

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

**FORM 10-QSB**

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

For the quarterly period ended December 31, 2005

Commission file number 018958

**GROEN BROTHERS AVIATION, INC.**

(Exact name of registrant as specified in its charter)

Utah  
State or other jurisdiction of  
Incorporation or organization

87-0489865  
I.R.S. Employer  
Identification No.

2640 W. California Avenue  
Salt Lake City, Utah  
Address of principal executive offices

84104  
Zip Code

Registrant's telephone number, including area code (801) 973-0177

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

Class  
Common Stock, No Par Value

Outstanding at December 31, 2005  
145,805,603

Transitional Small Business Disclosure Format Yes  No

**GROEN BROTHERS AVIATION, INC.**  
**FORM 10-QSB**  
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**PART 1 – FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**GROEN BROTHERS AVIATION, INC.**  
**Condensed Consolidated Balance Sheet (Unaudited)**  
**December 31, 2005**

**Assets**

Current assets:	
Cash	\$ 30,000
Accounts receivable	412,000
Related party notes receivable	63,000
Prepaid expenses	4,000
Inventories	366,000
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Total current assets	875,000
Property and equipment, net	428,000
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Total assets	\$ 1,303,000
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**Liabilities and Stockholders' Deficit**

Current liabilities:	
Accounts payable	\$ 1,181,000
Accrued expenses	4,432,000
Deferred revenue	559,000
Short-term notes payable	701,000
Related party notes payable	6,594,000
	<hr/>
Total current liabilities	13,467,000
Long-term liabilities:	
Accrued expenses	3,758,000
Deferred revenue	25,000
Long-term debt	457,000
Related party deposits	2,145,000
Series B 15% cumulative redeemable non-voting preferred stock, no par value, 50,000,000 shares authorized, 37,888 shares issued and outstanding	37,888,000
Liability to issue additional shares of Series B 15% preferred stock	1,239,000
	<hr/>
Total liabilities	58,979,000
Stockholders' deficit:	
Series A convertible preferred stock, no par value, 50,000,000 shares authorized, 1,400,000 shares issued and outstanding	70,000
Common stock, no par value, 500,000,000 shares authorized, 145,805,603 shares issued and outstanding	28,686,000
Accumulated deficit	(86,432,000)
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Total stockholders' deficit	(57,676,000)
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Total liabilities and stockholders' deficit	\$ 1,303,000
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See accompanying notes to condensed consolidated financial statements.

**GROEN BROTHERS AVIATION, INC.**  
**Condensed Consolidated Statements of Operations (Unaudited)**  
**Three Months Ended December 31,**

	<u>2005</u>	<u>2004</u>
Revenues	\$ 653,000	\$ 194,000
Costs and expenses:		
Cost of sales	647,000	235,000
Research and development	565,000	592,000
General and administrative expenses	439,000	386,000
Total costs and expenses	<u>1,651,000</u>	<u>1,213,000</u>
Loss from operations	<u>(998,000)</u>	<u>(1,019,000)</u>
Other income (expense):		
Related party interest income	2,000	4,000
Interest and other income	155,000	3,000
Interest expense	(375,000)	(387,000)
Series B preferred stock interest expense	(4,202,000)	(1,839,000)
Total other income (expense)	<u>(4,420,000)</u>	<u>(2,219,000)</u>
Loss before income taxes	(5,418,000)	(3,238,000)
Income tax benefit	<u>-</u>	<u>-</u>
Net loss	<u>\$ (5,418,000)</u>	<u>\$ (3,238,000)</u>
Net loss applicable to common stockholders	<u>\$ (5,418,000)</u>	<u>\$ (3,238,000)</u>
Net loss per share – basic and diluted	<u>\$ (0.04)</u>	<u>\$ (0.03)</u>
Weighted average number of common shares outstanding – basic and diluted	<u>135,973,000</u>	<u>114,813,000</u>

See accompanying notes to condensed consolidated financial statements.

**GROEN BROTHERS AVIATION, INC.**  
**Condensed Consolidated Statements of Operations (Unaudited)**  
**Six Months Ended December 31,**

	<u>2005</u>	<u>2004</u>
Revenues	\$ 849,000	\$ 360,000
Costs and expenses:		
Cost of sales	1,019,000	413,000
Research and development	1,208,000	1,059,000
General and administrative expenses	937,000	805,000
Total costs and expenses	<u>3,164,000</u>	<u>2,277,000</u>
Loss from operations	<u>(2,315,000)</u>	<u>(1,917,000)</u>
Other income (expense):		
Related party interest income	3,000	6,000
Interest and other income	164,000	11,000
Interest expense	(815,000)	(705,000)
Series B preferred stock interest expense	(7,043,000)	(3,453,000)
Total other income (expense)	<u>(7,691,000)</u>	<u>(4,141,000)</u>
Loss before income taxes	(10,006,000)	(6,058,000)
Income tax benefit	<u>-</u>	<u>-</u>
Net loss	<u>\$ (10,006,000)</u>	<u>\$ (6,058,000)</u>
Net loss applicable to common stockholders	<u>\$ (10,006,000)</u>	<u>\$ (6,058,000)</u>
Net loss per share – basic and diluted	<u>\$ (0.08)</u>	<u>\$ (0.05)</u>
Weighted average number of common shares outstanding – basic and diluted	<u>131,607,000</u>	<u>113,279,000</u>

See accompanying notes to condensed consolidated financial statements.

**GROEN BROTHERS AVIATION, INC.**  
**Condensed Consolidated Statements of Cash Flows (Unaudited)**  
**Six Months Ended December 31,**

	<u>2005</u>	<u>2004</u>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (10,006,000)	\$ (6,058,000)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization expense	78,000	62,000
Common stock issued for interest and services expenses	64,000	13,000
Stock options and warrants issued for interest and services expenses	1,154,000	68,000
Interest expense accrued on Series B preferred stock	6,118,000	3,453,000
Interest expense on put option liability	45,000	96,000
Accrued interest expense added to debt principal	-	35,000
Gain on settlement of debt	(149,000)	-
Other	(2,000)	(1,000)
(Increase) decrease in:		
Accounts receivable	(383,000)	(3,000)
Inventories	29,000	43,000
Increase (decrease) in:		
Bank overdraft	-	16,000
Accounts payable	281,000	63,000
Accrued expenses	691,000	917,000
Deferred revenue	(9,000)	35,000
	(2,089,000)	(1,261,000)
<b>Cash flows from investing activities:</b>		
Purchase of property and equipment	(129,000)	(28,000)
Issuance of related party notes receivable	(20,000)	-
	(149,000)	(28,000)
<b>Cash flows from financing activities:</b>		
Proceeds from the issuance of debt	445,000	425,000
Repayment of debt	(208,000)	(32,000)
Proceeds from the issuance of common stock and stock options	1,992,000	875,000
Payment of finders' compensation on issuance of common stock	(31,000)	(6,000)
	2,198,000	1,262,000
Net cash provided by financing activities	2,198,000	1,262,000
Net decrease in cash	(40,000)	(27,000)
Cash, beginning of period	70,000	27,000
Cash, end of period	\$ 30,000	\$ -

See accompanying notes to condensed consolidated financial statements.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Condensed Consolidated Financial Statements**  
**Six Months Ended December 31, 2005 (Unaudited)**

**Note 1: Organization and Basis of Presentation**

**Organization and 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 and marketing functions of AAI’s SparrowHawk gyroplane. GBA-USA will be doing business as (d.b.a.) American Autogyro for all of its SparrowHawk operations.

The unaudited condensed consolidated financial statements include the accounts of the Company and subsidiaries and include all adjustments (consisting of normal recurring items) which are, in the opinion of management, necessary to present fairly the financial position as of December 31, 2005, and the results of operations and cash flows for the three months and six months ended December 31, 2005 and 2004. The results of operations for the three months and six months ended December 31, 2005 are not necessarily indicative of the results to be expected for the full fiscal year ending June 30, 2006.

**Basis of Presentation and Going Concern Uncertainty**

The accompanying condensed 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, obtaining additional outside financing and/or restructuring its debt obligations. 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 operating revenues through December 31, 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 introduction of a new product and due to lower than expected sales volume.
- 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

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Condensed Consolidated Financial Statements**  
**Six Months Ended December 31, 2005 (Unaudited)**

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 vertical take-off and landing 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 what it expects to be 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, although there is no assurance that higher margins will be realized. 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 to \$50 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, but the Company is not in a position to conclude how likely a favorable outcome to these opportunities is. 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 Hawk 4 operations until FAA certification is obtained and sales of Hawk 4 gyroplanes reach planned levels.

As discussed in Note 2, the Company announced on November 7, 2005 that the US Defense Advanced Research Projects Agency ("DARPA") has selected the Company to lead a team to design a proof of concept high speed, long range, vertical takeoff and landing ("VTOL") aircraft designed for use in combat search and rescue roles. The Company believes that its share of revenues from phase one of this contract, currently estimated at approximately \$4.3 million, will have a positive impact on cash flows from operations; however, the Company will continue to add personnel, expand facilities and make other significant purchases to meet its obligations under this contract.

As a result, the Company anticipates that operating costs of personnel, facilities, research and development and sales and marketing will increase from levels reported for fiscal year 2005.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Condensed Consolidated Financial Statements**  
**Six Months Ended December 31, 2005 (Unaudited)**

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

**Note 2: DARPA Contract**

The Company announced on November 7, 2005 that the US Defense Advanced Research Projects Agency (“DARPA”) has selected the Company to lead a team to design a proof of concept high speed, long range, vertical takeoff and landing (“VTOL”) aircraft designed for use in combat search and rescue roles. Phase One of this potential multi year four phase program begins with a fifteen month \$6.4 million award to develop the preliminary design and perform key technology demonstrations. The Company estimates its share of Phase One payments will approximate \$4.3 million, with the remaining portion to be paid by the Company to subcontractors and consultants hired by the Company. Payments under this contract are conditional upon the Company attaining several milestone objectives during the course of Phase One of the contract. Contracts for subsequent phases are conditional on completion of Phase One and successor phases.

The Company will recognize revenue on this contract as each defined milestone is completed and the requisite meetings are held and technical data submitted and accepted by DARPA. At that time, DARPA will instruct the Company to submit an invoice for payment for the respective milestone at the amounts specified in the contract. Contract-related expenses incurred by the Company for each milestone of the contract, including its own labor, travel, supplies and other costs, and the costs of subcontractors and consultants, will be deferred and expensed to cost of sales as the contract revenue for the milestone is recognized. During December 2005, the Company completed the first milestone of the DARPA contract and recognized contract revenue of \$390,000. Direct costs of the first milestone of approximately \$281,000 were expensed to cost of sales. No deferred costs related to the contract were included in the condensed consolidated balance sheet as of December 31, 2005.

**Note 3: 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.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Condensed Consolidated Financial Statements**  
**Six Months Ended December 31, 2005 (Unaudited)**

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. During the six months ended December 31, 2005, 400,000 collateral shares were returned to the Company and cancelled when the related debt was repaid. At December 31, 2005, the Company had issued 5,350,000 shares of common stock as collateral.

**Note 4: Reclassifications**

Certain amounts in the financial statements for the three months and six months ended December 31, 2004 have been reclassified to conform with the current period presentation.

**Note 5: 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 condensed 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>Three Months Ended December 31,</b>	
	<b>2005</b>	<b>2004</b>
Reported net loss applicable to common stockholders	\$ (5,418,000)	\$ (3,238,000)
Deduct: Total stock-based employee compensation determined under fair value based method, net of related tax effects	(271,000)	(184,000)
Pro forma net loss	\$ (5,689,000)	\$ (3,422,000)
Basic and diluted loss per share:		
As reported	\$ (0.04)	\$ (0.03)
Pro forma	\$ (0.04)	\$ (0.03)

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Condensed Consolidated Financial Statements**  
**Six Months Ended December 31, 2005 (Unaudited)**

	<b>Six Months Ended December 31,</b>	
	<b>2005</b>	<b>2004</b>
Reported net loss applicable to common stockholders	\$ (10,006,000)	\$ (6,058,000)
Deduct: Total stock-based employee compensation determined under fair value based method, net of related tax effects	(965,000)	(1,113,000)
Pro forma net loss	\$ (10,971,000)	\$ (7,171,000)
Basic and diluted loss per share:		
As reported	\$ (0.08)	\$ (0.05)
Pro forma	\$ (0.08)	\$ (0.06)

**Note 6: Recent 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 fiscal periods beginning after June 15, 2005 (December 15, 2005 for small business issuers), however, the Securities and Exchange Commission has deferred this date for public companies. The new rule allows companies to implement FAS No. 123(R) at the beginning of their next fiscal year. 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

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Condensed Consolidated Financial Statements**  
**Six Months Ended December 31, 2005 (Unaudited)**

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.

**Note 7: Inventories:**

Inventories consisted of the following at December 31, 2005:

Raw materials and parts	\$ 196,000
Work-in-process	<u>170,000</u>
Total	<u><u>\$ 366,000</u></u>

**Note 8: Accrued Expenses:**

Accrued expenses reported as current liabilities consisted of the following at December 31, 2005:

Related party interest	\$ 3,267,000
Compensation, related taxes and benefits	505,000
Interest	445,000
Consulting fees	75,000
Finders' compensation	51,000
Royalties to related parties	16,000
Other	<u>73,000</u>
Total	<u><u>\$ 4,432,000</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.

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 December 31, 2005, royalties payable totaled \$8,000 to each of these individuals, which amounts are accrued as a component of cost of sales in the condensed consolidated statements of operations.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Condensed Consolidated Financial Statements**  
**Six Months Ended December 31, 2005 (Unaudited)**

Long-term accrued expenses consisted of the following at December 31, 2005:

Deferred compensation	\$ 3,279,000
Accrued payroll taxes on deferred compensation	142,000
Accrued interest on deferred compensation	<u>337,000</u>
Total	<u><u>\$ 3,758,000</u></u>

The deferred compensation is payable to twelve officers and directors of the Company, with amounts originating from fiscal year 1998 through the current fiscal year. 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 December 31, 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 December 31, 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 9: Debt**

Included in short-term notes payable at December 31, 2005 are notes payable to vendors and others totaling \$689,000, substantially all of which are technically in default. The Company continues ongoing negotiations with the vendors and has, in most instances, been granted grace periods and extensions without receipt of formal notices of default or threat of legal action.

Substantially all related party notes payable and long-term debt at December 31, 2005 are payable to stockholders of the Company who are considered related parties. The Company is also delinquent in making payments on capital lease obligations of \$660,000 and other notes payable totaling \$1,136,000 included in related party notes payable.

The Company is also delinquent on making payments of accrued interest payable on debt of \$723,000, of which \$286,000 is payable to related parties.

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Condensed Consolidated Financial Statements**  
**Six Months Ended December 31, 2005 (Unaudited)**

**Note 10: Put Option Liability**

During the year ended June 30, 2004, the Company and a 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 could exercise a put option and the Company could exercise the option to redeem, and increased both the put prices and the optional redemption prices. As a result, the stockholder had 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 could 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 could have redeemed 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 was payable 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 Company's option to redeem the 750,000 shares expired on November 7, 2005.

The Company used 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 required adjustment, with the adjustment recorded as an increase or decrease to interest expense.

In November 2005, the shareholder put the 750,000 shares to the Company. The Company did not have the cash or the ability to issue shares of registered, unrestricted common stock of the Company. However, the shareholder agreed to accept 5,004,009 unregistered, restricted shares of the Company's common stock in satisfaction of the put option liability of \$1,560,000, or approximately \$0.31 per share.

**Note 11: 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

**GROEN BROTHERS AVIATION, INC.**  
**Notes to Condensed Consolidated Financial Statements**  
**Six Months Ended December 31, 2005 (Unaudited)**

of the long-term prospects of obtaining the funding and completing the certification, dealer deposits have been recorded as long-term liabilities.

**Note 12: Preferred Stock**

**Series B 15% Preferred Stock**

At December 31, 2005, the Company had 37,888 shares of Series B 15% Preferred Stock outstanding with a recorded value of \$37,888,000.

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 \$37,888,000 in the consolidated balance sheet as of December 31, 2005 because of the extension of the redemption date to January 1, 2007.

The October 11, 2005 extension requires the following consideration to be paid to the Series B Holders:

- The cancellation on October 11, 2005 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 on October 11, 2005 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 during the extension period 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

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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.

The Company reviewed the requirements of Emerging Issues Task Force (EITF) No. 02-4, *Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is Within the Scope of FASB Statement 15*, and determined that the extension of the redemption date of the original issuance of the Company's Series B 15% Preferred Stock on October 14, 2003 met the criteria of a troubled debt restructuring outlined in Statement of Financial Accounting Standards (SFAS) No. 15, *Accounting for Debtors and Creditors for Troubled Debt Restructurings*. No gain or loss was recorded on the October 2003 extension and subsequent extension of the due date in October 2005. The value of the warrants issued to the Series B Holders in connection with the extensions of the due dates, estimated by the Black-Scholes option pricing model, was charged to interest expense. The value of the net additional warrants issued in October 2005 and charged to interest expense was \$925,000. The Series B 15% Preferred Stock will be classified as a troubled debt restructured through its redemption.

Included in the periodic interest expense on the Series B 15% Preferred Stock is the accretion of the \$10,700,000 obligation to issue 10,700 shares of additional Series B 15% Preferred Stock on January 1, 2007, calculated on the interest method. The cumulative accretion of this obligation is recorded as a long-term liability of \$1,239,000 in the Company's condensed consolidated balance sheet as of December 31, 2005.

### **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.

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- 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.

**Note 13: Stockholders' Equity**

During the six months ended December 31, 2005, the Company issued a total of 16,531,431 shares of its restricted common stock, primarily to accredited investors in transactions exempt from registration. These shares were issued at prices ranging from \$0.20 to \$0.35 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: 9,032,167 shares for cash of \$1,948,000; 536,002 shares in payment of accrued expenses of \$112,000; 94,907 shares in reduction of deferred revenue of \$19,000; 112,857 shares in payment of services of \$23,000; 1,146,213 shares in reduction of debt of \$234,000; 195,183 shares in

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payment of interest expense of \$41,000; 405,093 shares to acquire property and equipment of \$81,000, 5,000 shares in payment of a customer refund of \$1,000, and 5,004,009 shares in payment of a put option liability of \$1,560,000. In addition, cash finders' compensation and accrued finders' compensation on the sale of common stock totaled \$31,000 and \$95,000, respectively during the six 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 per share on the non-cash transactions equal to recent cash prices per share 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 six months ended December 31, 2005, ranging from \$0.20 to \$0.35 per share, that these values per share are appropriate to use for issuances of restricted common shares in non-cash transactions. These per share values also approximated the quoted market prices of the Company's common stock during the six-month period.

During the six months ended December 31, 2005, the Company issued options to purchase a total of 19,418,158 shares of common stock: 15,239,750 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; 1,528,408 options as a loan origination fee or interest to a lenders with exercise prices of \$0.20 to \$0.25 per share exercisable for a period of 1 to 3 years; 1,000,000 options to a vendor for services with an exercise price of \$0.50 per share exercisable for a period of three years; and 1,650,000 options to employees with exercise prices of \$0.25 per share exercisable for a period of 5 to 7 years (granted under the Company's employee stock option plan for which a Form S-8 registration statement has been filed). The Company estimated the value of the 1,528,408 options issued to the lenders at \$104,000 using the Black-Scholes option pricing model, and charged this amount to interest expense. The Company estimated the value of the 1,000,000 options issued to a vendor for services at \$30,000 using the Black-Scholes option pricing model, and charged this amount to general and administrative expense. The Company also issued options to purchase a total of 1,000,000 shares of common stock for cash of \$44,000, with an exercise price of \$0.20 per share for a period of one year. In addition, the Company recorded interest expense of \$76,000 on 3,200,000 variable stock options during the six months ended December 31, 2005 using the Black-Scholes option pricing model.

The Company cancelled warrants to purchase 2.5 million shares of the Company's common stock at \$0.30 per share issued to the Series B Holders and issued the Series B Holders 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 Company recorded interest expense estimated at \$925,000 using the Black-Scholes option pricing model during the six months ended December 31, 2005 attributable to the net additional warrants issued.

The Company has issued shares of its common stock as collateral for certain notes payable to related parties. 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. During

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the six months ended December 31, 2005, 400,000 collateral shares were returned to the Company and cancelled when the related debt was repaid. At December 31, 2005, the Company had issued 5,350,000 shares of common stock as collateral.

As discussed in Note 10, the Company acquired 750,000 shares of its common stock when a shareholder exercised a put option. These shares were subsequently cancelled.

**Note 14: Supplemental Statement of Cash Flows Information**

**During the six months ended December 31, 2005, the Company:**

- Decreased related party notes receivable through reduction of accrued expenses payable to related parties of \$11,000.
- Decreased accounts receivable and increased related party notes receivable by \$20,000.
- Issued 405,093 shares of common stock to acquire property and equipment of \$81,000.
- Decreased accounts payable and increased short-term notes payable by \$42,000.
- Issued 536,002 shares of common stock in payment of accrued expenses of \$112,000.
- Increased accrued expenses and decreased common stock by \$95,000 for accrued finders' compensation.
- Issued 94,907 shares of common stock in reduction of deferred revenue of \$19,000.
- Issued 5,000 shares of common stock in payment of a customer refund of \$1,000.
- Issued 1,146,213 shares of common stock in payment of debt of \$234,000.
- Issued 5,004,009 shares of common stock in payment of put option liability of \$1,560,000.
- Issued 195,183 shares of common stock in payment of interest expense of \$41,000.
- Issued 112,857 shares of common stock for services of \$23,000.

**During the six months ended December 31, 2004, the Company:**

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- Decreased related party notes receivable through reduction of accrued expenses payable to related parties of \$15,000.
- Issued 183,750 shares of common stock in payment of accounts payable of \$37,000.
- Issued 97,625 shares of common stock in payment of accrued expenses of \$20,000.
- Issued 65,109 shares of common stock in payment of interest expense of \$13,000.
- Issued 66,375 shares of common stock in return of deposits of \$13,000.
- Issued 100,000 shares of common stock for prepaid consulting services of \$20,000.
- Issued note payable to acquire property and equipment of \$3,000.
- Issued a note payable in return of deferred revenue of \$28,000.
- Increased accrued expenses and decreased common stock by \$39,000 for accrued finders' compensation.
- Issued 1,400,000 shares of Series A preferred stock for a decrease in accrued expenses of \$70,000.
- Converted \$40,000 of related party notes payable and \$27,000 of accrued interest payable into 67 shares of Series B preferred stock.
- Paid finders' compensation with 4,500 shares of common stock.

Cash paid for interest expense was \$62,000 and \$32,000 for the six months ended December 31, 2005 and 2004, respectively.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*This management's discussion and analysis of financial condition and results of operations and other portions of this Quarterly Report on Form 10-QSB contain forward-looking information that involves risks and uncertainties. Our actual results could differ materially from those anticipated by this forward-looking information. Factors that could cause or contribute to such differences include, but are not limited to, those discussed or referred to in the Annual Report on Form 10-KSB for the year ended June 30, 2005, filed on October 14, 2005, under the heading "Forward Outlook and Risks" and elsewhere. Investors should review this quarterly report on Form 10-QSB in combination with our Annual Report on Form 10-KSB in order to have a more complete understanding of the principal risks associated with an investment in our common stock. This management's discussion and analysis of financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated financial statements and related notes included elsewhere in this document.*

### **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 primarily 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. 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.

From 2003 onward through December 31, 2005, the Company's operating focus has been largely directed to the final development of the two-seat piston engine powered SparrowHawk, which it has designed and now manufactures and sells. 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

December 31, 2005, 22 American Autogyro dealerships have been established in the United States and 8 internationally.

A second emerging market is arising within the United States as a result of the Federal Aviation Administration (FAA) definition of a new category of aircraft, namely the Light Sport Aircraft (LSA). The Company has applied for an exemption applicable to gyroplanes that would allow the Company to participate initially in the LSA category through a sub-classification called Experimental Light Sport Aircraft (E-SLA). This will permit the Company to sell nearly fully assembled SparrowHawks, thereby entering a much larger market than the kit market.

In addition, the Company developed and sells modification kits designed to improve in-flight stability and safety for another manufacturer's kit gyroplane.

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 December 31, 2005, 80 initial orders for SparrowHawk gyroplane kits have been received, with 53 complete kits delivered. In the same period, 28 orders for the stabilization modification kits were ordered, with 27 kits delivered. During the six months ended December 31, 2005, the Company reported SparrowHawk sales revenues of \$420,000 on 13 delivered kits, upgrades and parts and 1 stabilization modification kit. The Company has received substantial advance payments from dealers and customers on SparrowHawk gyroplane kit orders during the past several quarters, 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 vertical take-off and landing 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.

On November 7, 2005, the Company announced that the U.S. Defense Advanced Research Projects Agency ("DARPA") had selected a Company-led team to design a proof of concept high-speed, long range, vertical takeoff and landing ("VTOL") aircraft designed for use in combat search and rescue roles. Phase One of this potential multi-year \$40 million four phase program begins with a fifteen month \$6.4 million award to develop the preliminary design and perform key technology demonstrations. The Company estimates its share of Phase One payments will approximate \$4.3 million, with the remaining portion to be paid by the Company to subcontractors and consultants hired by the Company. Payments under this contract are conditional upon the Company attaining several milestone objectives during the course of Phase One of the contract. Contracts for subsequent phases are conditional on completion of Phase One and successor phases. This modern rotorcraft, named by DARPA as the "Heliplane", is designed to exploit the Company's gyrodyne technology, offering the VTOL capability of a helicopter, the fast forward flight of an airplane, and the safety, simplicity and reliability of a GBA gyroplane. This aircraft type could be the next generation rotor wing aircraft, meeting economy and performance goals not considered achievable by any other type of VTOL aircraft.

DARPA is the central research and development organization for the US Department of Defense (DoD). It manages and directs select basic and applied research for DoD, emphasizing technology development projects where payoff is high and where success may provide dramatic advances in the capabilities of this country's combat forces.

During December 2005, the Company completed the first milestone of the DARPA contract and recognized contract revenue of \$390,000. Direct costs of the first milestone of approximately \$281,000 were expensed to cost of sales.

### **Going Concern Uncertainty**

The accompanying condensed 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, obtaining additional outside financing and/or restructuring its debt obligations. 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 and the DARPA contract, the Company's primary sources of operating revenues, are not currently sufficient, nor are they 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 introduction of a new product and due to lower than expected sales volume.
- 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 vertical take-off and landing 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 what it expects to be 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 to \$50 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, but the Company is not in a position to conclude how likely a favorable outcome to these opportunities is. 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 Hawk 4 operations until FAA certification is obtained and sales of Hawk 4 gyroplanes reach planned levels.

The Company will also receive revenues from the recently announced DARPA contract, under which the Company will lead a team to design a proof of concept high speed, long range VTOL aircraft. The Company believes that its share of revenues from phase one of this contract, currently estimated at \$4.3 million, which are payable only upon the Company attaining several milestone objectives, will have a positive impact on cash flows from operations; however, the Company will also be required to add personnel, expand facilities and make other significant purchases to meet its obligations under this contract.

As a result, the Company anticipates that operating costs of personnel, facilities, research and development and sales and marketing will increase from levels reported for fiscal year 2005.

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 condensed 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 \$653,000 in the three months ended December 31, 2005 from \$194,000 in the three months ended December 31, 2004. The revenues in the three months ended December 31, 2005 were comprised of government contract revenue of \$390,000, \$241,000 from the sale of 5 SparrowHawk kits, options and parts, \$6,000 from the sales of modification kits and other operating income and \$16,000 from flight training. In the three months ended December 31, 2004, revenues were comprised of \$160,000 from the sale of 5 SparrowHawk kits, options and parts, \$18,000 from the sale of modification kits and \$16,000 from flight training.

Total revenues increased to \$849,000 in the six months ended December 31, 2005 from \$360,000 in the six months ended December 31, 2004. The revenues in the six months ended December 31, 2005 were comprised of government contract revenue of \$390,000, \$420,000 from the sale of 10 SparrowHawk kits, options and parts, \$6,000 from the sales of modification kits and other operating income and \$33,000 from flight training. In the six months ended December 31, 2004, revenues were comprised of \$300,000 from the sale of 11 SparrowHawk kits, options and parts, \$31,000 from the sale of modification kits and \$29,000 from flight training.

The Company began delivering SparrowHawk kits in the third quarter of fiscal year 2004. SparrowHawk revenues increased in the current year over last year in spite a smaller number of kits sold

due to increased sales prices of the kits and additional sales of repair parts and options. As discussed above, the Company completed the first milestone of its DARPA contract during December 2005 and invoiced \$390,000.

At December 31, 2005, advance deposits collected over the past several quarters of \$559,000, 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.

The Company recognizes revenue on the DARPA contract as each defined milestone is completed and the requisite meetings are held and technical data submitted and accepted by DARPA. At that time, DARPA instructs the Company to submit an invoice for payment for the respective milestone at the amount specified in the contract.

### **Costs and Expenses**

Comparing the three months ended December 31, 2005 to the three months ended December 31, 2004, cost of sales increased to \$647,000 from \$235,000. The increase in fiscal year 2005 was primarily due to the cost of sales recorded for the DARPA contract of \$281,000 and the cost of sales of the SparrowHawk kits, options and parts of \$351,000. Comparing the six months ended December 31, 2005 to the six months ended December 31, 2004, cost of sales increased to \$1,019,000 from \$413,000, primarily due to the cost of sales recorded for the DARPA contract of \$281,000 and the cost of sales of the SparrowHawk kits, options and parts of \$715,000.

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 and due to lower than expected sales volume. 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 anticipates 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. All costs of incomplete SparrowHawk kits delivered as of December 31, 2005 have been deferred and included in work-in-process inventories.

Comparing the three months ended December 31, 2005 to the three months ended December 31, 2004, research and development expenses decreased to \$565,000 from \$592,000. Comparing the six months ended December 31, 2005 to the six months ended December 31, 2004, research and development expenses increased to \$1,208,000 from \$1,059,000.

The increase in research and development expenses on a year-to-date basis in the current fiscal year is due primarily to the addition of new engineering employees in relation to the development of

applications for contracts from government agencies, including the DARPA contract, and to increases in compensation for current employees. During the three months ended December 31, 2005, portions of the cost of these engineering employees and other related costs were charged to cost of sales of the DARPA contract as their efforts were redirected to the contract, resulting in a slight decrease in research and development expenses during the current quarter as compared to the same quarter last year. Research and development activities have consisted of ongoing variations 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 the three months ended December 31, 2005 to the three months ended December 31, 2004, general and administrative expenses increased to \$439,000 from \$386,000, a 14% increase. Comparing the six months ended December 31, 2005 to the six months ended December 31, 2004, general and administrative expenses increased to \$937,000 from \$805,000, a 16% 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 and government contract opportunities, including the DARPA contract.

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

Comparing the three months ended December 31, 2005 to the three months ended December 31, 2004, related party interest income decreased to \$2,000 from \$4,000 due to repayment of related party notes receivable in the current fiscal year. Similarly, comparing the six months ended December 31, 2005 to the six months ended December 31, 2004, related party interest decreased to \$3,000 from \$6,000.

Comparing the three months ended December 31, 2005 to the three months ended December 31, 2004, interest and other income increased to \$155,000 from \$3,000, primarily because of a \$149,000 gain on settlement of debt recognized in the current year second quarter. Similarly, comparing the six months ended December 31, 2005 to the six months ended December 31, 2004, interest and other income increased to \$164,000 from \$11,000. In addition to the gain on settlement of debt, interest and other income is comprised of interest income earned on the Company's bank deposits, sales of scrap materials and other miscellaneous sources.

Interest expense for the three months ended December 31, 2005 compared to the three months ended December 31, 2004 decreased slightly to \$375,000 from \$387,000. However, compared to the six months ended December 31, 2005 to the six months ended December 31, 2004, interest expense increased to \$815,000 from \$705,000. The increase on a year-to-date basis in the current fiscal year was due primarily to additional interest expense incurred in the first quarter of the current fiscal year on the issuance of stock options to lenders in connection with new debt or debt extensions, and the effect of current fiscal year net additions to debt.

Comparing the three months ended December 31, 2005 to the three months ended December 31, 2004, Series B Preferred Stock interest expense increased to \$4,202,000 from \$1,839,000. Compared to the six months ended December 31, 2005 to the six months ended December 31, 2004, Series B Preferred Stock interest expense increased to \$7,043,000 from \$3,453,000. 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 continued to increase. In addition, the \$925,000 estimated value of the additional warrants issued in connection with the extension of the due date of the Series B Preferred Stock in October 2005 was

charged to Series B Preferred Stock interest expense. This interest expense in the quarter ended December 31, 2005 was also increased by \$1,239,000 for the accretion of the future obligation to issue additional shares of Series B Preferred Stock on January 1, 2007, the extended maturity date.

### **Net Loss**

During the three months and six months ended December 31, 2005, the Company continued to record losses as it progressed toward full marketing and manufacturing of the SparrowHawk gyroplane kit, continued research and development activities on SparrowHawk gyroplane derivatives and other applications of the Company's gyroplane technology, and commenced work on the DARPA contract. For the three months ended December 31, 2005, the loss from operations was \$998,000 compared to the loss from operations of \$1,019,000 for the three months ended December 31, 2004. For the six months ended December 31, 2005, the loss from operations was \$2,315,000 compared to \$1,917,000 for the six months ended December 31, 2004. The increase in the loss from operations on a year-to-date basis 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 recognition of revenue from the DARPA contract in the three months ended December 31, 2005 resulted in a slight decrease in the loss from operations compared to the comparative three months in the prior fiscal year.

The net loss and the net loss applicable to common stockholders for the three months ended December 31, 2005 was \$5,418,000 compared to \$3,238,000 for the three months ended December 31, 2004. The net loss and the net loss applicable to common stockholders for the six months ended December 31, 2005 was \$10,006,000 compared to \$6,058,000 for the six months ended December 31, 2004. The increase in the net loss and the net loss applicable to common stockholders 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.

### **Liquidity and Capital Resources**

At December 31, 2005, the Company had total current liabilities of \$13,467,000 and current assets of \$875,000, resulting in a working capital deficiency of \$12,592,000. Total liabilities exceed total assets by \$57,676,000 at December 31, 2005. The Company anticipates that operating costs of personnel, facilities, research and development and sales and marketing will increase from levels reported for fiscal year 2005.

Net cash used in operating activities was \$2,089,000 for the six months ended December 31, 2005 compared to \$1,261,000 for the six months ended December 31, 2004, primarily due to negative gross margins on revenues and increases in operating costs and expenses as described above.

The Company has funded losses from operations in the current fiscal year and historically 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 used in investing activities for the six months ended December 31, 2005 was \$149,000, comprised of the purchase of property and equipment of \$129,000 and the issuance of a related party note receivable of \$20,000. Net cash used in investing activities for the six months ended December 31, 2004 was \$28,000 for the purchase of property and equipment.

Net cash provided by financing activities was \$2,198,000 for the six months ended December 31, 2005 comprised primarily of a net increase in debt of \$237,000 and net proceeds from the issuance of common stock of \$1,961,000. Net cash provided by financing activities for the six months ended December 31, 2004 was \$1,262,000, comprised of a net increase in debt of \$393,000 and net proceeds from the issuance of common stock of \$869,000. 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. The Company believes that its share of revenues from the recently awarded government contract, which are payable only upon the Company attaining several milestone objectives, will have a positive impact on cash flows from operations; however, the Company will also be required to add personnel, expand facilities and make other significant purchases to meet its obligations under this contract. There is no assurance that the Company will be successful in either raising sufficient capital or improving operations.

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

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 December 31, 2005, the Company was delinquent in making payments on substantially all promissory notes to vendors and to other unrelated party lenders, which totaled \$689,000. The Company continues ongoing negotiations with these vendors and lenders, 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 \$1,136,000, and accrued interest payable on debt of \$723,000.

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 \$35,850,000 in the consolidated balance sheet as of September 30, 2005 because of the extension of the redemption date to January 1, 2007, thus improving the working capital position of the Company.

The October 11, 2005 extension requires the following consideration to be paid to the Series B Holders:

- The cancellation on October 11, 2005 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 on October 11, 2005 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 during the extension period 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.

## **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.

The Company recognizes revenue on its current government contract as each defined milestone is completed and the requisite meetings are held and technical data submitted and accepted by DARPA. At that time, DARPA instructs the Company to submit an invoice for payment for the respective milestone at the amount specified in the contract. Contract-related expenses incurred by the Company for each milestone of the contract, including its own labor, travel, supplies and other costs, and the costs of

subcontractors and consultants, are deferred and expensed to cost of sales as the contract revenue for the milestone is recognized.

**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 has estimated the fair value of the put option liability using the Black-Scholes option-pricing model. Until the obligation was satisfied in November 2005, the Company used 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 required adjustment, with changes in the fair value recognized as interest cost. The fair value of the put option liability was 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 could have resulted 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.

### **Item 3. Controls and Procedures**

#### **(A) Evaluation of disclosure 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 December 31, 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 material weakness 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 completely 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 six months of fiscal year 2006, the Company has been implementing 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 hired 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, and currently estimates the accounting module of the ERP software will be fully implemented by July 1, 2006.

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 and continuing into fiscal year 2006, 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.

#### **(B) Changes in internal controls**

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.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings**

The Company is plaintiff in connection with four million shares 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 various claims and legal actions arising in the ordinary course of business, including certain matters relating to past due amounts payable to creditors. The past due amounts are recorded as liabilities in the Company's condensed 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 condensed consolidated financial statements.

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

During the period November 26 through December 31, 2005, the Company issued a total of 2,238,458 shares of its restricted common stock, primarily to accredited investors in transactions exempt from registration. These shares were issued at prices ranging from \$0.20 to \$0.30 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: 1,291,417 shares for cash of \$536,000; 154,273 shares in payment of accrued expenses of \$35,000; 2,857 shares in payment of services of \$1,000; 646,213 shares in reduction of debt of \$134,000; and 143,698 shares in payment of interest expense of \$31,000. In addition, accrued finders' compensation on the sale of common stock totaled \$41,000 during this period. The Company did not use underwriters in the sale or placement of these unregistered shares of common stock.

During the six months ended December 31, 2005, the Company issued options to purchase a total of 17,768,158 shares of its restricted common stock: 15,239,750 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; 1,528,408 options as a loan origination fee or interest to a lenders with exercise prices of \$0.20 to \$0.25 per share exercisable for a period of 1 to 3 years; and 1,000,000 options to a vendor for services with an exercise price of \$0.50 per share exercisable for a period of three years. The Company estimated the value of the 1,528,408 options issued to the lenders at \$104,000 using the Black-Scholes option pricing model, and charged this amount to interest expense. The Company estimated the value of the 1,000,000 options issued to a vendor for services at \$30,000 using the Black-Scholes option pricing model, and charged this amount to general and administrative expense. The Company also issued options to purchase a total of 1,000,000 shares of common stock for cash of \$44,000, with an exercise price of \$0.20 per share for a period of one year. In addition, the Company recorded interest expense of \$77,000 on 3,200,000 variable stock options during the six months ended December 31, 2005 using the Black-Scholes option pricing model.

### **Item 3. Defaults Upon Senior Securities**

The Company is current on its obligations pertaining to the Series B 15% Cumulative Redeemable Non-Voting Preferred Stock. However, as more fully discussed under “Liquidity and Capital Resources” above, the Company is delinquent in making payments on notes payable to vendors totaling \$689,000, capital lease obligations of \$660,000, notes payable to related parties totaling \$1,136,000, and \$723,000 of accrued interest payable on debt.

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

No matters were submitted to a vote of security holders during the quarter ended December 31, 2005.

### **Item 5. Other Information**

During the period November 26 through December 31, 2005, the Company issued a total of 2,238,458 shares of its restricted common stock, primarily to accredited investors in transactions exempt from registration. See Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds.

During the six months ended December 31, 2005, the Company issued options to purchase a total of 17,768,158 shares of its restricted common stock. See Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds.

### **Item 6. Exhibits**

(a) Exhibits (filed with this report unless indicated below):

- |      |  |
|------|--|
| 31.1 | Certification of principal executive officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of principal financial officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of principal executive officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 32.2 | Certification of principal financial officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |

## SIGNATURES

In accordance with the requirements of the Exchange Act, the Registrant caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

GROEN BROTHERS AVIATION, INC.

By: /s/ David Groen  
David Groen, President and Chief Executive Officer  
(Principal Executive Officer)

Date: February 21, 2006

By: /s/ Dennis P. Gauger  
Dennis P. Gauger, Chief Financial Officer and Secretary  
(Principal Financial and Accounting Officer)

Date: February 21, 2006

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER  
PURSUANT TO RULE 13a - 14(a) OF THE  
SECURITIES EXCHANGE ACT OF 1934, AS AMENDED,  
AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, David Groen certify that:

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

/s/ David Groen

David Groen, President and Chief Executive Officer  
(Principal Executive Officer)  
February 21, 2006

**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER  
PURSUANT TO RULE 13a - 14(a) OF THE  
SECURITIES EXCHANGE ACT OF 1934, AS AMENDED,  
AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Dennis P. Gauger certify that:

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

/s/ Dennis P. Gauger

Dennis P. Gauger, Chief Financial Officer and Secretary  
(Principal Accounting Officer)  
February 21, 2006

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Groen Brothers Aviation, Inc. (the "Company") on Form 10-QSB for the quarter ended December 31, 2005, as filed with the Securities and Exchange Commission on the date hereof (the "Quarterly Report"), I, David Groen, President and Chief Executive Officer of the Company, hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

- a. the Quarterly Report fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934; and
- b. the information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ David Groen  
David Groen, President and Chief Executive Officer  
(Principal Executive Officer)  
February 21, 2006

**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Groen Brothers Aviation, Inc. (the "Company") on Form 10-QSB for the quarter ended December 31, 2005, as filed with the Securities and Exchange Commission on the date hereof (the "Quarterly Report"), I, Dennis P. Gauger, Chief Financial Officer of the Company, hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

- a. the Quarterly Report fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934; and
- b. the information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Dennis P. Gauger

Dennis P. Gauger, Chief Financial Officer and Secretary  
(Principal Accounting Officer)  
February 21, 2006