

COMMODORE APPLIED TECHNOLOGIES INC  
Form 10-K  
April 17, 2007

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

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**FORM 10-K**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2006  
or**

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

**Commission File number 001-11871**

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**Commodore Applied Technologies, Inc.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**11-3312952**

(I.R.S. Employer Identification Number)

**507 Knight Street, Suite B**

**Richland, Washington**

(Address of Principal Executive Offices)

**99352**

(Zip Code)

Registrant's telephone number, including area code: **(509) 943-2565**

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

Title of Each Class  
**Common stock, par value \$0.001 per share**

Name of Each Exchange on Which  
**NASD Over the Counter Bulletin B**

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes

No

Indicate by check mark 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [  ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of [accelerated filer and large accelerated filer] in Rule 12b-2 of the Exchange Act.

Large accelerated filer [  ] Accelerated filer [  ] Non-accelerated filer [  ]

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

As of March 31, 2007, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$1,192,857 based upon the last sale price of the common stock on March 31, 2007 as reported by the NASD Over the Counter Bulletin Board.

There were 8,116,342 shares of the Registrant's common stock outstanding on March 31, 2007.

**DOCUMENTS INCORPORATED BY REFERENCE**

**None**

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**COMMODORE APPLIED TECHNOLOGIES, INC.**

**ANNUAL REPORT ON FORM 10-K  
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006**

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## **PART I**

This Annual Report on Form 10-K contains "[forward-looking statements." These forward-looking statements can generally be identified as such because the context of the statement will include words such as the Company "believes," "anticipates," "expects" or words of similar import. Similarly, statements that describe the Company's projected future results, future plans, objectives, goals, future conditions or events are also forward-looking statements. Actual results are inherently difficult to predict. Any such forward-looking statements are subject to the risks and uncertainties that could cause actual results of operations, financial condition, acquisitions, financing transactions, expenditures, expansion and other events to differ materially from those expressed or implied in such forward-looking statements. Any such forward-looking statements would be subject to a number of assumptions regarding, among other things, future economic, competitive and market conditions. Such assumptions would be based on facts and conditions as they exist at the time such statements are made as well as predictions as to future facts and conditions, the accurate prediction of which may be difficult and involve the assessment of events beyond the Company's control.

Further, the Company's business is subject to a number of risks and uncertainties that would affect any such forward-looking statements. These risks and uncertainties include, but are not limited to:

- the Company's critical need for additional cash to sustain existing operations and meet existing obligations and capital requirements (the Company's auditor's opinion on our fiscal 2002, 2003, 2004, 2005 and 2006 financial statements contains a "[going concern]" qualification in which they express doubt about the Company's

ability to continue in business);

- the ability to generate profitable operations from a large scale remediation project;
- the ability of the Company to implement its waste processing operations, including obtaining commercial waste processing contracts and processing waste under such contracts in a timely and cost effective manner.
- the timing and award of contracts by the U.S. Department of Energy for the cleanup of waste sites administered by it;
- the acceptance and implementation of the Company's waste treatment technologies in the government and commercial sectors;
- the Company's ability to obtain and perform under other large technical support services projects;
- developments in environmental legislation and regulation;
- the ability of the Company to obtain future financing on favorable terms;
- other circumstances affecting anticipated revenues and costs;
- the expiration of the Company's nationwide EPA permit in September 2001 (The Company believes that the permit may be renewed subject to providing additional information. The Company has not resubmitted information for a new permit); and
- the ability of the Company to replicate on a large scale, economically viable basis, the results of its technology test results.

These risks and uncertainties could cause actual results of the Company to differ materially from those projected or implied by such forward-looking statements.

## **ITEM 1.**

### **BUSINESS**

#### **GENERAL**

Commodore Applied Technologies, Inc. (the "Company") is an environmental solutions company offering a range of environmental and technical services to the public and private sectors related to (i) providing services related to, environmental management for on-site and off-site identification, investigation remediation and management of hazardous, mixed and radioactive waste and (ii) remediating contamination in soils, liquids and other materials and disposing of or reusing certain waste by-products by utilizing our Solvated Electron Technology ("SET").

The Company's corporate mission is to serve the *environmental remediation market* from its primary operating center to profitably provide government and industry with environmental and remediation solutions to legacy waste environmental problems. Our strategy focuses the Company on the unique and high profit niches of hazardous materials conversion and waste remediation.

The Company was incorporated in Delaware in March 1996. As used in this Annual Report, and except as the context otherwise requires, the "Company" means Commodore Applied Technologies, Inc. and its subsidiaries,

including Commodore Solutions, Inc., Government Environmental Technologies, Inc., and Commodore Advanced Sciences, Inc. The Company's principal executive offices are located at 507 Knight Street, Suite B, Richland, Washington 99352, and its telephone number at that address is (509) 943-2565.

## SEGMENT INFORMATION

The Company currently has identified two operating segments. These two segments are as follows:

- Commodore Advanced Sciences, Inc., which primarily provides various environmental and regulatory services to Government agencies on a fixed rate and lump sum basis; and
- Commodore Solutions, Inc., which is commercializing technologies to treat mixed and hazardous wastes, principally the Company's SET technology.

Additional information regarding the business of each segment is set forth below, and the information in Note 16 to the Company's Consolidated Financial Statements included in this Annual Report on Form 10-K is incorporated into this Part I by reference.

## COMMODORE ADVANCED SCIENCES, INC. - ENVIRONMENTAL MANAGEMENT

The Company, through Commodore Advanced Sciences, Inc. ("Advanced Sciences"), provides specialized technical and project management products and services primarily to government-sector customers, including the Department of Energy ("DOE") and the Department of Defense ("DOD"), and also to private-sector domestic industrial customers. Advanced Sciences engages in all aspects of environmental regulation and compliance, as well as access to leading technologies and innovative skills related to the identification, investigation, remediation and management of hazardous, mixed and radiological waste sites. Advanced Sciences currently operates a network of three offices located in three states, with its principal executive offices located in Richland, Washington.

### Services

**Environmental Services** Advanced Sciences is a nationwide firm specializing in environmental characterization, regulatory compliance technical support and waste management. Advanced Sciences qualifies as a small business under seven NAICS codes. This subsidiary employs approximately 30 professionals who are expert in providing environmental sample collection, transportation, and analyses, meeting rigorous quality assurance requirements while performing in accord with equally rigorous personnel health and safety requirements.

Advanced Sciences' history of program management and technical services include:

- Environmental Site Restoration Planning
- Preliminary Assessments/Site Investigations
- Environmental Audits & Assessments
- Underground-Storage-Tank Site Investigation
  
- D & D Planning & Implementation Support
- Waste Minimization
- Health & Safety Oversight & Planning
- Biological Sampling and Characterization
  
- Environmental Impact Assessments & Statements & Remediation
  
- Structural Engineering Analysis
- Deconstruction Planning
- Regulatory Compliance
  
- Remedial Investigations/Feasibility Studies
- Environmental Pollution Control
- Hazardous, Radioactive, Toxic & Mixed-Waste
  
- Federal & State Agency Coordination Management Including Treatment

- Public Involvement Support

- Hazardous Waste Site Remediation

The two most significant clients Advanced Sciences has had over the past 10 years have been the DOD and the DOE, while also providing services to private industry. Advanced Sciences' largest office provides environmental characterization and management, building decontamination and decommissioning (D&D), environmental protection, remediation, restoration, safety & health, and environmental regulatory compliance for the Department of Energy's Oak Ridge Complex.

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In addition to the Oak Ridge Complex in Tennessee, the Company has performed environmental monitoring and remediation services at Rocky Flats in Colorado, Los Alamos in New Mexico, Chatfield Basin in Colorado and other significant sites, predominantly nuclear energy sites run by the DOD or DOE.

**Remediation Services** Having already established a market position in the consulting and front-end analysis phase, Advanced Sciences plans to follow market demand into remediation services. After an environmental problem is identified, Advanced Sciences offers alternative remediation approaches that may involve providing on-site waste containment or management of on-site/off-site remediation and waste removal. Advanced Sciences can also redesign its customers' ongoing production processes and develop technical specifications to minimize or eliminate the generation of hazardous waste. The Company believes that Advanced Sciences' integration of environmental skills, plus its access to innovative technologies, provide Advanced Sciences with a competitive advantage in redesigning production processes.

**Technical Services** New technologies play a critical role in both the remediation of existing waste sites and in the reduction of waste generated by ongoing production processes. Advanced Sciences has access to the SET technology and all its derivatives. Additionally, Advanced Sciences has access to the Supported Liquid Membrane (SLiM) technology held by Commodore Separation Technologies, Inc. (Separation). This technology has the ability to selectively extract heavy metals and radioactive nuclides from liquids and gasses. The SLiM technology is held in an 85% owned subsidiary of Commodore Environmental Services, which owns 4.95 % of the Company. Advanced Sciences has at its disposal, on a per project basis, what it believes are among the most qualified professionals in the environmental consulting business. Advanced Sciences' scientists have participated on national boards for risk assessment and quality assurance, were instrumental in the development of environmental regulations for the DOE and the DOD, and have served as expert witnesses before the U.S. Congress and the Nuclear Regulatory Commission. To maintain its competitive position, Advanced Sciences intends to continue to develop viable remediation technologies and attract and retain qualified personnel.

### **Contracts**

**EDAM** Advanced Sciences was awarded an Environmental Data Acquisition and Management contract (EDAM) by Bechtel Jacobs Company LLC of Oak Ridge, TN (BJC) in September 2004. During 2004, 2005 and most of 2006, Advanced Sciences was the lead small business member of the Commodore Advanced Sciences Team (CAST), which also includes team members Science Applications International, Inc. (SAIC), and RCS Corporation (RCS).

CAST performed and managed the EDAM contract through its renewal in August 2006, when Advanced Sciences alone was awarded the full contract of reduced services, with BJC self-performing most tasks previously subcontracted to SAIC as part of the original contract. RCS continues as a teaming partner and subcontractor. BJC also assumed management and invoicing for 13 analytical laboratories that were subcontracted through Advanced Sciences. Analytical laboratory costs, although included as revenue of Advances Sciences, were a zero-margin pass-through activity as a condition to the EDAM contract in place for 2005 and most of 2006. As a result, gross contract revenues decreased in 2006, as well as for the balance of the contract period; however, Advanced Sciences expects better profit margin percentages because the pass-through subcontract to SAIC was a very low margin activity for Advanced Sciences. This program is continuously monitored and audited for safety, quality, productivity, efficiency, and value to BJC and Department of Energy-Oak Ridge.

Sampling activities under the EDAM contract include collection of multiple sample types from hundreds of monitoring locations and packaging and shipping of samples to appropriate analytical laboratories for analysis. Locations and environments include abandoned burial grounds and hazardous waste sites, fields and forests, streams, lakes, and ponds. Sampling tasks support a variety of ongoing monitoring programs, including the Water Resource Restoration Program (WRRP) to determine the effectiveness of remedial actions conducted under CERCLA and the ETTP Environmental Monitoring Program. Regulatory compliance data acquisition and management projects include Resource Conservation and Recovery Act (RCRA) and National Pollution Discharge Elimination System (NPDES) permit compliance, the Biological Monitoring and Abatement Program, and Stormwater Pollution Prevention Program (SWPPP) activities. All of these compliance sampling programs are closely monitored by regulators, stakeholders, BJC, and DOE-OR.

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The Company believes the EDAM contract may attract more DOE client groups than are contemplated in the base scope of the contract. The Company is seeking to extend its environmental monitoring service capabilities to other DOE sites, such as Portsmouth, OH and Paducah, KY. The EDAM contract, in which Advanced Sciences participates as a subcontractor, is for a total of approximately \$29 million through September of 2008, of which Advanced Sciences' portion is approximately \$2.1 million and is reflected in the Company's backlog.

**Energy Solutions** Advanced Sciences was awarded a one-year contract from Duratek Federal Services, Inc. (now Energy Solutions) beginning in January 2005, which was renewed in January 2006 and 2007 for additional one-year periods, to perform environmental monitoring services at two engineered landfills on the Oak Ridge Reservation. Environmental monitoring services include sample collection, packaging and shipping to offsite analytical laboratories. Samples are collected from surface water, groundwater, and landfill leachate collection locations on storm event, weekly, monthly, and quarterly bases.

**Chatfield Watershed Authority** Advanced Sciences is contracted annually to implement the Chatfield Water Quality Monitoring Program that involves sample and data collection, laboratory subcontract management, and data management for the entire Chatfield Basin watershed located southwest of Denver. The contract is ongoing through 2007 and has been renewed annually with Advanced Sciences since 1986.

**Tetra Tech Contract** Advanced Sciences provides engineering support under Tetra Tech's general engineering support contract with BJC. BJC is responsible for environmental oversight of the U.S. DOE's Oak Ridge, TN site. Advanced Sciences provided 1 to 3 engineering personnel on a time and material basis to Tetra Tech on a contract basis. This contract expired March 31, 2007.

**WESKEM** Advanced Sciences was awarded a one-year contract in March 2005 from WESKEM LLC., of Oak Ridge to support their sampling efforts with the Waste Disposition Services Project. The Sample Management Office (SMO) services required to meet the needs of this project are: (i) Assistance with the preparation of analytical statement of works (SOW), (ii) Maintenance of laboratory performance metrics, (iii) Procurement of best value laboratories, (iv) Performance of contract verification of data, and (v) Tracking of samples and sample residue. This contract expired in October 2006.

#### **COMMODORE SOLUTION TECHNOLOGIES, INC. -DECONTAMINATION**

The Company, through Commodore Solutions, Inc. (Solutions), has developed and has commercialized its patented process known as SET. Based on the results of its extensive testing and commercial processing activities, the Company believes that SET is capable of effectively treating and decontaminating soils and other materials, including sludges, sediments, oils and other hydrocarbon liquids, metals, clothing and porous and non-porous structures and surfaces, by destroying PCBs, pesticides, dioxins, chlorinated substances and other toxic contaminants to an extent sufficient to satisfy current federal environmental guidelines. The Company also believes that, based on the results of additional tests, SET is capable of neutralizing substantially all known chemical weapons materials and warfare agents, explosives and concentrating certain radioactive wastes for more effective disposal.

The Company believes that SET is the only patented, non-thermal, portable and scalable process that is currently available for treating and decontaminating soils, liquids and other materials containing PCBs,

pesticides, dioxins, chemical weapons and warfare agents and other toxic contaminants.

### **SET Contracts**

The Company was awarded an Advanced Remediation Demonstration contract by the Department of Energy's Office of Environmental Management (DOE-EM) for the Company's technology for the separation of radioactive (surrogate) and RCRA heavy metals from sludges and other waste matrices.

The DOE-EM awarded 12 contracts totaling \$3.3 million, of which the Company's demonstration was a part, to support the development of technologies that have the potential to reduce cleanup costs and increase the safety and efficiency of treating and disposing of various waste streams, including radioactive waste at such sites as Hanford, Idaho, Savannah River, and others.

The Company's Phase I contract was performed over a six month period, concluding in January 2007. Phase I activities included: laboratory/pilot-scale test results, developing a technical approach for demonstration, scale-up

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and implementation schedule, detailed system design, and a detailed cost estimate for implementation in Phase II. The results of Phase I are under review and Phase II of the contract is expected to be awarded in 2007.

### **The SET Technology**

The Company, its subsidiaries and predecessors have researched, developed, acquired, tested and proven the SET technology, including its processes and equipment, over several years.

The process is based upon a chemical phenomenon discovered by Sir Humphrey Davy in 1865, shown below for the liquid phase of a sodium and potassium solution:

The solution has been called solvated electrons since the dissolved metal releases electrons to the solution in huge numbers. These electrons, also known as free radicals, are the most powerful reducing agents known, quickly reacting with many compounds. Most of the alkali metals readily dissolve in anhydrous ammonia releasing their valence electrons into the ammonia in a relatively rare but stable state unassociated with any atom. In this state, both the electrons and the metal atoms are available to react with other elements and compounds.

The SET technology, which is based upon solvated electron chemistry, mixes anhydrous liquid ammonia and/or other similar solvents with reactive metals and contaminated elements to effect the selective destruction or neutralization of organic compounds (such as PCBs, pesticides and dioxins). The Company has demonstrated that SET can achieve consistently high levels of contaminant destruction when working with PCBs, dioxins and pesticides. SET has treated soils containing up to 10,000 parts per million (ppm) of contaminants, and oils containing up to 250,000 ppm, leaving residual soils and oils with contamination levels of less than one ppm. In addition, SET has been successfully applied to other PCB-contaminated surfaces such as concrete. The SET process can be used in conjunction with selected post-treatment processes such that no hazardous or toxic residues will result from the use of SET, nor will there be any toxic emissions into the air, water, soils or other surfaces. For example, most contaminated soils treated with SET can (subject, in some instances, to re-blending the soil with organic matter) be used subsequently for planting or for any other use for which non-contaminated soils are appropriate.

Equipment utilized in the SET process consists of tanks, pumps and piping to handle anhydrous ammonia and other solvents in liquid and vapor forms, and treatment vessels for holding contaminated materials and for the introduction of solvating solutions. The system can be transported to field sites and configured in numerous sizes.

The SET process requires placing the contaminated materials into a treatment vessel where they are mixed with a solvent and charged with a base metal (e.g. sodium). The chemical reaction produces metal salts such as calcium chloride, calcium hydroxide and non-halogenated inert organics. The ammonia within the treatment



vessel is then removed to a discharge tank for later reuse. The materials are removed, sampled for residual traces of PCB or other halogenated organic compounds, and placed in storage for disposal. In many cases, the decontaminated soil and metals can be replaced in their original location, recycled or reused. The solvents do not enter the chemical reaction, but merely serve as dissolving liquids for the solvated electron solution.

**Operational Characteristics** Substantially all existing systems in use for the destruction of PCBs and other halogenated compounds involve incineration or other thermal processes, and either the permanent installation of highly complex and expensive incinerators and waste disposal equipment at the affected site, or the removal of contaminated materials to off-site facilities. The Company believes that SET represents an approach to resolving serious environmental remediation issues that does not create or entail the safety risks of air pollution and transportation of hazardous materials. The Company believes that SET is more effective than incineration and other destruction processes for toxic substances in that:

- SET does not emit toxic fumes into the atmosphere, as is sometimes the case with thermal or incineration methods;
- SET is portable and can be moved directly to the contaminated site, thereby reducing the risk of off-site contamination;
- SET equipment can be customized and configured for various treatment applications;
- SET's reaction time is substantially less than that of alternative processes, such as thermal destruction and other forms of chemical treatment;

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- SET equipment can be installed and operated inside industrial plant facilities to treat hazardous wastes [on-line] as a continuation of the manufacturing process;
- SET, when used to treat soils, yields nitrogen-enriched soils that can be reused on-site, avoiding replacement and the post-treatment costs of off-site disposal; and
- SET has been shown to neutralize or destroy all chemical weapons material and warfare agents in the United States stockpile, and Lewisite (the primary chemical weapons material and warfare agent of the former Soviet Union), in tests conducted by an independent, federally certified surety laboratory.

The Company believes that SET is the only technology currently available that possesses all of these features and is capable of treating a wide variety of contaminants. The above characteristics (non-thermal, no air emissions, mobile) are particularly applicable when dealing with mixed waste. Wastes that contain radioactive material and hazardous waste regulated by RCRA and TSCA are particularly difficult to treat and have extremely limited disposal options. By applying the SET process to remove the RCRA and TSCA components, leaving only radioactive waste material, disposal options expand. SET not only removes the hazardous components but also does so by an efficient, non-thermal process that can control and contain the radioactive material so that it remains in the treated material and does not enter the environment in an uncontrolled fashion.

**EPA Nationwide Permit** The Company has previously qualified for a permit from the EPA to enable it to treat PCBs within the United States on all non-Superfund sites. Most EPA permits granted to date for PCB destruction are solely for single-site incineration treatment centers. Commodore's initial EPA Nationwide Permit was the first (and only) to be issued for nationwide use as a totally enclosed, non-thermal, chemical destruction process for PCB contaminated organic material. The permit authorized treatment of soils at contamination levels greater than 1,000 ppm PCBs, and also authorized treatment of miscellaneous metallic materials. The test results, confirmed by EPA's contract program laboratory, indicated organics contaminated with PCBs exceeding 5,000 ppm, were treated to non-detect levels of PCBs. In addition to soil treatment, the Nationwide Permit allows the Company to treat PCB contaminated metallic surfaces and waste oils, as well as wastewater (the wastewater is treated by a non-SET process). The Company has also successfully demonstrated SET as a treatment process for organic materials contaminated with PCBs and radionuclides and has received a draft revised EPA permit for these matrices. This permit revision covers the destruction of PCBs in soils, waste oils, organic materials, water, and on metallic surfaces.

Prior to securing a significant contract which utilizes the SET technology, the Company will be required to renew this permit, which expired in 2001. The renewal process may require the Company to provide additional information to the EPA at the time of renewal.

Based on currently published lists of EPA national operating permits, the Company believes that it possesses the only non-thermal PCB treatment technology for multiple applications permitted under the EPA's Alternate Destruction Technology Program. The EPA's Alternative Destruction Technology Program is designed to encourage remediation technologies as an alternative to incineration. EPA regulations governing permitting have been in effect for more than 15 years, and according to the latest EPA published list of non-thermal destructive processes, only seven companies have met EPA's stringent requirements for commercial operation. Of these, only the Company has been permitted for the chemical destruction of such a wide range of PCB contaminated materials.

**Test Results** The Company has performed treatability studies and actual commercial applications of the SET process that have resulted in successful treatment of over 120 regulated compounds. In more than 1,500 tests using SET, various high levels of contaminants, including PCBs, were reduced to levels approaching non-detectable with the destruction process occurring in a matter of minutes.

The Company has performed various treatability studies and processed commercial quantities of waste utilizing the SET process. Additionally, the Company has conducted several thousand tests of the SET technology on limited quantities of contaminated material, and there can be no assurance that SET will be able to replicate any of these test results on a large-scale commercial basis or on any specific project.

Discussions and selected test results are available at the Company's website at [www.commodore.com](http://www.commodore.com).

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## MARKETS AND CUSTOMERS

### *General*

The Company markets its services and technologies to governmental and industrial customers throughout the United States. The Company also plans to target customers in markets abroad, particularly in Eastern Europe and the Middle East. A majority of the Company's sales are technical in nature and involve senior technical and management professionals, supported by the Company's marketing groups. During the year ended December 31, 2006, sales of approximately 100% of the Company's environmental management services were derived from contracts with federal, state and municipal government agencies. Contracts with governmental customers generally may be terminated at any time at the option of the customer. In 2006, two contracts with a single customer, BJC, accounted for approximately 90.2% of Advanced Sciences' revenues. In 2005, BJC accounted for approximately 98.5% of Advanced Sciences' revenues. In 2004, the Company had three customers which accounted for 38%, 28%, and 9%, respectively of the Advanced Sciences' revenues. The loss of Bechtel Jacobs as a customer would have a material adverse effect upon the Company.

Demand for our environmental technologies is anticipated to arise principally from the following sources:

- Stricter legislation and regulations mandating new or increased levels of air and water pollution control and solid waste management; and
- the need for alternative environmental treatment and disposal methods for toxic substances (such as the SET technology), which involve limited safety risks with respect to air pollution and transportation of hazardous materials and do not result in large volumes of residual waste that require further treatment prior to disposal.

Our business strategy is to expand our environmental technologies businesses by:

- establishing additional collaborative joint working and marketing arrangements with established engineering and environmental service organizations to pursue commercial opportunities in the public and

private sector;

- diversifying the types of service and products offered to clients and potential new customers; and
- implementing the SET technology in selected niche markets within certain strategic environmental market segments, such as government mixed waste remediation and chemical weapons demilitarization.

### ***Decontamination***

The Company anticipates that the initial market for commercial applications of SET will be the hazardous and mixed waste and industrial by-products treatment and disposal market. Mixed waste is material that contains both a hazardous and radioactive component. The most common methods of treatment and disposal of hazardous wastes and industrial by-products include landfilling, chemical and biological treatment and incineration. Most of the current treatment and disposal methods entail air pollution and transportation risks. In a mixed waste, both hazardous and nuclear regulations apply, making disposal difficult, if not impossible. Currently, there exists very limited disposal options and these may not provide a permanent solution. Certain of these treatment and disposal methods result in large volumes of residual waste, which may require further treatment prior to disposal. As a result, a number of these methods are encountering increased public resistance and added regulatory oversight.

As with any new technology or process, there has been initial resistance to the use of SET on a large scale, especially in connection with a strong vested interest on the part of the U.S. Military (based on substantial expenditures and commitments previously made) to use incineration for the destruction of chemical weapons. In addition, other prospective projects for the Company have already been committed to other forms of destruction technology, including incineration, plasma arc, vitrification, molten metal, molten salt, chemical neutralization, biological treatment, catalytic electrochemical oxidation and supercritical wet oxidation. The Company, and its collaborative partners, have been attempting to overcome such competition by introducing SET in smaller clean-up projects and through feasibility studies demonstrating its applicability to larger projects, such as the Initial Harrisburg Contract during the years 2000 and 2001, and the WCS Fixed Facility Processing Contract during the year 2001. The SET process provides a significant advantage by allowing the processed material to be disposed of as a non-mixed waste by destroying the hazardous component.

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It may also be anticipated that, over an extended period, the market for decontamination of hazardous materials will continue to decline as past environmental degradation is corrected, and as the private and public sectors limit further pollution through prohibitions on production and use of a broad range of hazardous materials and through the modification and improved efficiency of various manufacturing processes. The mixed waste market is one of the few areas that shows growth and has limited competition when compared to the general hazardous waste market. The Company believes the SET process brings a unique solution to the problem of remediating mixed waste.

### ***Environmental Management***

Based on market data compiled by Advanced Sciences, the largest market for environmental services today within the United States is the U.S. Government. Government-wide spending levels for environmental services exceed \$10 billion per year. The DOD and DOE are expected to account for approximately 66% of such expenditures and together expect to spend in excess of \$200 billion for environmental work over the next twenty years. Advanced Sciences has a long-term record for providing environmental services to the U.S. Government with the DOD and DOE being its primary customers.

### **RAW MATERIALS**

The Company has historically experienced no difficulty in obtaining components used in the SET process for which it relies on a broad range of suppliers. Nevertheless, business disruptions or financial difficulties of such suppliers, shortages or other causes beyond the Company's control, could adversely affect the Company by increasing the cost of goods sold or reducing the availability of such components. If the Company was unable to obtain a sufficient supply of required components, it could experience significant delays in the furnishing of components used in the SET process, which could result in the loss of orders and customers and could have a

material adverse affect on the Company's business, financial condition and results of operations. In addition, if the cost of finished components were to increase, there can be no assurance that the Company would be able to pass such increase on to its customers. The use of outside suppliers also entails risks of quality control and disclosure of proprietary information.

## **BACKLOG**

At December 31, 2006, total potential backlog for the Company was approximately \$2.1 million as compared with approximately \$9.8 million as of December 31, 2005. The total backlog represents work for which the Company has entered into a signed agreement or purchase order with respect thereto or has received an order to proceed with work up to a specified dollar amount. The Company estimates that all of the total backlog represents work that will be completed in the next 12 months. Backlog amounts have historically resulted in revenues; however, no assurance can be given that all amounts included in backlog will ultimately be realized, even if covered by written contracts or work orders.

## **RESEARCH AND DEVELOPMENT**

Research and development activities are ongoing and utilize internal technical staff, as well as independent consultants retained by the Company and its subsidiaries. All such activities are company-sponsored. Research and development expenditures for the Company and its subsidiaries were approximately \$0, \$5 thousand, and \$9 thousand for the years ended December 31, 2006, 2005, and 2004, respectively.

## **INTELLECTUAL PROPERTY**

The Company currently has sixteen (16) issued U.S. and foreign patents. The average life expectancy for the currently issued patents is 10.67 years. As patents are issued, the U.S. Patent and Trademark Office assigns the Company a twenty (20) year patent-life for each patent issued.

The Company believes that its patent portfolio provides the Company the necessary [proprietary turf] in which it can market, distribute, and license the full range of the SET technology and all of its derivatives. Additionally, the Company's strength of its patent portfolio may operate as an effective [barrier to entry] in several of the markets in which the Company is presently conducting business.

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To protect its trade secrets and the un-patented proprietary information in its development activities, the Company requires its employees, consultants and contractors to enter into agreements providing for the confidentiality and the Company's ownership of such trade secrets and other un-patented proprietary information originated by such persons while in the employ of the Company. The Company also requires potential collaborative partners to enter into confidentiality and non-disclosure agreements.

There can be no assurance that any patents that may hereafter be obtained, or any of the Company's confidentiality and non-disclosure agreements, will provide meaningful protection of the Company's confidential or proprietary information in the case of unauthorized use or disclosure. In addition, there can be no assurance that the Company will not incur significant costs and expenses, including the costs of any future litigation, to defend its rights in respect of any such intellectual property.

## **COMPETITION**

### ***Decontamination***

The Company anticipates that the market for commercial private sector applications of SET will be hazardous and non-hazardous waste and industrial by-products treatment and disposal, in particular the more recalcitrant [mixed] wastes (wastes containing a radioactive element). Several large domestic and international companies and numerous small companies, many of whom have substantially greater financial and other resources than the Company, compete with the Company in this market. The Company primarily competes in the hazardous waste treatment market in the U.S. The top ten competitors in this market account for over 70 percent of the revenues for this market sector. The dominant companies in this sector include companies with permitted waste treatment and disposal sites, including Energy Solutions, Pacific EcoSolution, and American Ecology, as well as other

treatment companies such as PermaFix. The Company's revenues for 2005 account for less than 1 percent of the dollar volume of the hazardous waste market. Any one or more of the Company's competitors or other enterprises not presently known may develop technologies which are superior to the technologies utilized by the Company. To the extent that the Company's competitors are able to offer comparable services at lower prices or of higher quality, or more cost-effective remediation alternatives, the Company's ability to compete effectively could be adversely affected.

The domestic and international governmental public sector of the market is dominated by many large multinational corporations who are presently engaged in providing incineration and other conventional technologies in decontaminating chemical weapons and warfare agents, concentration of nuclear wastes and the decontamination of military vessels and other hardware. These competitors include Raytheon Corporation (the current general contractor for the Johnston Atoll incinerator), EG&G, Inc. (the general contractor for the Tooele Army Depot), Mason and Hanger (the general contractor for the Newport News Naval Facility), Waste Management Corporation (a bidder for domestic "large burial" stockpile weapons decontamination), and others, including Browning-Ferris Industries, Inc., Jacobs Engineering, Inc., Fluor Daniel Corporation and Lockheed Martin Marietta Corporation. All of these corporations have substantially greater financial, personnel and other resources than the Company. In addition, many prospective users of SET have already committed substantial resources to other forms of environmental remediation technology, including incineration, plasma arc, vitrification, bio-remediation, molten salt, chemical neutralization, catalytic electrochemical oxidation and supercritical wet oxidation.

The Company believes that its ability to compete in both the commercial private and governmental public sectors is dependent upon SET being accepted in these sectors as a superior, more cost-effective method to achieve decontamination of a variety of materials.

### ***Environmental Management***

In the hazardous waste management market, Advanced Sciences' competitors include such firms as Energy Solutions, Jacobs Engineering, Science Applications International Corp., CH2M Hill and CDM, all of whom have greater financial and other resources than the Company. In providing environmental impact assessment services, Commodore Advanced Sciences' principal competitors in this market sector include RSI, North Wind, Stoller, Weston Solutions, The Earth Technology Corp., Battelle, URS and Woodward-Clyde.

Commodore Advanced Sciences currently occupies a position in the waste management and environmental services arena by virtue of its long-term record for providing environmental services to the United States

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government. Primary factors affecting Advanced Sciences' competitiveness in this market are its ability to continue to attract and retain qualified technical and professional staff with quality project performance records and to control its costs of doing business.

In an effort to maintain its competitive position, Advanced Sciences believes that it has developed a solid infrastructure, acquired a qualified professional staff, and developed aggressive marketing objectives to provide hazardous waste management and environmental sciences to the United States government and private sector industrial customers. The Company believes its competitive position with the United States government is enhanced by the physical proximity of Advanced Sciences' plants to DOE and DOD sites, its skilled professional staff, prior project experience with the United States government, numerous existing multi-year contracts with the United States government, integrated services and high quality performance.

### **ENVIRONMENTAL REGULATION**

The environmental legislation and policies which the Company believes are applicable to SET in the United States primarily include TSCA, RCRA, and the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA"), as amended by the Superfund Amendments and Reauthorization Act of 1986 ("SARA"), and may include, on a case by case basis, the Clean Air Act of 1970, as amended (the "Clean Air Act"). These laws regulate the management and disposal of toxic and hazardous substances, provide for the protection of land and groundwater resources, and control the discharge of pollutants into the air. Many of these laws have international counterparts, particularly in Europe and elsewhere in North America.

TSCA regulates the manufacture, distribution, and sale of chemical substances, and requires testing of new chemicals and new uses of known chemicals that may present an unreasonable risk of injury to health or the environment. The EPA, through TSCA, has adopted comprehensive regulations for PCB's and other halogenated substances, as part of a vast regulatory program covering thousands of chemicals.

RCRA was enacted in 1976 with the primary objective to protect human health and the environment and to conserve valuable material and energy resources. The most important aspect of RCRA is its establishment of "cradle-to-grave" management and tracking of hazardous waste, from generator to transporter, to treatment, storage, and disposal.

CERCLA and subsequent amendments under SARA (often referred to collectively as Superfund) impose strict, retroactive liability upon persons who generated, transported, or arranged for the transportation of hazardous substances or owned or operated the vessels or facilities at which such substances were disposed. CERCLA provides for the investigation and remediation of hazardous substance sites and mandates that any hazardous substances remaining on-site must meet certain regulatory requirements, with a preference for innovative technology. These program regulations may create an incentive to utilize environmental-friendly technologies such as SET, which destroy targeted wastes without creating additional residual waste product. Moreover, to the extent hazardous substances are effectively destroyed, potential liability can be eliminated or significantly reduced.

The Clean Air Act empowered the EPA to establish and enforce ambient air quality standards and limitations on emissions of air pollutants from specific facilities. In 1987, the EPA began to enforce stricter standards for incineration emissions. With more stringent regulations on waste reduction technologies, the Company believes that SET could obtain a desired market share since, in most cases, it produces little or no air emissions.

CERCLA imposes strict joint and several liability upon owners or operators of facilities when a release or threatened release of a hazardous substance has occurred, upon parties who generated hazardous substances that were released at such facilities and upon parties who arranged for the transportation of hazardous substances to and from such facilities. The Company's plans to own and operate SET at on-site installations expose the Company to potential liability under CERCLA for releases of hazardous substances at those sites. In the event that off-site treatment, storage or disposal facilities utilized by the Company for final disposition of residues from SET are targeted for investigation and clean-up under CERCLA, the Company could incur liability as a generator of such materials or by virtue of having arranged for their transportation and disposal.

In light of such potential liability, the Company has designed the SET technology to minimize the potential for release of hazardous substances into the environment. In addition, the Company has developed plans to manage the

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risk of CERCLA liability, including training of operators, use of operational controls and structuring of its relationships with the entities responsible for the handling of waste materials and by-products. The Company also maintains insurance with respect to environmental claims, although there can be no assurance that such insurance will be adequate.

The Clean Air Act Amendments of 1990 impose strict requirements upon owners and operators of facilities that discharge pollutants into the environment. These amendments may require that certain air emission control technology be installed on the SET systems in the event that there is any discharge of non-recovered gases into the environment. Such additional air emission controls can be costly and require an air permit to construct and operate.

The Company obtained a Nationwide Permit issued by the EPA under the Alternative Destruction Technology Program that allowed it to use SET on-site to treat PCB-contaminated soils and metallic surfaces, although the permit is currently expired. The Nationwide Permit contains numerous conditions for maintaining the Nationwide Permit and there can be no assurance that the Company will be able to comply with such conditions to maintain and/or secure renewal of the Nationwide Permit. In addition, if environmental legislation or regulations are amended, or are interpreted or enforced differently, the Company may be required to meet stricter standards of

operation and/or obtain additional operating permits or approvals. Failure to obtain such permits or otherwise comply with such regulatory requirements could have a material adverse effect on the Company and its operations. Various revisions to the equipment and process parameters are being made to the existing permit. The Company believes that the revised permit will be issued pending the final site selection for the full or part-time operation of any SET system for the treatment of PCB wastes. The revised permit will require the Company to fund closure costs associated with the implementation of any SET system for the treatment of PCB wastes. The closure costs are calculated on a site-by-site basis and are funded accordingly by the Company.

## **EMPLOYEES**

As of December 31, 2006, the Company (including its direct subsidiaries) had a total of 29 full-time and 4 part-time employees, of which approximately 27 are engineers, scientists, environmental technicians and other professionals. None of such employees are covered by collective bargaining agreements and the Company's relations with its employees are believed to be good.

All 27 persons on the technical staff are extensively trained in proper procedures for handling waste materials and environmental media. Advanced Sciences' technical staff have more than 500 years of combined experience performing environmental and waste sampling tasks. Ten of our personnel hold DOE security clearances.

All Advanced Sciences' sampling personnel maintain currency in the following minimum training requirements:

- OSHA 40-hour Hazardous Waste Operations and Emergency Response (HAZWOPER)
- OSHA 8-hr Annual HAZWOPER Refresher
- OSHA HAZWOPER Supervisor
- Hazard Communication (HAZCOM)/Hazardous Materials Information System (HMIS) training
- Radiation Worker II
- First Aid/CPR
- Annual Medical Monitoring
- Respirator Fit Testing
- General Safety
- Hazardous Energy Control (Lockout/Tagout)
- Work Control Process
- Excavation/Penetration Permit
- Construction Equipment Inspection & Maintenance Program
- Hotwork (welding safety)
- Confined Space Program
- Asbestos and Other Fibrous Materials
- Chronic Beryllium Disease Prevention

- IATA Dangerous Good Awareness Certificate
- Workplace Substance Abuse Prevention Program participation

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## **OTHER INFORMATION**

See Item 8, Financial Statements and Supplementary Data, of this Annual Report on Form 10-K for information regarding revenue from customers, a measure of profit or loss and total assets for each of the Company's segments for the last 3 fiscal years.

The Company currently requires additional cash to sustain existing operations and to meet current obligations and ongoing capital requirements. The reports of our independent registered public accounting firms on our fiscal 2004, 2005 and 2006 consolidated financial statements contain a "going concern" qualification in which they express substantial doubt about our ability to continue in business.

## **ITEM 1A. RISK FACTORS**

Investing in our securities involves a material degree of risk. Before making an investment decision, you should carefully consider the risk factors set forth below as well as other information we include or incorporate by reference in this annual report and the additional information in the other reports we file with the U.S. Securities and Exchange Commission ("SEC").

### **Credit and Business Risks**

The documents governing our indebtedness restrict our ability and the ability of our subsidiaries to engage in some business transactions.

We have entered into a loan arrangement with the Shaar Fund, Ltd. that is collateralized by essentially all the assets of the Company that are not related to the receivable line of credit facility with Commerce Funding Corporation (the "New Shaar Note"). The New Shaar Note is used to fund working capital and general corporate requirements. As of December 31, 2006 and 2005, the outstanding balance was approximately \$6.5 million and \$5.4 million respectively. The agreements governing the Shaar Loan restrict our ability and the ability of our subsidiaries to, among other things, engage in the following actions:

- declare or pay dividends on and redeem or repurchase capital stock;
- transfer assets or make loans between us and some of our subsidiaries;
- make material changes in the nature or conduct of our business;
- merge or consolidate with, acquire substantially all of the stock or assets of any other companies; and
- transfer or sell assets.

Our failure to comply with obligations under the New Shaar Note could result in an event of default. A default, if not cured or waived, could permit acceleration of our indebtedness. We cannot be certain that we will be able to remedy any default. If our indebtedness is accelerated, we cannot be certain that we will have funds available to pay the accelerated indebtedness or that we will have the ability to refinance the accelerated indebtedness on terms favorable to us or at all.

**We have liquidity problems and are uncertain of our continued access to loans.**



Our current monthly operating expenses exceed cash revenues by approximately \$110 thousand. Currently, this cash shortfall is being covered by loans from The Shaar Fund, Ltd., but The Shaar Fund, Ltd. may discontinue these loans at any time and for any reason. If that happened, we would not be able to meet our current obligations and would be unable to continue operations unless alternative funding was obtained.

In addition, we owe approximately \$654 thousand in loans that are currently due or are payable on demand. Although the lenders on these loans have not yet called the loans, the Company does not currently have the ability to pay these loans absent additional financing.

If we are able to obtain financing to cover these obligations, it probably would involve additional dilution to shareholders or additional financial risk to the Company.

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### **Our ability to operate as a going concern is in doubt**

The reports of our independent registered public accounting firms on our fiscal 2006, 2005 and 2004 consolidated financial statements contains a "going concern" qualification in which they express substantial doubt about our ability to continue in business.

As shown in the consolidated financial statements for the years ended December 31, 2006, 2005, and 2004, the Company incurred losses before deemed dividends and dividends to preferred stockholders of approximately \$1.8 million, \$2.7 million and \$2.4 million, respectively. The Company has also experienced net cash outflows from operating activities of approximately \$596 thousand, \$1.3 million and \$1.5 million for the years ended December 31, 2006, 2005 and 2004, respectively. At December 31, 2006 and 2005 the Company had working capital deficit of approximately \$5.7 million and \$4.6 million, respectively.

Our losses have resulted from a combination of:

- costs associated with expansion of our environmental management services business;
- significant costs associated with our commercialization activities;
- financing and interest expenses;
- inadequate revenues due to significant delays in our obtaining material project contracts from potential governmental and private-sector customers; and
- general and administrative expenses.

Until we are able to obtain additional significant environmental services contracts, or one or more large projects for our SET technology, we will continue to experience losses.

### **Our business strategy depends on business collaborations.**

In the environmental services and hazardous waste treatment markets, the Company may not be able to enter into favorable business collaborations and might thus be required to bid upon projects for its own account. If such bids were successful, the Company would be required to make significant expenditures on personnel and capital equipment which would require significant financing.

Even if the Company is successful in achieving favorable business collaborations, the implementation of such arrangements and the expansion of the Company's business may require the commitment of significant capital resources toward the hiring of technical and operational support personnel, the development of a waste treatment facility for SET, and the building of equipment for on-site remediation of contaminated elements. In the event the Company is presented with one or more significant environmental services contracts, reclamation or clean-up projects, individually or in conjunction with collaborative working partners, it may require additional

capital to take advantage of such opportunities. There can be no assurance that such financing will be available or, if available, that it will be on favorable terms.

**Our previously reported losses could increase due to our inability to accurately estimate the overall risks, revenue, or costs on a contract.**

We generally enter into three principal types of contracts with our clients: firm fixed-price, fixed-unit-rate, and time-and-materials award. Under our firm fixed-price and fixed-unit-rate contracts, we receive a fixed price regardless of the actual costs we incur and, consequently, we are exposed to a number of risks. These risks include underestimation of costs, problems with new technologies, unforeseen costs or difficulties, delays beyond our control and economic and other changes that may occur during the contract period. Under our time-and-materials contracts, we are paid for labor and costs incurred at negotiated contractual rates. Profitability on these contracts is driven by the extent of utilization of our billable personnel and cost control.

Accounting for a contract requires judgment relative to assessing the contract's estimated risks, revenue, and costs, and on making judgments on other technical issues. Due to the size and nature of several of our contracts, the estimation of overall risks, revenue and costs at completion is complicated and subject to many variables. Changes in underlying assumptions, circumstances, or estimates may also adversely affect future period financial performance.

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**We may continue to encounter difficulties in pursuing our growth objectives.**

Although the Department of Energy has indicated that a number of new contracts will be awarded in 2007 and 2008, governmental awards are frequently delayed. Additionally, we cannot predict whether we will be successful in obtaining new federal services business awards. In some instances, we may choose to bid as the lead of a prime contractor team. In the past, we have operated mainly as a subcontractor or in a minority position on the prime contractor team. We expect to be bidding against organizations that have substantially greater resources and experience in being the leading prime contractor or sub-contractor for these kinds of projects.

In light of these uncertainties for new business awards in our commercial and federal services business units, our growth plan anticipates pursuing new opportunities for providing services with respect to sampling and data management, low-level radioactive waste treatment at DOE sites in the United States. In many of these potential opportunities, we may not have experience comparable to our current and past experience in our federal and commercial businesses. Thus, we may be subject to a range of risks in obtaining and performing these types of businesses, the adequacy and experience of management, and the adequacy of operational resources and technical capabilities needed to perform these mandates successfully. We cannot predict whether we will be successful in obtaining or performing any new business initiatives in these new business areas.

**Government Contracting Risks**

**The U.S. government can audit and disallow claims for compensation under our government contracts, and can terminate those contracts without cause.**

Our government contracts, which are primarily with the DOE and DOD, are, and are expected to continue to be, a significant part of our business. Allowable costs under cost reimbursement government contracts are subject to audit by the U.S. government. To the extent that these audits result in determinations that costs claimed as reimbursable are not allowable costs or were not allocated in accordance with Federal government regulations, we could be required to reimburse the U.S. government for amounts previously received. In addition, if we were to lose and not replace our revenues generated by one or more of the U.S. government contracts, our businesses, financial condition, results of operations, and cash flows could be adversely affected.

We derived approximately 100% of our consolidated revenues in 2006 and 2005 from contracts funded by the DOE. The work that we performed for customers that represented greater than 10% of the Company's segment revenues were with a prime contractor, Bechtel Jacobs Engineering. These contracts with Bechtel Jacobs were not, and are not, cost reimbursement contracts and therefore are not subject to the reimbursable cost audits.

We have a number of contracts and subcontracts with agencies of the U.S. government, principally for environmental services and data management, that extend beyond one year and for which additional government funding has not yet been appropriated. We cannot be certain that the U.S. government will appropriate such funds.

All contracts with agencies of the U.S. government are subject to unilateral termination at the option of the customer. In the event of a termination, we would not receive projected revenues or profits associated with the terminated portion of those contracts; however, all costs incurred prior to termination are recoverable in accordance with Federal Acquisition Regulations.

In addition, government contracts are subject to specific procurement regulations, contract provisions, and a variety of other socioeconomic requirements relating to the formation, administration, performance, and accounting of these contracts. Many of these contracts include express or implied certifications of compliance with applicable laws and contract provisions. As a result of our government contracting, claims for civil or criminal fraud may be brought by the government for violations of these regulations, requirements, or statutes. We may also be subject to qui tam litigation brought by private individuals on behalf of the government under the Federal Civil False Claims Act, which could include claims for up to treble damages. Further, if we fail to comply with any of these regulations, requirements, or statutes, our existing government contracts could be terminated, we could be suspended from government contracting or subcontracting, including federally funded projects at the state level, and our ability to participate in foreign projects funded by the United States could be adversely affected. If one or more of our government contracts are terminated for any reason, or if we are suspended from government work, we could suffer a significant reduction in expected revenues.

**Most of our government contracts are awarded through a regulated competitive bidding process. The inability to complete existing government contracts or win new government contracts over an extended period could harm our operations and adversely affect our future revenues.**

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Most of our government contracts are awarded through a regulated competitive bidding process. Some government contracts are awarded to multiple competitors, which increases overall competition and pricing pressure and may require us to make sustained post-award efforts to realize revenues under these government contracts. In addition, government clients can generally terminate or modify their contracts at their convenience. Moreover, even if we are qualified to work on a new government contract, we might not be awarded the contract because of existing government policies designed to protect small businesses and underrepresented minority contractors. The inability to complete existing government contracts or win new government contracts over an extended period could harm our operations and adversely affect our future revenues.

**If our partners fail to perform their contractual obligations on a project, we could be exposed to legal liability, loss of reputation and profit reduction or loss on the project.**

We perform projects jointly with outside partners, entering into subcontracts, joint ventures, and other contractual arrangements so that we can jointly bid and perform on particular projects. Success on these joint projects depends in large part on whether our partners fulfill their contractual obligations satisfactorily. If any of our partners fail to satisfactorily perform their contractual obligations as a result of financial or other difficulties, we may be required to make additional investments and provide additional services in order to make up for our partner's shortfall. If we are unable to adequately address our partner's performance issues, then our client could terminate the joint project, exposing us to legal liability, loss of reputation, and reduced profit or loss on the project.

Our future success will likely depend, in part, on the success of our existing collaborative relationships. Collaborative arrangements involve risks that the participating parties may disagree on business decisions and strategies resulting in potential delays, additional costs, and risks of litigation. Our inability to successfully maintain existing collaborative relationships or enter into new collaborative arrangements could have a material adverse effect on our results of operations.

## **Regulatory Risks**

**Our services expose us to significant risks of liability and our insurance policies may not provide adequate coverage.**

When we perform our hazardous waste treatment services, our personnel and equipment may be exposed to radioactive and hazardous materials and conditions. Although we are committed to a policy of operating safely and prudently, we may be subject to liability claims by employees, customers, and third parties as a result of such exposures. In addition, we may be subject to fines, penalties, or other liabilities arising under environmental or safety laws. To date, we have been able to obtain liability insurance for the operation of our business. However, there can be no assurance that our existing liability insurance is adequate or that it will be able to be maintained or that all possible claims that may be asserted against us will be covered by insurance. A partially or completely uninsured claim, if successful and of sufficient magnitude, could have a material adverse effect on our results of operations and financial condition.

**We operate in a highly regulated industry requiring our customers and us to have and comply with federal, state, and local government permits and approvals.**

We and our customers operate in a highly regulated environment. Facilities utilizing our hazardous waste treatment technology are required to have federal, state, and local government permits and approvals. Any of these permits or approvals may be subject to denial, revocation, or modification under various circumstances. Failure to obtain or comply with the conditions of permits or approvals or with environmental and safety laws may adversely affect our operations and may subject us to penalties and other sanctions.

In addition to regulatory requirements, environmental laws impose joint and several liabilities for the cleanup of contamination upon the current and former owners and operators of contaminated property and on any party who arranges for the disposal or treatment of hazardous substances at a facility that is or becomes contaminated. Such liability is imposed without regard to fault and regardless of knowledge or compliance with environmental requirements. There can be no assurance that we will not face such liability in the future.

In addition, if new environmental legislation or regulations are enacted or existing legislation or regulations are amended or are interpreted or enforced differently, we or our customers may be required to obtain additional operating permits or approvals. Changes in environmental requirements also may require us to change or improve our waste management technologies and services and incur additional expenses. There can be no assurance that we will be able to meet all of the applicable regulatory requirements.

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**Changes in existing environmental laws, regulations, and programs could reduce demand for our environmental services, which could cause our revenues to decline.**

A significant amount of our engineering services and hazardous waste treatment business is generated either directly or indirectly as a result of existing Federal and state laws, regulations, and programs related to pollution and environmental protection. federal, state, and local environmental legislation and regulations require substantial expenditures and impose liabilities for noncompliance. Accordingly, a relaxation or repeal of these laws and regulations, or changes in governmental policies regarding the funding, implementation, or enforcement of these programs, could result in a decline in demand for environmental services that may have a material adverse effect on our revenue.

**Competition Risks**

**We face increasing competition in the provision of environmental services and waste treatment technologies.**

The environmental services and hazardous waste treatment industry is characterized by several large companies and numerous small companies. Any of these companies may possess or develop technologies superior to our technologies. In addition, we compete with companies offering environmental services and hazardous waste treatment technologies alternatives. In our services business, our competitors range from major national and regional environmental service and consulting firms with large environmental services staffs to small local firms. To the extent that our competitors offer more cost-effective management technology alternatives or offer

comparable services at lower prices, our ability to compete effectively could be adversely affected.

**Our success depends on attracting and retaining qualified personnel in a competitive environment.**

We are dependent upon our ability to attract and retain highly qualified managerial and business development personnel, skilled technical specialists, and experts in a wide range of scientific, engineering, and health and safety fields. Competition for key personnel is intense. We cannot be certain that we will retain our key managerial, business development, and technical personnel or that we will attract or assimilate key personnel in the future. Failure to retain or attract such personnel could materially adversely affect our businesses, financial position, results of operations, and cash flows.

We are also highly dependent upon the technical expertise and management experience of our senior management. The loss of the services of any of these individuals could have a material adverse effect on our results of operations and financial condition. Senior management is not subject to employment agreements. There are no [key man] life insurance policies on any members of senior management or any other personnel.

**Other Risks**

**Certain anti-takeover provisions and potential adverse effect on market price of securities from issuance of preferred stock may limit the ability of security holders to dispose of their shares if the anti-takeover provisions were enacted.**

The Company's certificate of incorporation, as amended (the "Certificate of Incorporation"), and by-laws (the "By-laws") contain certain provisions that could have the effect of delaying or preventing a change of control of the Company, which could limit the ability of security holders to dispose of their shares in such transactions. The Certificate of Incorporation authorizes the Board of Directors to issue one or more series of preferred stock without stockholder approval. Such preferred stock could have voting and conversion rights that adversely affect the voting power of the holders of convertible preferred stock or common stock, or could result in one or more classes of outstanding securities that would have dividend, liquidation or other rights superior to those of the convertible preferred stock or common stock. Issuance of such preferred stock may have an adverse effect on the then prevailing market price of the convertible preferred stock or common stock. Additionally, the Company is subject to the anti-takeover provisions of Section 203 of the Delaware general corporate law ([DGCL]), which prohibits the Company from engaging in a "business combination" with an "interested stockholder" for a period of three years after the date of the transaction in which the person became an interested stockholder, unless the business combination is approved in a prescribed manner. Section 203 of the DGCL could have the effect of delaying or preventing a change of control of the Company.

**Our charter contains authorized, unissued preferred stock that may inhibit a change of control of our company under circumstances that could give shareholders an opportunity to realize a premium over prevailing market prices of our securities.**

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Our Certificate of Incorporation and By-Laws contain provisions that could make it more difficult for a third party to acquire the company under circumstances that could give stockholders an opportunity to realize a premium over then-prevailing market prices of our securities. Our Certificate of Incorporation authorizes our Board of Directors to issue preferred stock without stockholder approval and upon terms as it may determine. The rights of holders of our common stock are subject to, and may be adversely affected by, the rights of future holders of preferred stock. In addition, our by-laws require stockholders to provide advance notice to nominate candidates for election as directors and to submit proposals for consideration at stockholder meetings. Section 203 of the Delaware General Corporation Law makes it more difficult for an [interested stockholder] (generally a 15% stockholder) to effect various business combinations with a corporation for a three-year period after the stockholder becomes an [interested stockholder]. In general, these provisions may discourage a third party from attempting to acquire our company and, therefore, may inhibit a change of control of our company

**The value of our common stock could continue to be volatile.**

Our common stock has experienced substantial price volatility. In addition, the stock market has experienced extreme price and volume fluctuations that have affected the market price of many companies and that have often been unrelated to the operating performance of these companies. The overall market and the price of our common stock may continue to fluctuate greatly. The trading price of our common stock may be significantly affected by various factors, including:

- quarter-to-quarter variations in our financial results, including revenue, profits, and other measures of financial performance or financial condition;
- ability to continue to finance any shortfalls in cash flows which currently average approximately \$110 thousand per month;
- conversion of our convertible debt and preferred stock instruments into the Company's common stock will be dilutive;
- announcements of new contracts or technological development;
- announcements by us or our competitors of significant acquisitions;
- status of our collaborative arrangements or those of competitors;
- changes in investors' and analysts' perceptions of our business or any of our competitors' businesses;
- investors' and analysts' assessments of reports prepared or conclusions reached by third parties;
- changes in environmental legislation;
- patent or proprietary rights developments;
- broader market fluctuations; and
- general economic or political conditions.

Additionally, volatility or a lack of positive performance in our stock price may adversely affect our ability to retain key employees, many of whom are granted stock options, the value of which are dependent on the performance of our stock price.

**Our quarterly operating results may fluctuate significantly, which could have a negative effect on the price of our common stock.**

Our quarterly revenue, expenses, and operating results may fluctuate significantly because of a number of factors, including:

- unanticipated changes in contract performance that may affect profitability, particularly with contracts that have funding limits;
- the timing of resolutions on Requests for Equitable Adjustments ("REAs"), and other contract adjustments;
- the seasonality of the spending cycle of our public sector clients, notably the Federal government, and the spending patterns of our commercial sector clients;
- employee staff levels and utilization rates;

- the ability of our clients to terminate engagements without penalties;
- delays incurred in connection with an engagement;
- the size and scope of engagements;
- changes in the prices of services offered by our competitors;
- changes in accounting rules; and
- general economic or political conditions.

Variations in any of these factors could cause significant fluctuations in our operating results from quarter to quarter and could result in net losses.

**Potential exercises of convertible instruments, warrants and options may adversely affect the market price of securities due to future sales of common stock**

Assuming the conversion of all securities convertible into common stock, the payment of all interest and dividends with common stock, and the exercise of all warrants and options to purchase common stock without limitation, the Company would have 77,880,533 shares of common stock outstanding as of December 31, 2006. Of such shares, 8,413,749 shares of common stock would be freely tradable without restriction or further registration under the Securities Act, subject, if purchased by [affiliates] of the Company, to the volume and certain other limitations of Rule 144 promulgated under the Securities Act. The remaining 69,466,784 shares of common stock would be [restricted securities] as defined in Rule 144 promulgated under the Securities Act, and could only be sold in the public market if such shares were registered under the Securities Act or sold in accordance with Rule 144 or another exemption from registration under the Securities Act. No prediction can be made as to the effect, if any, that future sales of shares, or the availability of shares for future sale, will have on the market price of the common stock prevailing from time to time. Sales of substantial amounts of common stock (including shares of common stock issued upon the conversion of the convertible preferred stock and the exercise of outstanding warrants and stock options), or the perception that such sales could occur, could adversely affect prevailing market prices for the common stock. If such sales reduce the market price of the common stock, the Company's ability to raise additional capital in the equity markets could be adversely affected.

The conversion of the convertible note, the conversion of the Series J Preferred shares into common stock and the payment of interest and dividends in the form of common stock are subject to limitation, such that no conversion or payment in the form of stock can be made that would result in the holder owning 5% or more beneficial ownership of the Company's common stock. When compared to the shares outstanding at March 31, 2007, of the 63,953,429 common shares issuable upon conversion or payment of these instruments, the holder would be able to convert or receive a total of 420,860 shares under this limitation.

**Future sales of our common stock may have a depressive effect on the market price of our stock**

Sales of substantial amounts of our common stock, or the perception that those sales could occur, could adversely affect prevailing market prices for our common stock. On a fully-diluted basis (not including the shares of our common stock underlying any of our outstanding convertible preferred stock or the conversion feature of the New Shaar Note) and the interest and dividends payable with cash or stock associated with these convertible securities, approximately 13,927,104 shares of our common stock would be outstanding as of March 31, 2007. Of such shares, 8,413,749 shares would be freely tradable without restriction or further registration under the Securities Act, except to the extent those shares are held by our [affiliates.] The remaining 5,513,355 shares would be [restricted securities] as defined in Rule 144 promulgated under the Securities Act, and may only be sold in the public market if those shares are registered under the Securities Act of 1933, as amended, or sold in accordance with Rule 144 or another exemption from registration.

**Our stock price could decline due to sales of shares issued upon conversion of the Series J Convertible Preferred Stock or the New Shaar Note or by short sales.**

To the extent the Series J convertible preferred stock and/or the balance of the New Shaar Note are converted into shares of our common stock, or dividends in respect of those securities are paid in shares of our common stock rather than cash, a significant number of additional shares of common stock may be sold into the market, which could decrease the price of our common stock due to additional supply of shares relative to demand in the market. In

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that case, we could be required to issue an increasingly greater number of shares of our common stock upon future conversions of Series J convertible preferred stock and /or the exercise of the conversion feature on the New Shaar Note, sales of which could further depress the price of our common stock and have a material adverse effect on the value of a shareholder's investment. Moreover, since the conversion prices of the Series J convertible preferred stock and the conversion feature on the New Shaar Note will be based on the average of the closing prices of our common stock over a period of ten trading days prior to conversion, but in no case greater than \$0.50 per share or less than \$0.05 per share, the conversion prices could be less than the actual market price of our common stock on the date of conversion.

The conversion of the Series J Convertible Preferred Stock into common stock and the payment of dividends in the form of common stock is subject to limitation, such that no conversion or payment in the form of stock can be made that would result in the holder owning 5% or more beneficial ownership of the Company's common stock.

If the sale of a large amount of shares of our common stock upon conversion of the Series J convertible preferred stock and the exercise of the conversion feature on the New Shaar Note results in a decline in the price of our common stock, this event could encourage short sales of our common stock by stockholders, or margin calls upon investors in our common stock. Short sales or margin calls could place further downward pressure on the price of our common stock.

No corporation actions requiring stockholder approval can take place without the approval of our controlling stockholders. The executive officers, directors, and entities affiliated with them, in the aggregate, beneficially own approximately 47.5 percent of our voting stock. These stockholders acting together or with others would be able to decide or significantly influence all matters requiring approval by our stockholders, including the election of directors and the approval of mergers or other business combination transactions. This concentration of ownership may have the effect of delaying or preventing a merger or other business combination transaction, even if the transaction would be beneficial to our other stockholders.

#### **ITEM 1B. UNRESOLVED SEC STAFF COMMENTS**

None.

#### **ITEM 2.**

#### **PROPERTIES.**

The Company's principal executive offices are located in Richland, Washington. Advanced Science leases approximately 3,750 square feet of space for rental payments in the amount of \$3,500 per month under a yearly lease.

In addition to the Richland, Washington facilities, Advanced Sciences has leased approximately 20,000 square feet of space on five acres in Oak Ridge, TN for its administrative functions, on a three year lease, for a rental payment in the amount of \$6,667 per month.

Advanced Sciences also leases approximately 475 square feet of office space in Broomfield, Colorado with an average rental payment of \$555 per month over the term of the lease.



The Company has leased approximately 1,600 square feet of space in Alexandria, Virginia from Dr. Shelby T. Brewer, a director and executive officer of the Company, on a month-to-month basis, for a rental payment in the amount of \$1,700 per month.

The Company leases approximately 400 square feet of laboratory, office and storage space at Kirtland Air Force Base in Albuquerque, New Mexico for rental payments in the amount of \$826 per month, pursuant to a month-to-month lease arrangement.

The Company leases approximately 1000 square feet of exterior uncovered storage space for the Company's industrial and waste processing equipment in Hobbs, New Mexico for rental payments in the amount of \$527 per month, pursuant to a month-to-month lease arrangement.

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The Company leases approximately 500 square feet of storage for raw materials to be used in the Company's waste processing equipment in Mobile, Alabama for rental payments in the amount of \$172 per month, pursuant to a month-to-month lease arrangement

The Company leases approximately 500 square feet of office space located in Newport, Rhode Island for a rental payment in the amount of \$500 per month, pursuant to a month-to-month lease arrangement.

The Company believes that the foregoing properties will satisfy the business and operational needs of the Company and its subsidiaries in the present and in the foreseeable future.

### **ITEM 3.**

#### **LEGAL PROCEEDINGS**

##### **Indemnification Matters**

The Company, along with several other entities, in a prior year guaranteed a performance bond of Separation relating to a contract with the Port of Baltimore. The Company was notified on June 28, 2000 that the performance bond was being called. It is not known, at this time, the amount, if any, the Company's share of any potential liability would be. There has been no communication with the bond issuer or the Port of Baltimore since 2000, and the matter may no longer be an open issue.

As of April 17, 2007, no litigation or claim has been filed against the Company, or any of the Company's subsidiaries with respect to this indemnification issue. No amount has been recorded in the financial statements as the Company is unable to determine a loss amount, if any, on the issue of indemnification.

##### **Incidental Matters**

The Company and its subsidiaries are involved in ordinary, routine litigation incidental to the conduct of their business. Management believes that none of this litigation, individually or in the aggregate, is material to the Company's financial condition or results of operations.

### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.**

None

## **PART II**

### **ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.**

**MARKET INFORMATION**

Shares of the Company's common stock are quoted on the Over The Counter Bulletin Board of the National Association of Securities Dealers, Inc. (the "OTC Bulletin Board or OTCBB") under the symbol CXIA.

On August 29, 2005, at the close of business, the Company effectuated a previously approved reverse stock split with the established ratio of 1 for 20. Applied common stock began trading on a reverse-split basis on August 30, 2005. As a result of the reverse stock split, every 20 shares of Applied common stock were combined into one share of Applied common stock. As a result of the reverse stock split, the issued and outstanding shares of Applied common stock were reduced from approximately 156 million shares to approximately 7.8 million shares. The number of authorized shares is not reduced. All stock quotes in the table below have been adjusted for the 1 for 20 reverse split.

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The following table sets forth, for the fiscal periods shown, the high and low sale prices (rounded to the nearest cent) for the Company's common stock as reported on the OTCBB.

<b>Stock price by quarter</b>	<b>High</b>	<b>Low</b>
Fiscal year ended December 31, 2006		
First Quarter	\$ 0.30	\$ 0.15
Second Quarter	0.26	0.13
Third Quarter	0.17	0.09
Fourth Quarter	0.26	0.13
Fiscal year ended December 31, 2005		
First Quarter	\$ 0.34	\$ 0.12
Second Quarter	0.21	0.10
Third Quarter	0.30	0.12
Fourth Quarter	0.27	0.09

 Holders of Record 

As of December 31, 2006 there were 282 shareholders of record of our common stock and approximately 3100 additional shareholders whose shares are held through brokerage firms or other institutions.

 Dividends  *Exchange Agreement of Series E Preferred Stock and Series F Preferred Stock* 

On April 12, 2005, the Company authorized the issuance of 550,000 shares of Series I Convertible Preferred Stock ("Series I Preferred"), par value \$0.001 per share, each such share of Series I Preferred having a stated value of \$10.00 per share. These preferred shares are convertible into common stock at the rate of the average closing price of the Company's common stock for the previous ten trading days, and the conversion rate is not to exceed \$0.57 per share. Cumulative dividends accrue at ten percent, and will be payable quarterly beginning February 2006. The Company has reserved 3,750,000 shares of common stock for the potential conversion of the Series I Convertible Preferred Stock into common stock.

Also on April 12, 2005, a Series E and F preferred stockholder, Shaar Funding agreed to exchange all of their Series E and F preferred stock and all accrued and unpaid dividends thereon, for 395,302 shares of Series I Convertible Preferred Stock. Effective October 1, 2005, 388,302 shares of Series I Preferred were exchanged for 388,302 shares of Series J Preferred. The preferred stockholder has 0 shares of Series I preferred stock at December 31, 2006.

*Exchange Agreement of Series I Preferred Stock for Series J Preferred Stock*

Effective October 1, 2005, the Company authorized the issuance of 550,000 shares of Series J Convertible Preferred Stock (["Series J Preferred"]), par value \$0.001 per share, each such share of Series J Preferred having a stated value of \$10.00 per share. These preferred shares are convertible into common stock at the rate of the average closing price of the Company's common stock for the previous ten trading days, and the conversion rate no less than \$0.05 and no more than \$0.50 per share. Cumulative dividends accrue at ten percent, and were payable quarterly beginning February 2006. The Company has reserved 40,000,000 shares of common stock for the potential conversion of the Series J Convertible Preferred Stock and the Amended and Restated Shaar Note into common stock.

Also, effective October 1, 2005, a Series I Preferred stockholder agreed to exchange 388,302 shares of their Series I Preferred, excluding all accrued and unpaid dividends thereon, for 388,302 shares of Series J Preferred. The preferred stockholder has 388,302 shares of Series J Preferred at December 31, 2006.

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Series H Preferred Stock

The holders of the Company's Series H Convertible Preferred Stock, par value (\$0.001) per share (the ["Series H Preferred"]), are entitled to a dividend rate of 3%. Through December 31, 2006, the Company had not paid cash dividends and the Company has accrued approximately \$105 thousand in unpaid dividends. The Company has the option to pay the dividends accrued in all periods in additional shares of Series H Preferred.

Series I Preferred Stock

The holders of the Company's Series I Convertible Preferred Stock, par value (\$0.001) per share (the ["Series I Preferred"]), are entitled to a dividend of 10%. Through December 31, 2006, the Company has accrued approximately \$184 thousand in unpaid dividends. The Company has the option to pay the dividends accrued in all periods after March 31, 2006 in the Company's common stock rather than cash. During 2006 the Company has not paid any of the accrued dividends on all of the converted Series I Preferred shares to date. The payment of dividends in the form of common stock is subject to limitation, such that no payment in the form of stock can be made that would result in the holder owning 5% or more beneficial ownership of the Company's common stock.

Series J Preferred Stock

The holders of the Company's Series J Convertible Preferred Stock, par value (\$0.001) per share (the ["Series J Preferred"]), are entitled to a dividend of 10%. Through December 31, 2006, the Company has accrued approximately \$485 thousand in unpaid dividends. The Company has the option to pay the dividends accrued in all periods after March 31, 2006 in the Company's common stock rather than cash. During 2006, no shares of the Company's Series J Preferred Stock were converted. The conversion of the Series J Preferred shares into common stock and the payment of dividends in the form of common stock are subject to limitation, such that no conversion or payment in the form of stock can be made that would result in the holder owning 5% or more beneficial ownership of the Company's common stock.

Common Stock

The Company has never paid cash dividends on its common stock. Any future determination by the Board of Directors of the Company with respect to the payment of cash dividends on the common stock of the Company will depend on the ability of the Company to service its outstanding indebtedness, the Company's future earnings, capital requirements, the financial condition of the Company and such other factors as the Company's Board of Directors may consider. The Company currently intends to retain its earnings, if any, to finance the growth and development of its business, to repay outstanding indebtedness and does not anticipate paying cash dividends on its common stock in the foreseeable future.

Securities Authorized for Issuance under Equity Compensation Plans

The Company did not issue any shares or options to purchase shares of the Company's common stock under the 1998 Stock Option Plan during 2006, 2005 or 2004. The Company issued 200,000 warrants to purchase

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shares of the Company's common stock during 2005. At December 31, 2006, after removing forfeited options and expired warrants, the Company had the following options outstanding and available for issuance:

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance (c)
Equity compensation plans approved by security holders	456,404	\$1.61	265,384
Equity compensation plans not approved by security holders	5,474,358	\$0.57	-
Total	5,930,762	\$0.65	265,384

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Repurchase of Securities

During 2006, neither the Company nor any of its affiliates repurchased common shares of the Company registered under Section R of the Exchange Act.

Issuance of Common Stock Subsequent to December 31, 2006

None.

Recent Sales of Unregistered Securities

On September 5, 2006, the Company issued 220,000 shares of common stock to Aurelius Consulting Group, Inc. / RedChip Companies ("Aurelius") in partial consideration for the first six months of an agreement for Aurelius to provide investor relations services. The Company recorded investor relations expense of approximately \$28 thousand in the quarter ended December 31, 2006, the value of the shares issued at the average market price of \$0.13 on the date of issue.

On March 5, 2007, the Company issued 120,000 shares of common stock to Aurelius in additional consideration for the second six months of investor relations services to be provided under the agreement. The Company recorded investor relations expense of approximately \$23 thousand in the quarter ended March 31, 2007, the value of the shares issued at the average market price of \$0.19 on the date of issue.

**ITEM 6.**

**SELECTED FINANCIAL DATA.**

The following table presents selected financial data of the Company, as of December 31, 2006, 2005, 2004, 2003 and 2002 and for the years then ended. The following selected historical data is derived from the Company's Consolidated Financial Statements and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Company's Consolidated Financial Statements and Notes thereto included elsewhere in this Annual Report.

**Consolidated Statement of Operations Data: (in thousands, except per share data)**

	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>
Revenue:					
Contract revenues	\$ 7,254	\$10,275	\$ 738	\$ 660	\$ 3,710
Cost of sales:					
Cost of revenues	7,153	9,132	919	811	2,108
Research and development	-	5	9	70	297
General and administrative	1,431	2,072	1,674	1,700	1,792
Depreciation and amortization	25	54	136	267	314
Loss from operations	(1,355)	(988)	(2,000)	(2,188)	(801)
Interest expense	(659)	(1,183)	(404)	(769)	(104)
Derivative loss	-	(543)	-	-	-
Other Income	165	-	-	-	-
Loss from continuing operations	(1,849)	(2,714)	(2,404)	(2,957)	(905)
Loss on disposal of discontinued operations	-	-	-	-	(4,134)
Loss from discontinued operations	-	-	-	-	(933)
Net loss	(1,849)	(2,714)	(2,404)	(2,957)	(5,972)
Deemed dividends and dividends accrued to preferred stockholders	(412)	(4,067)	(291)	(374)	(528)
Net loss applicable to common shareholders	\$ (2,261)	\$ (6,781)	\$ (2,695)	\$ (3,331)	\$ (6,500)
Net loss per share - basic and diluted	\$(0.29)	\$(0.93)	\$(0.43)	\$(0.72)	\$(2.25)
Weighted average number of shares (000's) basic and diluted	7,847	7,309	6,334	4,602	2,889

**Consolidated Balance Sheet Data: (in thousands)**

	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>
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Cash and cash equivalents	\$ 127	\$ 65	\$ 15	\$ -	\$ 59
Total assets	1,243	2,474	369	246	736
Long term debt	6,509	5,426	3,034	1,575	431
Total liabilities	13,340	12,338	9,697	6,898	5,025
Stockholders' deficit	(12,097)	(9,864)	(9,328)	(6,652)	(4,289)

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## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND**

The Company is engaged in providing a range of environmental and technical services to the public and private sectors related to (i) providing services related to, environmental management for on-site and off-site identification, investigation remediation and management of hazardous, mixed and radioactive waste; and (ii) remediating contamination in soils, liquids and other materials and disposing of or reusing certain waste by-products by utilizing SET.

Through Advanced Sciences, formerly Advanced Sciences, Inc., a subsidiary acquired on October 1, 1996, the Company has contracts with various government agencies and private companies in the U.S. As some government contracts are funded in one-year increments, there is a possibility for cutbacks as these contracts constitute a major portion of Advanced Sciences' revenues, and such a reduction would materially affect operations. However, management believes Advanced Sciences' existing client relationships will allow the Company to obtain new contracts in the future. The Company has access to technologies related to the separation and destruction of mixed waste, polychlorinated biphenyls (PCBs) and chlorofluorocarbons (CFCs). The Company is currently working on the commercialization of these technologies through development efforts, licensing arrangements and joint ventures.

The Company has identified two reportable segments in which it operates, based on the guidelines set forth in the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 131. These two segments are as follows: Commodore Advanced Sciences, Inc., which primarily provides various environmental sampling, analysis and data management services to Government agencies on a lump sum and fixed cost basis; and Commodore Solutions, Inc., which is commercializing technologies to treat mixed and hazardous waste.

The Company currently requires additional cash to sustain existing operations and to meet current obligations and ongoing capital requirements. The Company's current monthly operating expenses exceed cash revenues by approximately \$110 thousand. Currently, the Company is addressing this cash shortfall through loans from The Shaar Fund, Ltd., but The Shaar Fund, Ltd. is under no obligation to continue to make such advances to the Company. If this lender decided to discontinue advances, the Company would not be able to meet its current obligations. In addition, the Company owes approximately \$654 thousand in loans that are currently due or are payable on demand. Although the lenders on these loans have not yet called the loans, the Company does not currently have the ability to pay these loans absent additional financing.

The reports of our independent registered public accounting firms on our fiscal 2004, 2005 and 2006 consolidated financial statements contain a "going concern" qualification in which they express substantial doubt about our ability to continue in business. The Company currently requires additional cash to sustain existing operations and to meet current obligations and ongoing capital requirements.

### **CRITICAL ACCOUNTING POLICIES**

We prepare our financial statements in conformity with U.S. generally accepted accounting principles. As such, we are required to make certain estimates, judgments and assumptions that we believe are reasonable based upon the information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods presented.

Our accounting policies that are the most important to the portrayal of our financial condition and results, and which require the highest degree of management judgment relate to the reserves for doubtful accounts receivable and the valuation of stock and options issued for services.

#### *Reserves for Doubtful Accounts*

Management estimates the amount of required reserves for potential uncollectible accounts receivable based upon the customer's financial condition, age of the customer's receivables, changes in payment histories, and consideration of other relevant factors. Because the reserve for doubtful accounts is an estimate of events that have not yet occurred, we could incur additional charges or benefits in the future to reflect differences between estimated and actual collections.

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#### *Valuation of Stock, Options and Embedded Derivatives*

We value and account for the issuance of equity instruments, embedded or otherwise, to non-employees to acquire goods and services based on the fair value of the goods and services or the fair value of the equity instrument at the time of issuance, whichever is more reliably measurable. The fair value of stock issued for goods or services is determined based on the quoted market price on the date the commitment to issue the stock has occurred. The fair value of stock options, warrants granted to non-employees for goods or services is calculated on the date of grant using the Black-Scholes options pricing model. The fair value of the embedded derivatives consisting of conversion features included in a note payable and in the Series I Convertible Preferred Stock is calculated using the Black-Scholes options pricing model.

#### *Revenue Recognition*

Substantially all the Company's current revenues consist of engineering and scientific services performed for the U.S. Government and prime contractors that serve the U.S. Government under a variety of contracts, most of which provide for unit prices. Revenue under unit price contracts are recorded when the services are provided.

Most of the Company's historical contracts provided for reimbursement of costs plus fixed fees. Direct and indirect contract costs incurred in reimbursement plus cost contracts are subject to audit by the Defense Contract Audit Agency ("DCAA"). Management does not expect these audits to materially affect the financial statements and has established appropriate allowances to cover potential audit disallowances. Contract revenues have been recorded in amounts which are expected to be realized upon final settlement. The DCAA has audited the Company's contracts through 1999. An allowance for potential disallowances is recorded as a reduction in revenue based upon the portion of billed and unbilled receivables that management believes may be disallowed upon audit by the DCAA.

## **RESULTS OF OPERATIONS**

### ***Year ended December 31, 2006 compared to Year ended December 31, 2005***

Revenues were approximately \$7.3 million for the year ended December 31, 2006, compared to approximately \$10.3 million for the year ended December 31, 2005. The decrease in revenues is due to the decreases in revenue contribution by Advanced Sciences as certain contracts were closed out during the year.

In the case of Advanced Sciences, revenues were approximately \$7.3 million for the year ended December 31, 2006, compared to approximately \$10.2 million for the year ended December 31, 2005. Revenues in 2006 were primarily from engineering and scientific services performed for the United States government under two contracts similar to those in place in 2005. Advanced Sciences had one major customer in 2006, which represents more than 10% of annual revenue. Revenue from this customer was approximately \$6.5 million or 90% of the Company's total 2006 revenue. The decrease in revenues at Advanced Sciences is primarily the result of the revision of the EDAM contract at a lower total amount, due to BJC performing more self-assessment tasks and the removal of management of laboratory activities from the contract. This modification to the contract upon renewal results in less pass-through revenues to the Company subcontractors which are at low or no margin. Cost of sales decreased from approximately \$9.1 million for 2005 to approximately \$7.2 million for 2006. A decrease in cost of sales at Advanced Sciences was the result of decreased revenues due to the completion of the original EDAM

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contract. The Company's backlog at December 31, 2006 totals approximately \$2.1 million, all of which represents work to be completed during calendar year 2007. This compares to a backlog of approximately \$9.8 million at December 31, 2005, not all of which was performed during calendar year 2006. Revenues and associated expenses in relation to the EDAM contract are expected to be lower for calendar 2007 when compared to 2006 as a result of the reduced backlog at the beginning of 2007.

Contracts of the Company may be subjected to audit by the DCAA. Anticipated losses on contracts are provided for by a charge to income during the period such losses are first identified. Subsequent to the end of the period, on January 25, 2007, the Company received a letter from the Department of Energy regarding a DCAA audit of a single contract of Commodore Applied Technologies for the period January 1995 through December 1999. The DCAA asserted that the Company incorrectly overbilled the Government for services rendered under contracts performed during the period under audit. The Company has recorded a liability totaling approximately \$376 thousand (included in other accrued liabilities for the years ended December 31, 2006 and 2005) as a reserve to settle any claims, including related legal fees and professional fees, that may be incurred related to this issue. The amount recorded

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was estimated based on an assessment of potential liability using an analysis of available information with respect to pending claims, historical experience and, where available, recent and current trends.

In the case of Solution, there were no revenues for the year ended December 31, 2006 as compared with approximately \$86 thousand for the year ended December 31, 2005. The decrease is due to the absence of revenue arising from feasibility studies and commercial processing during 2006. Revenues in 2005 were primarily from remediation services performed for a scrap metal recycling company in the U.S. under a subcontract. Solution had one major customer which represented more than 10% of annual revenue. There was \$0 revenue from this customer in 2006. Cost of sales was \$0 for the year ended December 31, 2006 as compared to approximately \$54 thousand for the year ended December 31, 2005. Should the Company be successful in securing contract revenues for its SET technology, Solution would reflect revenues once again.

For the year ended December 31, 2006, the Company did not incur any research and development related costs compared to \$5 thousand for the year ended December 31, 2005. 100% of the research and development costs are attributable to the operations of Advanced Sciences in 2005.

General and administrative expenses for the year ended December 31, 2006 were approximately \$1.4 million as compared to approximately \$2.1 million for the year ended December 31, 2005. This decrease reflects the impact of the reduction to general and indirect costs due to the reduction in the EDAM contract and some of the restructuring steps in the Company throughout 2006.

In the case of Advanced Sciences, general and administrative costs decreased to approximately \$369 thousand for the year ended December 31, 2006 from approximately \$618 thousand for the year ended December 31, 2005. This decrease reflects decreases sales and marketing costs as the Company made efforts to reduce costs to match reduced revenues. Advanced Sciences focused its sales and marketing efforts on the bid and proposal activities to achieve a higher contract base and seek new contracting opportunities. Solution did not incur any general and administrative costs for the year ended December 31, 2006 as compared with approximately \$16 thousand for the year ended December 31, 2005. This decrease was due to a decreased sales and marketing effort for Solution's services.

Interest expense decreased to approximately \$659 thousand in 2006 from approximately \$1.2 million in 2005, or 44%, due to lower balances on the Company's line of credit, and a decrease in non-cash expenses related to the amortization of the embedded derivative debt discount on the convertible note payable. During the year ended December 31, 2005, the Company amended the Amended and Restated Shaar Note, removing the provisions of the agreement that required embedded derivative liability accounting.

For the year ended December 31, 2006, the Company incurred a net loss of approximately \$1.8 million as compared to a net loss of approximately \$2.7 million for the year ended December 31, 2005. The decrease in the net loss was a direct result of the decrease in non-cash expenses associated with the embedded derivative



features concerning various financial instruments of the Company for the year ended December 31, 2006 compared to the year ended December 31, 2005. On April 11, 2005, Applied, through the issuance of the Series I Preferred and the Amended and Restated Shaar Note, recorded an embedded derivative liability due to the conversion feature of these financial instruments pursuant to SFAS No. 133 and EITF 00-19. Effective as of October 1, 2005, the Company issued Series J Preferred in exchange for the Series I Preferred as well as further amending the Amended and Restated Shaar Note, and the Company reclassified the derivative liability into equity as a result of the changes.

***Year ended December 31, 2005 compared to Year ended December 31, 2004***

Revenues were approximately \$10.3 million for the year ended December 31, 2005, compared to approximately \$738 thousand for the year ended December 31, 2004. The increase in revenues is due to the increases in revenue contribution by Advanced Sciences as certain contracts were renewed and other contracts were initiated.

In the case of Advanced Sciences, revenues were approximately \$10.2 million for the year ended December 31, 2005, compared to approximately \$698 thousand for the year ended 2004. Revenues in 2004 were primarily from engineering and scientific services performed for the United States government under two contracts similar to those in place in 2003. Advanced Sciences had a major customer in 2005, which represented more than 10% of annual revenue. The combined revenue for this customer was approximately \$9.4 million, or 91%, of the Company's total 2005 revenue. The increase in revenues at Advanced Sciences is primarily the result of the award of the EDAM

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contract, renewal of existing contracts, and overall, more subcontract work being performed in 2005. Cost of sales increased from approximately \$548 thousand for 2004 to approximately \$9.1 million for 2005. An increase in cost of sales at Advanced Sciences was the result of greater revenues due to the operation of the EDAM contract. The Company has a substantial backlog for a similar volume of work for the EDAM contract for the calendar year 2006. Revenues and associated expenses in relation to the EDAM contract are expected to be consistent with those observed in calendar year 2005. All other operating expenses remained constant as a direct result of operating efficiencies on the remaining contracts. Anticipated losses on contracts are provided for by a charge to income during the period such losses are first identified.

In the case of Solution, revenues were approximately \$86 thousand for the year ended December 31, 2005 as compared with approximately \$40 thousand for the year ended December 31, 2004. The decrease is primarily due to the decrease in feasibility studies and commercial processing. Revenues in 2005 were primarily from remediation services performed for a scrap metal recycling company in the U.S. under a subcontract. Solution had one major customer which represented more than 10% of annual revenue. The revenue for this customer was approximately \$86 thousand, or 100%, of Solution's total 2005 revenue. The increase in revenues at Solution is primarily the result of marginally greater subcontract work being performed in 2005. Cost of sales was approximately \$54 thousand for the year ended December 31, 2005 as compared to approximately \$371 thousand for the year ended December 31, 2004. The decrease in cost of sales is attributable to less machinery and equipment refurbishment costs relating to the revenues produced for subcontract work being performed in 2005. Anticipated losses on engagements, if any, will be provided for by a charge to income during the period such losses are first identified.

For the year ended December 31, 2005, the Company incurred research and development costs of approximately \$5 thousand, as compared to approximately \$9 thousand for the year ended December 31, 2004. 100% of the research and development costs are attributable to the operations of Advanced Sciences in 2005 and Solutions in 2004. In 2005, the Company invested less money in laboratory work than it had in 2004.

General and administrative expenses for the year ended December 31, 2005 were approximately \$2.1 million as compared to approximately \$1.7 million for the year ended December 31, 2004. This increase reflects the impact of the EDAM contract and some of the restructuring steps in the Company throughout 2005.

In the case of Advanced Sciences, general and administrative costs increased from approximately \$308 thousand for the year ended December 31, 2004 to approximately \$618 thousand for the year ended December 31, 2005. This increase reflects increased sales and marketing focus and the costs associated with bid and proposal efforts as Advanced Sciences continues to expand its contract base and seek new contracting opportunities. Solution incurred general and administrative costs of approximately \$16 thousand for the year ended December 31, 2005 as compared with approximately \$120 thousand for the year ended December 31, 2004. This decrease was primarily due to a decreased sales and marketing effort for Solution's services. All expenditures for the year ended December 31, 2005 were directly related to bid and proposal expenses, which may result in contracts that will produce revenue in 2006 and beyond.

The increase in interest expense of approximately \$779 thousand from 2004 to 2005 is primarily related to (i) greater balances on the Amended and Restated Shaar Note, (ii) higher balances on the Company's line of credit, and (iii) non-cash expenses related to the amortization of the embedded derivative debt discount on the associated convertible note payable.

For the year ended December 31, 2005, the Company incurred a net loss of approximately \$2.7 million as compared to a net loss of approximately \$2.4 million for the year ended December 31, 2004. The increase in the net loss was a direct result of the recognition of non-cash expenses associated with the embedded derivative features concerning various financial instruments of the Company for the year ended December 31, 2005 compared to the year ended December 31, 2004. On April 11, 2005, Applied, through the issuance of the Series I Preferred and the Amended and Restated Shaar Note, recorded an embedded derivative liability due to the conversion feature of these financial instruments pursuant to SFAS No. 133 and EITF 00-19. Applied recorded a non-cash other expense of approximately \$543 thousand for the year ended December 31, 2005. The fair value of the embedded derivatives consisting of conversion features included in a note payable and in the Series I Convertible Preferred Stock is calculated using the Black-Scholes options pricing model. Effective as of October 1, 2005, the Company issued Series J Preferred in exchange for the Series I Preferred as well as further amending the Amended and Restated Shaar Note, and the Company reclassified the derivative liability into equity as a result of the changes. Overall, the Company has experienced significantly greater revenues and has improved its results from operations from a loss of

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approximately \$2.0 million to a loss of approximately \$988 thousand for the year ended December 31, 2005 compared to the year ended December 31, 2004.

**OFF-BALANCE SHEET ARRANGEMENTS**

There are no off-balance sheet arrangements, such as financing or variable interest entities, that either have, or are reasonably likely to have, a current or future material effect on financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

**QUARTERLY RESULTS OF OPERATIONS**

The following table sets forth certain unaudited quarterly statement of operations data for the last eight quarters. This information has been derived from our unaudited consolidated financial statements, which, in management's opinion, have been prepared on the same basis as the audited financial statements and include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the information for the quarters presented. This information should be read in conjunction with the audited consolidated financial statements and related notes included elsewhere in this Form 10-K. The operating results for any quarter are not necessarily indicative of the operating results for any future period.

Quarter Ended			
December 31, 2006	September 30, 2006	June 30, 2006	March 31, 2006

**(unaudited)**  
**(in thousands, except per share data)**

Revenue	\$	911	\$	2,281	\$	1,826	\$	2,236
Loss from operations	\$	(704)	\$	(178)	\$	(335)	\$	(138)
Net loss applicable to common stockholders	\$	(982)	\$	(441)	\$	(597)	\$	(241)
Net loss per common share: Basic & diluted	\$	(0.13)	\$	(0.06)	\$	(0.08)	\$	(0.03)
Weighted average common shares: Basic & diluted		7,847		7,836		7,776		7,685

**Quarter Ended**

<b>December 31, 2005</b>	<b>September 30, 2005</b>	<b>June 30, 2005</b>	<b>March 31, 2005</b>
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**(unaudited)**  
**(in thousands, except per share data)**

Revenue	\$	2,016	\$	3,900	\$	2,733	\$	1,626
Income (loss) from operations	\$	(505)	\$	151	\$	(305)	\$	(329)
Net loss applicable to common stockholders	\$	(782)	\$	(341)	\$	(5,114)	\$	(544)
Net loss per common share: Basic & diluted	\$	(0.10)	\$	(0.04)	\$	(0.69)	\$	(0.08)
Weighted average common shares: Basic & diluted		7,830		7,819		7,442		6,817

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### Fluctuations in Quarterly Results

Factors that may affect quarterly results include:

- the award and successful operation of the EDAM contract in Oak Ridge, TN;
- the renewal of the EDAM contract in the third quarter of 2006 which removed the no-margin and low-margin revenues related to invoicing pass-through revenues on behalf of BJC for 13 subcontracted laboratories;
- the recognition of non-cash expenses associated with the embedded derivative from the conversion features on the Series I Preferred and the New Shaar Note;
- the interest expense associated with the increased amounts of notes payables;

- the introduction, development, timing, competitive pricing and market acceptance of our environmental services and those of our competitors; and
- changes in general economic conditions that could affect customer expenditures for environmental services.

The June 30, 2005 and September 30, 2005 information above varies from the amounts previously reported on Form 10Q/A and 10Q, respectively. Instead of recording the initial value of the embedded derivative of approximately \$8.6 million as other expense, the above information records the embedded derivative as a debt discount of approximately \$4.4 million and a deemed dividend of approximately \$3.7 million. The debt discount was amortized by approximately \$227 thousand and approximately \$273 thousand in the three months ended June 30, 2005 and September 30, 2005, respectively, in the above information.

As a result of the factors listed above and elsewhere in the "Forward-Looking Statements" and "Risk Factors" sections of this Form 10-K, it is possible that in some future periods our results of operations may fall below management's expectations as well as the expectations of public market analysts and investors. If revenue falls below management's expectations in any quarter and we are unable to reduce expenses, our operating results will be lower than expected.

### **LIQUIDITY AND CAPITAL RESOURCES**

At December 31, 2006 and December 31, 2005 Advanced Sciences had a \$0 and approximately \$141 thousand outstanding balance, respectively, on its two million dollar, receivables revolving line of credit. The line of credit is credit collateralized by worthy receivables of Advanced Sciences.

The Company currently requires additional cash to sustain existing operations and to meet current obligations and ongoing capital requirements. The Company's current monthly operating expenses exceed cash revenues by approximately \$110 thousand at December 31, 2006. Currently, the Company is addressing this cash shortfall through loans from The Shaar Fund, Ltd., but The Shaar Fund, Ltd. is under no obligation to continue to make such advances to the Company. If this lender decided to discontinue advances, the Company would not be able to meet its current obligations. In addition, the Company owes approximately \$654 thousand in loans that are currently due or are payable on demand as of December 31, 2006. Although the lenders on these loans have not yet called the loans, the Company does not currently have the ability to pay these loans absent additional financing.

The Company has experienced a significant decrease in total assets for the year ended December 31, 2006. The majority of the decrease was attributable to a reduction in accounts receivable, net. Accounts receivable, net, for the period ended December 31, 2006 was approximately \$802 thousand as compared to approximately \$2.1 million for the year ended December 31, 2005. The decrease in accounts receivable, net, is due to the decreases in revenue contribution by Advanced Sciences from the EDAM contract in Oak Ridge, TN.

The reports of our independent registered public accounting firms on our fiscal 2004, 2005 and 2006 consolidated financial statements contain a "going concern" qualification in which they express substantial doubt about our ability to continue in business. The Company currently requires additional cash to sustain existing operations and to meet current obligations and ongoing capital requirements.

For the year ended December 31, 2006, the Company incurred a net loss of approximately \$1.8 million as compared to a net loss of approximately \$2.7 million for the year ended December 31, 2005. The decrease in the net loss was a direct result of the recognition of non-cash expenses associated with the embedded derivative features

On April 11, 2005, Applied, through the issuance of the Series I Preferred and the Amended and Restated Shaar Note, recorded an embedded derivative liability due to the conversion feature of these financial instruments pursuant to SFAS No. 133 and EITF 00-19. Applied recorded a non-cash other expense of approximately \$543 thousand for the year ended December 31, 2005. The fair value of the embedded derivatives consisting of conversion features included in a note payable and in the Series I Convertible Preferred Stock is calculated using the Black-Scholes options pricing model. Effective as of October 1, 2005, the Company issued Series J Preferred in exchange for the Series I Preferred as well as further amending the Amended and Restated Shaar Note, and the Company reclassified the derivative liability into equity as a result of the changes.

As shown in the consolidated financial statements for the years ended December 31, 2006, 2005, and 2004, the Company incurred losses of approximately \$1.8 million, \$2.7 million and \$2.4 million, respectively. The Company has also experienced net cash outflows from operating activities of approximately \$596 thousand, \$1.3 million and \$1.5 million for the years ended December 31, 2006, 2005 and 2004, respectively.

As of December 31, 2006 and 2005, the Company had a stockholders' deficit of approximately \$12.1 million and \$9.9 million, respectively. The Company's net increase in stockholders' deficit from December 31, 2005 to December 31, 2006 is primarily due to the loss for the year ended December 31, 2006. At December 31, 2006 and 2005 the Company had working capital deficit of approximately \$5.7 million and \$4.6 million, respectively. The increase in the working capital deficit from December 31, 2005 to December 31, 2006 is mainly due to the decrease in Company's accounts receivable, net.

Certain prior-year amounts have been reclassified to conform to the current year presentation.

**Capital Stock:**

On August 29, 2005, at the close of business, the Company effectuated the previously approved reverse stock split with the established a ratio of 1-for 20. Applied common stock began trading on a reverse-split basis on August 30, 2005. As a result of the reverse stock split, every 20 shares of Applied common stock were combined into one share of Applied common stock. As a result of the reverse stock split, the issued and outstanding shares of Applied common stock were reduced from approximately 156 million shares to approximately 7.8 million shares. The number of authorized shares is not reduced. The effects of the reverse split have been presented retroactively.

The reverse stock split affected all shares of common stock, stock options and warrants of Applied outstanding as of immediately prior to the effective time of the reverse stock split. Fractional shares of common stock of the Company were not issued as a result of the reverse stock split, but instead, holders of pre-split shares of common stock who otherwise would have been entitled to receive a fractional share as a result of the reverse split received one whole share. Shares of Applied common stock trade on the NASD OTCBB Market under the symbol CXIA.

For the year ended December 31, 2005, the Company issued 291,707 shares of the Company's common stock upon conversion of 5,500 shares of Series E Preferred by the holders thereof. On April 12, 2005, the Company entered into an exchange agreement with The Shaar Fund, LTD (the "Shaar Exchange Agreement"). Under terms of the Shaar Exchange Agreement, the Company agreed that Shaar will exchange all of its right, title and interest in and to the remaining outstanding shares of the Series E Preferred and Series F Preferred (including all other accrued and unpaid dividends thereon) for 395,302 shares of the Company's Series I Preferred.

For the year ended December 31, 2005, the Company issued 439,206 shares of the Company's common stock upon conversion of 7,000 shares of Series I Preferred by the holders thereof. For the year ended December 31, 2006, the Company paid no dividends on the Series I Preferred Stock. The Company had accrued dividends payable on the Series I Preferred at December 31, 2006 of approximately \$184 thousand, which is included in Other Accrued Liabilities.

Effective October 1, 2005, the Company entered into an exchange agreement with The Shaar Fund, LTD (the "New Shaar Exchange Agreement"). Under terms of the Shaar Exchange Agreement, the Company agreed that Shaar will exchange all of its right, title and interest in and to 388,302 shares of the Series I Preferred (excluding all other accrued and unpaid dividends thereon) for 388,302 shares of the Company's Series J Preferred.

For the year ended December 31 2006, the Company converted no shares of Series H Preferred and issued no stock with respect to accrued dividends pertaining to the Series H Preferred. For the year ended December 31, 2006, the Company paid no accrued dividends on the Series H Preferred Stock. The Company had accrued dividends payable on the Series H Preferred at December 31, 2006 of approximately \$105 thousand, which is included in Other Accrued Liabilities.

For the year ended December 31 2006, the Company converted no shares of Series J Preferred and issued no stock with respect to accrued dividends pertaining to the Series J Preferred. For the year ended December 31, 2006, the Company paid no dividends on the Series J Preferred. The Company accrued dividends on Series J Preferred for the year ended December 31, 2006 of approximately \$388 thousand, increasing the total dividends accrued on Series J to approximately \$485 thousand at December 31, 2006, which is included in Other Accrued Liabilities.

In November 2000, the Company completed \$500 thousand in financing in the form of a loan (the "Weiss Group Note") from a group of four investors. The Weiss Group Note bears interest at 12% per annum and was due and payable on February 12, 2001. All holders of the Weiss Group Note have granted payment extensions to the Company until January 15, 2005 in exchange for warrants for 125,000 shares of the Company's common stock at an exercise price of \$0.57. The current principal balance of the Weiss Group Note is approximately \$252 thousand as of December 31, 2006 and remains unpaid. The Company is in default of this note.

Effective February 14, 2004, the members of the Weiss Group Note voluntarily cancelled all issued warrants to purchase 75,000 shares at an exercise price of \$1.00 per share of the Company's common stock in connection with the Weiss Group Note.

Effective February 15, 2004, the Company issued warrants to purchase 125,000 shares of its common stock at an exercise price of \$0.57 per share to all holders of the Weiss Group Note in consideration of the extension of the due date of such loans by such persons from May 31, 2002 to January 15, 2005. The Company believes that this transaction is exempt from the registration requirements of the Securities Act under Section 4(2) thereof as a transaction not involving any public offering of securities.

Mr. Blum, a director of the Company, provided cash installments in the form of a loan to the Company through February 2004 (the "Blum Demand Note"). The Blum Demand Note bears interest at 9% per annum and is payable on demand. The current principal balance of the Blum Demand Note is approximately \$312 thousand as of December 31, 2006 and remains unpaid as of April 17, 2007.

On November 19, 2003, the Company issued a warrant to purchase 1,367,790 shares of its common stock at an exercise price of \$0.57 per share (the closing price of our common stock on the OTCBB on such date) to the Blum Asset Trust, a company controlled by Bentley Blum, a Director of the Company, in consideration for the loans made to the Company and the usage of office space and personnel of the Blum Asset Trust over the last five years. The Company believes that this transaction is exempt from the registration requirements of the Securities Act under Section 4(2) thereof as a transaction not involving any public offering of securities.

Effective as of April 12, 2005, the Company authorized the issuance of 550,000 shares of Series I Convertible Preferred Stock ("Series I Preferred"), par value \$0.001 per share, each such share having a stated value of \$10.00 per share.

The Series I Preferred have the following rights, privileges, and limitations:

- a) The conversion feature shall be exercisable immediately.
- b) The conversion price shall be determined by the average closing price of Company's common stock in the previous 10 trading days, but in no event shall the conversion price be more than \$0.57 per share.
- c) If the Company's common stock is not listed on an exchange at the time of the conversion, the conversion price would be 50% of the market price at that time.

- d) The Series I Preferred has a cumulative annual dividend of 10%, payable in cash or shares of the Company's common stock at the Company's election.
- e) Dividends were to be paid quarterly commencing May 15, 2005, to the holders of record of shares of the Series I Preferred Stock. Dividends until February 14, 2006 would accrue but shall not be payable until February 15, 2006. As of December 31, 2006, no dividends had yet been paid under these terms.

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- f) The Company reserved 3,750,000 shares of its common stock for the conversion of the Series I Preferred.
- g) The payment of dividends in the form of common stock is subject to limitation, such that no payment in the form of stock can be made that would result in the holder owning 5% or more beneficial ownership of the Company's common stock.
- h) The Company accrued approximately \$184 thousand of dividends in 2005 on the Series I Preferred prior to its exchange, all of which is outstanding at December 31, 2006.

During the year ended December 31, 2005, 7000 shares were converted to 439,206 shares of common stock.

Effective October 1, 2005, the Company entered into the New Shaar Exchange Agreement, in which the Company agreed that Shaar will exchange all of its right, title and interest in and to the remaining outstanding shares of the Series I Preferred (excluding all other accrued and unpaid dividends thereon) for 388,302 shares of the Company's Series J Preferred Stock, which represents all of the Series J preferred stock outstanding at December 31, 2006.

Additionally, under the Shaar Exchange Agreement, the Company issued an Amended and Restated Secured Promissory Note, amending and restating a note originally issued June 13, 2001. The Note had an outstanding principal balance as of April 12, 2005 of approximately \$3.3 million (Old Shaar Note).

On April 11, 2005 The Shaar Fund, LTD (Shaar) executed a purchase agreement (Milford Capital Purchase Agreement) to Milford Capital & Management (Milford). In accordance with the terms of the Milford Capital Purchase Agreement, Shaar purchased a secured promissory note of the Company, initially issued to Milford on June 13, 2001, in the original principal amount of \$500 thousand, which had an outstanding principal balance on March 22, 2005 of approximately \$188 thousand (Old Milford Note), together with (i) all interest, additional obligations, forbearance fees, exit fees, penalties and other amounts due and payable from time to time under or in connection with the Old Milford Note, and (ii) the Forbearance Amount in connection with the Forbearance Agreement, dated January 30, 2004, between Milford and the Company, and Shaar in which Shaar agreed to forgive payment from the Company to Shaar of approximately \$300 thousand of accrued and unpaid dividends on shares of the Company's Series E Preferred held by Shaar (Forgiven Dividends) and consented to the transfer of the dollar value of the Forgiven Dividends to Milford as part of the forbearance fee payable to Milford under the Forbearance Agreement of 2004.

Shaar and the Company exchanged the outstanding principal amount of the Old Shaar Note and the Old Milford Note (including all accrued and unpaid interest, unpaid fees and Forgiven Dividends) for the Company's newly issued 10% convertible secured promissory note (New Shaar Convertible Note).

The New Shaar Convertible Note has the following rights, privileges, and limitations:

- a) The New Shaar Convertible Note bears an interest rate of 10% per annum, which is payable in cash or shares of the Company's common stock at the Company's election.
- b) Interest shall accrue on the principal amount for a one year period (Deferral Period). On March 22, 2006, the Company will make a single lump sum payment to the holder in an amount equal to all interest that accrued during the Deferral Period

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- c) Beginning April 15, 2006, and monthly thereafter on the 15th day of each month until March 22, 2009 (□Maturity Date□), the Company shall pay to Shaar all accrued and unpaid interest (□Interest Payments□) on the principal balance of the note accruing during the prior month.
- d) On the Maturity Date, the Company shall make a single lump sum payment to Shaar equal to the outstanding principal balance of the New Shaar Convertible Note (□Principal Balance□), together with all accrued and unpaid interest.
- e) At the option of Shaar, the outstanding Principal Balance may be converted, either in whole or in part, into shares of the Company□s common stock.
- f) The conversion price of the payment of the Principal Balance, the Deferral Period, and the Interest Payments shall be determined by the average closing price of Company□s common stock in the 10 trading days preceding the conversion date,, but in no event shall the conversion price be more than \$0.57 per share (□Conversion Price□).
- g) Both the conversion of the note into common stock and the payment of interest in the form of common stock were subject to limitation, such that no conversion or payment in the form of stock could be

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exercised or made that would result in the holder owning 5% or more beneficial ownership of the Company□s common stock.

- h) If the Company□s common stock is not listed on an exchange at the time of the conversion, then the conversion price will be 50% of the market price at that time.
- i) The New Shaar Convertible Note may not be prepaid by the Company prior to the Maturity Date.

On April 11, 2005, through the issuance of the Series I Preferred and the Amended and Restated Shaar Note, the Company recorded an embedded derivative liability due to the conversion feature of these financial instruments pursuant to ETIF 00-19. Applied recorded a loss of approximately \$543 thousand of non-cash expense for the year ended December 31, 2005.

On April 27, 2005, a private investor purchased \$100 thousand of the Company□s unregistered common stock at the market price. The Company issued the private investor 500,000 shares of unregistered common stock of the Company as a result of the equity purchase. In connection with the purchase of the shares of the Company□s common stock, the Company issued the private investor a 3-year warrant for 200,000 shares of the Company□s common stock at an exercise price of \$0.20 per share. The Company believes that this transaction is exempt from the registration requirements of the Securities Act under Section 4(2) thereof as a transaction not involving any public offering of securities.

Effective as of October 1, 2005, the Company authorized the issuance of 550,000 shares of Series J Convertible Preferred Stock (□Series J Preferred□), par value \$0.001 per share, each such share having a stated value of \$10.00 per share.

The Series J Preferred shall have the following rights, privileges, and limitations:

- a) The conversion feature shall be exercisable immediately.
- b) The conversion price shall be determined by the average closing price of Company□s common stock in the previous 10 trading days, but in no event shall the conversion price be more than \$0.50 per share or less than \$0.05 per share.
- c) If the Company□s common stock is not listed on an exchange at the time of the conversion, then the conversion price will be 50% of the market price at that time.



- d) The Series J Preferred shall have a cumulative annual dividend of 10%, payable in cash or shares of the Company's common stock at the Company's election.
- e) Dividends were to be paid quarterly commencing March 31, 2006, to the holder of the shares of the Series J Preferred Stock. As of December 31, 2006, no dividends had yet been paid under these terms, and the holder has agreed to a deferral of payment until June 30, 2007 without consequence to the Company. f) Both the conversion of the Series J Preferred into common stock and the payment of dividends in the

form of common stock are subject to limitation, such that no conversion or payment in the form of stock can be exercised or made that would result in the holder owning 5% or more beneficial ownership of the Company's common stock.

- g) The Company has reserved 40,000,000 shares of its common stock for the conversion of the Series J Preferred and the Amended New Shaar Convertible Note.
- h) The Company accrued approximately \$388 thousand and \$97 thousand of dividends in 2006 and 2005 on the Series J Preferred, totaling accumulated dividends of approximately \$485 thousand accrued through December 31, 2006.

Effective October 1, 2005, the Company entered into the New Shaar Exchange Agreement, in which the Company agreed that Shaar will exchange all of its right, title and interest in and to the remaining outstanding shares of the Series I Preferred (excluding all other accrued and unpaid dividends thereon) for 388,302 shares of the Company's Series J Preferred Stock, which represents all of the Series J preferred stock outstanding at December 31, 2006.

Upon liquidation, dissolution or winding up of Applied, holders of Series J Convertible Preferred Stock are entitled to receive liquidation distributions equivalent to a stated value of \$10.00 per share, plus 30% of the stated value, plus the aggregate of all accrued and unpaid dividends, the total of such distributions to be made before any distribution to holders of the common stock.

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Effective as of October 1, 2005, the Company entered into an exchange agreement with The Shaar Fund, LTD (the "New Shaar Exchange Agreement"). Under terms of the New Shaar Exchange Agreement, Shaar exchanged all of its right, title and interest in and to the remaining outstanding shares of the Series I Preferred (excluding all other accrued and unpaid dividends thereon) for 388,302 shares of the Company's Series J Preferred.

Effective as of October 1, 2005, Shaar and the Company amended the New Shaar Convertible Note (the "Amended New Shaar Convertible Note"). The Amended New Shaar Convertible Note has the following rights, privileges, and limitations:

- a) The Amended New Shaar Convertible Note bears an interest rate of 10% per annum, which is payable in cash or shares of the Company's common stock at the Company's election.
- b) Interest shall accrue on the principal amount for a one year period ("Deferral Period"). On March 22, 2006, the Company was to make a single lump sum payment to the holder in an amount equal to all interest that accrued during the Deferral Period. This payment was not made and has been extended to June 30, 2007.
- c) Beginning April 15, 2006, and monthly thereafter on the 15th day of each month until March 22, 2009 ("Maturity Date"), the Company shall pay to Shaar all accrued and unpaid interest ("Interest Payments") on the principal balance of the note accruing during the prior month. These payments have not been made during 2006, and have been extended to June 30, 2007.
- d) On the Maturity Date, the Company shall make a single lump sum payment to Shaar equal to the outstanding principal balance of the Amended New Shaar Convertible Note ("Principal Balance"), together with all accrued and unpaid interest.

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- e) At the option of Shaar, the outstanding Principal Balance may be converted, either in whole or in part, into shares of the Company's common stock.
- f) The conversion price of the payment of the Principal Balance, the Deferral Period, and the Interest Payments shall be determined by the average closing price of Company's common stock in the 10 trading days preceding the conversion date, but in no event shall the conversion price be more than \$0.50 per share or less than \$0.05 per share (Conversion Price).
- g) If the Company's common stock is not listed on an exchange at the time of the conversion, then the conversion price will be 50% of the market price at that time.
- h) Both the conversion of the note into common stock and the payment of interest in the form of common stock are subject to limitation, such that no conversion or payment in the form of stock can be exercised or made that would result in the holder owning 5% or more beneficial ownership of the Company's common stock.
- i) The Amended New Shaar Convertible Note may not be prepaid by the Company prior to the Maturity Date.
- j) The Company has reserved 40,000,000 shares of its common stock for the conversion of the Amended New Shaar Convertible Note and the Series J Preferred.

The current principal balance of the New Shaar Note is approximately \$6.5 million as of December 31, 2006 and remains unpaid as of April 17, 2007.

The recipient of securities in this transaction represented its intention to acquire the securities for investment only and not with a view to, or for sale in connection with, any distribution thereof, and appropriate restrictive legends were affixed to the warrants and the certificates representing the shares issued in this transaction. The Company made available to The Shaar Fund Ltd., written information about the Company in accordance with Rule 502 of the Securities Act and advised such recipient of the limitations on resale of such securities. In addition, The Shaar Fund Ltd. was offered the opportunity, prior to exchanging and/or purchasing any securities, to ask questions of, and receive answers from, the Company concerning the terms and conditions of the transaction and to obtain additional relevant information about the Company. Based upon the facts above, the Company believed this transaction to be exempt from the registration requirements of the Securities Act in reliance on Section 4 (2) thereof as a transaction not involving any public offering of securities.

The holders of all series of convertible preferred stock have the right, voting as a class, to approve or disapprove of the issuance of any class or series of stock ranking senior to or on a parity with the convertible preferred stock with respect to declaration and payment of dividends or the distribution of assets on liquidation, dissolution or winding-up.

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Cumulative unpaid dividends on all series of preferred stock are approximately \$773 thousand and \$361 thousand at December 31, 2006 and 2005, respectively.

**CONTRACTUAL OBLIGATIONS, MATURITIES AND COMMITMENTS**

The following table summarizes the Company's contractual obligations, maturities and commitments. See Notes 7 and 14 of the Notes to Consolidated Financial Statements for additional information regarding long-term debt and operating leases, in thousands.

	<b>1 Year or Less</b>	<b>1-3 Years</b>	<b>3-5 Years</b>	<b>More than 5 years</b>	<b>Total</b>
Long-term debt and					

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related party notes payable	\$	654	\$	6,509	\$	-	\$	-	\$	7,163
Operating leases		128		384		77		-		589
		<u>      </u>		<u>      </u>		<u>      </u>		<u>      </u>		<u>      </u>
	\$	782	\$	6,893	\$	77	\$	-	\$	7,752
		<u>      </u>		<u>      </u>		<u>      </u>		<u>      </u>		<u>      </u>

The Company hopes to meet its short-term capital requirements (including its approximately \$110 thousand monthly operating deficit) through continued loans from The Shaar Fund, Ltd., although this lender is under no obligation to continue to make advances to the Company. The Company intends to negotiate a forbearance arrangement with other lenders on loans that are currently due. Ultimately, the Company intends to reduce its cash shortfall and intends to meet its long term capital needs through obtaining additional contracts that will generate funds from operations and obtaining additional debt or equity financing as necessary or engaging in merger or sale transactions. There can be no assurance that such sources of funds will be available to the Company or that it will be able to meet its short or long term capital requirements.

**NET OPERATING LOSS CARRYFORWARDS**

The Company has net operating loss carryforwards (the [NOLs]) of approximately \$42.5 million as of December 31, 2006, which expire in the years 2010 through 2026. The amount of NOLs that can be used in any one year will be limited by the applicable tax laws that are in effect at the time such NOLs can be utilized. The unused NOLs balances may be accumulated and used in subsequent years. A full valuation allowance has been established to offset any benefit from the net operating loss carryforwards. It cannot be determined when or if the Company will be able to utilize the NOLs.

**NEW ACCOUNTING PRONOUNCEMENTS**

In February 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 155, Accounting for Certain Hybrid Instruments ("SFAS 155"). SFAS 155 amends SFAS 133 and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities ("SFAS 140"). SFAS 155 allows financial instruments that have embedded derivatives to be accounted for as a whole, eliminating the need to bifurcate the derivative from its host, if the holder elects to account for the whole instrument on a fair value basis. In addition, among other changes, SFAS 155 (i) clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS 133; (ii) 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; (iii) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and (iv) eliminates the prohibition on a qualifying special-purpose entity ("QSPE") from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial interest. SFAS 155 will be applied prospectively and is effective for all financial instruments acquired or issued for fiscal years beginning after September 15, 2006. SFAS 155 is not expected to have a material impact on the Company's consolidated financial statements. The FASB has issued additional guidance relating to derivative financial instruments as follows:

In June 2006, the FASB issued FASB interpretation No. 48 ([FIN 48]), [Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109.] Fin 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax

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return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective beginning in fiscal 2008. The Company is currently evaluating the impact of adopting FIN 48.

In September 2006, the FASB issued SFAS No. 157, [Fair Value Measurements] ([SFAS 157]). SFAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value

measurements required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. SFAS 157 is effective for the Company's fiscal year 2008. The Company is currently evaluating the impact of adopting SFAS 157.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans (an amendment of Financial Accounting Standards Board (FASB) Statements No. 87, 88, 106 and 132R)". SFAS 158 requires companies with defined benefit plans and certain other plans to recognize on the balance sheet the difference between benefit obligations and any plan assets of those benefit plans. The Company does not have any plans of this nature; therefore FASB 158 is not applicable to the Company and will have no impact.

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

Not applicable.

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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.**

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**Report of Independent Registered Public Accounting Firm**

Board of Directors

Commodore Applied Technologies, Inc.

We have audited the accompanying consolidated balance sheet of Commodore Applied Technologies, Inc. and its subsidiaries as of December 31, 2006, and the related consolidated statement of operations, changes in stockholders' deficit and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Commodore Applied Technologies, Inc. and its subsidiaries as of December 31, 2006, and the consolidated results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

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

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## **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

### **To the Board of Directors and Stockholders of Commodore Applied Technologies, Inc. and subsidiaries**

We have audited the consolidated balance sheet of **Commodore Applied Technologies, Inc. and subsidiaries** (the Company) as of December 31, 2005, and the related consolidated statements of operations, stockholders' deficit and cash flows for the years ended December 31, 2005 and 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of **Commodore Applied Technologies, Inc. and subsidiaries** as of December 31, 2005, and the results of their operations and their cash flows for the years ended December 31, 2005 and 2004, in conformity with U.S. generally accepted accounting principles.

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

/s/ Tanner LC

Salt Lake City, Utah

April 6, 2006

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## **Commodore Applied Technologies, Inc. and Subsidiaries**

### **Consolidated Balance Sheets**

### **December 31, 2006 and 2005**

(Amounts in thousands, except shares)

ASSETS	2006	2005
Current assets:		
Cash	\$ 127	\$ 65
Accounts receivable, net	802	2,065
Prepaid expense	138	139
	<u>1,067</u>	<u>2,269</u>
Total current assets		
Property and equipment, net	119	148
Other assets	57	57
	<u>1,243</u>	<u>2,474</u>
Total assets	\$	\$

## LIABILITIES AND STOCKHOLDERS' DEFICIT

Current liabilities:		
Accounts payable	\$ 1,012	\$ 1,376
Related party payable	-	310
Line of credit	-	141
Other accrued liabilities	5,165	4,450
Current portion of long-term debt	654	635
	<u>6,831</u>	<u>6,912</u>
Total current liabilities		
Long-term debt, net of current portion	6,509	5,426
	<u>13,340</u>	<u>12,338</u>
Total liabilities		

Commitments and contingencies (Note 14)

Stockholders' deficit:

Convertible Preferred Stock, Series H & J, par value \$.001 per share; aggregate liquidation value of \$6,712 and \$6,353 at December 31, 2006 and 2005, respectively; 3% non-cumulative dividends for Series H; 10% cumulative dividends for Series J; 1,550,000 shares authorized; 1,188,302 shares issued and outstanding as December 31, 2006 and 2005

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Common Stock, par value \$.001 per share; 300,000,000 shares authorized; 8,168,217 shares and 7,948,217 shares issued and

outstanding at December 31, 2006 and 2005, respectively	8	8
Additional paid-in capital	69,296	69,680
Accumulated deficit	(81,139)	(79,290)
Treasury stock, 171,875 shares, at cost	(263)	(263)
	<u>          </u>	<u>          </u>
Total stockholders' deficit	(12,097)	(9,864)
	<u>          </u>	<u>          </u>
Total liabilities and stockholders' deficit	\$ 1,243	\$ 2,474
	<u>          </u>	<u>          </u>

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

**Commodore Applied Technologies, Inc. and Subsidiaries**  
**Consolidated Statements of Operations**  
**For the years ended December 31, 2006, 2005 and 2004**  
(Amounts in thousands, except per share data)

	<b>2006</b>	<b>2005</b>	<b>2004</b>
Revenue	\$ 7,254	\$ 10,275	\$ 10,275
Costs and expenses:			
Cost of revenue	7,153	9,132	9,132
Research and development	-	5	-
General and administrative	1,431	2,072	1,431
Depreciation and amortization	25	54	25
	<u>          </u>	<u>          </u>	<u>          </u>
Total costs and expenses	8,609	11,263	2,714
	<u>          </u>	<u>          </u>	<u>          </u>
Loss from operations	(1,355)	(988)	(2,000)
Other income (expense):			
Derivative loss	-	(543)	-
Interest expense	(659)	(1,183)	(412)
Other income	165	-	-
	<u>          </u>	<u>          </u>	<u>          </u>
Total other income (expense)	(494)	(1,726)	(412)
	<u>          </u>	<u>          </u>	<u>          </u>
Net loss before income taxes	(1,849)	(2,714)	(2,412)
Income tax benefit	-	-	-
	<u>          </u>	<u>          </u>	<u>          </u>
Net loss	(1,849)	(2,714)	(2,412)
Deemed dividends and dividends accrued to preferred stockholders	(412)	(4,067)	(2,412)
	<u>          </u>	<u>          </u>	<u>          </u>
Net loss applicable to common shareholders	\$ (2,261)	\$ (6,781)	\$ (2,624)

Net loss per share - basic and diluted	\$	(0.29)	\$	(0.93)	\$	(0.
Weighted average shares outstanding - basic and diluted		7,847		7,309		6,

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

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**Commodore Applied Technologies, Inc. and  
Subsidiaries  
Consolidated Statements of Stockholders'  
Deficit  
For the years ended December 31, 2006, 2005 and  
2004**

(Amounts in thousands, except shares)

	<b>Preferred stock</b>		<b>Common Stock</b>		<b>Additional Paid-In Capital</b>	<b>Accu- D</b>
	<b>Shares</b>	<b>Amount</b>	<b>Shares</b>	<b>Amount</b>		
<b>Balance, January 1, 2004</b>	<b>1,033,700</b>	<b>\$ 1</b>	<b>5,885,108</b>	<b>\$ 6</b>	<b>\$ 67,776</b>	<b>\$</b>
Conversion of series E preferred stock into common stock	(32,500)	-	807,196	1	(1)	
Exercise of warrants	-	-	25,000	-	19	
Preferred stock dividends	-	-	-	-	(291)	
Net loss	-	-	-	-	-	
<b>Balance, December 31, 2004</b>	<b>1,001,200</b>	<b>1</b>	<b>6,717,304</b>	<b>7</b>	<b>67,503</b>	
Conversion of series E & F preferred into series I/J preferred stock - Note 9	(12,500)	-	730,913	1	(1)	
Conversion of accrued dividends into series I/J preferred stock - see Note 9	199,602	-	-	-	1,400	
Preferred stock dividends	-	-	-	-	(365)	
Sale of common stock for cash	-	-	500,000	-	100	
Deemed dividend from embedded derivative	-	-	-	-	(3,702)	
Reclassification of embedded derivative liability from liabilities to equity	-	-	-	-	4,745	
Net loss	-	-	-	-	-	
<b>Balance, December 31, 2005</b>	<b>1,188,302</b>	<b>1</b>	<b>7,948,217</b>	<b>8</b>	<b>69,680</b>	
Preferred stock dividends	-	-	-	-	(412)	
Stock issued for services	-	-	220,000	-	28	



Net loss

Balance, December 31, 2006

-	-	-	-	-			
<u>1,188,302</u>	\$	<u>1</u>	<u>8,168,217</u>	\$	<u>8</u>	<u>\$ 69,296</u>	\$

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

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**Commodore Applied Technologies, Inc. and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
**For the years ended December 31, 2006, 2005 and**  
**2004**

(Amounts in thousands)

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Cash flows from operating activities:			
Net loss	\$ (1,849)	\$ (2,714)	\$ (2,404)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	25	54	136
Gain on sale of property and equipment	(3)	-	-
Amortization of debt discount	-	500	31
Derivative loss	-	543	-
Issuance of common stock for services	28	-	-
Changes in assets and liabilities:			
Accounts receivable, net	1,263	(1,806)	(188)
Prepaid expense and other assets	1	(10)	13
Accounts payable	(364)	585	(240)
Other accrued liabilities	303	1,511	1,133
	<u>(596)</u>	<u>(1,337)</u>	<u>(1,519)</u>
Net cash used - operating activities			
Cash flows from investing activities:			
Property and equipment purchased or constructed	-	(107)	(61)
Proceeds from sale of property and equipment	7	-	-
	<u>7</u>	<u>(107)</u>	<u>(61)</u>
Net cash provided (used) - investing activities			
Cash flows from financing activities:			
Checks written in excess of cash	-	-	(13)
Repayments to related parties	(310)	-	(25)
(Repayments) borrowings under line of credit	(141)	141	(64)
Borrowings on debt and warrants	1,102	1,259	1,678
Payments on long-term debt and notes payable	-	(6)	-
Proceeds from the sale of common stock	-	100	-

Proceeds from exercise of warrants	-	-	19
Net cash provided by financing activities	651	1,494	1,595
Increase in cash and cash equivalents	62	50	15
Cash and cash equivalents at beginning of year	65	15	-
Cash and cash equivalents at end of year	\$ 127	\$ 65	\$ 15
Supplemental disclosure of cash flow information:			
Cash paid during the year for interest	\$ 104	\$ 32	\$ 55

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

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## **Commodore Applied Technologies, Inc. and Subsidiaries Consolidated Statements of Cash Flows For the years ended December 31, 2006, 2005 and 2004**

**(Amounts in thousands, except shares)**

### **Non-Cash Investing and Financing Activities:**

#### **2006**

- The Company recorded \$412 in accrued dividends payable to holders of preferred stock.

#### **2005**

- The Company recorded \$365 in accrued dividends payable to holders of preferred stock.
- The Company recorded an embedded derivative liability of \$8,063 on April 12, 2005, \$3,702 of which was recorded as a deemed dividend to preferred stockholders, and \$4,361 was recorded as a debt discount. The Company reclassified the embedded derivative liability to equity on October 1, 2005. The embedded derivative liability was \$8,606 and the remaining debt discount was \$3,861 at time of reclassification, which resulted in an increase to equity of \$4,745.
- On April 12, 2005, the Company entered into an exchange agreement with The Shaar Fund, LTD (the "Shaar Exchange Agreement"). Under terms of the Shaar Exchange Agreement, the Company agreed that Shaar will exchange all of its right, title and interest in and to the remaining outstanding shares of the Series E and Series F Preferred Stock (including all other accrued and unpaid dividends thereon of \$1,400) for 395,302 shares of the Company's Series I Convertible Preferred Stock. The Shaar note was also amended, in which \$833 of accrued interest and fees were added to the principal balance of the note.

- Effective October 1, 2005, the Company entered into an exchange agreement with The Shaar Fund, LTD (the "Shaar Exchange Agreement"). Under terms of the Shaar Exchange Agreement, the Company agreed that Shaar will exchange all of its right, title and interest in and to 388,302 shares of the Series I Preferred Stock (not including all other accrued and unpaid dividends thereon) for 388,302 shares of the Company's Series J Convertible Preferred Stock. The Shaar note was also amended effective October 1, 2005, in which the conversion feature was amended to include a minimum and maximum conversion rate.
- On August 29, 2005, the Company effected the previously approved 1-for-20 reverse common stock split. As a result of the reverse stock split, the issued and outstanding shares of the Company's common stock were reduced from approximately 156 million shares to approximately 7.8 million shares. The reverse stock split, including the effect on loss per share, has been presented retroactively as if it had occurred on January 1, 2004.

## **2004**

- The Company recorded \$291 in accrued dividends payable to holders of preferred stock.
- The Company purchased equipment in the amount of \$8 with a note payable.

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## **Commodore Applied Technologies, Inc. and Subsidiaries Notes to Consolidated Financial Statements**

### **1. Summary of Significant Accounting Policies**

#### ***Background***

Commodore Applied Technologies, Inc. and subsidiaries ("Applied" or the "Company") is engaged in the destruction and neutralization of hazardous waste from other materials. Applied owns technologies related to the separation and destruction of polychlorinated biphenyls ("PCBs") and chlorofluorocarbons ("CFCs"). Applied is currently working on the commercialization of these technologies through development efforts, licensing arrangements and joint ventures.

Through Commodore Advanced Sciences, Inc. ("Advanced Sciences"), a subsidiary acquired on October 1, 1996, Applied has contracts with various government agencies and private companies in the United States and abroad.

#### ***Principles of Consolidation***

The consolidated financial statements include the accounts of Applied and its majority-owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

#### ***Cash and Cash Equivalents***

Applied considers cash and highly liquid debt instruments with original maturities of three months or less at the date of purchase to be cash equivalents.

#### ***Concentration of Credit Risk and Significant Customers***

Applied maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. Applied has not experienced any losses in such accounts.

With respect to trade receivables, Applied generally does not require collateral as the majority of Applied's services are performed for the U.S. Government and prime contractors that serve the U.S. Government. Applied believes it is not exposed to any significant credit risk on cash, cash equivalents and trade receivables. Sales to major customers which exceeded 10 percent of revenues are as follows, in thousands:

		<u>2006</u>	<u>2005</u>		<u>2004</u>
Customer A	\$	6,542	\$	9,350	\$ 188
Customer B		-	\$	229	\$ 260
Customer C		-	\$	126	\$ 128

Customer A accounts for approximately 93% of the accounts receivable balance as of December 31, 2006.

#### ***Accounts receivable***

Trade receivables are carried at original invoice amount less an estimate made for doubtful receivables based on a review of all outstanding amounts on a monthly basis. Management determines the allowance for doubtful accounts by identifying troubled accounts and by using historical experience applied to an aging of accounts. Trade receivables are written off when deemed uncollectible. Recoveries of trade receivables previously written off are recorded when received.

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## **Commodore Applied Technologies, Inc. and Subsidiaries Notes to Consolidated Financial Statements**

### **1. Summary of Significant Accounting Policies, Continued:**

#### ***Accounts receivable, Continued:***

A trade receivable is considered to be past due if any portion of the receivable balance is outstanding for more than 90 days, not counting retainages billed, which are due at the end of the particular phase of the master government contract. At December 31, 2006 and 2005, retainages of approximately \$568 thousand and \$501 thousand were included in trade accounts receivable, respectively, all expected to be collected within one year. Interest is not charged on trade receivables.

#### ***Property and Equipment***

Property and equipment are recorded at cost, less accumulated depreciation. Improvements which substantially increase the useful lives of assets are capitalized. Maintenance and repairs are expensed as incurred. Upon retirement or disposal, the related cost and accumulated depreciation are removed from the respective accounts and any gain or loss is recorded in the Statement of Operations. Depreciation is computed on the straight-line method based on the estimated useful lives of the assets which range from 3 to 5 years.

#### ***Impairment of Long-Lived Assets***

Applied reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. The Company evaluates, at each balance sheet date, whether events and circumstances have occurred which indicate possible impairment. The carrying value of a long-lived asset is considered impaired when the estimated cumulative undiscounted cash flows of the related asset or asset group is less than the carrying value. In that event, a loss is recognized based on the amount by which the carrying value exceeds the estimated fair market value of the long-lived asset.

#### ***Revenue Recognition***

Substantially all of Applied's revenues are generated by its subsidiary, Advanced Sciences. Advanced Sciences' revenues consist of engineering and scientific services performed for the U.S. Government and prime contractors that serve the U.S. Government under a variety of contracts, most of which provide for unit prices. Revenue under unit price contracts is recorded when a contract or arrangement exists, the fees to be charged are fixed or determinable, the services have been provided, and collection of the billed amounts is reasonably assured.

### ***Research and Development***

Research and development expenditures are charged to operations as incurred.

### ***Income Taxes***

Income taxes are determined in accordance with Statement of Financial Accounting Standards ("SFAS") 109, which requires recognition of deferred income tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred income tax liabilities and assets are determined based on the difference between financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. SFAS 109 also provides for the recognition of deferred tax assets if it is more likely than not that the assets will be realized in future years.

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## **Commodore Applied Technologies, Inc. and Subsidiaries Notes to Consolidated Financial Statements**

### **1. Summary of Significant Accounting Policies, Continued:**

#### ***Fair Value of Financial Instruments***

The fair value of financial instruments is determined by reference to various market data and other valuation techniques as appropriate. Accounts receivable, cash equivalents, accounts payable, other accrued liabilities, long term debt and the line of credit are financial instruments that are subject to possible material market variations from the recorded book value. The fair value of these financial instruments approximates the recorded book value as of December 31, 2006 and 2005.

#### ***Use of Estimates***

The preparation of consolidated financial statements in conformity with U.S. Generally Accepted Accounting Principles ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

#### ***Recent Accounting Pronouncements***

In February 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 155, "Accounting for Certain Hybrid Financial Instruments, and Amendment of FASB No. 133 and 140" ("SFAS 155"), which establishes the accounting for certain derivatives embedded in other instruments. It simplifies accounting for certain hybrid financial instruments by permitting fair value remeasurement for any hybrid instrument that contains an embedded derivative, that otherwise would require bifurcation under SFAS No. 133, as well as eliminating a restriction on the passive derivative instruments that a qualifying special-purpose entity ("SPE") may hold under SFAS No. 140. This statement allows a public entity to irrevocably elect to initially, and subsequently, measure a hybrid instrument that would be required to be separated into a host contract and derivative in its entirety at fair value (with changes in fair value recognized in earnings) so long as that instrument is not designated as a hedging instrument pursuant to the statement. SFAS No.140 previously prohibited a qualifying special-purpose beneficial interest, other than another derivative financial instrument. The statement is effective for fiscal years beginning after September 15, 2006, with early adoption permitted as of the beginning of an entity's fiscal year. Management believes the adoption of this statement will have no immediate

impact on the Company's financial condition or results of operations.

In June 2006, the FASB issued FASB interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109. Fin 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective beginning in fiscal 2007. The Company is currently evaluating the impact of adopting FIN 48.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair-value measurements required under other accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. SFAS 157 is effective for the Company's fiscal year 2008. The Company is currently evaluating the impact of adopting SFAS 157.

In September 2006, the FASB issued SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans (an amendment of Financial Accounting Standards Board (FASB) Statements No. 87, 88, 106 and 132R). SFAS 158 requires companies with defined benefits plans and certain other plans to recognize on the balance sheet the difference between benefit obligations and any plan assets of those benefit plans. The Company does not have any plans of this nature; therefore FASB 158 is not applicable to the Company and will have no impact.

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## **Commodore Applied Technologies, Inc. and Subsidiaries Notes to Consolidated Financial Statements**

### **1. Summary of Significant Accounting Policies, Continued:**

#### ***Derivatives***

From time to time, the Company enters into transactions which contain conversion privileges, the settlement of which may entitle the holder or the Company to settle obligations by issuance of Company securities. These transactions, the value of which may be derived from the fair value of Company securities, are accounted for in accordance with EITF No. 00-27 Application of Issue No. 98-5 to Certain Convertible Instruments, and EITF 00-19 "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock". Additionally, the Company applies EITF No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios, and APB 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants. Fair value considerations required by these pronouncements is estimated using the Black-Scholes option pricing model. Note 10 Embedded Derivative Liability of these consolidated financial statements contains details of application of these pronouncements to the Series I Preferred stock issued by the Company in 2005. No transactions in 2006 meet the definition of a derivative.

#### ***Stock-Based Compensation***

Effective January 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (Revised), Share-Based Payment, using the modified-prospective transition method. Under this transition method, the Company recognizes stock-based compensation expense for stock-based awards granted subsequent to the year ended December 31, 2005 in accordance with the provisions of SFAS No. 123R, and the estimated expense for the portion vesting in the period for options granted prior to, but not vested as of December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123.

At December 31, 2006 and 2005, the Company had a stock plan for key employees, non-employee directors and management consultants, described more fully in Note 11 Share-Based Compensation. Management's

adoption of SFAS 123R resulted in recognition of \$0 of stock-based compensation expense in 2006.

### **Reclassifications**

Certain amounts in prior years have been reclassified to conform to the current year presentation.

## **2. Going Concern**

The accompanying consolidated financial statements have been prepared under the assumption that Applied will continue as a going concern. Such assumption contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. As shown in the consolidated financial statements, Applied incurred losses and negative cash flows from operating activities for the years ended December 31, 2006, 2005 and 2004. Applied also has a working capital deficit of approximately \$5.7 million and an accumulated deficit of approximately \$81.1 million at December 31, 2006 and several of the Company's notes payable are in default. These factors raise substantial doubt about the Company's ability to continue as a going concern. The consolidated financial statements do not include any adjustments that might be necessary should Applied be unable to continue as a going concern.

Applied's continuation as a going concern is dependent upon its ability to generate sufficient cash flow to meet its obligations on a timely basis, to obtain additional financing as may be required, and ultimately to attain profitability. Potential sources of cash include new contracts, external debt, the sale of shares of Company stock or alternative methods such as mergers or sale transactions. No assurances can be given, however, that Applied will be able to obtain any of these potential sources of cash. Applied currently requires additional cash funding from outside sources to sustain existing operations and to meet current obligations and ongoing capital requirements.

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## **Commodore Applied Technologies, Inc. and Subsidiaries Notes to Consolidated Financial Statements**

### **3. Accounts Receivable**

The components of Applied's trade receivables as of December 31, 2006 and 2005 are as follows, in thousands:

	<u>2006</u>		<u>2005</u>	
Contract receivables	\$	806	\$	2,069
Allowance for doubtful accounts		(4)		(4)
Accounts receivable, net	\$	802	\$	2,065

Substantially all of Advanced Sciences' trade receivables are pledged to collateralize its line of credit (see Note 6).

### **4. Property and Equipment**

Property and equipment consist of the following as of December 31, 2006 and 2005, in thousands:

	<u>2006</u>		<u>2005</u>	
Machinery and equipment	\$	571	\$	716
Furniture and fixtures		47		58
Computer equipment		99		246

Accumulated depreciation		717		1,020
		(598)		(872)
Property and equipment, net	\$	119	\$	148

During the year ended December 31, 2006, \$123 thousand of fully depreciated machinery and equipment was sold, resulting in a recognized gain of \$3 thousand. The Company also abandoned \$52 thousand of fully depreciated machinery and equipment. Cost and related accumulated depreciation have been removed from the respective accounts.

## 5. Other Accrued Liabilities

Other accrued liabilities consist of the following, in thousands:

		<u>2006</u>		<u>2005</u>
Compensation and employee benefits (1)	\$	213	\$	298
Deferred compensation (2)		1,883		1,689
Subcontractors (3)		355		724
Accrued interest (4)		1,249		694
Loss reserve (5)		376		376
Dividends payable (6)		773		361
Related party payable (7)		185		185
Other (8)		131		123
Total	\$	5,165	\$	4,450

- (1) Liability accrued for payroll, payroll taxes and employee benefits earned by company employees but paid subsequent to the close of the year of accrual.
- (2) Liability accrued for compensation deferred by certain members of the Company's executive management; not pursuant to any qualified deferred compensation plan or arrangement.
- (3) Liability accrued for services performed by subcontractors for the Company under its contracts with the Department of Energy or Department of Defense.
- (4) Interest accrued on short term notes, long term debt and related party payables.
- (5) Accrual for potential liability related to an ongoing DCAA audit of one of the Company's completed contracts (see Note 14).
- (6) Accrual for dividends payable on Series H, Series I and Series J Preferred stock.
- (7) Amounts payable to parties related to the Company by past ownership of an acquired company.
- (8) Accruals for other general liabilities of the Company.



## Commodore Applied Technologies, Inc. and Subsidiaries Notes to Consolidated Financial Statements

### 6. Line of Credit

At December 31, 2006 and 2005, Advanced Sciences had \$0 and \$141 thousand outstanding, respectively, owing on a revolving line of credit. The line of credit is not to exceed 90% of eligible receivables or \$2 million and is due January 20, 2007 with interest payable monthly at prime plus 2.0 percent (aggregate of 10.25% at December 31, 2006). The line of credit is collateralized by the assets of Advanced Sciences and is guaranteed by Applied.

### 7. Long-Term Debt

Long-term debt consists of the following as of December 31, 2006 and 2005, in thousands:

		<u>2006</u>		<u>2005</u>
Convertible note payable, 10% interest (1)	\$	6,509	\$	5,426
Note payable, 12% interest (2)		252		254
Note payable, 9% interest (3)		312		254
Note payable, 6% interest (4)		90		127
		<hr/>		<hr/>
		7,163		6,061
Less current portion		(654)		(635)
		<hr/>		<hr/>
	\$	6,509	\$	5,426
		<hr/>		<hr/>

- (1) Notes payable to The Shaar Fund, Ltd. with interest at 10%, interest only due in aggregate monthly installments beginning in June 30, 2007, maturing in March 2009, no prepayment option, and collateralized by property and equipment and patents. The note is convertible into common stock at any time, and the interest can be paid in cash or stock, at the option of either the Company or the holder. Both the conversion and the payment of interest in the form of common stock are subject to a limitation, such that no conversion or payment in the form of stock can be exercised or made that would result in the holder owning 5% or more beneficial ownership of the Company's common stock. The conversion price is the average closing price of the ten days preceding the conversion date, but shall not be more than \$0.50 per share or less than \$0.05 per share. See Note 9. Also, these notes payable restrict the Company's ability to declare or pay dividends on and repurchase common stock, materially change the Company's business, enter a business combination, or transfer or sell assets.
- (2) Notes payable to individuals bearing 12% interest and are in default as of January 15, 2005, collateralized by accounts receivable.
- (3) Note payable to Bentley Blum with interest at 9%, not collateralized and in default since June 30, 2003.
- (4) Note payable to Sterling Lending financing certain of the Company's insurance policies, with interest at 6%, payable in calendar 2007.

Future maturities of notes payable and long-term debt as follows, in thousands:

2007	\$	654
2008		-
2009		6,509
2010		-

Thereafter

\$	7,163
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## Commodore Applied Technologies, Inc. and Subsidiaries Notes to Consolidated Financial Statements

### 8. Income Taxes

Applied provides for deferred income taxes on temporary differences which represent tax effects of transactions reported for tax purposes in periods different than for book purposes.

The provision for income taxes for the years ended December 31, 2006 and 2005 results in an effective tax rate which differs from federal income tax rates as follows, in thousands:

	<u>2006</u>		<u>2005</u>		<u>2004</u>
Expected tax benefit at federal statutory rate	\$ (629)	\$	(928)	\$	(777)
State income tax benefit at federal statutory rate	(65)		(90)		(120)
Other	131		211		64
Change in valuation allowance	563		807		833
Income tax benefit	\$ -	\$	-	\$	-

The components of the net deferred tax assets as of December 31, 2006 and 2005 are as follows, in thousands:

		<u>2006</u>		<u>2005</u>
Reserves and accruals	\$	158	\$	178
Net operating loss carryforward		15,427		14,548
Depreciation, amortization and impairment charges		1,148		1,444
		16,733		16,170
Valuation allowance		(16,733)		(16,170)
Net deferred tax assets	\$	-	\$	-

Management estimates that our combined federal and state tax rates will be 36.3%. Applied conducts a periodic examination of its valuation allowance. Factors considered in the evaluation include recent and expected future earnings and Applied's liquidity and equity positions. As of December 31, 2006 and 2005, Applied has established a valuation allowance for the entire amount of net deferred tax assets, due to the Company's belief that it is more likely than not that the deferred tax asset will not be realized.

Applied has net operating loss ("NOL") carryforwards at December 31, 2006 of approximately \$42 million which expire in years 2010 through 2026. The NOL carryforwards are limited to use against future taxable income due to changes in ownership and control.

## **9. Stockholders' Deficit**

### **Reverse Stock Split**

On August 29, 2005, the Company effected the previously approved 1-for-20 reverse common stock split. As a result of the reverse stock split, the issued and outstanding shares of the Company's common stock were reduced from approximately 156 million shares to approximately 7.8 million shares. The reverse stock split, including the effect on loss per share, has been presented retroactively as if it had occurred on January 1, 2004.

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## **Commodore Applied Technologies, Inc. and Subsidiaries Notes to Consolidated Financial Statements**

### **9. Stockholders' Deficit, Continued:**

#### **Series E Convertible Preferred Stock**

Effective November 4, 1999 Applied issued 335,000 shares of Series E Convertible Preferred Stock with a stated value of \$10 per share. This stock had a dividend rate of 12% per annum through April 30, 2000 and thereafter 5% per annum paid quarterly. In addition the stock had a special dividend at the rate of 7.5% per annum which began to accrue on May 1, 2000 and continued to accrue until paid, and was payable on May 1, 2001. The Company accrued \$28 thousand and \$124 thousand of dividends in 2005 and 2004, respectively.

The Series E Convertible Preferred Stock was convertible into common stock at any time on or after April 30, 2000 at a conversion price equal to the arithmetic mean of the closing prices of common stock as reported in the respective stock exchange for the ten trading days immediately preceding the date of conversion.

During the years ended December 31, 2005 and 2004, 5,500 and 32,500 shares of Series E Convertible Preferred Stock were converted into 291,629 and 807,196 shares of common stock, respectively. As of December 31, 2006 and 2005 there are no shares of Series E Convertible Preferred Stock outstanding.

On April 12, 2005, the Company entered into the Shaar Exchange Agreement, in which the Company agreed that Shaar would exchange all of its right, title and interest in and to the remaining outstanding shares of the Series E and Series F Preferred (including all other accrued and unpaid dividends thereon) for 395,302 shares of the Company's Series I Preferred Stock.

#### **Series F Convertible Preferred Stock**

In March 2000, Applied issued 266,700 shares of Series F Convertible Preferred Stock with a stated value of \$10 per share. Transaction costs on the issuance totaled \$230 thousand resulting in net proceeds to Applied of \$1.8 million.

The stock had a dividend rate of 12% per annum through September 30, 2000 and thereafter 5% per annum paid quarterly. In addition the stock had a special dividend at the rate of 7.5% per annum which began to accrue October 1, 2000 and continued to accrue until paid, payable on October 1, 2001. The Company accrued \$41 thousand and \$148 thousand of dividends in 2005 and 2004, respectively.

The Series F Convertible Preferred Stock had a liquidation preference of \$10 per share. In connection with the issuance of Series F Convertible Preferred Stock, Applied issued warrants to purchase 18,174 shares of common stock at \$38.78 per share. These warrants expired on March 16, 2005.

The Series F Convertible Preferred Stock was convertible into common stock at any time on or after September 30, 2000. On conversion, the investor was to receive for each converted preferred share the greater number of

common stock as determined by (1) the face value per share (\$10) plus accrued dividends divided by the average of the closing prices over a ten consecutive trading day period ending on the trading day immediately preceding the conversion date, or (2) \$7.50 (the cash invested for each preferred share) divided by \$1.93875.

On April 12, 2005, the Company entered into the Shaar Exchange Agreement, in which the Company agreed that Shaar would exchange all of its right, title and interest in and to the remaining outstanding shares of the Series E and Series F Preferred (including all other accrued and unpaid dividends thereon) for 395,302 shares of the Company's Series I Preferred Stock.

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## **Commodore Applied Technologies, Inc. and Subsidiaries Notes to Consolidated Financial Statements**

### **9. Stockholders' Deficit, Continued: Series H Convertible Preferred Stock**

Applied issued 800,000 shares of Series H Preferred Stock (the "Series H Preferred"), par value \$0.001 per share, having a stated value of \$1 per share. The Series H Preferred shall have the following rights, privileges, and limitations:

- a) The conversion feature was exercisable on or after June 30, 2003.
- b) No Series H Preferred could be converted prior to June 30, 2003. Until July 31, 2005, only 80,000 shares could be convertible in any calendar quarter. The balance of any unconverted shares may be converted at any time on or after August 1, 2005.
- c) The conversion price is determined by the average closing price of Company's common stock in the previous 30 trading days, but in no event shall the conversion price be less than \$4.00 per share.
- e) The Series H Preferred has a non-cumulative annual dividend of 3%, payable in cash or Series H Preferred within 30 days of the end of Applied's fiscal year, at Applied's election. Dividends of \$24 thousand and \$24 thousand were accrued during 2006 and 2005 respectively, and total accumulated dividends of \$104 thousand had been accrued at December 31, 2006.
- f) The Series H Preferred is not transferable.

There have been no shares of Series H Preferred stock converted into common shares as of December 31, 2006.

In the event of liquidation, dissolution or winding up of Applied, holders of Series H Convertible Preferred Stock are entitled to receive liquidation distributions equivalent to \$1.00 per share, and no more, before any distribution to holders of the common stock.

### **Series I Convertible Preferred Stock**

Effective as of April 12, 2005, the Company authorized the issuance of 550,000 shares of Series I Convertible Preferred Stock ("Series I Preferred"), par value \$0.001 per share, each such share having a stated value of \$10.00 per share.

The Series I Preferred have the following rights, privileges, and limitations:

- a) The conversion feature was exercisable immediately upon issuance of the shares.
- b) The conversion price is determined by the average closing price of the Company's common stock in the previous 10 trading days, but in no event shall the conversion price be more than \$0.57 per share.

c) If the Company's common stock is not listed on an exchange at the time of the conversion, the conversion price would be 50% of the market price at that time.

d) The Series I Preferred has a cumulative annual dividend of 10%, payable in cash or shares of the Company's common stock at the Company's election.

e) The payment of dividends in the form of common stock is subject to limitation, such that payment in the form of stock can be exercised or made that would result in the holder owning 5% or more beneficial ownership of the Company's common stock.

f) Dividends were to be paid quarterly commencing May 15, 2005, to the holders of record of shares of the Series I Preferred Stock. Dividends until February 14, 2006 would accrue but shall not be payable until February 15, 2006. As of December 31, 2006, no dividends had yet been paid under these terms.

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## **Commodore Applied Technologies, Inc. and Subsidiaries Notes to Consolidated Financial Statements**

### **9. Stockholders' Deficit, Continued:**

#### **Series I Convertible Preferred Stock, Continued:**

- g) The Company reserved 3,750,000 shares of its common stock for the conversion of the Series I Preferred.
- h) The Company accrued approximately \$184 thousand of dividends in 2005 on the Series I Preferred prior to its

exchange, all of which is outstanding at December 31, 2006.

During the year ended December 31, 2005, 7,000 shares were converted to 439,206 shares of common stock.

Effective October 1, 2005, the Company entered into the New Shaar Exchange Agreement, in which Shaar exchanged all of its right, title and interest in and to the remaining outstanding shares of the Series I Preferred (excluding all other accrued and unpaid dividends thereon) for 388,302 shares of the Company's Series J Preferred Stock, which represents all of the Series J preferred stock outstanding at December 31, 2006.

#### **Series J Convertible Preferred Stock**

Effective October 1, 2005, the Company authorized the issuance of 550,000 shares of Series J Convertible Preferred Stock (Series J Preferred), par value \$0.001 per share, each such share having a stated value of \$10.00 per share.

The Series J Preferred have the following rights, privileges, and limitations:

- a) The conversion feature was exercisable immediately upon issuance of the shares.
- b) The conversion price is determined by the average closing price of the Company's common stock in the previous 10 trading days, but in no event shall the conversion price be more than \$0.50 per share or less than \$0.05 per share.
- c) If the Company's common stock is not listed on an exchange at the time of the conversion, then the conversion price will be 50% of the market price at that time.

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- d) The Series J Preferred have a cumulative annual dividend of 10%, payable in cash or shares of the Company's common stock at the Company's election.
- e) Dividends were to be paid quarterly commencing March 31, 2006, to the holder of the shares of the Series J Preferred Stock. As of December 31, 2006, no dividends had yet been paid under these terms, and the holder has agreed to a deferral of payment until June 30, 2007 without consequence to the Company.
- f) The Company has reserved 40,000,000 shares of its common stock for the conversion of the Series J Preferred and the Amended New Shaar Convertible Note.
- g) Both the conversion and the payment of dividends in the form of common stock are subject to limitation, such that no conversion or payment in the form of stock can be exercised or made that would result in the holder owning 5% or more beneficial ownership of the Company's common stock.
- h) The Company accrued approximately \$388 thousand and \$97 thousand of dividends in 2006 and 2005 on the Series J Preferred. Accumulated dividends totaled approximately \$485 thousand