these gyroplanes have not been designed and manufactured to aerospace standards, thereby incorporating a full understanding of gyroplane dynamics. Moreover, some have suffered accident and fatality statistics that do not reflect the inherent safety of the gyroplane. Because the Company has an important vested interest in the reputation for safety of gyroplanes in general, management believed that both to protect the reputation of the gyroplane and to take full advantage of an underserved market, the Company should enter this market.

To take advantage of these opportunities through utilization of its very considerable knowledge of gyroplane dynamics and aerodynamics built up over the years, the Company established AAI in December 2002. AAI was tasked with developing a new small gyroplane designed to aerospace standards that would set a new standard for safety in that class of aircraft. AAI started with the design and manufacture of a modification kit to enhance flight stability for another manufacturer's home built gyroplane and initiated delivery of such a kit in April 2003. The Company reported its first revenues in the fiscal year ended June 30, 2003, largely from AAI flight training and the sales of these modification kits.

AAI then undertook the task of designing its own two-seat piston engine powered gyroplane that it named the SparrowHawk. This aircraft, incorporating safety features based on aerospace standards, offers performance, stability and comfort standards that AAI believes are superior to any competitive kit-built gyroplane in its class. AAI finalized the design of its two-seat piston-powered gyroplane in the fiscal year ended June 30, 2004, and began deliveries of kits for the home built market in the third quarter of that fiscal year. This resulted in the Company recording initial revenues from this aircraft in the fourth quarter of fiscal year 2004. Effective November 1, 2004, the Company merged AAI into GBA USA. GBA USA will continue the manufacturing, sales and marketing, and customer support functions of the SparrowHawk.

Through June 30, 2005, 93 orders for the SparrowHawk and modification kits have been received (66 for the complete SparrowHawk kit and 27 for the modification kit). By June 30, 2005, 39

complete kits had been delivered and 13 SparrowHawk customers had flown their aircraft. Through June 30, 2005, 27 dealerships have been established, 21 in the United States and 6 internationally.

During fiscal year 2005, as expected, the FAA announced that it was introducing a new category of aircraft, called Light Sport Aircraft (LSA), that will permit manufacturers to produce and sell small, non-complex, fully assembled aircraft without the necessity of fulfilling the requirements for commercial certification. While helicopters have been excluded from the LSA category as being too complex, gyroplanes are included, but in view of the limited experience of the FAA with gyroplanes, initially in a sub-category defined as Experimental Light Sport Aircraft (ELSA). The ELSA category for gyroplanes will permit gyroplane manufacturers for three years to produce and sell aircraft that meet the LSA standards, with the expectation that at the end of the three-year period, the experience gained and demonstrated will justify full LSA authorization for gyroplanes. Management believes a large market is likely to arise within the United States as a result of this FAA action. The Company believes that its SparrowHawk product designs will be well suited to this market and be capable of conforming to the new regulations.

As previously noted, the Company identified an important potential untapped market for the Hawk 4 as a patrol and surveillance aircraft, both in the United States and overseas. It has now become evident that a small, professionally designed aircraft with ultra-low purchase and operating costs, such as the SparrowHawk, that can operate “off airport” and is easy to maintain and fly, would also have important applications for patrol surveillance. This is particularly the case in areas where skilled pilots and maintenance personnel were not readily available. For this reason, the Company believes the SparrowHawk sold as a fully assembled aircraft can be expected to be popular with law enforcement agencies around the world.

The Company’s discussions with Office of Domestic Preparedness (“ODP”) on gyroplane usage have emphasized the merits of the SparrowHawk as a readily available, ultra-low cost air surveillance vehicle, and the Company has been encouraged that Federal funding for this purpose may be made available to state agencies. Similarly, approaches are being made to the Department of Defense (“DOD”) for the use of the SparrowHawk for mine and bomb detection to counter those threats in Iraq and elsewhere, emphasizing again its low cost and early availability in relation to other solutions. Sales representatives have also been appointed in Korea and India to present the capabilities of the SparrowHawk to government agencies in those countries, and the Company has held meetings with several agencies in China in relation to the use of the SparrowHawk in China.

As a result of the new FAA regulations and the opportunities for government acquisition of fully assembled aircraft, the SparrowHawk market will likely now be primarily focused on complete aircraft, rather than on kits as originally envisaged. Thus the markets for the SparrowHawk and the Hawk 4 can no longer be considered as quite separate, as was the case when the SparrowHawk was being offered only as a kit built aircraft. As previously noted, the Company therefore decided to move the SparrowHawk operation, initially developed within its AAI subsidiary, into its GBA USA subsidiary.

### **Future Company Gyrodyne Aircraft**

The Company’s technology is fully scalable and readily adaptable to the gyroplane’s derivative form, the gyrodyne. As detailed later, the gyrodyne is a rotary wing aircraft that uses “tipjets” for short duration power permitting pure vertical takeoff and landing, providing the capability to hover. During the en-route portion of the flight the tipjets are turned off and the gyrodyne flies as a gyroplane in

autorotation. Such an aircraft is capable of both lifting substantial payloads in gyrodyne mode and covering substantial range as a gyroplane. The British Fairey Rotodyne demonstrated the technical validity of this concept in the 1960's. With the application of modern technology developed by the Company or in the public domain, the concept is ready to be turned into a highly utilitarian aircraft.

In recognition of these capabilities, over the past three years the Company has been assessing military applications of its gyrodyne technology to conceptual designs for a vertical takeoff aircraft with payload and range capabilities that no aerospace manufacturer has been able to offer. The Company's concept aircraft, which it calls the GBA GyroLifter, incorporates a rotary wing on an existing fixed-wing aircraft and has received wide-ranging coverage in the aerospace press.

The gyrodyne technology developed for the GyroLifter also has direct application to the design of short-range vertical take off and landing ("VTOL") commercial airliners. Growth in the economy can produce heavy demand for aircraft that do not require the use of increasingly congested runways and are not limited by air traffic control constraints, and the Company anticipates an opportunity to develop such an aircraft. By using the airframe of an existing type-certificated production airplane and adding the Company's rotor system, gyrodyne airliners can be delivered for substantially less investment and in less time than would normally be required to bring a new airliner to market. The Company's longer-range plans have identified opportunities for large (18-60 seat) gyrodynes to provide commercial passenger service in short and medium-range markets.

### **Potential Government Contracts**

In recognition of the potential of both its gyroplane and gyrodyne technologies contributing to the military and security needs of the United States Government, the Company has responded to requests for proposals from several agencies and military commands. These submissions have ranged from small UAV gyroplanes to large VTOL freighters. Several applications have been made in partnership with either a major aerospace company or an academic institution with preeminent aerospace credentials.

While the Company has not yet been successful to date in achieving an award from its proposals, the proposals that it has presented or participated in presenting have been well received and helped generate credibility for the value of the Company's technology among key segments of the aerospace industry. The Company remains optimistic that the team that it leads will succeed in achieving a specific and very significant research grant to develop its technology to meet an important government objective that other technologies are unlikely to be able to achieve. Successful performance under such a grant could lead to a substantial contract for production aircraft following the research and development program.

The Company will continue to seek opportunities to obtain government research and development contracts for use of its technology in both military and civilian agency fields where it believes that it can offer meaningful advantages in performance or cost over competing technologies. The Company also continues to offer its SparrowHawk and Hawk 4 aircraft to government agencies for patrol and surveillance duties under wet lease, that is including crew and maintenance.

## ***Market***

Management believes that it is in the national interest that the Company's unique gyroplane technology is developed. The terrorist actions of September 11, 2001 and later have triggered important new opportunities to use the Company's technology in new counter-terrorism markets. The new circumstance of our country, as well as other countries, is requiring sharply increased levels of vigilance by many branches of government to protect critical national assets against terrorist attack. Public use regulations would permit the Hawk 4 to be utilized as a highly efficient, safe, and inexpensive means of providing needed surveillance by government agencies for such roles. These include border patrol as well as protection of pipelines, nuclear power plants and key transportation infrastructures for which the Hawk 4 is particularly well suited, performing such missions far more effectively, and often at far lower cost, than other air or ground vehicles.

The attempted shooting down of an Israeli commercial aircraft approaching Mombasa airport in Kenya by Al Qaeda terrorists using surface-to-air "SAM" man-portable missiles has made the protection of commercial aircraft from such missile attacks an extremely important issue. Several proposals have been made to fit military missile defense systems to commercial aircraft, but these approaches are extremely expensive, and would take years to develop and install. Significantly, however, the Kenya incident precisely fits the scenario presented by the Company as a serious risk to the Salt Lake City 2002 Winter Olympics, which resulted in the Hawk 4 demonstrating its capacity to guard against such an attack. The subsequent arrest in New York of individuals attempting to import Russian SAM missiles into the United States heightened concerns about this threat.

The Company asserts that the most practical and effective deterrent to missile attacks remains intensive patrolling of airport approach and departure paths by safe Hawk 4 Gyroplanes, which could perform this role more economically and effectively than fixed-wing airplanes or helicopters. The Company has therefore approached principal government agencies, including the Transportation Security Administration (TSA) of the Department of Homeland Security, the Office of Domestic Preparedness (ODP) of the Department of Justice, as well as representatives of airport authorities, to present the case for the Hawk 4 in this role.

The Company is also seeking orders from foreign governments with intensive border patrol needs. Since the maintainability of the Hawk 4 Gyroplane enables it to excel in operating where infrastructure is relatively undeveloped, the potential for sales in foreign countries is great. In the expectation of such sales, the Company has evaluated the efficiency of assembling Hawk 4 Gyroplanes in strategic overseas locations, and has had discussions with different foreign entities on possible locations.

This included the offering of the Hawk 4 to the agency responsible for security for the 2002 Winter Olympic Games held in Utah, for whom the Hawk 4 Gyroplane, fitted with infrared camera and other gear, performed effectively and flawlessly. Following this success, the Company was one of 50 companies from around the nation that were selected from among hundreds of applicants to display products designed to strengthen homeland security at the Small Business Homeland Defense Expo. Through these and other demonstrations, the Company has received positive response from potential law enforcement agency users.

## ***Government Regulation***

The nature of aviation products has resulted in their manufacture being regulated by governments for public safety, national defense, and economic and/or political purposes. Such regulations vary widely by country, by product type and by usage. The Company's products and intended products are principally impacted by United States laws and regulations, but also by requirements in its export markets. As its products can be used for private, commercial, public agency or military purposes, their sale and operation are governed by regulations appropriate to each category. Developmental flight testing of the Company's aircraft is carried out under exemption rules covering experimental aircraft. The following section reviews the principal regulations applicable to each category of the Company's activities in the United States.

### **GBA Hawk 4 Series Gyroplanes**

**Commercial or Private Use:** Certification is the process by which the United States government ensures that aircraft sold into the US civil market meet appropriate standards for all civil users. FAA certification is not required by military aircraft and by many aircraft in "Public Use," roles operated by Federal, State or local agencies. Civil aircraft operated outside the United States are regulated by the authorities of those countries and may be required to obtain additional certification. The analysis and testing leading to a US certificate is, however, currently acceptable in most foreign countries as the basis for granting certification in those countries.

FAA certification has two related components. The first, Aircraft Type Certification assesses the integrity of the design and associated engineering through analysis and testing of components and complete aircraft to insure that the aircraft can achieve its performance standards safely. The second, Aircraft Production Certification, assesses the manufacturing organization to insure that its processes and procedures will result in the production of aircraft that fully conform to the standards of the aircraft type certificate.

The regulations pertaining to aircraft certification are contained in Title 14 of the United States Code, the "Federal Aviation Regulations" (FAR). Aircraft in the category of the Company's Hawk 4 aircraft, to be operated commercially or privately, must receive a Type Certificate under Part 27 (normal category rotorcraft weighing less than 6,000 lbs) of the FAR, while the Production Certificate must be obtained under Part 21 of the FAR.

**Public Use:** The Company's efforts to sell its Hawk 4 to government agencies in the United States is based on the specific exemption for operation of aircraft used by government agencies as authorized by Federal Public Law 103-411, which defines what is a "public aircraft operation." This law permits training and flights in "public aircraft" for performance of the following governmental functions:

- Flights in response to fire fighting;
- Flights in response to search and rescue;
- Flights in response to law enforcement activities; and
- Flights in support of aeronautical research or biological or geological resource management.

In this context, "public aircraft" means an aircraft:

- (i) used only for the United States Government;

- (ii) owned by the United States Government and operated by any person for purposes related to crew training, equipment development, or demonstration; or
- (iii) owned and operated (except for commercial purposes), or exclusively leased for at least 90 continuous days, by a government (except the United States Government), including a State, the District of Columbia, or a territory or possession of the United States, or political subdivision of that government;

It does not include a government-owned aircraft:

- (i) transporting property for commercial purposes; or
- (ii) transporting passengers other than –
  - (I) transporting (for other than commercial purposes) crewmembers or other persons aboard the aircraft whose presence is required to perform, or is associated with the performance of, a governmental function such as firefighting, search and rescue, law enforcement, aeronautical research, or biological or geological resource management; or
  - (II) transporting (for other than commercial purposes) persons aboard the aircraft if the aircraft is operated by the Armed Forces or an intelligence agency of the United States.

An aircraft described in the preceding sentence shall, notwithstanding any limitation relating to use of the aircraft for commercial purposes, be considered to be a public aircraft for the purposes of this part without regard to whether the aircraft is operated by a unit of government on behalf of another unit of government, pursuant to a cost reimbursement agreement between such units of government, if the unit of government on whose behalf the operation is conducted certifies to the Administrator of the Federal Aviation Administration that the operation was necessary to respond to a significant and imminent threat to life or property (including natural resources) and that no service by a private operator was reasonably available to meet the threat.

**Military Use:** Aircraft sold to the US military are not required to meet FAA regulations, but must conform to military specifications that serve a similar purpose. The Company has not attempted to sell its Hawk 4 to the United States Armed Forces and is thus not familiar with the detailed requirements that would have to be met. It believes, however, that should a military application for the Hawk 4 be needed by the US Armed Forces, a version of the Hawk 4 could be designed to meet military specifications.

### **GBA SparrowHawk Gyroplanes**

**Homebuilt Kit Aircraft:** While it might be possible to design and manufacture a gyroplane in the size and performance class of the SparrowHawk to meet the FAA FAR Parts 21 and 27 regulations that the Hawk 4 is designed to meet, the Company has not chosen to do this. The Company's entry to the SparrowHawk market has been through the alternative path of producing homebuilt aircraft kits for which there is an established market. Homebuilt aircraft kits are permitted by the FAA under its FAR Part 21 regulations governing the certification and operation of amateur-built aircraft. Such kits, however, require that the majority portion of the kit be built by an amateur (the "51% rule"), limiting the manufacturer's portion to 49%.

**Light Sport Aircraft:** The FAA has issued new regulations in 2004 defining a new classification of aircraft called Light Sport Aircraft (“LSA”) and regulated in two categories, namely Special Light Sport Aircraft (“SLSA”) and Experimental Light Sport Aircraft (“ELSA”). These regulations define an LSA by specific detailed limits upon size, weight, speed, and complexity. The LSA regulations specifically exclude helicopters and other aircraft types considered to be overly complex for the LSA classification. Such aircraft are not limited by the 51% rule, with the manufacturer permitted to fully build the aircraft.

Aircraft conforming to the SLSA category, must in addition to the basic LSA limitations, be designed and manufactured to certain defined standards that include requirements such as, for example, the need for engines that are either FAA-certified or have parts traceability.

Unlike helicopters, gyroplanes are not specifically excluded from the LSA classification, but in view of the FAA’s relative unfamiliarity with the type, are eligible for a subcategory defined as Experimental or ELSA. ELSA aircraft must meet the LSA size, weight and other limits and can be sold as fully assembled aircraft, but are not required to meet the SLSA manufacturing standards. Manufacture of ELSA aircraft is, however, limited to the period ending January 31, 2008.

The Company is intending to offer fully assembled aircraft for sale in fiscal year 2006 that meet the ELSA requirements. It has also begun the process of modifying its design and manufacturing procedures so that it can meet the SLSA standards. It will then manufacture and sell ELSA aircraft to SLSA standards with the expectation that by January 31, 2008, the FAA will have had the opportunity to review sufficient gyroplane ELSA operation to permit gyroplanes to be included in the SLSA category.

**Public Use Aircraft:** The Company is offering SparrowHawk aircraft fully built to US government agencies for Public Use, for which the regulations and limitations are covered by the same regulation, Public Law 103-411, that governs Public use for the Hawk 4 described above.

### **Test Aircraft Flown under Government Contract**

Any aircraft developed and flown under government contracts that the Company may be granted will be flown under FAA regulations governing experimental aircraft.

### ***Distribution and Marketing***

It has been the Company’s plan to market the Hawk 4 through a dealer network, both in the United States and the rest of the world. A GBA Authorized Dealer network with 14 United States dealers, 3 International dealers and over 60 national sales representatives was established and these dealers placed firm orders with deposits for 145 Hawk 4 gyroplanes. As of June 30, 2005, dealer deposits totaled \$2,145,000, which amount has been reported as a long-term liability in the accompanying consolidated financial statements. The deposit guarantees a delivery sequence number and represents a percentage of the total estimated purchase price. The Company has also issued common stock to dealers as partial consideration for the delay in the certification of the Hawk 4 gyroplane. These costs have been charged to interest expense as incurred. The dealers have been given the opportunity to convert a portion of their deposits into shares of the Company’s restricted common stock. As stockholders of the Company, the dealers are considered related parties.

Public use and military sales of the Hawk 4 will be made directly by the Company.

All the Company's government marketing and therefore its responses to requests for proposals to participate in research and development programs suited to its technology have been directed exclusively to the United States Government.

As discussed previously, the Company is building a dealer network for the sales of its SparrowHawk gyroplane kits, primarily throughout North America with some international locations. This dealer network will be the principal means of marketing and selling its SparrowHawk kits, and intends that it will sell its kits primarily through this network. Through June 30, 2005, 27 dealerships have been established, 21 in the United States and 6 internationally. Sales representatives have also been appointed in Korea and India to present the capabilities of the SparrowHawk for civil use to government agencies in those countries.

The Company continues to place a particular focus on demonstrations of the SparrowHawk at regional and national air shows attended by kit-built aircraft enthusiasts. Together with several of its dealers, it has given demonstrations to attendees at the Popular Rotorcraft Association Show at Mentone, Indiana, the Experimental Aircraft Association (EAA) Show at Oshkosh, Wisconsin, the EAA Sun 'n Fun Show in Lakeland, Florida, and the Bensen Days Show in Wauchula, Florida. Additional demonstrations have been given by dealers at shows in Arizona, Texas, Florida and Washington. As the dealer network expands, it can be expected that the exposure of potential customers to the merits of the SparrowHawk will increase.

### *Competition*

To the Company's knowledge, no other gyroplane is being prepared for commercial FAA certification, nor are any certified commercial gyroplanes currently being manufactured. The sole company known to be developing a gyroplane with modern technology, the CarterCopters, LLC (Carter), has designed a hybrid between a gyroplane and a conventional airplane, with both a rotorwing and a fixed wing. Carter, like the Company, has identified the potential for a safe and efficient gyroplane that can operate without the need for a runway. Carter has, however, approached the market from a very different perspective than the Company. The Company has based its designs and market objectives on aircraft that adapt proven technology to the gyroplane and address the market for efficient, low cost, and short haul vehicles. Carter, on the other hand, is attempting the more technically challenging task of producing a high-speed, long haul gyroplane. Further, Carter has stated that its business strategy is to be a technology development company, not a manufacturer, and therefore, for these reasons the CarterCopter does not represent any direct competition to the Hawk 4.

Other competition for the Hawk 4 lies largely in the helicopter segment, although the aircraft is competitive with airplanes for certain missions and is expected to obtain part of its market from fixed-wing markets. Its principal competitors are therefore comparably-sized turbine-powered helicopters, with similar speed, payload and range capabilities, notably the Schweizer 333, the Enstrom 480, the Bell 206BIII and the MD 500E. The Company believes that the much lower maintenance cost, greater daily utilization capability and inherent safety will enable the Hawk 4 to compete effectively against these aircraft as well as the lower cost, but lower-performing piston-powered Robinson R44.

As the Company's heavy lift technology is principally directed towards missions that require either VTOL or near VTOL capability, its most significant competition comes from helicopters or

hybrid aircraft that combine both helicopter and airplane characteristics. For heavy lift applications, both civil and military, these include tilt rotors in both two and four rotor configurations, proposed by Bell and Boeing, compound tandem helicopters with augmented lift from small wings and augmented thrust from external jet engines, proposed by Boeing and coaxial twin rotor helicopters proposed by Sikorsky. The Company believes that inherent advantages in its technology allow it to compete effectively with these approaches.

Competitive aircraft in the two-seat closed cockpit class are principally the Canadian side-by-side two-seat RAF 2000, and the tandem Sycamore produced in South Africa. The Company believes that its SparrowHawk has important advantages in its flying characteristics and safety over the RAF 2000, and that its side-by-side configuration will be more popular than the tandem Sycamore. There are also several manufacturers of amateur-built aircraft, including fixed wing, helicopter and other aircraft, that represent competition for the Company's kit built SparrowHawk gyroplane.

### ***Patents***

The Company presently owns several patents that relate to collective pitch and flight controls. The important element of these patents is collective pitch control on a semi-rigid, teetering rotor head for gyroplanes. This is different from similar sounding claims for helicopters, as this concept has never before been applied to gyroplanes. The patent claims are written very broadly, which makes it difficult to design around them. The Company's patent opportunity existed because of a fifty-year hiatus in development in gyroplane technology.

### **Item 2. Description of Property**

The Company leases its development/manufacturing facility located at 2640 W. California Avenue, Suite A, Salt Lake City, UT 84104-4593 from an unrelated party. This property of approximately 25,000 square feet, houses the Company's headquarters and its administrative offices, and within this facility the Company has assembled the Hawk 4 prototypes, and manufactured parts and assembled kits for the SparrowHawk. The Company extended this lease through April 30, 2008.

In addition, the Company leases a flight facility in Buckeye Airport, Arizona, of approximately 12,000 square feet, on a month-to-month basis, which it manages on behalf of the Airport Authority. All flight testing of the Company's aircraft and flight training takes place at Buckeye, as well as machining of certain parts and assembly of SparrowHawk products.

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

The Company is plaintiff in connection with four million shares of the Company's common stock issued for the purposes of obtaining a foreign loan in Luxembourg in 1993. In that suit, the Company obtained injunctions in Germany and Luxembourg preventing those shares from being sold or liquidated. The Company prevailed in the case at appellate levels. The Company continues in the process of obtaining a court order from Luxembourg to have the certificates returned to the Company.

The Company is subject to the potential of various claims and legal actions arising in the ordinary course of business, including certain matters relating to past due amounts to creditors. The past due amounts are recorded as liabilities in the Company's consolidated financial statements, and

management believes that the amount, if any, that may result from other claims will not have a material adverse effect on the consolidated financial statements.

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

There were no matters submitted to a vote of security holders during the fourth quarter of fiscal year 2005.

## PART II

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

#### *(a) Market Information.*

The common stock of the Company, no par value, is currently traded over the counter and is listed on the OTC Bulletin Board under the symbol "GNBA.OB." The following table sets forth the approximate range of high and low closing prices for the common stock of the Company during the periods indicated. The quotations presented reflect inter-dealer prices, without retail markup, markdown, or commissions, and may not necessarily represent actual transactions in the common stock.

		<u>Closing Prices</u>	
<b>Fiscal Year Ended June 30:</b>		<b><u>High</u></b>	<b><u>Low</u></b>
<b>2005</b>	First Quarter	\$0.25	\$0.15
	Second Quarter	\$0.22	\$0.13
	Third Quarter	\$0.22	\$0.12
	Fourth Quarter	\$0.21	\$0.18
<b>2004</b>	First Quarter	\$0.25	\$0.12
	Second Quarter	\$0.25	\$0.14
	Third Quarter	\$0.31	\$0.20
	Fourth Quarter	\$0.27	\$0.14

On September 15, 2005, the closing quotation for the common stock was \$0.18 per share. As reflected by the high and low prices on the foregoing table, the trading price of the common stock of the Company can be volatile with dramatic changes over short periods. The trading price may reflect imbalances in the supply and demand for shares of the Company, market reaction to perceived changes in the industry in which the Company sells products and services, general economic conditions, and other factors. Investors are cautioned that the trading price of the common stock can change dramatically based on changing market perceptions that may be unrelated to the Company and its activities.

#### *(b) Number of equity security holders.*

The number of record holders of the Company's common stock as of September 15, 2005 was 1,564, which does not include shareholders whose stock is held through securities position listings.

#### *(c) Dividends.*

The Company did not declare or pay any cash dividends on its common stock during the past two fiscal years.

***(d) Securities authorized for issuance under equity compensation plans.***

The Company's Amended and Restated 2000 Stock Option Plan (the "Plan") has been approved by the shareholders of the Company. Under the Plan, a maximum of 60,000,000 common shares are available for granting of options to purchase common stock. The Company may issue both non-qualifying stock options and qualifying incentive stock options. The Company has also issued stock options and warrants outside the Plan which have been approved by the Company's Board of Directors and which have been issued under no specific plan approved by the shareholders. The following table presents information concerning outstanding stock options and warrants issued by the Company as of June 30, 2005.

<b>Plan Category</b>	<b>Number of Securities to be Issued Upon Exercise of Outstanding Options</b>	<b>Weighted-Average Exercise Price of Outstanding Options</b>	<b>Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a))</b>
	<b>(a)</b>	<b>(b)</b>	<b>(c)</b>
Equity compensation plans approved by security holders	49,000,000	\$0.50	25,825,000

See also Notes 12 and 13 of the accompanying Notes to Consolidated Financial Statements for further information regarding the Plan and stock options and warrants issued by the Company.

***(e) Recent sales of unregistered securities.***

During the three months ended June 30, 2005, the Company issued a total of 3,721,250 shares of its restricted common stock, generally at a price of \$0.20 per share through private placement offerings in reliance upon the exemption from registration contained in Rule 506 of Regulation D. The shares were issued for the following consideration: 3,542,500 shares for cash of \$709,000; 5,000 shares in payment of finders' compensation on the sale of common stock; 47,500 shares in payment of accounts payable of \$9,000; 76,250 shares in payment of accrued expenses of \$15,000; and 50,000 shares in payment of consulting services of \$10,000. In addition, cash finders' compensation and accrued finders' compensation on the sale of common stock totaled \$6,000 and \$27,000, respectively, during the three month period. The Company did not use underwriters in the sale or placement of these unregistered shares of common stock.

The Company has generally placed a value of \$0.20 per share on the non-cash transactions where shares of the Company's restricted common stock have been issued in payment of goods and services, reduction of debt and other purposes. The Company believes, based on the many cash sales of the Company's restricted common stock during the year ended June 30, 2005, all at \$0.20 per share, that \$0.20 per share is an appropriate value per share to use for issuances of restricted common shares in non-cash transactions. The \$0.20 per share also approximated the average quoted market price of the Company's common stock during the year.

During the three months ended June 30, 2005, the Company issued a total of 7,736,591 stock options not subject to the Company's Registration Statement on Form S-8: 6,240,000 options to investors in connection with the sale of common stock of the Company with exercise prices of \$0.20 to \$0.25 per share exercisable for periods of 1 to 2 years; 996,591 options as a loan origination fee or other compensation to lenders with an exercise price of \$0.20 per share exercisable for a period of 1 to 3 years; and 500,000 options to vendors for services with an exercise price of \$0.20 to \$1.00 per share exercisable for periods of one to five years.

In connection with the extension of the maturity date of the Series B 15% Preferred Stock to January 1, 2007, holders of the preferred shares were issued warrants exercisable through January 1, 2009 to purchase 6,850,000 shares of the Company's common stock at \$0.30 per share. Existing warrants to purchase 2,500,000 shares held by the holders were cancelled.

*(f) Purchases of equity securities by the small business issuer and affiliated purchasers.*

During the fourth quarter of fiscal year 2005, neither the Company nor any of its affiliates purchased any equity securities of the Company.

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

**Background**

The Company has developed proprietary technology that promises significant advances for rotary-winged aircraft. The initial objective of the Company was to develop and market an easy-to-fly and cost-efficient gyroplane that could compete effectively in the general aviation market.

Effective July 1, 1993 and continuing through March 31, 2003, the Company was considered a development stage company as defined in SFAS No. 7. The Company's development stage activities consisted of the development and preparation for FAA certification of the Hawk 4 gyroplane. Sources of financing for these development stage activities were primarily debt and equity financing.

During the first quarter of fiscal year 2003, the Company suspended its flight testing of the Hawk 4 at its Buckeye facility in Arizona due to lack of financial resources. Further development toward commercial certification of the Hawk 4 has been deferred pending the receipt of required funding. The Company's business plan for the Hawk 4 is now oriented in its immediate priorities toward offering this aircraft in its already well tested form to the US government, and to governments of friendly countries. This would give the Company the opportunity to receive revenues ahead of FAA certification, and as a result, to reduce the need for funding to permit the start of production of the Hawk 4. Consistent with this objective, the Company has been presenting the case for the Hawk 4's utility in this role to members of Congress, appropriate Federal Agencies, and to State and local agencies across the nation for Public Use applications, particularly Homeland Defense, and is seeking orders within the Federal 2006 Budget. The Company is confident that the safety, reliability, maneuverability and low operating cost of the Hawk 4 will permit it to perform competitively with helicopters (and airplanes) for many missions requiring low, slow flight, but without the requirement for a runway for take-off or landing. As noted earlier, the Company is currently in discussions with foreign investors relating to potential funding of Hawk 4 certification, although there is no assurance that the Company will be successful in obtaining such funding.

The Company has received significant deposits on aircraft from the Company's authorized dealers in anticipation of full-scale production of the Hawk 4. These dealer deposits are recorded as a long-term liability in the Company's consolidated balance sheet.

The Company has designed, and now manufactures and sells SparrowHawk gyroplane kits for the home-built market. In addition, the Company developed and sells modification kits designed to improve in-flight stability and safety for another manufacturer's kit gyroplane.

During the years ended June 30, 2005 and 2004, the Company's operating focus has been directed to the final development of the two-seat piston engine powered SparrowHawk. The initial market for this aircraft lies with builders of home-built aircraft from kits; however, management also believes that there are larger, untapped markets for fully assembled SparrowHawk gyroplane aircraft. Important among these emerging markets is the potential use of the SparrowHawk as a patrol aircraft by law enforcement agencies both in the United States and overseas. An intensive marketing program for the SparrowHawk is being developed. Through June 30, 2005, 27 American Autogyro dealerships have been established, 21 in the United States and 6 internationally.

The Company began deliveries of SparrowHawk kits during the third quarter of its fiscal year ended June 30, 2004, recording initial revenues from this aircraft in the fourth quarter of fiscal year 2004. Through June 30, 2005, 66 initial orders for SparrowHawk gyroplane kits have been received, with 39 complete kits delivered. During the year ended June 30, 2005, the Company reported SparrowHawk sales revenues of \$746,000 on 26 delivered kits, upgrades and parts. The Company has received substantial advance payments from dealers and customers on SparrowHawk gyroplane kit orders, which have been recorded as deferred revenue. Additional revenues have also been received from the sale of modification kits, flight training and from contract manufacturing; however, these revenue sources have not been, and are not projected to be, significant to the Company.

The Company's technology is scalable to much larger aircraft and has potential applications for both heavy lift vertical take-off military aircraft and runway independent short-haul airliners. The Company has been actively engaged in discussions with government agencies and potential aerospace strategic partners in this country and in Europe and China with respect to those applications.

### **Going Concern Uncertainty**

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. Because of recurring operating losses, the excess of current liabilities over current assets, the stockholders' deficit, and negative cash flows from operations, there is substantial doubt about the Company's ability to continue as a going concern. The Company's continuation as a going concern is dependent on attaining profitable operations, restructuring its debt obligations, and obtaining additional outside financing. The Company has funded losses from operations in the current year primarily from the issuance of debt and the sale of the Company's restricted common stock in private placement transactions. The Company anticipates that the issuance of debt and the sale of the Company's restricted common stock will continue to fund operating losses in the short-term, or until revenues grow to the point where they are sufficient to cover operating costs and expenses.

Operating revenues from the sale of SparrowHawk kit gyroplanes, the Company's primary source of revenues through June 30, 2005, are not currently sufficient, and not projected to be sufficient in the near future, to cover operating expenses for the following reasons:

- To date, the Company has experienced a negative gross profit on sales because of the start-up and "learning curve" costs that are normally experienced in the production of a new product.
- The Company projects that as the Company improves its manufacturing capabilities and increases its sales efforts, the negative gross profit on sales will narrow in fiscal year 2006, although there is no assurance that the Company will be successful in reducing the negative gross margin.
- The Company continues to incur significant research and development expenditures related to fully assembled SparrowHawk gyroplane derivatives and to potential applications of the Company's technology to heavy lift vertical take-off military aircraft, runway independent short-haul airliners and other aircraft.
- Marketing and sales efforts continue, but the number of SparrowHawk kits sold is below expectations, due in part to lack of funding to undertake product development and to pay for increased sales and marketing efforts.

The Company will continue to explore larger, untapped markets for fully assembled SparrowHawk gyroplane aircraft, including law enforcement agencies both in the United States and overseas using the SparrowHawk as a surveillance aircraft. The Company believes the margins on these completed aircraft will be substantially higher than on kit gyroplanes. However, through the date of this filing, no sales of fully assembled SparrowHawk gyroplane aircraft to law enforcement agencies have occurred.

The Company does not expect revenues from the sale of Hawk 4 gyroplanes will be realized until the Company completes FAA or equivalent international certification of the aircraft. Currently, the Company estimates that approximately \$40 million and a two to three year period will be required to complete the certification. As previously discussed, the Company is in discussions with parties that have expressed interest in funding the completion of the certification and commencing the production of the Hawk 4 gyroplane. These discussions are ongoing, and the Company is not in a position to conclude how likely a favorable outcome to these opportunities is, and there is no assurance that additional funding will be realized. If one or more of these funding transactions is completed, the Company believes there will be sufficient working capital to fund operating deficits for fiscal year 2006 and for the next 2 to 3 years. In addition, with the announcement of such a funding source, the Company believes prospects will improve to raise equity capital from other sources to fund operations and meet debt obligations. Because of ongoing research and development efforts and the projected costs of certification, the Company does not project that it will have net income or positive cash flows from operations until FAA certification is obtained and sales of Hawk 4 gyroplanes reach planned levels.

The Company does not anticipate that operating costs of personnel, facilities, research and development and sales and marketing will decrease from levels reported for fiscal year 2005, and may increase.

There can be no guarantee or assurance that the Company will be successful in its ability to generate revenue or to raise capital at favorable rates or at all. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

## **Results of Operations**

### **Revenues**

Total revenues increased to \$864,000 in the year ended June 30, 2005 from \$509,000 in the year ended June 30, 2004. The revenues in fiscal year 2005 were comprised of \$746,000 from the sale of 26 SparrowHawk kits, options and parts, \$56,000 from the sales of modification kits, and \$62,000 from flight training. The revenues in fiscal year 2004 were comprised of \$343,000 from the sale of 13 SparrowHawk kits, \$77,000 from the sales of modification kits, \$39,000 from flight training and \$50,000 from subcontract manufacturing. The Company began delivering SparrowHawk kits in the third quarter of fiscal year 2004. The increase in the number of SparrowHawk kits sold in fiscal year 2005 resulted from a full year of related sales and marketing activities.

At June 30, 2005, advance deposits of \$588,000, included in deferred revenue, from customers and dealers principally for SparrowHawk kits, have added significantly to overall cash flow. During fiscal year 2006, the Company will be progressively increasing its focus on satisfying a growing demand for SparrowHawk kits, and, to a lesser extent, for modification kits. The Company recognizes revenues on the sale of SparrowHawk kits when a complete kit has been delivered and the collection of the remaining purchase price is reasonably assured. While less in dollar amount, flight training revenue will be an ongoing addition to Company cash flow. The Company does not consider subcontract manufacturing revenues as a significant future source of ongoing revenue to the Company.

### **Costs and Expenses**

Comparing fiscal year 2005 to fiscal year 2004, cost of sales increased to \$1,237,000 from \$495,000. The increase in fiscal year 2005 was primarily due to the cost of sales of the SparrowHawk kits of \$1,172,000 resulting from more kits sold in the current year. The Company continues to experience a negative gross profit on the SparrowHawk kits because of the nonrecurring and “learning curve” costs that are normally experienced in the introductory production of a new product. Ongoing improvements to the design and packaging of the kits without a similar increase in the sales price of the kits and the transition of substantial portions of kit manufacturing and assembly operations to the Salt Lake City facility also contributed to increasing negative margins on the sale of SparrowHawk kits. The Company projects that as the Company improves its manufacturing capabilities and increases its sales efforts, the negative gross profit on sales will narrow in fiscal year 2006, but may not turn positive. In addition, only nominal gross margin is realized on the sale of modification kits and on flight training. The consolidated statement of operations for the year ended June 30, 2004 reported a modest gross margin on total sales. However, this margin was attributed primarily to flight training and subcontract manufacturing revenues. All costs of incomplete SparrowHawk kits delivered as of June 30, 2005 have been deferred and included in work-in-process inventories.

Comparing fiscal year 2005 to fiscal year 2004, research and development expenses increased to \$1,874,000 from \$1,796,000. The increase in research and development expenses in the current fiscal year is due primarily to the addition of new engineering employees in relation to the development of applications for grants from government agencies and to increases in compensation for current employees. Research and development activities have consisted of ongoing modifications to the

SparrowHawk, fully assembled SparrowHawk gyroplane derivatives, potential applications of the Company's technology to heavy lift vertical take-off military aircraft, runway independent short-haul airliners and other aircraft, including government contract opportunities.

Comparing fiscal year 2005 to fiscal year 2004, general and administrative expenses increased to \$1,923,000 from \$1,697,000, a 13% increase. The increase in the current year is due primarily to the addition of personnel and to increases in compensation for current personnel supporting the sales and development of the SparrowHawk.

#### **Other Income and Expenses**

Comparing fiscal year 2005 to fiscal year 2004, related party interest income decreased from \$9,000 to \$8,000 due to repayment of related party notes receivable in the current fiscal year.

Comparing fiscal year 2005 to fiscal year 2004, interest and other income decreased to \$25,000 from \$170,000 due to the gain on sale of assets recorded in fiscal year 2004 primarily from the sale of investment art against which full impairment losses had been recorded in prior years.

Interest expense for fiscal year 2005 compared to fiscal year 2004 decreased to \$1,214,000 from \$1,583,000. The decrease in the current fiscal year was due primarily to additional interest expense incurred in the prior fiscal year on the issuance of stock options and warrants to lenders in connection with new debt or debt extensions, net of the effect of current fiscal year additions to debt.

Comparing fiscal year 2005 to fiscal year 2004, Series B Preferred Stock interest expense increased to \$8,003,000 from \$7,639,000. Dividends on the Series B Preferred Stock, which are recorded as interest expense, have been "paid in kind" with additional shares of Series B Preferred Stock. As a result, the number of shares on which the interest expense is computed has increased during the current fiscal year. In addition, 66,603 new shares of Series B Preferred Stock were issued in November 2004 upon the conversion of a promissory note and related accrued interest payable.

#### **Net Loss**

During fiscal year 2005, the Company continued to record losses as it progressed toward full marketing and manufacturing of the SparrowHawk gyroplane kit and continued research and development activities on SparrowHawk gyroplane derivatives and other applications of the Company's gyroplane technology. For fiscal year 2005, the loss from operations was \$4,170,000 compared to the loss from operations of \$3,479,000 for fiscal year 2004. The increase in the loss from operations in the current fiscal year resulted from negative gross margins on revenues and increases in operating costs and expenses as described above, offset by the increase in revenues.

The net loss for fiscal year 2005 was \$13,354,000 compared to \$12,522,000 for fiscal year 2004. The increase in the net loss in the current fiscal year resulted from increases in operating costs and expenses and Series B Preferred Stock interest expense, as described above, offset by the increase in revenues.

The net loss applicable to common stockholders for fiscal year 2004 included a charge of \$1,448,000 from the issuance of a put option in that year. As a result, the net loss applicable to common stockholders was \$13,970,000 in fiscal year 2004 compared to the net loss applicable to common stockholders in fiscal year 2005 of \$13,354,000, which is equal to the fiscal year 2005 net loss.

## Liquidity and Capital Resources

At June 30, 2005, the Company had total current liabilities of \$14,543,000 and current assets of \$550,000, resulting in a working capital deficiency of \$13,993,000. Total liabilities exceed total assets by \$52,766,000 at June 30, 2005.

On October 11, 2005, the holders of the Series B 15% Preferred Stock (“Series B Holders”) extended the redemption date of the Series B 15% Preferred Stock from October 31, 2005 to January 1, 2007. The Company amended its Articles of Incorporation on October 11, 2005 to reflect the modification to the redemption date. The Series B 15% Preferred Stock has been reported as a long-term liability of \$33,009,000 in the consolidated balance sheet as of June 30, 2005 because of the extension of the redemption date to January 1, 2007, thus improving the working capital position of the Company.

The extension requires the following consideration to be paid to the Series B Holders:

- The cancellation of existing warrants issued to the Series B Holders to purchase 2.5 million shares of the Company’s common stock at an exercise price of \$0.30 per share.
- The issuance of warrants to purchase 6.85 million shares of the Company’s common stock exercisable through January 1, 2009 at an exercise price of \$0.30 per share.
- The issuance of additional shares of Series B 15% Preferred Stock with a redemption value of \$10.7 million face value (10,700 shares) on January 1, 2007, with reductions in the number of shares to be issued allowed for repayments of amounts due to the Series B Holders in accordance with an agreed-upon formula.

In connection with the extension of the redemption date of the original issuance of the Company’s Series B 15% Preferred Stock and the sale of 8,000 shares of the Series B 15% Preferred Stock during the second quarter of fiscal year 2004, the Company’s Articles of Incorporation were amended to require that all redemptions of the Series B 15% Preferred Stock be paid in cash.

The Articles of Incorporation have been further amended to define the maturity date as the first to occur of (a) January 1, 2007, (b) the occurrence of a defined “liquidation event”, or (c) the date that is six months following the receipt by the Company or its affiliates of proceeds from one or more financing transactions in excess of \$50 million. In addition, the amended Articles of Incorporation require pro rata redemptions of the Series B 15% Preferred Stock with the proceeds of certain financing transactions that exceed \$20 million in the aggregate. As a result, if the Company is successful in raising the levels of funding that it requires to bring its obligations current and fund its planned operations, significant portions of this funding will be required to make redemption payments on the Series B 15% Preferred Stock in advance of the January 1, 2007 maturity date.

Following the economic downturn of 9/11 and its impact on the aerospace industry, the Company’s fund-raising activities in the venture capital market were seriously impaired, resulting in active development of its Hawk 4 gyroplane for commercial certification being deferred. The Company, however, continues to actively seek sales and funding for government and public use applications of the Hawk 4 as well as for the SparrowHawk.

In the face of continuing fund-raising difficulties, in fiscal years 2002 and 2003, the Company successfully approached many of its principal vendors requesting that they accept extensions of payments beyond their normal terms. As a result, the Company is servicing much of its pre-November 2001 obligations to vendors utilizing a combination of repayment plans, which include monthly payments for smaller vendor liabilities and promissory notes for larger vendor liabilities. As of June 30, 2005, the Company was delinquent in making payments on substantially all promissory notes to vendors and to an unrelated party lender, which totaled \$663,000. The Company continues ongoing negotiations with these vendors and lender, and has, in most instances, been granted grace periods and extensions without receipt of formal notices of default or threat of legal action. The Company intends to repay in full all vendors and lenders, including accrued interest where applicable. The Company is also delinquent in making payments on capital lease obligations to a related party of \$660,000, other related party notes payable totaling \$443,000, and accrued interest payable on debt of \$517,000.

Net cash used in operating activities was \$3,365,000 for fiscal year 2005 compared to \$3,809,000 for fiscal year 2004. In fiscal year 2004, compared to fiscal year 2005, the Company reduced accounts payable and also paid significant amounts of accrued expenses from the proceeds of the issuance of Series B preferred stock, which resulted in more cash used in operating activities in the prior fiscal year. The Company also had an increase in inventories of \$396,000 during fiscal year 2004, which decreased the net cash used in operating activities in the prior year, compared to a decrease in inventories of \$93,000 during the current fiscal year, which increased the net cash used in operating activities in the current fiscal year.

The Company has funded losses from operations in the current fiscal year primarily from the issuance of debt and the sale of the Company's restricted common stock in private placement transactions, and will require additional funding from these sources to sustain its future operations. Net cash provided by financing activities for fiscal year 2005 was \$3,414,000, comprised primarily of a net increase in debt of \$919,000 and net proceeds from the issuance of common stock of \$2,495,000. Net cash provided by financing activities for fiscal year 2004 was \$3,754,000, comprised of a net increase in debt of \$422,000, net proceeds from the issuance of common stock of \$1,332,000, and \$2,000,000 proceeds from the issuance of Series B preferred stock. The Company anticipates that the issuance of debt and the sale of the Company's restricted common stock will continue to fund operating losses in the short-term, or until revenues grow to the point where they are sufficient to cover operating costs and expenses. However, there is no assurance that the Company will be successful in either raising sufficient capital or improving operations.

The Company does not anticipate that operating costs of personnel, facilities, research and development and sales and marketing will decrease from levels reported for fiscal year 2005, and may increase.

Management does not anticipate that revenues or expenses will be materially affected by inflation during the next twelve months of operations.

## Off Balance Sheet Commitments

The Company leases certain property, vehicles and facilities under noncancellable operating leases. Future minimum rental payments required under these leases are as follows:

<u>Years Ending June 30,</u>	<u>Amount</u>
2006	\$ 144,000
2007	147,000
2008	122,000
	<u>\$ 413,000</u>

## Critical Accounting Policies

The Company's critical accounting policies include the following:

**Research and Development Costs-** Research and development costs are expensed as incurred in accordance with SFAS No. 2, "Accounting for Research and Development Costs." The costs of materials and other costs acquired for research and development activities are charged to expense as incurred. Salaries, wages, and other related costs of personnel, as well as other facility operating costs are allocated to research and development expense through management's estimate of the percentage of time spent by personnel in research and development activities.

**Revenue Recognition** - The Company recognizes revenues from goods and services when there is a binding agreement, the product has been completely shipped or service has been delivered, collection is reasonably assured, and the Company has no significant obligations remaining. Portions of the purchase price of the Company's products collected from customers in advance of product delivery are recorded as deferred revenue. Therefore, revenues from the sale of SparrowHawk gyroplane kits are not recorded until all kit components and parts are delivered to the customer and collection of any remaining amounts due is reasonably assured.

**Financial Instruments with Characteristics of Both Liabilities and Equity** - In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Instruments with Characteristics of Both Liabilities and Equity." This statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. The statement was effective on July 1, 2003 for financial instruments entered into or modified after May 31, 2003, and otherwise effective for existing financial instruments entered into before May 31, 2003. The adoption of SFAS No. 150 resulted in the reporting of the Company's Series B 15% Preferred Stock and a put option obligation as liabilities. The carrying value of the Series B 15% Preferred Stock was the same before and after adoption of SFAS No. 150, and therefore no cumulative effect adjustment was required.

**Put Option Liability** - To comply with SFAS No. 150, the Company estimated the fair value of the put option liability at \$1,515,000 at June 30, 2005 using the Black-Scholes option-pricing model. Until the obligation is satisfied, the Company will continue to use this methodology to periodically reassess the fair value of the put option liability to determine if the carrying value of the liability in the

consolidated financial statements requires adjustment, with changes in the fair value recognized as interest cost. The fair value of the put option liability is inversely related to the fair value of the Company's common stock. Any material changes in the fair value of the Company's common stock may result in material changes in the fair value of the put option liability.

**Non-Employee Stock Options and Warrants** – In accordance with SFAS No. 123, "Accounting for Stock-Based Compensation", the Company estimates the fair value of the consideration recorded for stock options and warrants issued to non-employees using the Black-Scholes option-pricing model. For those stock options and warrants that have variable characteristics, the Company will continue to use this methodology to periodically reassess the fair value of the consideration to determine if the value of the consideration recorded in the consolidated financial statements requires adjustment. Changes in the assumptions used in the option-pricing model, including the market price of the Company's common stock and risk-free interest rates, may result in fluctuations in the estimated fair value and carrying value of the consideration recorded for variable non-employee stock options and warrants.

### **Recently Issued Accounting Principles**

In December 2004, the Financial Accounting Standards Board ("FASB") issued Financial Accounting Standard ("FAS") No. 123(R), *Share-Based Payment*, an amendment of FASB Statements No. 123 and 95. FAS No. 123(R) replaces FAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. This statement requires companies to recognize the fair value of stock options and other stock-based compensation to employees prospectively beginning with the first interim or annual period of the first fiscal year beginning after December 15, 2005 for small business issuers, as deferred by the Securities and Exchange Commission. This means that the Company will be required to implement FAS No. 123(R) no later than the quarter beginning July 1, 2006. The Company currently measures stock-based compensation in accordance with APB Opinion No. 25, as discussed above. The Company anticipates adopting the modified prospective method of FAS No. 123(R) on July 1, 2006. The impact on the Company's financial condition or results of operations will depend on the number and terms of stock options outstanding on the date of change, as well as future options that may be granted. However, the Company believes the adoption of FAS No. 123(R) may have a material effect on the Company's financial position and results of operations.

The FASB has issued FAS Statement No. 154, *Accounting Changes and Error Corrections*. This new standard replaces APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*. Among other changes, Statement 154 requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle, unless it is impracticable to do so. Statement 154 also provides that (1) a change in method of depreciating or amortizing a long-lived nonfinancial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be termed a "restatement." The new standard is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. Early adoption of this standard is permitted for accounting changes and correction of errors made in fiscal years beginning after June 1, 2005. The Company anticipates adopting FAS No. 154 on January 1, 2006, and does not believe the adoption of this new accounting pronouncement will result in a material impact on the Company's financial condition or results of operations.

## **Forward Outlook and Risks**

*The Company, from time to time, may publish forward-looking statements relating to such matters as anticipated financial performance, business prospects, technological development, new products, research and development activities and similar matters. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. In order to comply with the terms of the safe harbor, the Company notes that a variety of factors could cause the Company's actual results and experience to differ materially from the anticipated results or other expectations expressed in any of the Company's forward-looking statements. The risks and uncertainties that may affect the operations, performance, development and results of the Company's business include, but are not limited to, the following: (a) the failure to obtain additional borrowed and/or equity capital on favorable terms for acquisitions and expansion; (b) adverse changes in federal and state laws, or other matters affecting the Company's business; (c) the demand for the Company's products and services; and (d) other risks detailed in the Company's Securities and Exchange Commission filings.*

*This Form 10-KSB contains and incorporates by reference certain "forward-looking statements" within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act with respect to results of operations and businesses of the Company. All statements, other than statements of historical facts, included in this Form 10-KSB, including those regarding market trends, the Company's financial position, business strategy, projected costs, and plans and objectives of management for future operations, are forward-looking statements. In general, such statements are identified by the use of forward-looking words or phrases including, but not limited to, "intended, will, should, may, expect, anticipate, estimates, projects" or the negative thereof or variations thereon or similar terminology.*

*Forward-looking statements are based on the Company's current expectations. Although the Company believes that the expectations reflected in such forward-looking statements are reasonable, there can be no assurance that such expectations will prove to be correct. Because forward-looking statements involve risk and uncertainty, the Company's actual results could differ materially. Important factors that could cause actual results to differ materially from the Company's expectations are disclosed hereunder and elsewhere in this Form 10-KSB. These forward-looking statements represent the Company's judgment as of the date of this Form 10-KSB. All subsequent written and oral forward-looking statements attributable to the Company are expressly qualified in their entirety by the Cautionary Statements. The Company disclaims, however, any intent or obligation to update its forward-looking statements.*

### **Item 7. Financial Statements**

The consolidated financial statements of the Company required by this Item are contained in a separate section of this report. See "Index to Consolidated Financial Statements" on Page F-1 for the consolidated financial statements of the Company included in this report.

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

None.

**Item 8A. Controls and Procedures**

The Company's Chief Executive Officer and Chief Financial Officer have conducted an evaluation of the Company's disclosure controls and procedures as of June 30, 2005. Based on their evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective, except as described below, to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the applicable Securities and Exchange Commission rules and forms.

During the audit of the Company's consolidated financial statements for the year ended June 30, 2005, management and the Company's independent auditors identified a reportable condition in the Company's internal control over the financial reporting process relating to the identification, recording and reporting of cost of sales of the Company's products, the cost of raw materials and parts inventories, and the cost of work-in-process inventories through the Company's manufacturing and cost accounting software. In addition, the Company has not implemented the accounting module of this ERP software to enable the costs of the Company's purchasing, manufacturing and sales activities to integrate with the financial statements of the Company.

During the first quarter of fiscal year 2006, the Company has implemented the following actions to address the cost accounting weakness described above. The Company purchased an upgrade to the ERP system and has committed to fully implement the accounting module of the software. Training has been conducted for finance and other personnel of the Company in the use of the ERP software, and such training will continue during fiscal year 2006. Consultants from the vendor of the software have visited the Company and provided a report recommending improvements and providing instructions for fully integrating all modules of the software which the Company is using in its plans to strengthen controls. The Company has also committed to hire a cost accountant experienced in a manufacturing environment similar to that of the Company. The Company believes that it will require four to six months to implement the changes necessary to fully address the cost accounting weakness.

Management has also determined that a weakness in internal controls over financial reporting exists due to an overall lack of segregation of duties resulting from the limited number of personnel in the Company's accounting department. The Company's independent auditors have classified this weakness as a reportable condition. Management believes that as the Company expands with increased sales activities and government contract opportunities, additional accounting personnel will be added, resulting in improved ability to segregate key accounting and financial reporting duties.

In connection with the audit of the Company's consolidated financial statements for the year ended June 30, 2004, management and the Company's independent auditors identified certain material weaknesses in the Company's internal control over the financial reporting process pertaining to the timely evaluation and recording of transactions related to the Company's Series B 15% Preferred Stock and the Company's put option liability. The Company recorded adjusting entries in the fourth quarter of

its fiscal year ended June 30, 2004 to correct errors in the second and third quarters of fiscal year 2004 related to these financial statement items. Subsequently, the Company restated the condensed consolidated statements of operations for the quarterly periods in fiscal year 2004 included for comparison purposes in its quarterly reports on Form 10-QSB for fiscal year 2005 to reflect the correcting entries in the appropriate interim periods of the prior fiscal year.

During fiscal year 2005, the Company implemented changes to improve its internal controls over financial reporting. These changes included, among other procedures, more comprehensive documentation of accounting policies and procedures, implementation of analytical review procedures, schedules and checklists for the preparation of interim and annual financial statements, and executive level review of journal entries.

Other than the matters discussed above, there were no other significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of the most recent evaluation of these controls by the Company's Chief Executive Officer and Chief Financial Officer.

**Item 8B. Other Information**

None

### PART III

#### Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(A) of the Exchange Act

The following table contains the names and ages of all Directors and Executive Officers of the Company and offices held by each such person.

<u>Name</u>	<u>Age</u>	<u>Positions</u>
David L. Groen	54	Director, President, Chief Executive Officer, and Treasurer
H. Jay Groen	61	Director, Chairman of the Board of Directors
Dennis P. Gauger	53	Director, Chief Financial Officer, Secretary

#### Term of Office

The appointment of Messrs. Groen as members of the Board of Directors was ratified and approved by the stockholders at a meeting for that purpose on May 20, 2000. Mr. Gauger was appointed a member of the Board of Directors on January 22, 2004. The terms of service of Messrs. Groen and Mr. Gauger as members of the Board of Directors continue until the next annual meeting of the stockholders. With the exception of compliance with the duties of a director as set forth in the Articles of Incorporation or By-laws of the Company or in the provisions of the Utah Business Corporation Act, there are no arrangements or understandings pursuant to which any of the foregoing persons were selected to serve on the Board of Directors of the Company. Each of the foregoing persons consented to serve as a director of the Registrant prior to their designation or subsequent election as such.

#### Family Relationships

H. Jay Groen and David L. Groen are brothers.

#### Background on Directors and Executive Officers

**David L. Groen** As a founder of Groen Brothers Aviation, David Groen has performed in an executive management role for twenty years, nearly a decade and a half of which as its President and Chief Executive Officer. David and his brother Jay grew the company from just the two of them in 1986 to more than 130 people by 2001, all the while developing and re-discovering the science of autorotative flight. They have weathered the severe economic down turn cause by the “Tech Sector” crash, made even worse by the events of 9/11, and yet continued moving the science forward. Following 9/11, the Company experienced a reduction in its work force of more than 100 people through layoffs, but has now grown the Company back to nearly 60 full time and part time employees divided between its Salt Lake City, Utah and Buckeye, Arizona facilities. They have brought the Company to where it is now poised for expansion while fully exploiting the technology of autorotative flight.

Immediately prior to forming Groen Brothers Aviation, David Groen was a founding partner and Chief Financial Officer for Seagull Recycling Company. Previously, he has held numerous

executive positions in the helicopter industry with Sales and Marketing, Safety Officer, Branch Manager, and Chief Pilot responsibilities.

Having extensive military and commercial experience in helicopters, Mr. Groen has logged over 7,000 hours in rotor-wing and fixed-wing aircraft. Mr. Groen received his Certificate of Graduation in 1970 from the U.S. Army Warrant Officer Flight Training School, was awarded Army Aviator Wings and promoted to the rank of Warrant Officer. As a combat helicopter pilot and Aircraft Commander in Vietnam, he flew hundreds of combat sorties. He is qualified as a pilot in most American and French helicopters, and has attended Aerospatiale factory schools.

Over the years, Mr. Groen's numerous commercial helicopter missions have involved such work as EMS (emergency medical service hospital air ambulance), power line construction and patrol, topographical survey, USGS map making, wildlife management, predator control, herd management, back country tour guides, heli-skiing, forest fire fighting, long line seismic oil exploration, and wildcat on shore and off shore oil drilling operations.

These years of commercial flying, added to his tenure serving in management positions within the rotor-wing industry, gave Mr. Groen a wealth of management and leadership experience in a variety of related fields. David Groen is co-author, along with his brother Jay, of a best selling novel entitled Huey.

**H. Jay Groen** In addition to his Chairman of the Board duties, Jay Groen is currently based in Washington D.C., representing Groen Brothers Aviation's interests to Congress and the Pentagon. Amongst his many successes, GBA has received special recognition by the US Senate's Homeland Defense Industries Small Business Development Program and by the Aerospace Industries Association who published in their 2002 annual report that, "What the Wright Brothers have done for fixed wing aviation, the Groen Brothers are doing for rotor-wing aviation," a complement from the nation's most important organization representing the interest of the aerospace industry.

Before Jay and his brother David formed GBA, Jay Groen co-founded Seagull Recycling Company, an organization that developed an original supply of secondary paper fiber for sale to domestic and Far East markets. Prior to this business venture, he was the President of China West, Inc., a Washington D.C. based organization representing U.S. firms in the Peoples Republic of China. In this role, Mr. Groen negotiated joint venture and trade agreements in such diverse industries as machine building, petroleum, coal, agriculture, light manufacturing, handicrafts, and forest products.

Early in his career, Mr. Groen spent ten years as an Economist for the Central Intelligence Agency (CIA) doing original research on Asia, with a particular interest on the People's Republic of China. As part of his responsibilities with the CIA, Mr. Groen prepared written and oral briefs for the White House staff and members of Congress, and lectured at the National War College. Mr. Groen served in the U.S. Air Force as a Chinese Linguist in both Vietnam and Asia, logging more than 100 combat missions in a special airborne intelligence function.

Mr. Groen is the co-author, along with his brother David, of a best selling book entitled Huey, a novel about the Vietnam War. He has also published several other writings including: 1) "The Sweet and Sour China Market", China Under Four Modernizations; and, 2) "Buying from China", U.S.-China Economic Relations: A reappraisal.

Mr. Groen has an M.A. in Economics from Virginia Polytechnic Institute, a B.A. in Economics from the University of Utah and a Language Certificate in Mandarin Chinese from Yale University. A private pilot with a practical background in aeronautical design, Mr. Groen has added much innovation to the Hawk Gyroplane.

**Dennis P. Gauger, CPA** Dennis P. Gauger, Certified Public Accountant, has over 28 years of experience as a financial executive, corporate troubleshooter and consultant, and accounting and auditing professional. His professional background includes 21 years of service in three offices of Deloitte & Touche, a "Big Four" international accounting firm, including 9 years as an accounting and auditing partner, and seven years operating his own Certified Public Accounting firm specializing in contract financial and executive management.

As a Deloitte partner, Mr. Gauger directed domestic and international firm interactions with senior executive management, audit committees and boards of directors relating to audited financial statements, SEC accounting and reporting, initial public offerings, mergers and acquisitions, technical accounting issues, cost accounting, internal controls, employee benefit plans, corporate governance, financing, cash management, and operations. Since leaving Deloitte, Mr. Gauger has completed both short and long-term engagements as a corporate troubleshooter, "turn around" specialist, financial consultant and analyst, compliance officer, and chief financial officer for a variety of public and privately-owned companies. He has experience in a wide variety of industries, including manufacturing, high technology, software, Internet, retail and distribution, financial services, hospitality, mining, telecommunications and real estate.

Mr. Gauger serves as part-time, contract Chief Financial Officer for two other public companies. He is a licensed Certified Public Accountant in the states of Utah and Nevada, and a member of the American Institute of Certified Public Accountants and the Utah Association of Certified Public Accountants. He graduated with honors from Brigham Young University with a BS degree in accounting.

### **Communications Between Shareholders and the Board of Directors**

The Board of Directors of the Company has not adopted a formal procedure that shareholders must follow to send communications directly to it. The Board of Directors does receive communication from shareholders, from time to time, and addresses those communications as appropriate. Shareholders can send communication to the Board of Directors in one of the following ways:

- In writing, to Groen Brothers Aviation, Inc., 2640 West California Avenue, Suite A, Salt Lake City, Utah 84104, Attention of Board of Directors
- By Email, at [directors@gbagyros.com](mailto:directors@gbagyros.com).

The Company did not hold an annual meeting of shareholders during the fiscal year ended June 30, 2005.

## **Officers of Subsidiary Corporations**

As stated earlier, the Company has a wholly-owned subsidiary, Groen Brothers Aviation USA, Inc. Robert (Robin) H. H. Wilson currently serves as Executive Vice President of Groen Brothers USA, Inc. and a member of that company's Board of Directors. A background on Mr. Wilson follows:

**Robin H.H. Wilson** has had a long and prominent career in aviation. He is a native of Ireland, but began his career with Rolls-Royce Aero-Engines in England, where he worked as an engineer for eight years, obtaining his Engineering degree from Cambridge University. During this period he was a section leader on the development of the Tyne engine intended among other applications as the powerplant for the Fairey Rotodyne, a large commercial gyrodyne.

Mr. Wilson left Rolls-Royce to attend graduate school, obtaining an MBA with High Distinction from Harvard University. From Harvard he joined TWA as a Financial Analyst, where over the following seventeen years he held several Vice President positions across many functional areas, including Planning, Marketing, Maintenance and Engineering and finally Senior Vice President, Operations. He left TWA to become President of the Long Island RailRoad, the nation's oldest and largest passenger carrying railroad. His 3½ years in this position were marked by significant improvement in the railroad with a commendation by the NY State legislature for outstanding performance.

Mr. Wilson returned to aviation as President of Western Airlines, where he participated in the build up of its Salt Lake City hub as part of the team that managed the major turnaround of that carrier and merger with Delta. Later, he was appointed President of Burlington Air Express, before returning to Ireland, as Chief Technical Officer of Guinness Peat Aviation, then the world's largest aircraft leasing company.

Following TWA's Chapter 11 filing in 1992, Mr. Wilson was asked to return to TWA as Co-Chief Executive to take the company out of bankruptcy. When this was accomplished, he remained as Vice Chairman until new management was recruited. He then became a partner in the international aviation consultancy, SH&E, advising Governments, Banks, Airlines and other parties on aviation matters over a five-year period.

In August 2001 he joined Groen Brothers Aviation as Chief Financial Officer and Head of Business Development. Late in 2003, he took on added responsibility for GBA and AAI Marketing and Sales, while relinquishing his CFO role.

James P. Mayfield III, who previously served as a non-executive officer Vice President of Groen Brothers Aviation USA, Inc., resigned effective January 18, 2005.

## **Section 16(a) Beneficial Ownership Reporting Compliance**

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires the directors and executive officers of the Company, and persons who own more than 10% of a registered class of the Company's equity securities, to file initial reports of ownership and reports of changes in ownership with the SEC. Such persons are required by SEC regulations to furnish the Company with copies of all Section 16(a) forms they file.

Based solely on the review of the copies of such forms received by the Company or written representations from certain reporting persons, that no other reports were required, management of the Company believes that all filing requirements applicable to its officers, directors, and greater than 10% beneficial owners were complied with during the year ended June 30, 2005 with the exception of two Form 4 reports which were filed late by Jay Groen and were related to private transfers of common stock not transacted in the open market.

### Committees of the Board of Directors

The three members of the Company's Board of Directors, none of whom is deemed independent, currently serve as the Audit Committee and Compensation Committee of the Board.

The Audit Committee reviews internal accounting and financial practices and controls, as well as all services performed by the Company's independent auditors, including recommending the selection of the independent auditors. The Audit Committee has not adopted a written charter. The Company's Board of Directors has determined that Dennis P. Gauger is an "audit committee financial expert," as that term is defined by the rules and regulations of the Securities and Exchange Commission.

### Code of Ethics

The Company has adopted Standards of Conduct applicable to all employees and a Statement of Corporate Values, also applicable to all employees. Copies of the Standards and the Statement were filed as Exhibit 14.2 and 14.1, respectively, to the Company's Annual Report on Form 10-KSB for fiscal year 2004 and are also available on the Company's web site.

### Item 10. Executive Compensation

Set forth below is information concerning the annual and long-term compensation for services in all capacities to the Company for the years ended June 30, 2004, 2003 and 2002 for the President and Chief Executive Officer (the "Named Executive Officer").

Name and Position	Year	Annual Compensation			Long-Term Compensation		
		Salary (1) \$	Bonus \$	Other Annual Compensation \$	Restricted Stock Awards \$	Securities Underlying Options #	All Other Compensation (2) \$
David Groen	2005	103,404	-	-	-	4,925,000	1,151
President and Chief	2004	95,000	-	-	-	50,000	110
Executive Officer	2003	95,000	-	-	-	2,500,000	238

(1) Represents annual salary for the fiscal year. Unpaid back salary included in these amounts payable to Mr. Groen at June 30, 2005 included \$71,250 for fiscal year 2005, \$58,462 for fiscal year 2004 and \$18,269 for fiscal year 2003.

(2) Includes matching contributions made by the Company on behalf of Mr. Groen pursuant to the Company's Profit Sharing 401(k) Plan.

At June 30, 2005, unpaid back wages from the past three fiscal years payable to David Groen were \$147,981. Unpaid back wages from the past three fiscal years payable to another officer were \$169,308 at June 30, 2005.

The Company does not have written employment agreements with its executive officers.

Jay Groen is not an employee of the Company, but is paid consulting fees for services rendered as a member of the Board of Directors of the Company and as the Company's representative in Washington DC, currently at \$95,000 per year. At June 30, 2005, unpaid consulting fees to Jay Groen for the past several years were \$312,945. The Company does not have a written consulting agreement with Jay Groen.

In addition to cash compensation, the Company has a deferred compensation arrangement for executive officers and certain of its senior management that accrues additional salary. The terms of the Company's Series B 15% Preferred Stock preclude the Company from making any deferred compensation payments until all outstanding amounts due relating to the Series B 15% Preferred Stock have been paid in full. Therefore, deferred compensation totaling \$3,010,000, related accrued payroll taxes of \$131,000 and related accrued interest payable of \$383,000 are classified as long-term liabilities at June 30, 2005. Absent payment restrictions related to outstanding Series B 15% Preferred Stock or other restrictions, the deferred compensation is payable in part or in whole only by resolution of the Company's Board of Directors. Through June 30, 2005, the Board of Directors has not authorized payment of any of the deferred compensation, and will not authorize payments until the Board determines such payments are allowed under the Company's outstanding financing agreements and would be prudent in light of the Company's financial condition and availability of cash. In fiscal year 2001, the Company began accruing interest expense on the deferred compensation at the rate of 8% per annum. The accrual of interest was permanently discontinued on July 1, 2004. At June 30, 2005, deferred compensation and related interest accrued to executive officers, resulting from accruals originating from fiscal years 1998 through 2005, amounted to \$1,408,565 to David Groen, \$460,251 to Jay Groen for years when he was an employee, \$538,297 to Robin Wilson, and \$45,833 to Dennis Gauger.

**Option/SAR Grants in Fiscal Year 2005**

The following table sets forth as to the Named Executive Officer certain information with respect to options to purchase shares of the Company's common stock granted during fiscal year 2005.

<b>Name</b>	<b>Number of Securities Underlying Options/SARS Granted #</b>	<b>% of Total Options/SARS Granted to Employees in Fiscal Year 2005</b>	<b>Exercise or Base Price (\$/Share)</b>	<b>Expiration Date</b>
David Groen	4,925,000	21.18%	0.25 – 1.00	10/19/09

**Aggregated Option/SAR Exercises in Last Fiscal Year and Fiscal Year End Option/SAR Values**

The following table sets forth the aggregate value of unexercised options to acquire shares of common stock held by the Named Executive Officer on June 30, 2005. There were no options exercised by the Named Executive Officer during the year ended June 30, 2005.

<b>Name</b>	<b>Shares Acquired on Exercise #</b>	<b>Value Realized \$</b>	<b>Number of Securities Underlying Unexercised Options/SARs at FY-End (#) Exercisable/Unexercisable</b>	<b>Value of Unexercised In-the-Money Options/SARs at FY-End (\$) Exercisable/Unexercisable (1)</b>
David Groen	-	-	5,041,667 / 4,958,333	100,000 / -

- (1) Reflects the difference between the exercise price of the options granted and the value of the common stock on June 30, 2005. The closing price of the Company's common stock was \$0.19 per share on June 30, 2005.

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

The following tabulation shows, as of September 30, 2005, the number of shares of common stock, no par value, and the number of shares of Series A preferred stock owned beneficially by: (a) all persons known to be the holders of more than five percent (5%) of voting securities, (b) Directors, (c) the Named Executive Officer and (d) all other Executive Officers and Directors as a group:

<u>Name and Address of Beneficial Owner</u>	<u>Amount and Nature of Beneficial Ownership (1)</u>					
	<u>Common Shares</u>		<u>Series A Preferred Shares</u>		<u>Total Voting Shares (6)</u>	
	<u>Shares</u>	<u>%</u>	<u>Shares</u>	<u>%</u>	<u>Shares</u>	<u>%</u>
David Groen 2640 W. California Ave., Ste. A Salt Lake City, Utah 84104	18,880,884	(2) 12.3	900,000	64.3	108,880,884	37.1
Jay Groen 2640 W. California Ave., Ste. A Salt Lake City, Utah 84104	11,003,470	(3) 7.2	500,000	35.7	61,003,470	20.8
Dennis P. Gauger 2640 W. California Ave., Ste. A Salt Lake City, Utah 84104	1,216,667	(4) 0.8	-	-	1,216,667	0.4
Robert H. H. Wilson 2640 W. California Ave., Ste. A Salt Lake City, Utah 84104	4,050,000	(5) 2.6	-	-	4,050,000	1.4
All officers and directors as a group (4 persons)	35,151,021	22.9	1,400,000	100.0	175,151,021	59.7

- (1) Unless otherwise indicated, each person identified in the table has sole voting and investment power with respect to the common stock beneficially owned by such person. The total number of outstanding shares included in the computation of percentages is 118,123,368 plus 22,250,001 options which are exercisable by executives and directors within 60 days.
- (2) Includes 8,452,884 shares owned by David Groen, 2,103,000 shares beneficially owned held by family trusts and 8,325,000 options exercisable by David Groen.
- (3) Includes 4,547,645 shares owned by Jay Groen, 14,158 shares beneficially owned held by family trusts and 6,441,667 options exercisable by Jay Groen.
- (4) Includes 50,000 shares owned by Dennis Gauger and 1,166,667 options exercisable by Dennis Gauger.
- (5) Includes 300,000 shares owned by Robin Wilson, 100,000 shares beneficially owned held by family trusts and 3,650,000 options exercisable by Robin Wilson.
- (6) Each share of Series A preferred stock entitles the holder to cast one hundred (100) votes on all matters submitted to the stockholders for a vote, voting together with the holders of the common stock as a single class.

David Groen, President and Chief Executive Officer, owns 900,000 shares of the Company's Series A Convertible Preferred Stock, and Jay Groen, Chairman of the Board of Directors, owns 500,000 shares of the Company's Series A Convertible Preferred Stock, combined representing 100% of the outstanding shares of that series of preferred stock. Each share of the Series A Convertible Preferred Stock entitles the holder to cast one hundred (100) votes, or a total of 90,000,000 and

50,000,000 votes, respectively, on all matters submitted to the stockholders for a vote, voting together with the holders of the common stock of the Company as a single class.

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

Voting control by one of the Company's founders, David Groen, had existed from November 7, 2000 by means of shares of Series A Preferred Stock issued to him in exchange for a note receivable. The note receivable matured in November 2003, and Mr. Groen surrendered all Series A Preferred Stock in cancellation of the note. The Board of Directors and management of the Company believed that the continuity of voting control by one or both of the founders of the Company was crucial to the ongoing operations and growth of the Company.

On October 8, 2004, the Company amended and restated its Articles of Incorporation to change the rights and terms of its Series A Convertible Preferred Stock. On October 8, 2004, the Board of Directors approved the issuance of 1,400,000 shares of Series A Convertible Preferred Stock to the Company's founders: 900,000 shares to David Groen, President and Chief Executive Officer, and 500,000 shares to Jay Groen, Chairman of the Board of Directors, at a purchase price of \$0.05 per share, or total consideration of \$70,000. The amended rights, terms and preferences of the Series A Convertible Preferred Stock are summarized as follows:

- Each share may cast one hundred (100) votes on all matters submitted to the stockholders for a vote, voting together with the holders of the common stock of the Company as a single class, effectively giving current voting control to the Company's founders.
- The voting rights expire seven years from the date of issue.
- Upon, and only upon, the Company reaching significant revenue milestones, the shares are convertible into common stock of the Company through payment of a cash conversion price of \$0.50 per share of common stock, convertible on a one-for-one hundred (1:100) basis (100 shares of common stock for each share of Series A Convertible Preferred Stock). Conversion is allowed at the rate of 25% of the preferred shares for each \$30 million in defined cumulative gross sales, for a total of \$120 million in sales. This convertibility is also only available if these significant revenue milestones are met within seven years from the date of issue of the Series A Convertible Preferred Stock.
- The shares, including all voting and conversion rights, to the extent not converted into common shares, will expire seven years from the date of issue, and will be cancelled by the Company.
- Upon the death or permanent incapacity of a holder of Series A Convertible Preferred Stock, all shares held by such holder will be divided between the then existing members of the Company's Board of Directors on a pro-rata basis, based upon the number of months they have served on the Board, with the holder's survivor(s) (if more than one person, treated collectively as one person) being included in the same pro-rata basis, crediting the survivor's "months served" as those of the deceased or permanently mentally incapacitated holder. Upon a temporary mental incapacity of a holder of Series A Convertible Preferred Stock, all shares will be voted by the remaining holders of the Series A Convertible Preferred Stock until the end of the temporary incapacity.

- The shares are non-transferable, non-assignable, and have no dividend or liquidation rights.

The value of \$.05 per share was assigned to the Series A Preferred Stock by the Company's Board of Directors after evaluating several factors, including those listed above relating to limitations on the transferability of the shares, the limited life of the voting rights, the significant revenue milestones to be met before conversion to common stock can occur, and the absence of dividend or liquidation rights.

At June 30, 2005, the Company had a note payable, originating in 1990, of \$180,000, plus accrued interest of \$122,086, due to a company owned by David and Jay Groen.

At June 30, 2005, the Company had unsecured notes receivable from officers and related parties, resulting primarily from cash advances, totaling \$31,000, bearing interest at 8% and due on demand. These notes receivable totaled \$48,000 at June 30, 2004. The Company has implemented a procedure to reduce these notes receivable each quarter by offsetting amounts due to the officers by the Company for accrued compensation and interest expense.

Royalty payments of 1% of the gross sales price of gyroplanes are to be paid to the Company's founders, David and Jay Groen. Through June 30, 2005, royalties payable totaled \$6,000 to each of these individuals, which amounts are included in cost of sales in the accompanying consolidated statement of operations for the year ended June 30, 2005. No royalties were recorded in fiscal year 2004.

Included in accrued expenses in the consolidated balance sheet at June 30, 2005 is \$3,010,000 in deferred compensation to ten management employees, including officers and directors of the Company, with amounts originating from fiscal year 1998 through fiscal year 2005.

In addition to cash compensation, the Company has a deferred compensation arrangement for executive officers and certain of its senior management that accrues additional salary. The terms of the Company's Series B 15% Preferred Stock preclude the Company from making any deferred compensation payments until all outstanding amounts due relating to the Series B 15% Preferred Stock have been paid in full. Therefore, deferred compensation totaling \$3,010,000, related accrued payroll taxes of \$131,000 and related accrued interest payable of \$383,000 are classified as long-term liabilities at June 30, 2005. Absent payment restrictions related to outstanding Series B 15% Preferred Stock or other restrictions, the deferred compensation is payable in part or in whole only by resolution of the Company's Board of Directors. Through June 30, 2005, the Board of Directors has not authorized payment of any of the deferred compensation, and will not authorize payments until the Board determines such payments are allowed under the Company's outstanding financing agreements and would be prudent in light of the Company's financial condition and availability of cash. In fiscal year 2001, the Company began accruing interest expense on the deferred compensation at the rate of 8% per annum. The accrual of interest was permanently discontinued on July 1, 2004.

At June 30, 2005, the Company had notes payable to related parties, primarily stockholders of the Company, totaling \$6,570,000. Most of these notes are unsecured, due on demand, and bear interest at annual rates ranging from 8% to 25%. Included in these notes payable at June 30, 2005 are two notes payable to stockholders totaling \$422,000 that are payable in monthly payments and that are in default. Also included in these notes payable at June 30, 2005 are capital lease obligations to a finance company owned by stockholders of the Company totaling \$660,000 that are in default. See Notes 8 and 10 to the accompanying consolidated financial statements.

At June 30, 2005, the Company had long-term notes payable to two stockholders totaling \$361,000. See Note 9 to the accompanying consolidated financial statements.

At June 30, 2005, the Company had accrued interest expense to related parties totaling \$2,844,000, comprised of interest payable on the notes payable to related parties.

**Item 13. Exhibits and Reports on Form 8-K.**

(a) Exhibits

- 3.1 Amendment to Second Restated Articles of Incorporation of Groen Brothers Aviation, Inc. (1)
- 3.2 Second Amendment to Second Restated Articles of Incorporation of Groen Brothers Aviation, Inc. (1)
- 3.3 Third Restated Articles of Incorporation of Groen Brothers Aviation, Inc. (2)
- 3.4 Amendment to Third Restated Articles of Incorporation of Groen Brothers Aviation, Inc. (3)
- 3.5 Second Amendment to Third Restated Articles of Incorporation of Groen Brothers Aviation, Inc. (this filing)
- 3.6 By-laws (this filing)
- 4.1 Amended and Restated 2000 Option Plan (6)
- 10.1 Amendment to the Common Stock Purchase Agreement Dated November 7, 2000 (2)
- 10.2 Form of SparrowHawk Dealer Agreement (this filing)
- 10.3 Form of Amendment No. 2 to Securities Exchange Agreement (this filing)
- 10.4 Form of Stock Option (this filing)
- 11 Statement re:computation of per share earnings. (4)
- 14.1 Groen Brothers Aviation Corporate Values (2)
- 14.2 Standards of Conduct (2)
- 19.1 Notice of Action to be Taken Pursuant to the Joint Written Consent of the Board of Directors and Majority Stockholders in Lieu of a Special Meeting of the Stockholders (5)

- 21 Subsidiaries of the small business issuer. (4)
- 23 Independent Auditors' Consent (this filing).
- 31.1 Certification of Principal Executive Officer required by Rule 13a-14(a) (this filing).
- 31.2 Certification of Principal Financial Officer required by Rule 13a-14(a) (this filing).
- 32.1 Certification of Principal Executive Officer required by Rule 13a-14(b) and 18 U.S.C. 1350 (this filing).
- 32.2 Certification of Principal Financial Officer required by Rule 13a-14(b) and 18 U.S.C. 1350 (this filing).

- (1) Filed as exhibits to the Company's report on Form 10-QSB for the quarter ended December 31, 2003 and incorporated herein by reference.
- (2) Filed as exhibits to the Company's report on Form 10-KSB for the year ended June 30, 2004 and incorporated herein by reference.
- (3) Filed as an exhibit to the Company's report on Form 10-QSB for the quarter ended December 31, 2004 and incorporated herein by reference.
- (4) Information included in Notes to Consolidated Financial statements filed with this report.
- (5) Included in Definitive Information Statement on Schedule 14C filed with the Securities and Exchange Commission on December 10, 2004 and incorporated herein by reference.
- (6) Filed as an exhibit to the Company's registration statement on Form S-8 file June 10, 2005 and incorporated herein by reference.

(b) The Company did not file any reports on Form 8-K during the fourth quarter of the year ended June 30, 2005.

**Item 14. Principal Accountant Fees and Services**

The following schedule presents the professional fees paid to Tanner LC, the Company's independent auditors, for the fiscal years ended June 30, 2005 and 2004.

	<b>2005</b>	<b>2004</b>
Audit fees	\$ 47,653	\$ 31,175
Audit related fees	21,618	16,315
Tax fees	160	5,200
Other fees	-	-
	<hr/>	<hr/>
Total	<u>\$ 69,431</u>	<u>\$ 52,690</u>

Audit related fees were for services related to the review of periodic reports of the Company, including Forms 10-QSB and 10-KSB. Tax fees were for preparation of federal and state income tax returns and related tax consultation. No other fees were incurred to Tanner LC during 2005 and 2004.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the small business issuer has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

GROEN BROTHERS AVIATION, INC.

/s/ David Groen

David Groen, President and Chief Executive Officer  
(Principal Executive Officer)

Date: October 13, 2005

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

<u>Signatures</u>	<u>Capacity in Which Signed</u>	<u>Date</u>
<u>/s/ David Groen</u> David Groen	President and Chief Executive Officer (Principal Executive Officer)	October 13, 2005
<u>/s/ Dennis P. Gauger</u> Dennis P. Gauger	Chief Financial Officer and Secretary (Principal Financial Officer)	October 13, 2005
<u>/s/ Jay Groen</u> Jay Groen	Director	October 13, 2005

**GROEN BROTHERS AVIATION, INC.**  
**Index to Consolidated Financial Statements**

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

### To the Board of Directors and Stockholders of Groen Brothers Aviation, Inc.

We have audited the consolidated balance sheet of **Groen Brothers Aviation, Inc.** (the Company) as of June 30, 2005, and the related consolidated statements of operations, stockholders' deficit and cash flows for the years ended June 30, 2005 and 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of **Groen Brothers Aviation, Inc.**, as of June 30, 2005, and the results of its operations and its cash flows for the years ended June 30, 2005 and 2004, in conformity with accounting principles generally accepted in the United States of America.

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

**TANNER LC**

Salt Lake City, Utah  
September 30, 2005, except for Note 21, which is dated October 11, 2005

**GROEN BROTHERS AVIATION, INC.**  
**Consolidated Balance Sheet**

<u>Assets</u>	<u>June 30, 2005</u>
Current assets:	
Cash	\$ 70,000
Accounts receivable	49,000
Related party notes receivable	32,000
Prepaid expenses	4,000
Inventories	395,000
	395,000
Total current assets	550,000
Property and equipment, net	291,000
	291,000
Total assets	\$ 841,000
<u>Liabilities and Stockholders' Deficit</u>	
Current liabilities:	
Accounts payable	\$ 942,000
Accrued expenses	4,149,000
Deferred revenue	588,000
Notes payable	779,000
Related party notes payable	6,570,000
Put option liability	1,515,000
	1,515,000
Total current liabilities	14,543,000
Long-term liabilities:	
Accrued expenses	3,524,000
Deferred revenue	25,000
Related party long-term debt	361,000
Related party deposits	2,145,000
Series B 15% cumulative redeemable non-voting preferred stock, no par value, 50,000,000 shares authorized, 35,199 shares issued and outstanding	33,009,000
	33,009,000
Total liabilities	53,607,000
Stockholders' deficit:	
Series A convertible preferred stock, no par value, 50,000,000 shares authorized, 1,400,000 shares issue and outstanding	70,000
Common stock, no par value, 500,000,000 shares authorized, 130,424,172 shares issued and outstanding	23,590,000
Accumulated deficit	(76,426,000)
	(76,426,000)
Total stockholders' deficit	(52,766,000)
Total liabilities and stockholders' deficit	\$ 841,000

See accompanying notes to consolidated financial statements.

**GROEN BROTHERS AVIATION, INC.**  
**Consolidated Statements of Operations**

	Years Ended June 30,	
	<u>2005</u>	<u>2004</u> <u>As Restated</u>
Revenues	\$ 864,000	\$ 509,000
Costs and expenses:		
Cost of sales	1,237,000	495,000
Research and development	1,874,000	1,796,000
General and administrative expenses	1,923,000	1,697,000
Total costs and expenses	5,034,000	3,988,000
Loss from operations	(4,170,000)	(3,479,000)
Other income (expense):		
Related party interest income	8,000	9,000
Interest and other income	25,000	170,000
Interest expense	(1,214,000)	(1,583,000)
Series B preferred stock interest expense	(8,003,000)	(7,639,000)
Total other income (expense)	(9,184,000)	(9,043,000)
Loss before income taxes	(13,354,000)	(12,522,000)
Income tax benefit	-	-
Net loss	\$ (13,354,000)	\$ (12,522,000)
Issuance of put option	-	(1,448,000)
Net loss applicable to common stockholders	\$ (13,354,000)	\$ (13,970,000)
Net loss per share – basic and diluted	\$ (0.11)	\$ (0.14)
Weighted average number of common shares outstanding – basic and diluted	116,597,000	101,369,000

See accompanying notes to consolidated financial statements.

**GROEN BROTHERS AVIATION, INC.**  
**Consolidated Statements of Stockholders' Deficit**  
**Years Ended June 30, 2005 and 2004**

	Series B 15%		Series A Convertible		Series A Convertible Preferred Stock	Common Stock		Accumulated	Total
	Cumulative Redeemable		Preferred Stock		Subscription	Common Stock		Deficit	
	Non-Voting Preferred Stock	Non-Voting Preferred Stock	Preferred Stock	Preferred Stock	Subscription	Shares	Amount	Deficit	
	Shares	Amount	Shares	Amount	Receivable	Shares	Amount	Deficit	Total
<b>Balance, July 1, 2003</b>	18,443	\$ 19,964,000	10,000,000	\$ 2,717,000	\$(2,717,000)	98,819,978	\$ 14,938,000	\$(50,550,000)	\$(15,648,000)
Reclassify Series B preferred stock to debt per SFAS 150	(18,443)	(19,964,000)	-	-	-	-	-	-	(19,964,000)
Capital contribution of Series B preferred stock premium accretion	-	-	-	-	-	-	4,844,000	-	4,844,000
Accrued interest on subscription receivable	-	-	-	43,000	(43,000)	-	-	-	-
Surrender of Series A preferred stock	-	-	(10,000,000)	(2,760,000)	2,760,000	-	-	-	-
Issuance of common stock for:									
Cash	-	-	-	-	-	6,843,413	1,368,000	-	1,368,000
Finders' compensation	-	-	-	-	-	81,500	-	-	-
Accounts payable	-	-	-	-	-	830,473	180,000	-	180,000
Notes payable	-	-	-	-	-	312,659	63,000	-	63,000
Collateral for notes payable	-	-	-	-	-	900,000	-	-	-
Interest expense	-	-	-	-	-	601,254	124,000	-	124,000
Return of deposits	-	-	-	-	-	1,583,625	317,000	-	317,000
Employer 401(k) expense	-	-	-	-	-	340,841	68,000	-	68,000
Settlement of put option	-	-	-	-	-	6,125,000	-	-	-
Issuance of put option	-	-	-	-	-	-	(1,448,000)	-	(1,448,000)
Finders' compensation	-	-	-	-	-	-	(36,000)	-	(36,000)
Issuance of stock options for:									
Interest expense	-	-	-	-	-	-	391,000	-	391,000
Accounts payable	-	-	-	-	-	-	50,000	-	50,000
Net loss	-	-	-	-	-	-	-	(12,522,000)	(12,522,000)
<b>Balance, June 30, 2004</b>	-	\$ -	-	\$ -	\$ -	116,438,743	\$20,859,000	\$(63,072,000)	\$(42,213,000)

See accompanying notes to consolidated financial statements.

**GROEN BROTHERS AVIATION, INC.**  
**Consolidated Statements of Stockholders' Deficit** *Continued*  
**Years Ended June 30, 2005 and 2004**

	Series B 15%		Series A Convertible		Series A	Common Stock		Accumulated	Total
	Cumulative Redeemable		Preferred Stock		Convertible			Deficit	
	Non-Voting Preferred Stock		Preferred Stock		Preferred Stock	Subscription	Shares	Amount	
	Shares	Amount	Shares	Amount	Receivable	Shares	Amount	Deficit	
<b>Balance forward, June 30, 2004</b>	-	\$ -	-	\$ -	\$ -	116,438,743	\$20,859,000	\$(63,072,000)	\$(42,213,000)
Issuance of Series A preferred stock for accrued expenses	-	-	1,400,000	70,000	-	-	-	-	70,000
Issuance of common stock for:									
Cash	-	-	-	-	-	12,574,580	2,515,000	-	2,515,000
Finders compensation	-	-	-	-	-	10,750	-	-	-
Accounts payable	-	-	-	-	-	287,500	57,000	-	57,000
Accrued expenses	-	-	-	-	-	355,125	71,000	-	71,000
Interest expense	-	-	-	-	-	65,109	13,000	-	13,000
Return of deposits	-	-	-	-	-	66,375	13,000	-	13,000
Employer 401(k) expense	-	-	-	-	-	440,990	88,000	-	88,000
Consulting fees	-	-	-	-	-	185,000	32,000	-	32,000
Finders' compensation	-	-	-	-	-	-	(131,000)	-	(131,000)
Issuance of stock options for:									
Interest	-	-	-	-	-	-	61,000	-	61,000
Accounts payable	-	-	-	-	-	-	12,000	-	12,000
Net loss	-	-	-	-	-	-	-	(13,354,000)	(13,354,000)
<b>Balance, June 30, 2005</b>	-	\$ -	1,400,000	\$ 70,000	\$ -	130,424,172	\$23,590,000	\$(76,426,000)	\$(52,766,000)

See accompanying notes to consolidated financial statements.

**GROEN BROTHERS AVIATION, INC.**  
**Consolidated Statements of Cash Flows**

	<b>Years Ended June 30,</b>	
	<b><u>2005</u></b>	<b><u>2004</u></b>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (13,354,000)	\$ (12,522,000)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization expense	117,000	142,000
Common stock issued for interest expense	13,000	124,000
Common stock issued for services	32,000	-
Common stock issued for 401(k) expense	88,000	68,000
Stock options issued for interest expense	73,000	391,000
Interest expense accrued on Series B preferred stock	8,003,000	7,639,000
Interest expense on put option liability	67,000	-
Accrued interest expense added to debt principal	24,000	42,000
Interest income added to related party notes receivable	(9,000)	(13,000)
Gain on disposal of assets	-	(107,000)
(Increase) decrease in:		
Accounts receivable	(32,000)	(36,000)
Prepaid expenses	-	8,000
Inventories	93,000	(396,000)
Increase (decrease) in:		
Accounts payable	158,000	(18,000)
Accrued expenses	1,386,000	500,000
Deferred revenue	(24,000)	406,000
Related party deposits	-	(37,000)
Net cash used in operating activities	(3,365,000)	(3,809,000)
<b>Cash flows from investing activities:</b>		
Purchase of property and equipment	(95,000)	(6,000)
Proceeds from the sale of assets	-	107,000
Issuance of related party notes receivable	-	(23,000)
Payments of related party notes receivable	89,000	-
Net cash provided by (used in) investing activities	(6,000)	78,000
<b>Cash flows from financing activities:</b>		
Proceeds from the issuance of debt	1,126,000	605,000
Repayment of debt	(207,000)	(183,000)
Proceeds from the issuance of Series B preferred stock	-	2,000,000
Proceeds from the issuance of common stock	2,515,000	1,368,000
Payment of finders' compensation on issuance of common stock	(20,000)	(36,000)
Net cash provided by financing activities	3,414,000	3,754,000
Net increase in cash	43,000	23,000
Cash, beginning of year	27,000	4,000
Cash, end of year	\$ 70,000	\$ 27,000

See accompanying notes to consolidated financial statements.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**

**Note 1: Organization and Summary of Significant Accounting Policies**

**Organization and Principles of Consolidation** –Effective November 1, 2004, Groen Brothers Aviation, Inc. (the “Company”) merged American Autogyro, Inc. (“AAI”), a wholly owned subsidiary, into Groen Brothers Aviation USA, Inc. (“GBA-USA”), a wholly owned subsidiary. GBA-USA will continue the manufacturing, sales, marketing, and customer support functions of AAI’s SparrowHawk gyroplane. GBA-USA will be doing business as (d.b.a.) American Autogyro for most of the SparrowHawk operations.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, GBA-USA and, through November 1, 2004, AAI. All significant intercompany balances and transactions have been eliminated. The primary business purpose of the Company is to develop, manufacture and market the gyroplane, which activities are considered one business segment.

**Concentration of Credit Risk** - The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents.

**Cash and Cash Equivalents** – For purposes of the consolidated statements of cash flows, the Company considers all cash and investments with original maturities to the Company of three months or less to be cash equivalents.

**Inventories** – Inventories are stated at the lower of cost or market. Cost is determined using primarily the first-in-first-out (FIFO) method.

**Property and Equipment** – Property and equipment are carried at cost, less accumulated depreciation and amortization. Depreciation and amortization are computed under an accelerated method based on the estimated useful lives of the assets or term of the lease. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed and any resulting gain or loss is recognized in operations for the period. The cost of maintenance and repairs is charged to operations as incurred. Significant renewals and betterments are capitalized.

**Related Party Deposits** - Deposits consist of amounts received from the Company’s authorized dealers on aircraft in anticipation of full-scale production of the Company’s Hawk 4 gyroplane. The deposit guarantees a delivery sequence number and represents a percentage of the total estimated purchase price. The Company has also issued common stock to dealers as partial consideration for the delay in the certification of the Hawk 4 gyroplane. These costs have been charged to interest expense as incurred. The dealers have been given the opportunity to convert a portion of their deposits into shares of the Company’s restricted common stock. As stockholders of the Company, the dealers are considered related parties. The Company continues its efforts to obtain the funding to complete the certification of the Hawk 4. Once such funding is obtained, the Company estimates the certification process will require two to three years to complete. Because of the long-term prospects of obtaining the funding and completing the certification, dealer deposits have been recorded as long-term liabilities.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
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**Impairment of Long-Lived Assets** - The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable through undiscounted future cash flows. If it is determined that an impairment loss has occurred based on expected cash flows, such loss is recognized in the statement of operations.

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

**Stock Options and Stock-Based Compensation** - For stock options granted to employees, the Company utilizes the footnote disclosure provisions of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*. SFAS No. 123 encourages entities to adopt a fair-value based method of accounting for stock options or similar equity instruments. However, it also allows an entity to continue measuring compensation cost for stock-based compensation using the intrinsic-value method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. The Company has elected to continue to apply the provisions of APB 25 and provide pro forma footnote disclosures required by SFAS No. 123 as applicable. Accordingly, no compensation cost has been recognized in the consolidated financial statements for stock options granted to employees. Had compensation cost for the Company's stock option plans been determined based on the fair value at the grant date consistent with the provisions of SFAS No. 123, the Company's net loss and loss per share would have been as indicated below:

	<b>Years Ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
	<b>As Restated</b>	
Reported net loss applicable to common stockholders	\$ (13,354,000)	\$ (13,970,000)
Deduct: Total stock-based employee compensation determined under fair value based method, net of related tax effects	(1,328,000)	(2,058,000)
Pro forma net loss	\$ (14,682,000)	\$ (16,028,000)
Basic and diluted loss per share:		
As reported	\$ (0.11)	\$ (0.14)
Pro forma	\$ (0.13)	\$ (0.16)

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
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The fair value of each option and warrant granted is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	<b>Years Ended June 30,</b>	
	<b>2005</b>	<b>2004</b>
Expected dividend yield	\$ -	\$ -
Expected stock price volatility	59%	66%
Risk-free interest rate	3.5%	2.2%
Expected life of options	1 - 7 years	1 - 7 years

The weighted average fair value of options and warrants granted during 2005 and 2004 was \$0.07 and \$0.08, respectively.

**Research and Development Costs** - Research and development costs are expensed as incurred in accordance with SFAS No. 2, "Accounting for Research and Development Costs." The costs of materials and other costs acquired for research and development activities are charged to expense as incurred. Salaries, wages, and other related costs of personnel, as well as other facility operating costs are allocated to research and development expense through management's estimate of the percentage of time spent by personnel in research and development activities.

**Revenue Recognition** - The Company recognizes revenues from goods and services when there is a binding agreement, the product has been completely shipped or service has been delivered, collection is reasonably assured, and the Company has no significant obligations remaining. Portions of the purchase price of the Company's products collected from customers in advance of product delivery are recorded as deferred revenue. Therefore, revenues from the sale of SparrowHawk gyroplane kits are not recorded until all kit components and parts are delivered to the customer and collection of any remaining amounts due is reasonably assured.

**Financial Instruments with Characteristics of Both Liabilities and Equity** - In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Instruments with Characteristics of Both Liabilities and Equity." This statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. The statement was effective on July 1, 2003 for financial instruments entered into or modified after May 31, 2003, and otherwise effective for existing financial instruments entered into before May 31, 2003. The adoption of SFAS No. 150 resulted in the reporting of the Company's Series B 15% Preferred Stock and a put option obligation as liabilities. The carrying value of the Series B 15% Preferred Stock was the same before and after adoption of SFAS No. 150, and therefore no cumulative effect adjustment was required.

**Put Option Liability** - To comply with SFAS No. 150, the Company estimated the fair value of the put option liability at \$1,515,000 at June 30, 2005 using the Black-Scholes option-pricing model. Until the obligation is satisfied, the Company will continue to use this methodology to periodically reassess the fair value of the put option liability to determine if the carrying value of the liability in the consolidated financial statements requires adjustment, with changes in the fair value recognized as

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
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interest cost. The fair value of the put option liability is inversely related to the fair value of the Company's common stock. Any material changes in the fair value of the Company's common stock may result in material changes in the fair value of the put option liability.

**Non-Employee Stock Options and Warrants** – In accordance with SFAS No. 123, "Accounting for Stock-Based Compensation", the Company estimates the fair value of the consideration recorded for stock options and warrants issued to non-employees using the Black-Scholes option-pricing model. For those stock options and warrants that have variable characteristics, the Company will continue to use this methodology to periodically reassess the fair value of the consideration to determine if the value of the consideration recorded in the consolidated financial statements requires adjustment. Changes in the assumptions used in the option-pricing model, including the market price of the Company's common stock and risk-free interest rates, may result in fluctuations in the estimated fair value and carrying value of the consideration recorded for variable non-employee stock options and warrants.

**Advertising** - Advertising costs are non-direct in nature, and are expensed over the periods in which the advertising takes place. Advertising expense totaled \$7,000 and \$8,000 for the years ended June 30, 2005 and 2004, respectively.

**Income Taxes** - The Company accounts for income taxes according to the asset and liability method. The asset and liability method requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of temporary differences between tax bases and financial reporting bases of existing assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

**Loss per Common and Common Equivalent Share** - The computation of basic loss per common share is computed using the weighted average number of common shares outstanding during each year.

The computation of diluted loss per common share is based on the weighted average number of shares outstanding during the period plus common stock equivalents which would arise primarily from the exercise of stock options and warrants outstanding using the treasury stock method and the average market price per share during the year. Options and warrants to purchase 78,215,921 shares of common stock at exercise prices ranging from \$0.15 to \$1.10 and 49,985,504 shares of common stock at exercise prices ranging from \$0.15 to \$1.41 were outstanding at June 30, 2005 and 2004, respectively. Certain notes payable, long-term debt and related accrued interest payable were convertible into a total of 24,167,515 and 18,344,901 shares of common stock at June 30, 2005 and 2004, respectively, with conversion prices ranging from \$0.20 to \$1.25. Common stock equivalents were not included in the diluted loss per share calculation because the effect would have been antidilutive.

Restricted shares of common stock issued as collateral for notes payable are excluded from the calculation of loss per common share.

**Reclassifications** - Certain amounts in the consolidated financial statements for 2004 have been reclassified to conform with the current year presentation.

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**Notes to Consolidated Financial Statements**  
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**Recently Issued Accounting Pronouncements** - In December 2004, the Financial Accounting Standards Board ("FASB") issued Financial Accounting Standard ("FAS") No. 123(R), *Share-Based Payment*, an amendment of FASB Statements No. 123 and 95. FAS No. 123(R) replaces FAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. This statement requires companies to recognize the fair value of stock options and other stock-based compensation to employees prospectively beginning with the first interim or annual period of the first fiscal year beginning after December 15, 2005 for small business issuers, as deferred by the Securities and Exchange Commission. This means that the Company will be required to implement FAS No. 123(R) no later than the quarter beginning July 1, 2006. The Company currently measures stock-based compensation in accordance with APB Opinion No. 25, as discussed above. The Company anticipates adopting the modified prospective method of FAS No. 123(R) on July 1, 2006. The impact on the Company's financial condition or results of operations will depend on the number and terms of stock options outstanding on the date of change, as well as future options that may be granted. However, the Company believes the adoption of FAS No. 123(R) may have a material effect on the Company's financial position and results of operations.

The FASB has issued FAS Statement No. 154, *Accounting Changes and Error Corrections*. This new standard replaces APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*. Among other changes, Statement 154 requires that a voluntary change in accounting principle be applied retrospectively with all prior period financial statements presented on the new accounting principle, unless it is impracticable to do so. Statement 154 also provides that (1) a change in method of depreciating or amortizing a long-lived nonfinancial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be termed a "restatement." The new standard is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. Early adoption of this standard is permitted for accounting changes and correction of errors made in fiscal years beginning after June 1, 2005. The Company anticipates adopting FAS No. 154 on January 1, 2006, and does not believe the adoption of this new accounting pronouncement will result in a material impact on the Company's financial condition or results of operations.

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**Notes to Consolidated Financial Statements**  
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**Note 2: Going Concern**

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. Because of recurring operating losses, the excess of current liabilities over current assets, the stockholders' deficit, and negative cash flows from operations, there is substantial doubt about the Company's ability to continue as a going concern. The Company's continuation as a going concern is dependent on attaining profitable operations, restructuring its debt obligations, and obtaining additional outside financing. The Company has funded losses from operations in the current year primarily from the issuance of debt and the sale of the Company's restricted common stock in private placement transactions, and will require additional funding from these sources to sustain its future operations. The Company anticipates that the issuance of debt and the sale of the Company's restricted common stock will continue to fund operating losses in the short-term, or until revenues grow to the point where they are sufficient to cover operating costs and expenses.

Operating revenues from the sale of SparrowHawk kit gyroplanes, the Company's primary source of revenues through June 30, 2005, are not currently sufficient, nor will they be sufficient in the near future, to cover operating expenses for the following reasons:

- To date, the Company has experienced a negative gross profit on sales because of the start-up and "learning curve" costs that are normally experienced in the production of a new product.
- The Company projects that as the Company improves its manufacturing capabilities and increases its sales efforts, the negative gross profit on sales will narrow in fiscal year 2006, although there is no assurance that the Company will be successful in reducing the negative gross margin.
- The Company continues to incur significant research and development expenditures related to fully assembled SparrowHawk gyroplane derivatives and to potential applications of the Company's technology to heavy lift vertical take-off military aircraft, runway independent short-haul airliners and other aircraft.
- Marketing and sales efforts continue, but the number of SparrowHawk kits sold is below expectations, due in part to lack of funding to undertake product development and to pay for increased sales and marketing efforts.

The Company will continue to explore larger, untapped markets for fully assembled SparrowHawk gyroplane aircraft, including law enforcement agencies both in the United States and overseas using the SparrowHawk as a surveillance aircraft. The Company believes the margins on these completed aircraft will be substantially higher than on kit gyroplanes. However, through the date of this filing, no sales of fully assembled SparrowHawk gyroplane aircraft to law enforcement agencies have occurred.

The Company does not expect revenues from the sale of Hawk 4 gyroplanes will be realized until the Company completes the Federal Aviation Administration ("FAA") or equivalent international certification of the aircraft. Currently, the Company estimates that approximately \$40 million and a two to three year period will be required to complete the certification. The Company is in discussions with parties that have expressed interest in funding the completion of the certification and commencing the production of the Hawk 4 gyroplane. These discussions are ongoing, and the Company is not in a

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
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position to conclude how likely a favorable outcome to these opportunities is. If one or more of these funding transactions is completed, the Company believes there will be sufficient working capital to fund operating deficits for fiscal year 2006 and for the next 2 to 3 years. In addition, with the announcement of such a funding source, the Company believes prospects will improve to raise equity capital from other sources to fund operations and meet debt obligations. Because of ongoing research and development efforts and the projected costs of certification, the Company does not project that it will have net income or positive cash flows from operations until FAA certification is obtained and sales of Hawk 4 gyroplanes reach planned levels.

The Company does not anticipate that operating costs of personnel, facilities, research and development and sales and marketing will decrease from levels reported for fiscal year 2005, and may increase.

There can be no guarantee or assurance that the Company will be successful in its ability to generate revenue or to raise capital at favorable rates or at all. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

**Note 3: Restatement and Loss Per Common Share**

The computation of basic net loss per common share is computed using the weighted average number of common shares outstanding during each period. The computation of diluted net loss per common share is based on the weighted average number of shares outstanding during the period plus common stock equivalents which would arise from the exercise of stock options and warrants outstanding using the treasury stock method and the average market price per share during the period, as well as common shares issuable upon the conversion of debt and preferred stock to common stock. Common stock equivalents were not included in the diluted loss per share calculation because the effect would have been antidilutive.

The calculation of the weighted average number of common shares outstanding excludes common shares that have been issued as collateral for certain notes payable to related parties (Note 8). These collateral shares are restricted and bear a legend prohibiting the holder from selling or transferring the shares at any time. The Company has assigned no value to these shares, and the terms of the notes payable require the holder of the collateral shares to return the shares to the Company when the applicable note and accrued interest are paid in full. At June 30, 2005, the Company had issued 5,750,000 shares of common stock as collateral.

The calculation of the weighted average number of common shares outstanding previously reported for the year ended June 30, 2004 and prior years did not exclude common shares that have been issued as collateral for certain notes payable to related parties. Therefore, the calculation of net loss per share was not correctly made. The consolidated statement of operations for the year ended June 30, 2004 has been restated to correct the error in reporting the weighted average number of common shares outstanding and the net loss per share as follows.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
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Weighted average number of common shares outstanding – basic and diluted as previously reported	107,119,000
Adjustment	<u>(5,750,000)</u>
Weighted average number of common shares outstanding – basic and diluted as adjusted	<u>101,369,000</u>
Net loss per share – basic and diluted as previously reported	\$ (0.13)
Adjustment	<u>(0.01)</u>
Net loss per share – basic and diluted as restated	<u>\$ (0.14)</u>

**Note 4: Related Party Notes Receivable**

Related party notes receivable, resulting primarily from cash advances, consist of two unsecured notes receivable totaling \$32,000 from officers and shareholders, bearing interest at 8% per annum and due on demand.

**Note 5: Detail of Certain Balance Sheet Accounts**

Inventories consist of the following:

Raw materials and parts	\$ 226,000
Work-in-progress	<u>169,000</u>
	<u>\$ 395,000</u>

Property and equipment consists of the following:

Equipment and tools	\$ 825,000
Computer equipment and software	317,000
Aircraft	120,000
Vehicles	66,000
Leasehold improvements	53,000
Furniture	<u>55,000</u>
	1,436,000
Accumulated depreciation and amortization	<u>(1,145,000)</u>
	<u>\$ 291,000</u>

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
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Accounts payable consist of the following:

Trade accounts payable	\$ 365,000
Related party payables	<u>577,000</u>
	<u><u>\$ 942,000</u></u>

Deferred revenue consists of the following:

Related party customer advance payments	\$ 274,000
Customer advance payments	<u>314,000</u>
	<u><u>\$ 588,000</u></u>

Deposits consist of the following:

Related party dealer deposits	\$1,741,000
Dealer deposits	<u>404,000</u>
	<u><u>\$2,145,000</u></u>

Related parties consist of officers, directors and shareholders.

**Note 6: Accrued Expenses:**

Accrued expenses reported as current liabilities consist of the following:

Compensation and related taxes	\$ 563,000
Related party interest	2,844,000
Interest	497,000
Consulting fees	81,000
Finders' compensation	74,000
Royalties to related parties (Note 19)	12,000
Other	<u>78,000</u>
Total	<u><u>\$ 4,149,000</u></u>

Accrued related party interest payable is comprised of interest expense payable on notes payable to related parties, consisting primarily of stockholders of the Company.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
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Long-term accrued expenses consist of the following:

Deferred compensation	\$ 3,010,000
Accrued payroll taxes on deferred compensation	131,000
Accrued interest on deferred compensation	<u>383,000</u>
Total	<u><u>\$ 3,524,000</u></u>

The deferred compensation is payable to ten officers and directors of the Company, with amounts originating from fiscal year 1998 through fiscal year 2005. In addition to cash compensation, the Company has a deferred compensation arrangement for executive officers and certain of its senior management that accrues additional salary. The terms of the Company's Series B 15% Preferred Stock preclude the Company from making any deferred compensation payments until all outstanding amounts due relating to the Series B 15% Preferred Stock have been paid in full. Therefore, the deferred compensation and related accrued payroll taxes and interest payable are classified as long-term liabilities at June 30, 2005. Absent payment restrictions related to outstanding Series B 15% Preferred Stock or other restrictions, the deferred compensation is payable in part or in whole only by resolution of the Company's Board of Directors. Through June 30, 2005, the Board of Directors has not authorized payment of any of the deferred compensation, and will not authorize payments until the Board determines such payments are allowed under the Company's outstanding financing agreements and would be prudent in light of the Company's financial condition and availability of cash. In fiscal year 2001, the Company began accruing interest expense on the deferred compensation at the rate of 8% per annum. The accrual of interest was permanently discontinued on July 1, 2004.

**Note 7: Notes Payable**

Current notes payable are comprised of the following:

Unsecured notes payable to vendors with interest at 20% for the first three months and 25% thereafter, in default as of June 2005	\$ 291,000
Unsecured note payable to a vendor with interest at 12%, in default as of June 2005	272,000
Unsecured note payable to an individual with interest at 12%, due on demand	89,000
Unsecured note payable to a company with interest at 10.5%, due on demand	10,000
Unsecured note payable to a company with interest at 12%, due on demand	10,000

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**Notes to Consolidated Financial Statements**  
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Unsecured notes payable to a governmental sponsored organization due in monthly installments of 3% of gross monthly revenues, including interest at the prime rate plus 2% (6% at June 30, 2005), in default as of June 2005	100,000
Other unsecured notes payable	7,000
	\$ 779,000

Short-term notes payable at June 30, 2005 include notes payable to vendors and others totaling \$663,000 that is technically in default. In addition, the Company is delinquent in making payments of accrued interest payable of \$460,000 on this debt at June 30, 2005. The Company continues ongoing negotiations with these lenders and has, in most instances, been granted grace periods and extensions without receipt of formal notices of default or threat of legal action.

Certain of these note holders may choose to convert outstanding principal and interest balances to common stock at a price of \$0.20 per share. At June 30, 2005, \$118,000 of principal and interest were convertible into 587,578 shares of the Company's common stock (see Note 13).

**Note 8: Related Party Notes Payable**

Related party notes payable are comprised of the following:

Unsecured notes payable to stockholders with interest at 18%, due on demand	\$ 3,292,000
Unsecured note payable to stockholder with interest at 16%, due on demand	50,000
Unsecured notes payable to stockholders with interest at 12%, due on demand	821,000
Unsecured notes payable to a stockholder with interest at 60%, due on demand	50,000
Unsecured note payable to a stockholder with interest at 25%, in default as of June 30, 2005	21,000
Unsecured note payable to stockholder with interest at 12.5%, due on demand	100,000
Unsecured notes payable to stockholders with interest at 8%, due in the next twelve months or on demand	554,000

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**Notes to Consolidated Financial Statements**  
*(Continued)*

Unsecured note payable to an entity owned by certain members of senior management, with interest at 12%, due on demand	180,000
Note payable to a stockholder with interest at 18%, due on demand, secured by research and development parts	50,000
Notes payable to stockholders with interest at 12%, due on demand, secured by common stock	365,000
Unsecured note payable to a stockholder with interest at 12%, monthly payments of principal and interest of \$11,000 beginning January 2005 through December 2006, in default as of June 2005	224,000
Notes payable to stockholders with interest at 10%, monthly payments of principal and interest ranging from \$2,000 to \$5,000 through September to November 2006, secured by common stock, in default as of June 2005	198,000
Other unsecured note payable	5,000
Capital lease obligations (see Note 10)	660,000
	\$ 6,570,000

Related party notes payable at June 30, 2005 include notes payable and capital lease obligations totaling \$1,103,000 that are technically in default. In addition, the Company is delinquent in making payments of accrued interest payable of \$57,000 on this related party debt at June 30, 2005.

Certain shareholder related party note holders may choose to convert outstanding principal and interest balances to common stock. The prices per share range from \$0.20 per share to \$1.25 per share. At June 30, 2005, \$7,561,000 of principal and interest were convertible into 21,646,246 shares of the Company's common stock (see Note 13).

A total of 5,750,000 shares of the Company's common stock have been issued as collateral for related party notes payable totaling \$563,000 (see Note 3).

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
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**Note 9: Related Party Long-Term Debt**

Related party long-term debt is comprised of the following:

Unsecured related party note payable to a stockholder with interest at 5%, due February 2007	\$ 175,000
Unsecured related party note payable to a stockholder with interest at 12%, due February 2010	<u>186,000</u>
Total	<u><u>\$ 361,000</u></u>

The stockholders may choose to convert outstanding principal and interest balances to common stock at \$0.20 per share. At June 30, 2005, \$382,000 of principal and interest were convertible into 1,910,545 shares of the Company's common stock (see Note 13).

Future maturities of related party long-term debt are as follows:

Years Ending June 30:

2006	\$ -
2007	175,000
2008	-
2009	-
2010	<u>186,000</u>
	<u><u>\$ 361,000</u></u>

**Note 10: Capital Lease Obligations**

The Company has entered into capital lease agreements with a related party financial institution for certain property and equipment and research and development components. The principals of the financial institution are shareholders of the Company who are also considered related parties. Assets held under capital lease and included in property and equipment at June 30, 2005 are as follows:

Shop equipment and tools	\$ 170,000
Accumulated amortization	<u>(125,000)</u>
	<u><u>\$ 60,000</u></u>

Depreciation expense for assets under capital lease is included with depreciation expense for all other depreciable assets.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
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Future minimum lease payments are as follows:

Year Ending June 30:	
2005	\$ 684,000
Less amount representing interest	<u>(24,000)</u>
Present value of minimum lease payments (see Note 8)	<u>\$ 660,000</u>

Under the terms of the capital leases, if a lease is in default the lessor has the ability to declare as due and payable all unpaid rentals under the lease. As of June 30, 2005, all capital leases were in default.

**Note 11: Stockholder Put Options and Put Option Liability**

In September 2000, the Company entered into a Common Stock Purchase Agreement with a stockholder whereby the stockholder purchased from the Company 875,000 shares of the Company's restricted common stock for \$350,000 cash, or \$0.40 per share. In the agreement, the Company granted the stockholder the right to put to the Company, at the stockholder's election, up to 875,000 shares of the common stock at the rate of \$1.60 per share, exercisable on September 28, 2003 or within thirty calendar days thereafter.

During the year ended June 30, 2004, the Company and the stockholder entered into a modified Stock Purchase Agreement to redefine and complete the obligations of the first agreement. Pursuant to the modified agreement, the stockholder put the 875,000 common shares to the Company for an aggregate price of \$1,400,000. The Company issued 6,125,000 shares of restricted common stock in net settlement of the put, with a market value of \$.20 per share, or \$1,400,000 assigned to the shares issued and recorded as an increase to the common stock account. However, the other side of this accounting entry, a debit of \$1,400,000 for the redemption of the 875,000 shares was also recorded to the common stock account. The debit and credit for the same amount in the same account netted to zero with the net result of no value assigned to the transaction in the common stock account. The Company retained an exclusive option through November 15, 2004 and a non-exclusive option from November 16, 2004 through November 15, 2008 to repurchase the 6,125,000 common shares. The exercise price of this option initially was \$0.20 per share, increasing by once cent (\$0.01) per share every four months from November 15, 2003 until July 15, 2008.

In November 2000, the Company entered into a Common Stock Purchase Agreement with the same stockholder whereby the stockholder purchased 750,000 shares of the Company's restricted common stock for \$300,000 cash, or \$0.40 per share. In the agreement the Company granted the stockholder the right to put to the Company, at the stockholder's election, up to 750,000 shares of the common stock at the rate of \$1.60 per share, exercisable on November 7, 2003 or within thirty calendar days thereafter. At the option of the Company, the Company retained the right to redeem up to 750,000 of the shares of common stock from the stockholder at redemption prices of \$1.20 per share prior to November 7, 2002, \$1.40 per share between November 8, 2002 and May 7, 2003 and \$1.60 per share between May 8, 2003 and November 7, 2003.

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During the year ended June 30, 2004, the Company and the stockholder entered into an Amendment to the Common Stock Purchase Agreement Dated November 7, 2000 whereby the Company extended the dates to which the stockholder can exercise the put option and the Company can exercise the option to redeem, and increased both the put prices and the optional redemption prices. As a result, the stockholder has the right to put up to 750,000 shares of common stock of the Company, exercisable on November 7, 2005 or at any time during the three years ending on November 7, 2008. The put price may be paid by the Company in cash or in registered, unrestricted, freely tradable common shares of the Company at \$2.08 per share prior to May 7, 2006, \$2.16 per share between May 7 and November 6, 2006, \$2.25 per share between November 7, 2006 and May 6, 2007, \$2.33 per share between May 7 and November 6, 2007, \$2.41 per share between November 7, 2007 and May 6, 2008, and \$2.50 per share between May 7 and November 7, 2008.

At its option, the Company may redeem up to 750,000 shares of common stock of the Company at any time from December 15, 2003 through November 7, 2005. The redemption price shall be paid in cash at \$1.72 per share prior to May 7, 2004, \$1.84 per share between May 7 and November 6, 2004, \$1.96 per share between November 7, 2004 and May 6, 2005, and \$2.08 per share between May 7 and November 7, 2005.

The Amendment to the Common Stock Purchase Agreement Dated November 7, 2000 was finalized in the fiscal year ended June 30, 2004, therefore the put option is subject to the accounting requirements of Statement of Financial Accounting Standards No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity, which was effective for periods beginning after June 15, 2003. Pursuant to SFAS No. 150, the Company has estimated the value of its obligation under the put option at \$1,515,000 at June 30, 2005 using the Black-Scholes option pricing model. This obligation is recorded as a current liability in the consolidated balance sheet as of June 30, 2005. Until the obligation is satisfied, the Company will continue to use the Black Scholes option pricing model to periodically reassess the fair value of the put option liability to determine if the carrying value of the liability in the consolidated financial statements requires adjustment, with changes in fair value recognized as interest cost. The fair value of the put option liability is inversely related to the fair value of the Company's common stock. Any material changes in the fair value of the Company's common stock may result in material changes in the fair value of the put option liability.

At its option, the Company may redeem up to 750,000 shares of common stock of the Company at any time from December 15, 2003 through November 7, 2005. The redemption price shall be paid in cash at \$1.72 per share prior to May 7, 2004, \$1.84 per share between May 7 and November 6, 2004, \$1.96 per share between November 7, 2004 and May 6, 2005, and \$2.08 per share between May 7 and November 7, 2005.

**Note 12: Preferred Stock**

The Company has authorized 200,000,000 shares of preferred stock having no par value. There are four series of preferred stock with 50,000,000 shares authorized within each series. The rights, terms and preferences of preferred stock are set by the Board of Directors. As of June 30, 2005, the Board of Directors has set rights, terms and preferences of Series B and Series A Preferred Stock for issue.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
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**Series B 15% Preferred Stock**

At June 30, 2005, there were 35,199 shares of Series B 15% Cumulative Redeemable Non-Voting Preferred Stock (the "Series B 15% Preferred Stock") outstanding. The rights, terms, and preferences of the outstanding preferred shares are as follows:

- The shares have no voting rights other than those voting rights provided under applicable laws.
- Each share's original Stated Value, upon which unpaid dividends may accumulate, is \$1,000.
- The shares have right to dividends at a 15% annual dividend rate, payable in cash or in kind at the end of each fiscal quarter. Accumulated but unpaid dividends shall be cumulative and shall be added to the Stated Value for purposes of subsequent quarterly dividend calculations.
- The shares shall have superior liquidation priority to any other series of the Company's capital stock, equal to the Stated Value plus all accrued but unpaid dividends thereon.

In February 2002, a total of 15,000 shares of Series B 15% Preferred Stock with a Stated Value of \$15,000,000 were originally issued in exchange for 12,500,000 shares of common stock and related put options valued at \$5,000,000. Accretion of the difference was computed under the straight-line method over the life of the Series B 15% Preferred Stock.

When originally issued, the Company was obligated on October 31, 2003 to redeem all issued and outstanding shares of the Series B 15% Preferred Stock. The Company had the option to pay the redemption price, for a premium, in registered, unrestricted, shares of common stock of the Company with a redemption price equal to 125% of the Stated Value of the shares of the Series B 15% Preferred Stock plus 125% of all accrued but unpaid dividends thereon. Accretion of the premium was computed under the straight-line method over the life of the initial Stated Value and over the life of accrued but unpaid dividends thereon, as applicable.

On October 14, 2003, and in exchange for 2,500,000 warrants to purchase common shares at \$0.30 per common share, exercisable within three years of the date of issue, the holders of the shares of the Series B 15% Preferred Stock agreed to extend the redemption date to October 31, 2005. The Company estimated the value of these warrants at \$125,000 using the Black-Scholes option pricing model and charged this amount to interest expense. In connection with this extension, the Company and the holders also agreed to certain modifications to the features of the Series B 15% Preferred Stock, and the Company amended its Articles of Incorporation as follows:

- Eliminated the Company's option to pay the redemption price in shares of its common stock and requires the redemption price to be paid in cash.
- Increased the amount of indebtedness that the Company may incur without consent of the holders of the Series B 15% Preferred Stock from \$18 million to \$18.5 million.
- Requires the Company to give notice to the holders of the Series B 15% Preferred Stock prior to making any capital expenditures in excess of \$300,000.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
*(Continued)*

With the elimination of the option to redeem the Series B Preferred Stock with shares of the Company's common stock, the Company discontinued accretion of the anticipated premium, and recorded a contribution to capital for the amount of the accretion of the premium recorded prior to the amendment to the Articles of Incorporation. The result was an increase to common stock and a decrease to the Series B Preferred Stock in the amount of \$4,844,000.

In October 2003, the Company issued 180 shares of Series B 15% Preferred Stock, with a redemption date of October 31, 2005, in exchange for notes payable and accrued interest payable totaling \$180,000.

In November 2003, the Company issued 8,000 shares of Series B 15% Preferred Stock with a Stated Value of \$8,000,000 in exchange for cash of \$2,000,000. Accretion of the difference is computed under the straight-line method over the life of the Series B 15% Preferred Stock. In connection with this transaction, the Company and the holders of the Series B 15% Preferred Stock agreed to additional modifications to the features of the Series B 15% Preferred Stock, and the Company further amended its Articles of Incorporation as follows:

- Defined the maturity date of the Series B 15% Preferred Stock as the first to occur of (a) October 31, 2005 (see however Note 21), (b) the occurrence of a defined "liquidation event", or (c) the date that is six months following the receipt by the Company or its affiliates of proceeds from one or more financing transactions in excess of \$50 million.
- Requires pro rata redemptions of the Company's Series B 15% Preferred Stock six months from the date that the Company receives proceeds from certain financing transactions that exceed \$20 million in the aggregate.
- Requires all redemptions of Series B 15% Preferred Stock to be made wholly in cash.

In October 2004, the Company issued 67 shares of its Series B 15% Preferred Stock in payment of a related party note payable of \$40,000 and accrued interest payable of \$27,000.

As a result of the November 2003 modifications to the features of the Series B 15% Preferred Stock, if the Company is successful in raising the levels of funding that it requires to bring its debt obligations current, fund its planned operations, and complete aircraft certification requirements for its Hawk 4 gyroplane, significant portions of this funding may be required to make redemption payments on the Series B 15% Preferred Stock in advance of the October 31, 2005 maturity date (extended to January 1, 2007, see Note 21). At June 30, 2005, the recorded value of the Series B 15% Preferred Stock was \$33,009,000, which was recorded as a long-term liability.

Statement of Financial Accounting Standards No. 150 (SFAS 150), "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity," was issued in May 2003 and is effective for periods beginning after June 15, 2003. SFAS 150 establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. SFAS 150 requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an obligation of the issuer. Many of those instruments were previously classified as equity.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
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For the years ended June 30, 2005 and 2004, and for all periods beginning after June 15, 2003, the Company's Series B 15% Preferred Stock is classified as a liability because it embodies an obligation of the Company and falls within the scope of SFAS 150. Previously, the Company's Series B 15% Preferred Stock was classified as equity. As a result, at June 30, 2005 the Company's Series B 15% Preferred Stock is classified as a liability. Because the carrying value of the Series B 15% Preferred Stock was the same before and after adoption of SFAS 150, the Company's consolidated statement of operations for the year ended June 30, 2004 does not include the cumulative effect of a change in accounting principle as required by Paragraph 29 of SFAS 150. Series B 15% Preferred Stock accretion and dividends have been expensed during the years ended June 30, 2005 and 2004 as an interest cost. Previously, Series B 15% Preferred Stock accretion and dividends were not expensed as an interest cost, but were applied to the net loss applicable to common stockholders.

**Series A Convertible Preferred Stock**

Voting control by one of the Company's founders, David Groen, had existed from November 7, 2000 by means of shares of Series A Preferred Stock issued to him in exchange for a note receivable. The note receivable matured in November 2003, and Mr. Groen surrendered all Series A Preferred Stock in cancellation of the note. The Board of Directors and management of the Company believed that the continuity of voting control by one or both of the founders of the Company was crucial to the ongoing operations and growth of the Company.

On October 8, 2004, the Company amended and restated its Articles of Incorporation to change the rights and terms of its Series A Convertible Preferred Stock. On October 8, 2004, the Board of Directors approved the issuance of 1,400,000 shares of Series A Convertible Preferred Stock to the Company's founders: 900,000 shares to David Groen, President and Chief Executive Officer, and 500,000 shares to Jay Groen, Chairman of the Board of Directors, at a purchase price of \$0.05 per share, or total consideration of \$70,000. The amended rights, terms and preferences of the Series A Convertible Preferred Stock are summarized as follows:

- Each share may cast one hundred (100) votes on all matters submitted to the stockholders for a vote, voting together with the holders of the common stock of the Company as a single class, effectively giving current voting control to the Company's founders.
- The voting rights expire seven years from the date of issue.
- Upon, and only upon, the Company reaching significant revenue milestones, the shares are convertible into common stock of the Company through payment of a cash conversion price of \$0.50 per share of common stock, convertible on a one-for-one hundred (1:100) basis (100 shares of common stock for each share of Series A Convertible Preferred Stock). Conversion is allowed at the rate of 25% of the preferred shares for each \$30 million in defined cumulative gross sales, for a total of \$120 million in sales. This convertibility is also only available if these significant revenue milestones are met within seven years from the date of issue of the Series A Convertible Preferred Stock.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
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- The shares, including all voting and conversion rights, to the extent not converted into common shares, will expire seven years from the date of issue, and will be cancelled by the Company.
- Upon the death or permanent incapacity of a holder of Series A Convertible Preferred Stock, all shares held by such holder will be divided between the then existing members of the Company's Board of Directors on a pro-rata basis, based upon the number of months they have served on the Board, with the holder's survivor(s) (if more than one person, treated collectively as one person) being included in the same pro-rata basis, crediting the survivor's "months served" as those of the deceased or permanently mentally incapacitated holder. Upon a temporary mental incapacity of a holder of Series A Convertible Preferred Stock, all shares will be voted by the remaining holders of the Series A Convertible Preferred Stock until the end of the temporary incapacity.
- The shares are non-transferable, non-assignable, and have no dividend or liquidation rights.

The value of \$.05 per share was assigned to the Series A Preferred Stock by the Company's Board of Directors after evaluating several factors, including those listed above relating to limitations on the transferability of the shares, the limited life of the voting rights, the significant revenue milestones to be met before conversion to common stock can occur, and the absence of dividend or liquidation rights.

**Note 13: Common Stock**

On October 8, 2004, pursuant to the joint written consent of the Board of Directors of the Company and the combined majority of holders of the Company's common stock and holders of the Company's Series A Preferred Stock entitled to vote together on such matters as one class (the "Majority Stockholders") in lieu of a special meeting of the stockholders, the following actions were approved:

- The Company amended its articles of incorporation to increase the number of authorized shares of common stock from two hundred million (200,000,000) shares to five hundred million (500,000,000) shares.
- The Company amended its 2000 Stock Option Plan to increase the number of shares of common stock available for issuance under the Plan from thirty million (30,000,000) shares to sixty million (60,000,000) shares.

The notice of these actions taken pursuant to the joint written consent of the Majority Stockholders was mailed to the stockholders of the Company in December 2004.

During the year ended June 30, 2005, the Company issued a total of 13,985,429 shares of its restricted common stock, primarily to accredited investors in transactions exempt from registration. These shares were issued generally at a price of \$0.20 per share through private placement offerings in reliance upon the exemption from registration contained in Rule 506 of Regulation D. The shares were issued for the following consideration: 12,574,580 shares for cash of \$2,515,000; 10,750 shares in payment of finders' compensation on the sale of common stock; 287,500 shares in payment of accounts payable of \$57,000; 355,125 shares in payment of accrued expenses of \$71,000; 440,990 shares in payment of the Company's matching contribution to its 401(k) plan of \$88,000; 185,000 shares in

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payment of consulting services of \$32,000; 65,109 shares in payment of interest expense of \$13,000; and 66,375 shares for the return of \$13,000 of deposits. In addition, total finders' compensation on the sale of common stock totaled \$131,000. The Company did not use underwriters in the sale or placement of these unregistered shares of common stock.

The Company has generally placed a value of \$.20 per share on non-cash transactions where shares of the Company's restricted common stock have been issued in payment of goods and services, reduction of debt and other purposes. The Company believes, based on the many cash sales of the Company's restricted common stock during the year ended June 30, 2005, all at \$.20 per share, that \$.20 per share is an appropriate value per share to use for issuances of restricted common shares in non-cash transactions. The \$.20 per share also approximated the average quoted market price of the Company's common stock during the year.

During the year ended June 30, 2005, the Company issued a total of 44,889,921 stock options: 23,250,000 options to employees under the Company's ISO 2000 stock option plan with exercise prices of \$0.25 to \$1.00 per share exercisable for periods of 3 to 7 years; 19,265,830 options to investors in connection with the sale of common stock of the Company with exercise prices of \$0.20 to \$0.25 per share exercisable for periods of 1 to 2 years; 1,596,591 options as a loan origination fee or other compensation to lenders with an exercise price of \$0.20 per share exercisable for a period of 1 to 3 years; and 777,500 options to vendors for services with exercise prices of \$0.20 to \$1.00 per share exercisable for periods of 1 to 5 years. The Company estimated the value of the vested portion of options issued to lenders at \$61,000 using the Black-Scholes option pricing model, and charged this amount to interest expense. The Company estimated the value of the 277,500 options issued to vendors for services at \$12,000 using the Black-Scholes option pricing model, and charged this amount to general and administrative expense.

During the years ended June 30, 2003 and 2004, the Company issued a total of 4,850,000 and 900,000 shares of restricted common stock, respectively, as collateral for certain convertible notes payable. No value was assigned to these shares because the shares are further restricted and bear a legend prohibiting the holder from selling or transferring the shares at any time.

The legend will only be removed if the Company is in default on the applicable loan, at which time, a new certificate will be issued and a value recorded for the shares to account for the loan and accrued interest settled. In addition, the terms of the notes payable require the holder of the collateral shares to return the shares to the Company when the applicable loan and accrued interest are paid in full. To date, the Company has not defaulted on any loan where common stock has been pledged as collateral. It is the Company's position that there will be no default on these loans, and therefore, all 5,750,000 collateral shares will be returned. Under this assumption, the Company believes it is appropriate to not assign any value to the collateral shares issued and to not include these shares in the calculation of loss per share.

The conversion prices per share of the convertible notes payable and long-term debt disclosed in Notes 7, 8 and 9 were based on the cash price per common share paid in private placement transactions on or near the date the debt agreements were negotiated. The cash price per common share and the conversion prices per share approximated the quoted market price per share of the Company's common stock on or near the date the note agreements were negotiated. The conversion prices per share have all been set at the market price of the common stock, or above the market price whenever possible, with

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
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market price typically established at the price per share that the Company was selling restricted common shares for cash at the time. Because the conversion price per share was generally “under water” in substantially all of these transactions, the Company concluded that the conversion terms did not represent a beneficial conversion feature. Therefore, no beneficial conversion features have been accounted for in the Company’s consolidated financial statements for these transactions.

**Note 14: Stock Option Plan**

Under the Company’s 2000 amended and restated stock option plan (Plan), there are 60 million shares that are authorized for stock options. The Company may issue both non-qualifying stock options and qualifying incentive stock options. All stock options have an exercise price that is not less than 100 percent of the fair market value on the date of the grant. While expiration dates vary on particular grants, no stock options may be exercised more than ten years after the date of grant. Qualifying incentive stock options are granted only to employees, while non-qualifying options may be granted to employees, directors, and non-employees.

On May 17, 2002 and June 10, 2005, the Company filed Form S-8 Registration Statements (“Registration”) for the Plan under the Securities Act of 1933. Options granted under the Plan prior to the filing of the 2002 Registration can only be exercised for restricted common stock as defined under the Securities and Exchange Commission Rule 144. Options granted under the Plan after the 2002 Registration can be exercised for unrestricted and free trading common stock.

The Company’s Board of Directors may also authorize the issuance of other stock options and warrants outside of the Plan.

A summary of the Company’s stock options and warrants is as follows:

<b>Year Ended June 30, 2004</b>	<b>Number of Options and Warrants</b>	<b>Weighted Average Exercise Price</b>
Outstanding at Beginning of Year	40,630,567	\$ 0.56
Granted	20,718,851	0.26
Exercised	(25,000)	0.20
Canceled	(1,175,000)	0.55
Expired	(10,163,914)	0.50
Outstanding at End of Year	49,985,504	\$ 0.45
Exercisable at End of Year	41,307,169	\$ 0.45

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**Notes to Consolidated Financial Statements**  
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<b>Year Ended June 30, 2005</b>	<b>Number of Options and Warrants</b>	<b>Weighted Average Exercise Price</b>
Outstanding at Beginning of Year	49,985,504	\$ 0.45
Granted	44,889,921	0.37
Canceled	(6,875,000)	0.75
Expired	(9,784,504)	0.25
Outstanding at End of Year	<u>78,215,921</u>	<u>\$ 0.40</u>
Exercisable at End of Year	<u>54,242,589</u>	<u>\$ 0.37</u>

Of the total options and warrants outstanding, 34,175,000 and 17,300,000 options were granted under the Plan at June 30, 2005 and 2004, respectively.

The following table summarizes information about stock options and warrants outstanding at June 30, 2005:

<b>Options and Warrants Outstanding</b>				<b>Options and Warrants Exercisable</b>		
<b>Range of Exercise Prices</b>	<b>Number Outstanding</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life (Years)</b>	<b>Number Exercisable</b>	<b>Weighted Average Exercise Price</b>	
\$ 0.15 - 0.20	18,756,171	\$ 0.18	1.81	17,756,171	\$	0.18
0.25 - 0.30	40,083,750	0.25	3.38	24,518,751		0.26
0.50 - 0.63	2,901,000	0.54	1.36	2,734,333		0.54
1.00 - 1.10	16,475,000	1.01	3.27	9,233,334		1.01
<u>\$ 0.15 - 1.10</u>	<u>78,215,921</u>	<u>\$ 0.40</u>	<u>2.90</u>	<u>54,242,589</u>	<u>\$</u>	<u>0.37</u>

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**Notes to Consolidated Financial Statements**  
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**Note 15: Income Taxes**

The benefit for income taxes differs from the amount computed at the federal statutory rate as follows:

	Years Ended June 30,	
	2005	2004
Income tax benefit at federal statutory rate	\$5,208,000	\$4,257,000
Series B preferred stock interest expense	(3,121,000)	(2,597,000)
Research and development credit	96,000	126,000
Other	(251,000)	(76,000)
Change in valuation allowance	(1,932,000)	(1,710,000)
	\$ -	\$ -

Deferred tax assets (liabilities) are as follows:

Net operating loss carryforwards	\$21,245,000
Research and development credit carryforward	1,845,000
Charitable contributions carryforward	57,000
Accrued payroll	1,341,000
Other	51,000
Valuation allowance	(24,539,000)
	\$ -

At June 30, 2005, the Company has net operating loss carryforwards available to offset future taxable income of approximately \$54 million which will begin to expire in 2006. The utilization of the net operating loss carryforwards is dependent upon the tax laws in effect at the time the net operating loss carryforwards can be utilized. The Tax Reform Act of 1986 limits the annual amount that can be utilized for certain of these carryforwards as a result of changes in ownership of the Company. An ownership change may have occurred which may severely impact the utilization of the net operating loss carryforwards.

Due to uncertainties surrounding the realization of all carryforwards and currently non-deductible accruals, a valuation allowance has been established to offset the net deferred income tax asset resulting from such deferred tax items.

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**Note 16: Supplemental Statement of Cash Flows Information**

During the year ended June 30, 2005, the Company:

- Decreased related party notes receivable through reduction of accrued expenses payable to related parties of \$25,000.
- Issued debt to acquire property and equipment of \$7,000.
- Issued common stock in payment of accounts payable of \$57,000.
- Issued common stock in payment of accrued expenses of \$71,000.
- Increased accrued expenses and decreased common stock by \$111,000 for accrued finders' compensation.
- Decreased accrued expenses and increased Series A convertible preferred stock by \$70,000 for the issuance of 1,400,000 shares of Series A convertible preferred stock.
- Decreased accrued expenses by \$27,000, decreased debt by \$40,000 and increased Series B preferred stock by \$67,000 for the conversion of debt and accrued interest payable into 67 shares of Series B preferred stock.
- Increased accrued expenses and decreased debt by \$14,000 for the reclassification of interest payable.
- Issued common stock in return of deposits of \$13,000.
- Decreased deferred revenue through the issuance of debt of \$28,000.

During the year ended June 30, 2004, the Company:

- Acquired aircraft through reduction in accounts receivable of \$29,000.
- Increased related party notes receivable and accrued expenses by \$5,000.
- Decreased related party notes receivable through reduction of accrued expenses payable to related parties of \$38,000.
- Issued common stock in payment of debt of \$63,000.
- Issued common stock in return of deposits of \$317,000.
- Issued common stock in payment of accounts payable of \$180,000.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
*(Continued)*

- Increased prepaid expenses through the issuance of accounts payable of \$12,000.
- Issued stock options in payment of accounts payable of \$50,000.
- Decreased deposits through the issuance of debt of \$187,000.
- Paid debt of \$100,000 and accrued interest payable of \$80,000 through the issuance of Series B Preferred Stock of \$180,000.
- Reduced debt through the increase of accrued expenses of \$162,000.
- Increased the put option liability and decreased common stock by \$1,448,000 through the amendment of a put option.
- Transferred debt of \$3,000 to accounts payable.
- Accrued interest on the stock subscription receivable, which effectively increased the Series A Convertible Preferred Stock amount by \$43,000.
- Cancelled the Series A Convertible Preferred Stock of \$2,760,000 through reduction of the stock subscription receivable of \$2,760,000.
- Issued 6,125,000 shares of common stock as net settlement of a stockholder put option.
- Collateralized certain notes payable with 900,000 shares of common stock.
- Issued 81,500 shares of common stock in satisfaction of finders' compensation on equity sales.
- Increased common stock and decreased the Series B 15% Preferred Stock by \$4,844,000 for the contribution to capital of accretion of premium on the Series B 15% Preferred Stock.

Actual cash paid for interest was \$162,000 and \$162,000 in fiscal years 2005 and 2004, respectively.

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**17: Operating Lease Obligations**

The Company leases certain property, vehicles and facilities under noncancellable operating leases. Future minimum rental payments required under these leases are as follows:

<u>Years Ending June 30,</u>	<u>Amount</u>
2006	\$ 144,000
2007	147,000
2008	<u>122,000</u>
	<u>\$ 413,000</u>

Rental expense for noncancellable operating leases was \$236,000 and \$221,000 for the years ended June 30, 2005 and 2004, respectively.

**Note 18: 401(k) Saving Plan**

The Company has a 401(k) Plan (the Plan) to provide retirement and incidental benefits for its employees. Employees may contribute from 1% to 25% of their gross pay to the Plan, limited to a maximum annual amount as set periodically by the Internal Revenue Service. The Company may contribute a matching contribution at a rate set by the Board of Directors. The Plan operates on a calendar year basis. In fiscal year 2005, and based on contributions by employees during calendar year 2004, the Company made a matching contribution to the Plan in the form of 440,990 shares of its common stock valued at \$88,000. In fiscal year 2004, and based on contributions by employees during calendar year 2003, the Company made a matching contribution to the Plan in the form of 340,841 shares of its common stock valued at \$68,000. Shares issued under the Plan are “restricted” as defined under the Securities and Exchange Commission Rule 144.

**Note 19: Commitments and Contingencies**

The Company has entered into employment agreements with certain officers of the Company. The employment agreements can be terminated at any time. Upon termination, the Company retains all rights to the gyroplane and the related technology and the officers have a covenant not to compete for a period of three years.

Royalty payments of 1% of the gross sales price of gyroplanes are to be paid to the Company’s founders, David and Jay Groen. Through June 30, 2005, royalties payable totaled \$6,000 to each of these individuals, which amounts are included in cost of sales in the consolidated statement of operations for the year ended June 30, 2005. No royalties were recorded in fiscal year 2004.

The Company has royalty agreements with two holders of notes payable totaling \$300,000 which entitle the note holders to receive royalties on the sales by the Company of certain gyroplanes other than the SparrowHawk gyroplane. The royalties are calculated on each aircraft sold, and are limited to a combined maximum total of \$1.3 million.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Consolidated Financial Statements**  
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The Company has a royalty agreement with an investor entitling the investor to receive royalties equal to \$2,500 for each Hawk 4 Gyroplane sold, limited to a maximum total of \$125,000.

The Company has various agreements to compensate individuals and companies with finders' compensation up to 10% for securing debt and equity financing for the Company.

The Company is subject to various claims and legal actions arising in the ordinary course of business, including certain matters relating to past due amounts due creditors. The past due amounts are recorded as liabilities in the consolidated balance sheet, and management of the Company believes that the amount, if any, that may result from other claims will not have a material adverse effect on the consolidated financial statements.

**Note 20: Fair Value of Financial Instruments**

The Company's financial instruments consist of cash, receivables, payables, and notes payable. The carrying amount of cash, receivables and payables approximates fair value because of the short-term nature of these items. The aggregate carrying amount of the notes payable approximates fair value as the individual borrowings bear interest at market interest rates.

**Note 21. Subsequent Events**

On October 11, 2005, the holders of the Series B 15% Preferred Stock ("Series B Holders") extended the redemption date of the Series B 15% Preferred Stock from October 31, 2005 to January 1, 2007. The Company amended its Articles of Incorporation on October 11, 2005 to reflect the modification to the redemption date. The Series B 15% Preferred Stock has been reported as a long-term liability of \$33,009,000 in the consolidated balance sheet as of June 30, 2005 because of the extension of the redemption date to January 1, 2007.

The extension requires the following consideration to be paid to the Series B Holders:

- The cancellation of existing warrants issued to the Series B Holders to purchase 2.5 million shares of the Company's common stock at an exercise price of \$0.30 per share.
- The issuance of warrants to purchase 6.85 million shares of the Company's common stock exercisable through January 1, 2009 at an exercise price of \$0.30 per share.
- The issuance of additional shares of Series B 15% Preferred Stock with a redemption value of \$10.7 million face value (10,700 shares) on January 1, 2007, with reductions in the number of shares to be issued allowed for repayments of amounts due to the Series B Holders in accordance with an agreed-upon formula.