

AXIAL VECTOR ENGINE CORP
Form 10QSB
November 14, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-QSB

Quarterly Report pursuant to Section 13 or 15(d) of
the Securities Exchange Act of 1934

For the quarterly period ended **September 30, 2006**

Transition Report pursuant to 13 or 15(d) of the
Securities Exchange Act of 1934

For the transition period _____
to _____

Commission File Number: **000-49698**

Axial Vector Engine Corporation

(Exact name of small business issuer as specified in its charter)

Nevada

(State or other jurisdiction of incorporation or
organization)

20-3362479

(IRS Employer Identification No.)

One World Trade Center

121 S.W. Salmon Street, Portland, Oregon 97204

(Address of principal executive offices)

503-471-1348

(Issuer's telephone number)

(Former name, former address and former fiscal year, if changed since last report)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the issuer 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

State the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:
36,094,096 common shares as of September 29, 2006.

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

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Our unaudited consolidated financial statements included in this Form 10-QSB are as follows:

- F-1 Consolidated Balance Sheet as of September 30, 2006 (Unaudited) and September 30, 2005 (Restated);
- F-2 Consolidated Statements of Operations for the three months ended September 30, 2006 and 2005 (Restated) with Cumulative Totals Since Inception (Unaudited);
- F-3 Consolidated Statement of Changes in Stockholders' Equity for the three months ended September 30, 2006;
- F-4 Consolidated Statements of Cash Flows for the three months ended September 30, 2006 and 2005 (Restated) with Cumulative Totals Since Inception (Unaudited); and
- F-5 Notes to Consolidated Financial Statements.

These unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the SEC instructions to Form 10-QSB. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. Operating results for the interim period ended September 30, 2006 are not necessarily indicative of the results that can be expected for the full year.

**AXIAL VECTOR ENGINE CORPORATION AND SUBSIDIARY
(FORMERLY AERO MARINE ENGINE, INC.)
(A DEVELOPMENT STAGE COMPANY)
CONSOLIDATED BALANCE SHEETS
SEPTEMBER 30, 2006 AND 2005 (Restated)
(Unaudited)**

	September 30, 2006	September 30, 2005 (Restated) Note 2
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 291,859	\$ 162,015
Deposit	22,670	22,670
Subscription receivable	53,000	-
Prepaid expenses	15,000	22,330
Total Current Assets	382,529	207,015
Property and equipment, net (Note 5)	72,537	39,161
Due from shareholder (Note 13)	10,000	
Intangible assets- patents, net (Note 6)	243,324	217,544
TOTAL ASSETS	\$ 708,390	\$ 463,720
LIABILITIES AND STOCKHOLDERS' DEFICIT		
LIABILITIES		
Current Liabilities:		
Accounts payable and accrued expenses	\$ 594,828	\$ 104,866
Payroll tax liabilities	26,971	-
Current portion of note payable (Note 6)	1,245,000	995,000
Contingent share-based payment (Note 7)	-	-
Liability for stock to be issued (Note 8)	393,326	695,362
Share-based fee liability- warrants (Note 9)	2,084,884	6,504,250
Share-based fee liability- options (Note 10)	2,856,220	3,559,128
	5,615,400	8,762,780

Share-based compensation liability- options (Note 11)		
Accrued interest - shareholder loan (Note 13)	77,297	42,171
Due to related company (Note 12)	301,339	301,339
Total Current Liabilities	13,195,265	20,964,896
Due to shareholder (Note 13)	917,030	387,683
Total Liabilities	14,112,295	21,352,579
STOCKHOLDERS' DEFICIT		
Preferred stock, \$.001 par value; 100,000,000 shares authorized no shares issued and outstanding	-	-
Common stock, \$.001 par value; 100,000,000 shares authorized 36,094,096 and 34,657,010 shares issued and outstanding (Note 14)	36,094	34,657
Additional paid-in capital	23,239,905	21,998,233
Prepaid share-based fees (Note 15)	(2,306,950)	(2,900,702)
Prepaid share-based compensation (Note 15)	(352,625)	(1,003,625)
Beneficial reduction of share-based liability (Note 16)	13,528,016	-
Deficit accumulated during the development stage	(47,548,345)	(39,017,422)
Total Stockholders' Deficit	(13,403,905)	(20,888,859)
TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIT		
	\$ 708,390	\$ 463,720

The accompanying notes are an integral part of these consolidated financial statements.

AXIAL VECTOR ENGINE CORPORATION AND SUBSIDIARY
(FORMERLY AERO MARINE ENGINE, INC.)
(A DEVELOPMENT STAGE COMPANY)
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005 (Restated)
(WITH CUMULATIVE TOTALS SINCE INCEPTION)
(Unaudited)

	For the Three Months Ended September 30, 2006	For the Three Months Ended September 30, (Restated) Note 2	Cumulative Totals December 30, 2002 through September 30, 2006
SALES	\$ -	\$ -	\$ -
COST OF SALES	-	-	-
GROSS PROFIT	-	-	-
OPERATING EXPENSES			
Accounting and Auditing	176,875	13,435	274,778
Administration	3,366	9,715	153,304
Advertising, promotion, consulting and travel (Note 17)	486,304	795,412	7,427,115
Beneficial share-based fee (Note 18)	139,272	4,827,272	2,148,760
Board compensation (Note 19)	58,590	142,290	1,330,830
Depreciation (Note 5)	1,480	1,552	48,094
Financing cost - standby equity agreement (Note 2)	-	760,000	7,320,000
Legal fees (Note 20)	220,596	584,579	5,653,076
Insurance	19,245	2,128	66,110
Interest	802	17,622	134,693
Office expense	21,397	5,463	231,805
Officer's compensation (Note 21)	415,250	1,202,606	11,000,613
Payroll taxes	30,274	6,885	75,318
Rent	6,529	999	87,274
Research and development (Note 22)	112,954	615,851	5,062,522
Salaries and wages-administration	54,752	57,000	485,340
Salaries and wages-engineering	25,000	-	141,712
Impairment of intangible asset	-	-	3,701,347
Total Operating Expenses	1,772,686	9,042,809	45,342,691
NET LOSS BEFORE OTHER INCOME (EXPENSE)	(1,772,686)	(9,042,809)	(45,342,691)
OTHER INCOME (EXPENSE)			

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Bank interest	-	65	71
Write off worthless inventory	-	-	(266,519)
Refunds	(28,400)	-	(25,813)
Lawsuit settlements	-	-	(1,805,429)
Impairment of property and equipment	-	-	(107,964)
Total Other Income (Expenses)	(28,400)	65	(2,205,654)

NET LOSS BEFORE PROVISION FOR INCOME TAXES	(1,801,086)	(9,042,744)	(47,548,345)
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Provision for income taxes (Note 23)	-	-	-
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NET LOSS APPLICABLE TO COMMON SHARES	\$ (1,801,086)	\$ (9,042,744)	\$ (47,548,345)
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NET LOSS PER SHARE -BASIC (Note 4)	(.04)	(.26)	
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NET LOSS PER FULLY DILUTED SHARES (Note 4)	\$ (.04)	\$ (.23)	
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The accompanying notes are an integral part of these consolidated financial statements.

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**AXIAL VECTOR ENGINE CORPORATION AND SUBSIDIARY
(FORMERLY AERO MARINE ENGINE, INC.)
(A DEVELOPMENT STAGE COMPANY)**
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2006 (Restated)**
(Unaudited)

Description	Prepaid Shares & Beneficial Reduction	Common	Additional Paid-In Capital	Deficit Accumulated During the Development Stage	Total Stockholders Equity
Balance, June 30, 2006-restated (Note 2)	\$ 9,428,959	\$ 35,004	\$ 20,988,208	\$ (45,747,259)	\$ (15,295,088)
Issuance of shares for services		73	566,814		566,887
Reduction in prepaid shares	400,148				400,148
Beneficial reduction in option value outstanding	1,039,334				1,039,334
Issuance of stock for cash	-	1,017	1,674,883		1,675,900
Net loss for the three months ended September 30, 2006				(1,801,086)	(1,801,086)
Balance, September 30, 2006	\$ 10,868,441	\$ 36,094	\$ 23,229,905	\$ (47,548,345)	\$ (13,413,905)

The accompanying notes are an integral part of these consolidated financial statements.

AXIAL VECTOR ENGINE CORPORATION AND SUBSIDIARY
(FORMERLY AERO MARINE ENGINE, INC.)
(A DEVELOPMENT STAGE COMPANY)
CONSOLIDATED STATEMENTS OF CASH FLOW
FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005 (Restated)
(WITH CUMULATIVE TOTALS SINCE INCEPTION)
(Unaudited)

	2006	2005 (Restated) See Note 2	Cumulative Totals December 30, 2002 through September 30, 2006
CASH FLOWS FROM OPERATING ACTIVITIES			
Net (Loss)	\$ (1,801,086)	\$ 9,042,744	\$ (47,548,345)
Adjustments to reconcile net loss to net cash used in operating activities			
Common stock issued for services	212,960	4,156,500	9,163,179
Options issued for services	119,500	1,181,654	4,350,300
Options issued as compensation	-	57,000	7,847,510
Warrants issued for services	-	796,500	6,024,218
Depreciation and amortization	1,480	1,552	48,094
Shares issued for lawsuit settlements	-	-	1,805,428
Impairment of property and equipment	-	-	107,964
Impairment of goodwill and intangibles	-	-	3,701,347
Write-off of inventory	-	-	266,519
Changes in assets and liabilities			
(Increase) in prepaid expenses and other current assets	(28,000)	-	(100,670)
Increase in accounts payable and accrued expenses	714,959	23,077	699,096
Total adjustments	1,020,899	6,216,283	33,912,985
Net cash (used in) operating activities	(780,187)	2,826,461	(13,635,360)
CASH FLOWS FROM INVESTING ACTIVITIES			
Bank interest	-	65	71
Acquisition of intangible assets	-	(153,794)	(243,324)
Acquisitions of fixed assets	(38,241)	(19,572)	(83,873)
	(38,241)	(173,301)	(327,126)

Net cash (used in) investing activities			
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from the sale of stock	1,675,900	-	6,163,670
Proceeds from standby equity distribution agreement	-	2,150,000	4,000,000
Liability for stock to be issued	(354,252)	610,862	393,326
Conversion of shareholder debt to equity	-	-	975,000
Proceeds from note payable	-	-	1,245,000
Advances from shareholders	136,712	500,000	2,923,826
Payments on shareholder loan	(401,320)	(140,914)	(1,992,797)
Advances (payments to) related company-net	-	(10,000)	301,339
Exercise of stock options	-	44,469	244,981
Net cash provided by financing activities	1,057,040	3,154,417	14,254,345
NET INCREASE IN CASH AND CASH EQUIVALENTS	238,612	154,655	291,859
CASH AND CASH EQUIVALENTS - July 1	53,247	7,360	-
CASH AND CASH EQUIVALENTS - September 30	\$ 291,859	\$ 162,015	\$ 291,859

The accompanying notes are an integral part of these consolidated financial statements.

**AXIAL VECTOR ENGINE CORPORATION AND SUBSIDIARY
(FORMERLY AERO MARINE ENGINE, INC.)
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2006 AND 2005
(Unaudited)**

NOTE 1 GOING CONCERN UNCERTAINTY

As shown in the accompanying financial statements, as is typical of companies going through the development stage, the Company incurred net losses for the three months ended September 30, 2006 and 2005 and for the period December 30, 2002 to September 30, 2006.

The Company is currently in the development stage, and there is no guarantee whether the Company will be able to generate enough revenue and/or raise capital to support current operations and generate anticipated sales .

This raises substantial doubt about the Company's ability to continue as a going concern. Management believes that the Company's capital requirements will depend on many factors including the success of the Company's product development efforts. The financial statements do not include any adjustments that might result from the outcome of these uncertainties.

NOTE 2 BASIS OF PRESENTATION AND RESTATEMENT

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary Dyna-Cam, Aero Marine Engine Corp. All significant inter-company accounts and transactions are eliminated.

These consolidated financial statements reflect all adjustments, including normal recurring adjustments which, in the opinion of management, are necessary to present fairly the operations and cash flows for the periods presented. In addition, the consolidated financial statements for the three months ended September 30, 2005 have been restated to reflect the following changes in accounting principles and changes due to corrections of errors.

RESTATEMENT TO REFLECT CHANGE IN ACCOUNTING PRINCIPLE

Effective for the reporting periods after December 15, 2005, Companies are required to account for issuance of share-based payments in accordance with Statement of Financial Standard No. 123. This statement requires companies to value issuance of common stock, stock options and stock warrants at 'fair value' upon the completion of services rendered. For public companies, this fair value is arrived at by using an 'econometric model' to take into consideration variability of stock price, tax-free interest rate and time-value of money. Common stock issued for compensation or services are valued at the publicly disclosed price at the date of valuation. Compensation expense, Attorney expense, Advertising and Promotion expense have been retroactively adjusted to reflect this valuation principle for three months ended September 30, 2005. In accordance with Standard of Financial Accounting Standards No. 154 the following changes are disclosed below:

**AXIAL VECTOR ENGINE CORPORATION AND SUBSIDIARY
(FORMERLY AERO MARINE ENGINE, INC.)**

(A DEVELOPMENT STAGE COMPANY)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2006 AND 2005

(Unaudited)

NOTE 2 BASIS OF PRESENTATION AND RESTATEMENT (CONTINUED)

Income Statement for the three months ended September 30, 2005:

	As Originally Reported	As Adjusted	Effect of Change
Sales	\$ -	\$ -	-
Cost of goods sold	-	-	-
Compensation	29,062	1,401,896	(1,372,834)
Professional and consulting	227,163	1,358,014	(1,130,851)
Advertising, promotion, consulting, and travel	42,851	5,622,684	(5,579,833)
Rent	999	999	-
Research and development	615,851	615,851	-
General and administrative	96,579	24,191	72,388
Depreciation	1,552	1,552	-
Total Expenses	1,014,057	9,025,187	(8,011,130)
Interest income	65	65	-
Interest expense	(17,622)	(17,622)	-
Net Income (Loss)	\$ (1,031,614)	\$ (9,042,744)	\$ (8,011,130)
Per Share Basic	(.03)	(.27)	(.24)
Per Share Fully Diluted	(.03)	(.23)	(.20)

In addition to the cumulative effects of the change in accounting principle above, stockholders' deficit for the year ending June 30, 2005 has been increased to reflect the discovery of an error. Previous management incorrectly recognized compensation expense of \$3,350,000 for stock options that were never issued. Other balance sheet accounts have been adjusted to reflect other immaterial but non-routine items.

**AXIAL VECTOR ENGINE CORPORATION AND SUBSIDIARY
(FORMERLY AERO MARINE ENGINE, INC.)
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2006 AND 2005
(Unaudited)**

NOTE 2 BASIS OF PRESENTATION AND RESTATEMENT (CONTINUED)

**Balance Sheet
September 30, 2005**

	As Originally Reported	As Adjusted	Effect of Change
Assets			
Cash	\$ 149,015	\$ 162,015	\$ 13,000
Deposit	22,670	22,670	-
Prepaid expenses	22,330	22,330	-
Total current assets	194,015	207,015	13,000
Property and equipment-net	39,162	39,161	(1)
Intangible assets-net	217,544	217,544	-
Total Assets	\$ 450,721	\$ 463,720	\$ 12,999
Liabilities and Stockholders'			
Deficit			
Accounts payable	\$ 154,492	\$ 104,866	\$ 49,626
Current portion of note payable	1,500,000	995,000	505,000
Liability for stock to be issued	337,095	695,362	(358,267)
Share-based fee liabilities	-	18,826,158	18,826,158
Accrued interest - shareholder	-	42,171	(42,171)
Due to related company	301,339	301,339	-
Total current liabilities	2,292,926	20,964,896	(18,671,970)
Note payable	1,500,000	-	1,500,000
Due to shareholder	1,740,191	387,683	1,352,508
Total Liabilities	5,528,117	21,352,579	(15,824,462)
Stockholders' Deficit			
Prepaid share-based fee	-	(2,900,702)	2,900,702
Prepaid share-based compensation.	-	(1,003,625)	1,003,625
Common stock	32,728	34,657	(1,929)
Additional paid-in capital	12,766,588	21,998,233	(9,231,645)
Accumulated deficit	(17,876,712)	(39,017,422)	21,140,710
Total Stockholders' Deficit	(5,077,396)	(20,888,859)	15,811,463
Total Liabilities and Stockholders'			
Deficit	\$ 450,721	\$ 463,720	\$ (12,999)

**AXIAL VECTOR ENGINE CORPORATION AND SUBSIDIARY
(FORMERLY AERO MARINE ENGINE, INC.)
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2006 AND 2005
(Unaudited)**

NOTE 2 BASIS OF PRESENTATION AND RESTATEMENT (CONTINUED)

Subsequent to the audit of financial statements for the year ended June 30, 2006, several omitted material transactions were discovered. On May 5, 2005 in connection with the standby equity finance agreement with Alliance Capital, 2,000,000 warrants, exercise price \$4.00 a share for a period of two years were authorized but not issued. This transaction was not recorded on the accounting books or financial statements of the company at June 30, 2006. The cumulative effect is to increase the accumulated deficit of the Company by \$7,320,000 at June 30, 2006. In addition, an improper accrual of accounts payable was discovered for the three months ended March 31, 2006 reducing accounts payable by \$447,565.

Accumulated Deficit June 30, 2006 original	\$ (38,874,824)
Cumulated effect of Alliance warrants	\$ (7,320,000)
Incorrect accounts payable accrual	\$ 447,565
Accumulated deficit June 30, 2006 restated	\$ (45,747,259)

NOTE 3 ORGANIZATION

Princeton Ventures, Inc. (the "Company") was incorporated in the State of Nevada on May 10, 2001. The Company had not commenced operations. On May 30, 2003, the Company exchanged 37,994,923 shares of its common stock for all of the issued and outstanding shares of Aero

Marine Engine Corp. ("Aero"). Aero was formed on March 30, 2002. Aero had no operations and was formed to acquire the assets of Dyna-Cam Engine Corporation. The Company changed its name from Princeton Ventures, Inc. to Aero Marine Engine, Inc.

At the time that the transaction was agreed to, the Company had 20,337,860 common shares issued and outstanding. In contemplation of the transaction with Aero, the Company's two primary shareholders canceled 9,337,860 shares of the Company's common stock held by them, leaving 11,000,000 shares issued and outstanding. As a result of the acquisition of Aero, there were 48,994,923 common shares outstanding, and the former Aero stockholders held approximately 78% of the Company's voting stock. For financial accounting purposes, the acquisition was a reverse

acquisition of the Company by Aero, under the purchase method of accounting, and was treated as a recapitalization with Aero as the acquirer. Accordingly, the historical financial statements have been restated after giving effect to the May 30, 2003, acquisition of the Company. The financial statements have been prepared to give retroactive effect to December 30, 2002, the date of inception of Aero, of the reverse acquisition completed on May 30, 2003, and represent the operations of Aero. Consistent with reverse acquisition accounting: (i) all of Aero's assets, liabilities, and accumulated deficit, are reflected at their combined historical cost (as the accounting acquirer) and (ii) the preexisting outstanding shares

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**AXIAL VECTOR ENGINE CORPORATION AND SUBSIDIARY
(FORMERLY AERO MARINE ENGINE, INC.)
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2006 AND 2005
(Unaudited)**

NOTE 3 ORGANIZATION (CONTINUED)

of the Company (the accounting acquiree) are reflected at their net asset value as if issued on May 30, 2003.

Additionally, on June 30, 2003, the Company acquired the operating assets of Dyna-Cam Engine Corp. ("Dyna-Cam"). Dyna-Cam was a development stage enterprise developing a unique, axial cam-drive, free piston, internal combustion engine. Dyna-Cam intended to produce and sell the engine primarily for aircraft and marine applications. Dyna-Cam had not generated significant revenues at the time of the Company's acquisition.

The Company, under its new management, has raised over \$9,600,000 in cash to affect the development of the Axial Vector Engine "E" (Electronic). Management believes that significant capital is required to adequately develop the Axial Vector Engine "E" engine and begin operations. For the twelve months ended June 30, 2006, shareholders of the Company have advanced a net of \$1,515,926 to assist in funding the operations.

The Company will require additional capital. Although the current majority stockholders of the Company, as well as an affiliate, have made verbal commitments with no guarantees to continue to fund the development and sales and marketing efforts of the Company, if alternate financing cannot be obtained. There can be no assurance that any new capital will be available to the Company or that adequate funds for the Company's operations, whether from the Company's revenues, financial markets, or other arrangements will be available when needed or on terms satisfactory to the Company. The failure of the Company to obtain adequate additional financing will require the Company to delay, curtail or scale back some or all of its research and development programs, sales, marketing efforts and manufacturing operations.

On May 19, 2005, the Company announced that it had changed its name to Axial Vector Engine Corporation ("Axial"). Management believes the new name will more accurately describe the Company's mission. The Company's stock symbol changed to AXVC.

NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

**AXIAL VECTOR ENGINE CORPORATION AND SUBSIDIARY
(FORMERLY AERO MARINE ENGINE, INC.)
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2006 AND 2005
(Unaudited)**

NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Cash and Cash Equivalents

Cash and cash equivalents consists principally of currency on hand, demand deposits at commercial banks, and liquid investment funds having an original maturity of three months or less at the time of purchase.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to credit risk consist of cash equivalents and accounts receivable.

The Company's policy is to review the amount of credit exposure to any one financial institution and place investments with financial institutions evaluated as being credit worthy. In the ordinary course of business, the Company has bank deposits that may exceed federally insured limits. As of September 30, 2006, the Company was not in excess of the \$100,000 insured limit.

Property and Equipment

Property and equipment is stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, three to seven years. Reviews are regularly performed to determine whether facts and circumstances exist that indicate the carrying amount of assets may not be recoverable or the useful life is shorter than originally estimated. The Company assesses the recoverability of its property and equipment by comparing the projected undiscounted net cash flows associated with the related asset or group of assets over their remaining lives against their respective carrying amounts. Impairment, if any, is based on the excess of the carrying amount over the fair value of those assets.

If assets are determined to be recoverable, but the useful lives are shorter than originally estimated, the net book value of the assets is depreciated over the newly determined remaining useful lives. When equipment is retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and the resulting gain or loss is included in operations.

**AXIAL VECTOR ENGINE CORPORATION AND SUBSIDIARY
(FORMERLY AERO MARINE ENGINE, INC.)
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2006 AND 2005
(Unaudited)**

NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Reclassifications

Certain amounts for the three months ended September 30, 2005 have been reclassified to conform to the presentation of the September 30, 2006 amounts. The reclassifications have no effect on net loss for the three months ended September 30, 2005.

Income Taxes

The Company has adopted the provisions of Statement of Financial Accounting Standards (“SFAS”) No. 109, Accounting for Income Taxes. The Statement requires an asset and liability approach for financial accounting and reporting of income taxes, and the recognition of deferred tax assets and liabilities for the temporary differences between the financial reporting bases and tax bases of the Company’s assets and liabilities at enacted tax rates expected to be in effect when such amounts are realized or settled.

Advertising, Promotion, Consulting, and Travel Expenses

The Company’s policy is to expense the costs of advertising, promotion, consulting, and travel expenses as they are incurred. In accordance with SFAS 123r, consulting fees paid with Common Shares or Derivatives such as Options or Warrants are expensed when requisite services have been performed and valued using an econometric model. Advertising expense for the three months ending September 30, 2006 and 2005 was \$486,304 and \$795,412, respectively.

Research and Development

Research and development costs are expensed as incurred.

Intangible Assets

During the three months ended September 30, 2006, the Company incurred no additional cost in applying and registering of patents. These patents are currently pending. Due to the nature of the patents, the Company anticipates receiving confirmation on their applications in an expedited fashion.

**AXIAL VECTOR ENGINE CORPORATION AND SUBSIDIARY
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(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2006 AND 2005
(Unaudited)**

NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Start-up Costs

In accordance with the American Institute of Certified Public Accountants Statement of Position 98-5, "*Reporting on the costs of Start-up Activities*", the Company expenses all costs incurred in connection with the start-up and organization of the Company.

Share-Based Compensation

Employee stock awards under the Company's compensation plans are accounted for in accordance with Statement of Financial Accounting Standards No. 123, "*Accounting for Share-Based Compensation*" ("SFAS 123"), and related interpretations. Stock-based awards to non-employees are accounted for under the provisions of SFAS 123 and the Company has adopted the enhanced disclosure provisions.

(Loss) Per Share of Common Stock

Historical net income (loss) per common share is computed using the weighted average number of common shares outstanding. Diluted earnings per share (EPS) include additional dilution from common stock equivalents, such as stock issuable pursuant to the exercise of stock options and warrants. Common stock equivalents are not included in the computation of diluted earnings per share when the Company reports a loss because to do so would be anti-dilutive for the periods presented.

The following is a reconciliation of the computation for basic and diluted EPS:

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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005 (Restated)
Net (Loss)	\$ (1,801,086)	\$ (9,042,744)
Weighted-average common shares outstanding (Basic)	36,094,046	34,657,010
Weighted-average common stock equivalents:		
Stock warrants	2,500,000	2,075,000
Stock options	3,638,000	3,239,939
Weighted-average common shares outstanding (Fully Diluted)	42,232,046	39,971,949

Fair Value of Financial Instruments

The carrying amount reported in the balance sheets for cash and cash equivalents and liability for stock to be issued approximate fair value because of the immediate or short-term maturity of these financial instruments.

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 151, "Inventory Costs." SFAS No. 151 requires abnormal amounts of inventory costs related to idle facility, freight handling and wasted material expenses to be recognized as current period charges. Additionally, SFAS No. 151 requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The standard is effective for fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 did not have a material impact on the Company's financial position or results of operations.

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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

In December 2004, FASB issued Statement of Financial Accounting Standards No. 153, Exchanges of Non-monetary Assets, an amendment of APB Opinion No. 29, Accounting for Non-monetary Transactions ("SFAS 153"). This statement amends APB Opinion 29 to eliminate the exception for non-monetary exchanges of similar productive assets and replaces it with a general exception for exchanges of non-monetary assets that do not have commercial substance. Under SFAS 153, if a non-monetary exchange of similar productive assets meets a commercial-substance criterion and fair value is determinable, the transaction must be accounted for at fair value resulting in recognition of any gain or loss. SFAS 153 is effective for non-monetary transactions in fiscal periods that begin after June 15, 2005. The Company does not anticipate that the implementation of this standard will have a material impact on its financial position, results of operations or cash flows.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections." SFAS No. 154 replaces Accounting Principles Board ("APB") Opinion No. 20, "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements." SFAS No. 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle unless it is impracticable. APB No. 20 previously required that most voluntary changes in accounting principle be recognized by including the cumulative effect of changing to the new accounting principle in net income in the period of the change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140." SFAS No. 155 resolves issues addressed in SFAS No. 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," and permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS No. 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives and amends SFAS No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of the first fiscal year that begins after September 15, 2006.

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NOTE 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The Company is currently evaluating the effect the adoption of SFAS No. 155 will have on its financial position or results of operations.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140." SFAS No. 156 requires an entity to recognize a servicing asset or liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract under a transfer of the servicer's financial assets that meets the requirements for sale accounting, a transfer of the servicer's financial assets to a qualified special-purpose entity in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as either available-for-sale or trading securities in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities" and an acquisition or assumption of an obligation to service a financial asset that does not relate to financial assets of the servicer or its consolidated affiliates. Additionally, SFAS No. 156 requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, permits an entity to choose either the use of an amortization or fair value method for subsequent measurements, permits at initial adoption a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights and requires separate presentation of servicing assets and liabilities subsequently measured at fair value and additional disclosures for all separately recognized servicing assets and liabilities. SFAS No. 156 is effective for transactions entered into after the beginning of the first fiscal year that begins after September 15, 2006. The Company is currently evaluating the effect the adoption of SFAS No. 156 will have on its financial position or results of operations.

NOTE 5 PROPERTY AND EQUIPMENT

Property and equipment consist of the following at September 30, 2006 and 2005.

	2006	2005
Computer	\$ 26,572	\$ 26,572
Equipment and machinery	13,274	13,273
Leasehold Improvements	5,533	
Office equipment	38,495	2,723
	83,874	42,568
Less: accumulated depreciation	(11,337)	(3,407)
	\$ 72,537	\$ 39,161

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NOTE 5 PROPERTY AND EQUIPMENT (CONTINUED)

Depreciation expense for the three months ended September 30, 2006 and 2005 was \$1,480 and \$1,552 respectively.

NOTE 6 CURRENT PORTION OF NOTES PAYABLE

\$250,000 Note payable to Twilight Bay, LLC commencing January 2006 for working capital needs. The note is due in one year and carries a stated interest rate of two percent.

\$995,000 Note payable to Transporter Inc. commencing August 2004 for the purchase of exclusive rights to certain video-conferencing technology. Original amount of Note was \$1,000,000. The Company is currently in litigation with Transporter Inc. regarding the technology for which the note was issued. The Company has defaulted on this note and this note is due in full. See Note 11 regarding the litigation of this matter.

NOTE 7 CONTINGENT SHARE-BASED PAYMENT

In addition to the Note Payable above, the Transporter Inc., purchase in August 2004, consisted of the issuance by the Company of 1,000,000 shares to the former shareholders of Transporter, Inc. These shares are guaranteed to have a value of \$2.00 per share for a period of 2 years. Because market share value is above \$2.00 per share, there is no value placed for this contingent liability as of the reporting dates September 30, 2006 and 2005, but is disclosed for reporting purposes only.

NOTE 8 LIABILITY FOR STOCK TO BE ISSUED

The Company has entered into consulting contracts where the fees paid to the vendor are paid with Company common shares. An expense is recorded when the requisite service has been provided by the consultant in accordance with the consulting agreement. The expense is valued at fair market value of the services provided. At September 30, 2006 and 2005 services were provided and earned but yet to received share payment by the company. In addition, 134,000 shares subscribed to and paid for before September 30, 2006 by private placement were unissued by the the registrar at period end.

	Shares to be issued	Market Value
September 30, 2005	381,259	\$ 695,362
September 30, 2006	169,000	\$ 393,326

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NOTE 9 SHARED-BASED FEE LIABILITY- WARRANTS

The company has entered into consulting contracts where the consideration paid to the vendor is with options which are a common stock equivalent. Warrants provide the holder with the right to buy shares of Company stock at a set price (exercise price) within a set period of time.

In accordance with SFAS 123r, the Company has recognized an expense when the requisite service has been performed by the vendor. Any unexercised warrants are recorded as a liability and revalued using an econometric model at each reporting period.

Warrant #	Unexercised # Shares	Exercise Price	Until	Value at	Value at
				September 30, 2006	September 30, 2005
11	2,000,000	4.00	5/2007	\$ 1,600,000	\$ 6,220,000
16-19	50,000	1.75-2.50	3/2010	\$ 117,250	\$ 284,250
12-14	35,001	3.00-5.00	10/2007	\$ 40,134	\$ -
15	250,000	4.00	11/2007	\$ 327,500	\$ -
Total				\$ 2,084,884	\$ 6,504,250

NOTE 10 SHARED-BASED FEE LIABILITY- OPTIONS

The company has entered into consulting contracts where the consideration paid to the vendor is with options which are a common stock equivalent. Options provide the holder with the right to buy shares of Company stock at a set price (exercise price) within a set period of time.

In accordance with SFAS 123r, the Company has recognized an expense when the requisite service has been performed by the vendor. Any unexercised options are recorded as a liability and revalued using an econometric model at each reporting period.

Option #	Price	Until	Unexercised		Unexercised	
			#Shares September 30, 2006	Value September 30, 2006	#Shares September 30, 2005	Value September 30, 2005
6	1.52	4/2010	762,000	\$ 1,760,220	2,604,820	\$ 3,559,128
8	3.00	5/2011	10,000	23,000	-	-
12	2.63	4/2011	50,000	117,000	-	-
14	2.00	7/2011	50,000	119,500	-	-
13	2.03	6/2011	350,000	836,500	-	-
Total			1,222,000	2,856,220	2,604,820	\$ 3,559,128

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NOTE 11 SHARED-BASED COMPENSATION LIABILITY- OPTIONS

The company has entered into compensation contracts where the consideration paid to the employee is with options which are a common stock equivalent. Options provide the holder with the right to buy shares of Company stock at a set price (exercise price) within a set period of time.

In accordance with SFAS 123r, the Company has recognized an expense when the requisite service has been performed by the employee. Any unexercised options are recorded as a liability and revalued using an econometric model at each reporting period.

Title	Option#	Unexercised		Until	Value at	Value at
		#Shares	Price		September 30, 2006	September 30, 2005
Board	1-3	279,000	.50	12/09	\$ 675,180	\$ 1,065,780
Sec/Treas	4	1,000,000	1.52	4/10	\$ 2,310,000	\$ 3,820,000
CEO	5	1,000,000	1.52	4/10	\$ 2,310,000	\$ 3,820,000
Admin	7,8-11	140,000	2.15-2.63	8/10	\$ 320,220	\$ 57,000
Total					\$ 5,615,400	\$ 8,762,780

NOTE 12 DUE TO RELATED COMPANY

Transmax, Inc., a related party, whose ownership is also a director and officer of the Company, provided office space to the Company at no charge, and funded payroll, moving and other general expenses during the year ended June 30, 2003. The advances in funding were based on verbal commitments with no guarantees of future advances or funding. The amount recorded as due to Transmax Inc. at September 30, 2006 was \$301, 339. The Company is disputing this liability at September 30, 2006.

NOTE 13 DUE TO SHAREHOLDERS

Certain shareholders of the Company have advanced funds to the Company to cover cash flow deficiencies. These advances have no stated repayment terms and bear interest at 5% with interest payable annually.

On March 14, 2006, we agreed to accept the proposal of Samuel J. Higgins to convert \$975,000.00 of the debt owed to International Equity Partners by our company for 319,672 shares of restricted common stock at the closing market price on March 14, 2006 of \$3.05 per

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NOTE 13 DUE TO SHAREHOLDERS (CONTINUED)

share. Mr. Higgins is an officer and director of our Company and is the sole owner International Equity Partners.

NOTE 14 COMMON STOCK

The Company has 100,000,000 shares of common stock authorized, par value \$.001. As of September 30, 2006, the Company has 36,094,096 shares of common stock issued and outstanding.

For three months ended September 30, 2006, the Company issued 1,016,739 subscribed to by the January 2006 private placement memorandum.

For the three months ended September 30, 2006, the Company issued 123,500 shares for consulting services.

NOTE 15 PREPAID SHARE-BASED FEES AND COMPENSATION

The Company has paid consultants and employees with common shares and equivalents for services. An expense is recorded when requisite services are performed and valued at fair market value. Common share equivalents such as warrants and options are valued using an econometric model. At September 30, 2006 and 2005, the Company has paid consultants and employees in advance of the earning of fees and compensation. The Company has elected to record this as a decrease to shareholder equity.

NOTE 16 BENEFICIAL REDUCTION OF SHARE-BASED LIABILITIES

In accordance with SFAS 123r, the Company revalues unexercised common share equivalents such as warrants and options issued for payments to consultants and employees. These unexercised common share equivalents are carried as liabilities until exercised and recorded as common share issuance and additional paid-in capital. Decreases in this liability due to the revaluation of common share equivalents are recorded as a beneficial reduction of share-based liabilities. The Company has elected to classify this account as stockholder's equity.

NOTE 17 ADVERTISING, PROMOTION, CONSULTING AND TRAVEL

The Company has paid consultants with common shares and equivalents for services. An expense is recorded when requisite services are performed and valued at fair market value. Common share equivalents such as warrants and options are valued using an econometric model.

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NOTE 17 ADVERTISING, PROMOTION, CONSULTING AND TRAVEL (CONTINUED)

For the three months ending September 30, 2006 and 2005, the following amounts were paid for advertising, promotion, consulting, and travel:

	September 30, 2006	September 30, 2005
Cash and accrued expense	\$ 178,543	\$ 126,174
Common Shares	307,761	632,738
Options	-	36,500
Warrants	-	-
Total	\$ 486,304	\$ 795,412

NOTE 18 BENEFICIAL SHARE-BASED FEE EXPENSE

The Company records a beneficial share-based fee expense when the market value as calculated in accordance with SFAS 123r of share-based awards to vendors are over and above the stated fair value of the services provided.

NOTE 19 BOARD COMPENSATION

On December 9, 2004, the Company compensated board members with options with an exercise price of \$.50 per share good for five years. No options have been exercised to date. In accordance with SFAS 123r this share-based compensation is retroactively expensed in the year issued and valued with an econometric model. Options to purchase 279,000 shares were valued at \$3.31 per share at the date of issue.

NOTE 20 LEGAL FEES

The Company has paid legal professionals with common shares and equivalents for services. An expense is recorded when requisite services are performed and valued at fair market value. Common share equivalents such as warrants and options are valued using an econometric model. For the three months ending September 30, 2006 and 2005, the following amounts were paid for legal fees.

	September 30, 2006	September 30, 2005
Cash and accrued expense	\$ 88,696	\$ 191,544
Common Shares	-	-
Options	131,900	393,035
Total	\$ 220,596	\$ 584,579

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NOTE 21 OFFICERS COMPENSATION

In addition to regular monthly salary payments, the Company has paid officers with common shares and equivalents for employment services. An expense is recorded when requisite services are performed and valued at fair market value. Common share equivalents such as warrants and options are valued using an econometric model. For the three months ending September 30, 2006 and 2005, the following amounts were paid for officer's compensation.

	September 30 2006	September 30 2005
CEO, Ray Brouzes		
Salary	\$ 37,500	\$ 15,000
Common Shares	162,750	162,750
Options	100,000	510,000
Total	\$ 300,250	\$ 687,750
Secretary/Treasurer, Samuel Higgins		
Salary	\$ 15,000	\$ 3,856
Options	100,000	510,000
Total	\$ 115,000	\$ 513,856
CFO, Benjamin Langford		
Salary	\$ -	\$ 1,000
Total	\$ -	\$ 1,000
Total Officer's Compensation	\$ 415,250	\$ 1,202,606

NOTE 22 RESEARCH AND DEVELOPMENT

On August 2004, the Company entered into a contract with Adaptive Propulsion Systems, Inc. a subsidiary of Tacronics, Inc. to assist in the engineering, manufacture and marketing of the digital axial vector cam engine technology. In January, 2005 the Company entered into an additional contract with Adaptive to provide similar assistance in developing multiple electricity generator technologies that coordinate with the digital engine technology. The agreements provide no guarantees to either party relief or refund if the technologies developed prove unviable. No common shares or equivalents have been paid in connection with research and development. The Company has elected to expense research and development expense when it is incurred.

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NOTE 23 PROVISION FOR INCOME TAXES

Deferred income taxes will be determined using the liability method for the temporary differences between the financial reporting basis and income tax basis of the Company's assets and liabilities. Deferred income taxes will be measured based on the tax rates expected to be in effect when the temporary differences are included in the Company's tax return. Deferred tax assets and liabilities are recognized based on anticipated future tax consequences attributable to differences between financial statement carrying amounts of assets and liabilities and their respective tax bases.

At September 30, 2006, deferred tax assets consist of the following:

	2006
Deferred tax assets	\$ 2,095,906
Less: valuation allowance	(2,095,906)
Net deferred assets	\$ -0-

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NOTE 23 PROVISION FOR INCOME TAXES (CONTINUED)

At September 30, 2006, the Company had federal net operating loss carry forwards in the approximate amounts of \$22,501,000 available to offset future taxable income through 2026. The Company established valuation allowances equal to the full amount of the deferred tax assets due to the uncertainty of the utilization of the operating losses in future periods.

NOTE 24 COMMITMENTS AND CONTINGENCIES

On August 24, 2004 the Company entered into a Joint Venture Agreement with Adaptive Propulsion Systems, LLC (“Adaptive”), a wholly owned subsidiary of Tactronics. Adaptive will provide 100% of the capital and labor to build military grade engines based on the Registrant’s Dyna-Cam engine design. Adaptive will pay the Company a 20% gross royalty on all orders of the engines sold to the United States Government. The Company will have the rest of the world military market and all civilian commercial applications, and the Company will pay a five (5%) percent royalty on such orders to Adaptive. For the three months ended September 30, 2006 the Company has research and development costs of approximately \$112,954.

In May 2005, the Company filed suit against Transporter, Inc and its principals, David Werner and Craig Della Penna. The suit seeks to rescind the August 2004 agreement under which the Company acquired the exclusive rights to certain video-conferencing technology. The Company contends that the principals intentionally misrepresented the status and capabilities of the technology that was acquired under the original agreement. The case is pending litigation. The Company has determined that the technology is worthless, and thus impaired the asset in its entirety as of June 30, 2006.

In October 2005, the Company entered into a business consulting agreement with Wexler Kronen Capital Associates. Wexler is to provide consulting and promotional services for a period of 12 months. The payment for these services is \$7,000 per month, 10,000 shares of restricted stock and 3 warrants. Each warrant is exercisable for 35,000 shares at various exercise prices. - one for \$4.00, the second for \$4.50 and the third for \$5.00. The warrants expire October 2007.

In November 2005, the Company entered into a business consulting agreement with Redwood Consultants L.L.C. Redwood is to provide consulting services for a period of 12 months to the Company. As part of this agreement, the Company issued 75,000 restricted shares with an additional 25,000 shares to be issued February 27, 2006 and 100,000 shares issued on May 22, 2006. All 200,000 were issued at commencement of the agreement and have been recorded as a prepaid asset on a prorata basis. In addition, the company has granted warrants to purchase 250,000 shares at \$4.00 per share which expire November 2007.

In January 2006, the Company entered into a business consulting agreement with John F. Walter. Walter is to provide consulting services for a period of 12 months to the Company in exchange for monthly payments of \$10,000. The contract is renewable annually.

Item 2. Plan of Operation

Forward-Looking Statements

Certain statements, other than purely historical information, including estimates, projections, statements relating to our business plans, objectives, and expected operating results, and the assumptions upon which those statements are based, are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements generally are identified by the words “believes,” “project,” “expects,” “anticipates,” “estimates,” “intends,” “strategy,” “plan,” “may,” “will,” “would,” “will be,” “will continue,” “will likely result,” and similar expressions. V such forward-looking statements to be covered by the safe-harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and are including this statement for purposes of complying with those safe-harbor provisions. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties which may cause actual results to differ materially from the forward-looking statements. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse affect on our operations and future prospects on a consolidated basis include, but are not limited to: changes in economic conditions, legislative/regulatory changes, availability of capital, interest rates, competition, and generally accepted accounting principles. These risks and uncertainties should also be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise. Further information concerning our business, including additional factors that could materially affect our financial results, is included herein and in our other filings with the SEC.

Recent Developments in Our Business

We are in the business of developing, producing and selling lightweight and energy-efficient engines, power generators and electric motors. We have entered into an agreement with Adaptive Propulsion Systems, LLC (“Adaptive”) to develop our engines, power generators and electric motors. Under the terms of the Agreement, Adaptive agreed to utilize its expertise to develop these products; however, we automatically acquired all rights to any patentable and proprietary technology as well as the know-how that emerges. Adaptive will be obligated to pay us a royalty of 20% of the gross sales to the military licenses it currently holds. Conversely, for all commercial non-military sales, we will pay Adaptive a royalty of 5% of gross sales. The term of this agreement with Adaptive is 20 years unless revised by joint agreement of the parties.

Developments in Our Agreement with Adaptive

Because we decided to develop and utilize the more efficient Axial Flux generator in our GENSET rather than conventional, off-the-shelf generators integrated into our GENSET, Adaptive required an additional sum for these upgraded features. Thus, on December 5, 2005,

we entered into a subsequent agreement with Adaptive to pay them \$668,160.00 in six monthly instalments of \$111,360.00. The first payment was due and paid in February 2006. We eventually paid our March 2006 payment, although not on time. The April 2006 payment was due and not yet paid in full as of June 30, 2006. We have since modified this agreement and we are paying a minimum of \$25,000.00 per week. As of September 30, 2006, the balance owed to Adaptive was \$233,959.30 of which \$163,297.30 is due on our Generator Engineering Support Agreement with Adaptive. The additional costs incurred, \$ 70,662.00, are from the anticipated costs for off-site performance evaluation, operating costs and other data collection on the GENSET. This includes the setup and decommissioning cost for \$28,900, and monthly rental at the testing facility for the generator is \$44,000 per month for two months.

Advent of the Axial Vector Workhorse 7.1

We have a number of different prototypes in the design stage in the family of Axial Vector digital engines, but one is completed and in the testing phase. Adaptive has completed the development of the 352 HP prototypical Axial Vector “Workhorse 7.1” engine for our prototypical 200 kW Axial Flux generator.

Developments in Initial Testing

The engine was started (fired-up) and produced power for the first time at a third-party Detroit automotive engineering firm on September 14, 2006. Since then the engine has been fired-up on a number of occasions with operations periodically interrupted for improvements, fine tunings, and repairs to the test cell equipment. We anticipate commencing Beta testing on our prototypical generator initially at the Adaptive facilities in approximately December 2006. Thereafter, we intend to conduct Beta testing at three different global locations with varying climates and elevations commencing for a period of 4,000 hours (5.5 months) to validate the 40,000-hour design of mean-time-between-major overhauls. These latter Beta tests will be carried out with “production” grade engines and generators that incorporate all improvements identified during the testing phase. It is expected that we shall have the production grade engines, generators, electronic control systems and GENSETs ready in the first quarter of 2007.

As part of the Agreement we have with Adaptive, the 352 HP Workhorse 7.1 liter prototypical engine is presently going through a detailed start-up program, performance analyses and endurance testing in well appointed and certified third party dynamometer facilities in Detroit, Michigan. The generator is about to begin independent performance analyses and durability evaluation at a second third-party facility also located in Detroit.

It should be noted at the onset that giving birth to a GENSET is a colossal effort. There are many interlocking and interdependent components and sub-systems whose operations must be perfectly orchestrated to produce the lowest priced electrical power from a 40,000 hour-mean-time-to-major-overhaul internal combustion technology. Testing an engine, its generator and the Generator Set (GENSET) and the sophisticated electronic systems for commercial applications is a serious and complex matter without shortcuts and cannot be hurried. Delays and unexpected surprises are to be expected, and may affect the timeframes indicated for completion. We have already experienced some slippage in our optimistic time-line in the execution of the required

testing. The delays have been caused by some minor modifications on our engine, delays in delivery of components by suppliers and some minor difficulties with some of the monitoring equipment that comes with the test cell. In spite of these obstacles, we expect to have a fully functioning engine and generator in time for the International PowerGen show in Orlando at the end of November 2006. However, we may not be able to have the GENSET fully integrated in time for the Orlando show. If not ready in time for that event, it should be ready shortly thereafter. We cannot cut short the testing and evaluation protocols and procedures which are outlined below.

It should also be noted that the data accumulated from the engine and generator trials will be adequate and sufficient to provide us with the information required to determine with considerable accuracy the energy efficiency of our system and cost per kilowatt hour produced. Cost per kilowatt hour data allows us to begin the sales process of our first commercial products. We anticipate taking orders for units ranging in size from 200 kW to 1 megawatt. A production schedule is being developed in conjunction with our Joint Venture negotiations. Orders taken will require a deposit; military related purchase orders placed with Adaptive shall receive production preference over civilian orders.

Our developmental testing can be broken into five sections, namely:

1. Subsystem testing
2. Engine Testing @ an independent third party firm "A" specialized in engines
3. Generator Testing @ an independent third party firm "B" specializing in generators
 4. Generator Set (GENSET) Testing
 5. Reliability and Homologation Testing

The main testing tasks for each section are identified as follows:

1. **Subsystem testing** consists of four main tests:
 - a)