

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-QSB

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

**For the Quarterly Period Ended September 30, 2004**

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

Commission file number 033-03362-D

### **KLEENAIR SYSTEMS, INC.**

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

State of Nevada  
(State or other jurisdiction of  
incorporation or organization)

87-0431043  
(I.R.S. Employer  
Identification #)

1711 Langley Avenue, Irvine CA 92614  
(Address of principal executive offices and zip code)

(949) 955-3492  
(Registrant's telephone number)

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

There were 57,727,753 shares of common stock, \$0.001 Par Value,  
outstanding as of October 20, 2004.

Transitional Small Business Disclosure Format (check one); Yes ☐ [ ] No ☒ [X]

KLEENAIR SYSTEMS, INC.

FORM 10-QSB

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## **PART I -- FINANCIAL INFORMATION**

### **Item 1. Financial Statements**

#### **REPORT ON REVIEW BY INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS**

Board of Directors,  
KleenAir Systems, Inc.  
Irvine, CA

We have reviewed the accompanying consolidated balance sheet of KleenAir Systems, Inc. (a development stage enterprise) (the "Company") as of September 30, 2004, and the related consolidated statements of operations for three and nine months and stockholders' equity and cash flows for nine months ended September 30, 2004 and 2003. We have also reviewed the cumulative statements of operations, stockholders' equity and cash flows for the period from January 1, 1995 through September 30, 2004. These financial statements are the responsibility of the Company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical review procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements for them to be in conformity with generally accepted accounting principles.

We have previously audited, in accordance with generally accepted auditing standards, the consolidated balance sheet as of December 31, 2003, and the related statements of operations, stockholders' equity and cash flows for the year then ended (not presented herein); and, in our report dated March 22, 2004, we expressed an opinion on those financial statements that was qualified based on the Company's ability to continue as a going concern. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2003 is fairly stated in all material respects in relation to the consolidated balance sheet from which it has been derived.

/s/ Robert Early & Company, P.C.  
ROBERT EARLY & COMPANY, P.C.  
Abilene, Texas

November 4, 2004

**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Company)  
**CONSOLIDATED BALANCE SHEETS**

	September 30, 2004 <u>Unaudited</u>	December 31, 2003 <u></u>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash	\$ 13,168	\$ 28,739
Accounts receivable	21,933	15,699
Accounts receivable from related parties	77,447	33,288
Inventory-raw materials (at cost)	37,493	57,126
Marketable security	501,079	-
Prepaid expenses	<u>46,592</u>	<u>47,000</u>
Total Current Assets	697,712	181,852
 PROPERTY AND EQUIPMENT (net)	 127,051	 155,611
 <b>OTHER ASSETS:</b>		
Patent license (net)	1,482,682	1,530,756
Advances to equity investee	<u>105,206</u>	<u>-</u>
Total Other Assets	<u>1,587,888</u>	<u>1,530,756</u>
 <b>TOTAL ASSETS</b>	 <u><u>\$ 2,412,651</u></u>	 <u><u>\$ 1,868,219</u></u>
 <b>LIABILITIES AND STOCKHOLDER'S EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable (\$87,008 and \$84,358 due to related parties, respectively)	\$ 259,097	\$ 487,176
Accrued expenses	21,535	17,573
Capital lease liability	-	372
Notes payable to related parties	210,000	197,000
Advances from directors	<u>116,671</u>	<u>96,584</u>
Total Current Liabilities	<u>607,303</u>	<u>798,705</u>
 <b>STOCKHOLDERS' EQUITY:</b>		
Preferred stock, series A, \$.001 par value (10,000,000 shares authorized, none outstanding)	-	-
Common stock, \$.001 par value (100,000,000 shares authorized, 57,532,236 and 31,422,161 outstanding, respectively)	57,532	31,422
Additional paid-in capital	9,935,903	8,006,296
Deficit accumulated during the development stage	(8,188,832)	(6,968,204)
Other comprehensive income:		
Cumulative translation adjustment	<u>745</u>	<u>-</u>
Total Stockholder's Equity	<u>1,805,348</u>	<u>1,069,514</u>
 <b>TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY</b>	 <u><u>\$ 2,412,651</u></u>	 <u><u>\$ 1,868,219</u></u>

See accompanying accountants' report and selected information.

# KLEENAIR SYSTEMS, INC.

(A Development Stage Company)

## CONSOLIDATED STATEMENTS OF OPERATIONS

For Three and Nine Months Ended September 30, 2004 and 2003

	Three Months		Nine Months		Cumulative During Development Stage
	2004	2003	2004	2003	
REVENUES	\$ 36,676	\$ 655,192	\$ 40,995	\$ 893,255	\$ 945,486
Cost of goods sold	<u>23,086</u>	<u>414,709</u>	<u>32,445</u>	<u>610,024</u>	<u>730,782</u>
Gross Profit	<u>13,590</u>	<u>240,483</u>	<u>8,550</u>	<u>283,231</u>	<u>240,121</u>
PRODUCT DEVELOPMENT COSTS	<u>35,914</u>	<u>20,853</u>	<u>120,977</u>	<u>128,240</u>	<u>1,359,982</u>
OPERATING EXPENSES:					
Personnel costs and director fees	17,911	75,528	140,199	87,638	1,377,943
Consultants	93,713	117,437	485,192	316,974	3,211,918
Professional fees	16,376	17,773	49,349	87,566	548,576
Office expenses	1,860	2,399	5,485	15,069	58,763
Depreciation	12,341	12,445	36,836	36,871	148,356
Amortization of intangible assets	32,914	36,466	95,421	85,599	277,080
Advertising and promotion	2,966	25,884	8,056	125,746	238,997
Loss on cancelling licensing agreements	-	-	-	-	19,860
Rent	27,942	24,041	74,690	71,380	284,907
Travel	12,788	20,721	60,919	82,580	357,492
Other expenses	13,072	15,594	38,618	69,100	205,775
Bad debts	(4,993)	-	1,000	100,000	221,000
Unknown sources prior to current ownership	-	-	-	-	151,518
Total operating expenses	<u>226,890</u>	<u>348,288</u>	<u>995,765</u>	<u>1,078,523</u>	<u>7,102,185</u>
(LOSS) FROM OPERATIONS	(249,214)	(128,658)	(1,108,192)	(923,532)	(8,222,046)
OTHER INCOME AND (EXPENSES):					
Interest income	-	1	-	11	2,526
Interest expense	(4,706)	(4,434)	(14,974)	(13,044)	(34,411)
Foreign exchange loss	-	-	(4,715)	-	(4,715)
Loss on sale of stock	-	-	(92,747)	-	(92,747)
Amortization of discount on receivables	-	-	-	-	20,259
(Loss) before income taxes	(253,920)	(133,091)	(1,220,628)	(936,565)	(8,331,134)
Benefit from deferred taxes	-	-	-	-	397,852
<b>(Loss) Before Extraordinary Item</b>	<b>(253,920)</b>	<b>(133,091)</b>	<b>(1,220,628)</b>	<b>(936,565)</b>	<b>(7,933,282)</b>
Extraordinary Item:					
Costs of terminated acquisition	-	-	-	-	(255,550)
Net (Loss)	<u>\$ (253,920)</u>	<u>\$ (133,091)</u>	<u>\$ 1,220,628</u>	<u>\$ (936,565)</u>	<u>\$ (8,188,832)</u>
Basic and Diluted Earnings Per Share:					
(Loss) per share before extraordinary item	\$ (0.00)	\$ (0.01)	\$ (0.03)	\$ (0.04)	\$ (0.71)
(Loss) per share from extraordinary item	-	-	-	-	(0.02)
Net (Loss) Per Share	<u>\$ (0.00)</u>	<u>\$ (0.01)</u>	<u>\$ (0.03)</u>	<u>\$ (0.04)</u>	<u>\$ (0.73)</u>
Weighted Average Shares Outstanding	<u>52,141,770</u>	<u>22,202,549</u>	<u>43,929,493</u>	<u>21,168,143</u>	<u>11,252,866</u>

See accompanying accountants' report and selected information.

**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Company)  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

	<u>Preferred Stock</u>		<u>Common Stock</u>		<u>Additional</u>	<u>Unearned</u>	<u>Accumulated</u>
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>	<u>Paid-In</u>	<u>Compensation</u>	<u>Deficit During</u>
					<u>Capital</u>		<u>Development</u>
							<u>Stage</u>
BALANCES, 1/1/95	-	\$ -	74,132	\$ 74	\$ 151,444	\$ -	\$ (151,518)
Stock issued: For cash	-	-	27,334	27	66,982	-	-
For adjustment	-	-	534	1	-	-	-
For consulting services	-	-	86,148	86	279,439	-	-
For professional services	-	-	4,666	5	12,745	-	-
For purchase of patent rights	933,334	934	60,000	60	13,905	-	-
For directors' compensation	-	-	4,000	4	22,496	-	-
For officers' compensation	33,334	33	9,334	9	194,958	-	-
Other contributed capital	-	-	-	-	2,367	-	-
Options compensation	-	-	-	-	70,313	(152,016)	-
Net loss	-	-	-	-	-	-	(329,289)
BALANCES, 12/31/95	966,668	967	266,148	266	814,649	(152,016)	(480,807)
Stock issued for services	13,332	13	24,666	25	201,837	(78,750)	-
For officers' compensation	33,332	33	-	-	15,592	(15,625)	-
For aborted acquisition	-	-	40,000	40	140,510	-	-
Exercise of options	-	-	75,000	75	112,424	-	-
Conversion to common	(318,666)	(319)	318,666	319	-	-	-
Net Loss	-	-	-	-	-	187,346	(716,511)
BALANCES, 12/31/96	694,666	694	724,480	725	1,285,012	(59,045)	(1,197,318)
Stock issued: For cash	-	-	120,000	120	14,880	-	-
For officers' compensation	33,334	33	-	-	3,842	(3,875)	-
Conversion to common	(100,000)	(100)	100,000	100	-	-	-
Net loss	-	-	-	-	-	37,979	(55,438)
BALANCES, 12/31/97	628,000	627	944,480	945	1,303,734	(24,941)	(1,252,756)

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See accompanying accountants' report and selected information.

**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Company)  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(Continued from previous page)

	<u>Preferred Stock</u>		<u>Common Stock</u>		<u>Additional</u>	<u>Unearned</u>	<u>Accumulated</u>
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>	<u>Paid-In</u>	<u>Compen-</u>	<u>Deficit During</u>
					<u>Capital</u>	<u>sation</u>	<u>Development</u>
							<u>Stage</u>
Stock issued: For cash	-	\$ -	\$ 800,000	\$ 800	\$ 199,200	\$ -	\$ -
For services	-	-	2,120,000	2,120	92,255	-	-
For officer/director services	-	-	320,000	320	59,680	-	-
For diesel license	-	-	2,000,000	2,000	60,500	-	-
Conversion to common	(403,334)	(403)	403,334	403	-	-	-
Net loss	-	-	-	-	-	24,941	(305,561)
BALANCES, 12/31/98	224,666	224	6,587,814	6,588	1,715,369	-	(1,558,317)
Stock issued: For cash	-	-	146,800	147	35,653	-	-
For services	-	-	1,103,334	1,103	247,179	-	-
For equipment	-	-	33,200	33	8,267	-	-
For officer/director services	-	-	1,425,000	1,425	408,808	-	-
Conversion to common	(61,334)	(61)	61,334	61	-	-	-
Net loss	-	-	-	-	-	-	(802,722)
BALANCES, 12/31/99	163,332	163	9,357,482	9,357	2,415,276	-	(2,361,039)
Stock issued: For cash	-	-	1,414,000	1,414	357,336	-	-
For services	-	-	1,642,666	1,643	600,024	-	-
As promotion	-	-	1,600	2	3,199	-	-
Conversion to common	(163,332)	(163)	163,334	163	-	-	-
Net loss	-	-	-	-	-	-	(717,012)
BALANCES, 12/31/00	-	-	12,579,082	12,579	3,375,835	-	(3,078,051)

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See accompanying accountants' report and selected information.

**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Company)  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(Continued from previous page)

	Preferred Stock		Common Stock		Additional	Unearned	Accumulated
	Shares	Amount	Shares	Amount	Paid-In Capital	Compensation	Deficit During Development Stage
Stock issued: For cash	-	\$ -	\$ 195,000	\$ 195	\$ 104,805	\$ -	\$ -
For services	-	-	1,749,487	1,749	293,087	-	-
For officer/director services	-	-	850,000	850	77,690	-	-
For rent	-	-	17,500	18	6,232	-	-
Net loss	-	-	-	-	-	-	(623,811)
BALANCES, 12/31/01	-	-	15,391,069	15,391	3,857,649	-	(3,701,862)
Stock issued: For cash	-	-	2,804,545	2,805	1,717,195	-	-
For services	-	-	1,201,692	1,202	404,232	-	-
For Acquisition of Carbon Cloth	-	-	873,250	873	968,434	-	-
Contributed inventory	-	-	-	-	12,207	-	-
Net loss	-	-	-	-	-	-	(1,119,045)
BALANCES, 12/31/02	-	-	20,270,556	20,271	6,959,717	-	(4,820,907)
Stock issued:							
For cash	-	-	750,000	750	74,250	-	-
To officers and directors	-	-	7,600,000	7,600	511,490	-	-
For services	-	-	2,801,605	2,801	460,839	-	-
Net loss	-	-	-	-	-	-	(2,147,297)
BALANCES, 12/31/03	-	-	31,422,161	31,422	8,006,296	-	(6,968,204)
Stock issued:							
For cash	-	-	750,000	750	74,250	-	-
For services	-	-	4,832,076	4,832	559,897	-	-
For investments	-	-	20,527,999	20,528	1,295,460	-	-
Net loss	-	-	-	-	-	-	(1,220,628)
BALANCES, 09/30/04	-	\$ -	<u>57,532,236</u>	<u>\$ 57,532</u>	<u>\$ 9,935,903</u>	<u>\$ -</u>	<u>\$ (8,188,832)</u>

See accompanying accountants' report and selected information.



**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Company)  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
For Nine Months Ended September 30, 2004 and 2003

	<u>2004</u>	<u>2003</u>	<u>Cumulative During Devel- opment Stage</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net (loss)	\$(1,220,628)	\$ (936,565)	\$ (8,188,832)
Adjustments to reconcile net income/(loss) to net cash provided by operations:			
Losses prior to current ownership	-	-	151,518
Depreciation	36,836	36,872	148,356
Amortization of:			
Intangibles	95,421	85,599	277,080
Prepaid expenses	15,908	117,750	1,240,645
Stock issued for services	472,483	200,000	3,234,355
Stock issued for extraordinary loss	-	-	140,550
Deferred income taxes	-	-	(397,852)
Bad debts	1,000	100,000	221,000
Loss on sale of stock	92,747	-	92,747
Changes in operating assets and liabilities:			
Accounts and note receivable	(51,393)	(240,104)	(57,983)
Inventory	19,633	33,793	(14,955)
Prepaid expenses	(15,500)	(11,542)	(262,500)
Accounts payable and accrued expenses	(224,117)	466,509	184,488
Customer deposit	-	-	-
Net Cash Used by Operating Activities	<u>(777,610)</u>	<u>(147,688)</u>	<u>(3,231,383)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Property and equipment	(8,276)	(9,034)	(265,714)
Patent licensing costs	(47,347)	(29,180)	(208,359)
Business acquisition	-	-	(44,820)
Proceeds from sale of stock	814,408	-	814,408
Notes receivable and advances	(105,206)	-	(325,206)
Net Cash Provided by/(Used in) Investing Activities	<u>653,579</u>	<u>(38,214)</u>	<u>(29,691)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from issuing stock	75,000	50,000	2,946,826
Capital lease obligation	-	-	7,765
Payments on capital lease	(372)	(3,349)	(7,765)
Foreign currency translation adjustment	745	-	745
Proceeds from loans from related parties	91,000	123,000	288,000
Advances from directors	37,590	734	134,174
Repayments to directors and related parties	(95,503)	-	(95,503)
Net Cash Provided by Financing Activities	<u>108,460</u>	<u>170,385</u>	<u>3,274,242</u>
Net Increase/(Decrease) in Cash	(15,571)	(15,517)	13,168
Cash at Beginning of Year	<u>28,739</u>	<u>76,758</u>	<u>-</u>
<b>CASH AT END OF PERIOD</b>	<u><u>\$ 13,168</u></u>	<u><u>\$ 61,241</u></u>	<u><u>\$ 13,168</u></u>

**SUPPLEMENTAL CASH FLOW INFORMATION:**

See Note 5.

See accompanying accountants' report and selected information.

**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Enterprise)  
**SELECTED INFORMATION FOR CONSOLIDATED FINANCIAL STATEMENTS**  
September 30, 2004  
(Unaudited)

**NOTE 1: BASIS OF PRESENTATION**

The accompanying unaudited financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions of Regulation S-B. They do not include all information and footnotes required by generally accepted accounting principles for complete financial statements. However, except as disclosed herein, there has been no material change in the information included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2003. In the opinion of Management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The report of Robert Early & Company, P.C. commenting on their review accompanies the financial statements included in Item 1 of Part 1. Operating results for the nine-month period ended September 30, 2004, are not necessarily indicative of the results that may be expected for the year ending December 31, 2004.

**NOTE 2: PROPERTY AND EQUIPMENT**

The Company has purchased testing equipment, test vehicles, and office equipment and furniture as presented in the following table. Depreciation expense for the first nine months of 2004 and 2003 was \$36,836 and \$36,872, respectively.

Office furniture and equipment	\$ 62,072
Test vehicles	28,928
Analysis equipment	174,840
Leasehold improvements	<u>11,682</u>
Total	277,522
Accumulated depreciation	<u>(150,471)</u>
Net property & equipment	<u><u>\$ 127,051</u></u>

**NOTE 3: AMORTIZATION OF PREPAID EXPENSES**

The Company frequently prepays for services to be rendered either in cash or by stock issuance. These transactions are recorded as prepaid expenses and amortized over the period covered by the agreement. Amortization totaled \$93,624 in the nine months ended September 30, 2003. There has been none in 2004.

During 2004, the Company has prepaid partial insurance premiums and is continuing payments on the premium balance over a period of less than one year. The policies have a one-year term. Total premiums are being amortized over the term of the policy. Amortization charged to insurance expense for the nine months was \$10,466.

**NOTE 4: PATENTS AND AMORTIZATION**

The Company owns patents for its CarbonGuard™ product and its other products that it has developed. The cost of internally developed products is expensed as Research and Development as incurred. The CarbonGuard™ was a purchased product. Legal fees to perfect, file, maintain, and defend these patents are capitalized as patent costs. Cumulative patent costs of \$285,759 for the KleenAir products are being amortized over a ten-year period ending March 2013. The costs of the CarbonGuard™ is being amortized over its 15-year estimated useful ending March 2017.

Amortization for the nine months ended September 30, 2004 and 2003 totaled \$95,421 and \$85,599. Accumulated amortization at September 30, 2004 was \$277,080.

#### NOTE 5: SUPPLEMENTAL CASH FLOW DISCLOSURES

The following table sets forth supplemental cash flow disclosures for the nine months and cumulative periods ended September 30, 2004 and 2003.

	<u>2004</u>	<u>2003</u>	<u>Cumulative During Devel- opment Stage</u>
Cash payments for:			
Interest	\$ 4,612	\$ 5,356	\$ 12,876
Income taxes	-	-	-
Non-cash investing and financing transactions:			
Stock issued for:			
Compensation and directors' fees	\$ 79,985	\$ 65,340	\$ 1,418,635
Services and prepaid services	392,498	240,713	2,546,895
Equipment	-	-	8,300
Patent licensing	-	-	14,900
Repurchase of U.S. diesel license	-	-	62,500
Acquisition of National Diversified Telecom, Inc.	-	-	140,550
Sale of marketing licenses for notes receivable	-	-	1,736,558
Acquisition of Carbon Cloth Technologies, Inc.	-	-	981,514
Uncompleted business acquisition	-	-	87,500
Investment in marketable securities	1,408,324	-	1,408,324

#### NOTE 6: STOCK TRANSACTIONS

During the first quarter of 2004, the Company sold 250,000 restricted shares for \$25,000. It also issued 350,000 restricted shares valued at \$30,525 for financial consulting services. Another 340,000 unrestricted S-8 shares valued at \$65,400 were issued to consultants for business promotion and financial consulting services. A total of 8,000 unrestricted S-8 shares valued at \$2,160 were issued for development and clerical services. The Company also issued 10,026,333 restricted shares to Jubilee Investment Trust PLC and a combination of 501,666 S-8 shares and 501,666 warrants to a consultant for the acquisition of 910,569 shares of Jubilee Investment Trust PLC. The issued shares and warrants were recorded at total value of \$907,155. These warrants are exercisable at \$0.21 at any time before March 4, 2007.

During the second quarter of 2004, the Company sold 500,000 restricted shares for \$50,000. It issued 512,022 S-8 shares valued at \$77,323 for business promotion and financial consulting services. At total of 3,000 S-8 shares valued at \$690 were issued for development and clerical services. Another 500,000 S-8 shares valued at \$57,500 were issued for consulting services regarding development of the Company's business interests in England. A total of 1,200,000 restricted shares valued at \$79,200 were issued to directors and a key consultant for their annual management services.

During the third quarter of 2004, the Company issued 36,267 S-8 and 1,354,483 restricted 144 shares valued at \$4,896 and \$124,907, respectively, for business promotional and financial consulting services. A total of 3,000 S-8 shares valued at \$440 were issued for development and clerical services. Another 275,304 S-8 shares and 250,000 restricted 144 shares valued at a total of \$29,442 were issued for consulting services related to the Company's activities in England. An investment in a security traded on the London exchange was acquired for the issuance of 10,000,000 restricted common shares valued at \$501,079.

**NOTE 7: ACCOUNTS RECEIVABLE FROM RELATED PARTIES**

This balance consists of the elements presented below. KleenAir Systems International LTD. (KASI) is partially owned by the Company and controlled by the Company's President. KleenAir Systems LTD. is wholly owned by KASI. The \$76,342 consists primarily of advances and the unpaid balance of \$45,000 in billings for equipment and support services during the testing phases leading to approval of the systems in the U.K.

**NOTE 8: LOSS ON SALE OF STOCK**

As mentioned in Note 6, the Company issued restricted stock in exchange for trading shares of Jubilee Investment Trust PLC. A contract with a consultant required the Company to issue additional shares and warrants due to the consummation of this transaction. The Jubilee shares were placed almost immediately in a block trade to provide much needed cash. Because of the way the transaction was structured and the consultant fee involved, the Company realized a loss on the sale.

**NOTE 9: MARKETABLE SECURITY**

During the third quarter, the Company consummated an offshore agreement to exchange 10,000,000 common shares subject to Regulation S for, initially, 901,707 shares of Langley Park Investment Trust Plc., a new British investment trust that has been formed and registered on the London Stock Exchange. Half the shares received became tradable by the Company when the investment corporation was listed. The other half of the shares are to be held, subject to a two-year adjustment period. Should the Company's stock price decline by the end of the two years, the trust will buy back a prorated number of its shares at one British pound per share. The investment corporation has agreed to a lock-up provision that restricts its ability to sell its KleenAir shares without written approval from the Company during the two-year adjustment period .

**NOTE 10: NOTES PAYABLE TO RELATED PARTIES**

During the first quarter, officers and entities related to them loaned the Company \$71,000. These loans bear interest at 7% compounded monthly and are due on demand. The Company's President also advanced a net \$14,000 for temporary working capital requirements. During the second quarter, the Company repaid loans and advances totaling \$95,503.

In the third quarter, officers loaned the Company \$20,000 and advanced another \$23,590 temporarily.

**NOTE 11: SUBSEQUENT EVENTS**

In October 2004, the U.K. investment company was successfully listed on the London Stock Exchange. The Company sold a portion of its shares.

The Company's U.K. affiliate completed negotiations with Dinex to distribute the Company's products as a package with Dinex's products in the European market. The Company also negotiated a non-exclusive distribution agreement with Dinex for the United States.

## Item 2. Management's Discussion and Plan of Operation

The Company was incorporated under the laws of the State of Nevada on February 4, 1986, under the name of Covington Capital Corporation. In 1986, the Company filed an S-18 and registered certain stock. From 1989 through 1993, the Company underwent a series of name changes in order to explore various business opportunities. However, none of the business opportunities was successfully completed.

In April, 1995, under the name Investment and Consulting International, Inc., the Company acquired a patent for a proprietary device designed to neutralize nitrogen oxide (NOx) automobile emissions from a separate company which was then known as KleenAir Systems, Inc. Simultaneously with the acquisition of the patent, the Company acquired the right to use the corporate name KleenAir Systems, Inc., and changed to its current name.

Since acquiring the patent in 1995, the Company has been a developmental stage company and has worked towards the completion of the development and testing of the NOxMaster<sup>TM</sup> technology. The Company owns U.S. Patent #5,224,346 Engine NOx Reduction System issued in 1993, U.S. Patent #5,609,026 Engine NOx Reduction issued in 1997. In 1999 the Company was issued a third patent on Ammonia Injection in NOx Control, U.S. Patent #5,992,141. The Company has applied for and maintained patent protection under the Patent Cooperation Treaty (PCT) to protect its intellectual property in a variety of countries that are significant producers of automotive products.

The Company has applied for additional patents related to its NOxMaster<sup>TM</sup> technology, two of which have been granted. The U.S. Patent #6,446,940 has been issued for a new emission control device, the Sonic Flow Carburetor, which atomizes fuel on gasoline powered engines, enhancing operating efficiency and reducing emissions. An additional U.S. Patent #6,499,463 has been issued for a device which atomizes diesel fuel to enhance the performance of and reduce emissions in diesel engines. Patent awards have now been confirmed for several European countries including the U.K., Germany, France, Italy, Spain and Sweden. Patents are anticipated soon for Japan, Brazil, and China.

The Company occupies a 10,000 square-foot R & D facility at 1711 Langley, Irvine, CA 92614. The Company has a chassis dynamometer in addition to its engine dynamometer to cope with increasing levels of R & D engine and device testing programs as it prepares for commercializing its technology.

As a result of an extensive test and evaluation program funded by the Energy Savings Trust (EST) in England and implementation on a variety of vehicles over the last 3 years, the Company has now been included as an approved vendor on the EST Cleanup Register in a number of categories.

The Company is the only entry in the Register in the SCR category for retrofit. In addition, the Company's Selected Catalytic Reduction and Filter (SCR) systems, which combine high levels of emission reduction for both NOx and PM (particulate matter) with CO and HC reductants, has become the sole entry for light and medium duty vehicles in a new especially created category called SCR. This category has the highest level of funding grants. The Eminox<sup>TM</sup> is the only other SCR product for heavy duty engines and has recently been added to the Cleanup Register. The Company's systems have now been qualified for a variety of vehicles ranging from light-duty taxi applications to light commercial vans, shuttle buses and heavy duty bus transport applications.

These qualifications open the door to product launches in a variety of market segments in the U.K. and, subsequently, in other European countries such as Germany and Denmark. Eight SCR systems have been installed on buses in Copenhagen.

Distribution and supply agreements for the KleenAir product line have been established through the Company's U.K. affiliate with Dinex A/S of Denmark and Dinex Exhaust Systems Ltd. of the U.K. Dinex specializes in after-market sales of particulate filters, silencers, and exhaust system components for medium and heavy-duty diesel-powered vehicles. The supply agreements will enable the Company to source product at most favored nation pricing and distribute to its own list of customers in Europe and elsewhere. The Company, through its affiliate, is undertaking negotiations with a number of U.K. fleet operators with a view to retrofitting and upgrading their vehicles to Euro 3 requirements.

During 2003, over \$750,000 of system components were shipped to Dinex. However, in October 2003, the EST suspended funding payments due to budget problems and these were not reinstated until April 2004. Systems orders for over 100 buses, worth \$500,000 in Company sales, were put on hold. The Company is awaiting clarification as to whether these orders will now be funded or whether new applications have to be filed to fund these

systems. As of the current date, only limited funding has been released for special programs and it is not clear whether this will include taxis. Many hope that some of the bus applications applied for will be processed.

Anticipations are that the Public Carriage Office (PCO) will shortly announce a mandate for the upgrade of some 17,500 London taxis to Euro 3 emission standards. The PCO has recently announced that the start date for this program will be delayed from January 2005 until April 2005. Estimates are that there will be 3,500 upgrades for 2005/2006, for which Company deliveries from the U.S. to Europe would need to commence during the first quarter of 2005. The estimated number for 2006/2007 is 9,000 with an additional 5,000 in 2007. The Company expects that its strategic partner Dinex will be the principal supplier of systems for this application with a net revenue potential to the Company of over \$500 per vehicle.

In his post-election policy statement in July 2004, the Mayor of London, Ken Livingstone, outlined plans for a Low Emission Zone for all areas of London within the M25 Ring Road. It has been estimated that the provisions of this zone will impact 100,000 to 200,000 vehicles by the end of 2007 and an additional 500,000 to 600,000 vehicles by the end of 2010. The Company's products already qualify to meet the required emission standards for such mandated upgrades and have been approved by the EST for such applications.

Orders have been received for the installation of the DINOX<sup>TM</sup> system, an emissions control package, as a Dealer-Fit option. This package is comprised of the Company's NOxMaster<sup>TM</sup> SCR system and Dinex' particulate reduction system. Some 758 Light Commercial Vans have been ordered, subject to funding, by a leading Local Authority in the U.K. These vans are to include a Volkswagen factory approved emission package and are one of the leading models sold in the U.K. Similar additional orders of dealer-installed systems are anticipated in the near future.

The Company has formed a consortium, together with Dinex, ATS Euromaster (a subsidiary of Michelin), Air Products Plc. and Terra Nitrogen(U.K.) Ltd., for the purpose of creating and supporting the infrastructure for ammonia supply, installation and maintenance. It is anticipated that a similar consortium with the same members will be formed to handle the U.S. infrastructure once Environmental Protection Agency (EPA) and California Air Resources Board (CARB) Retrofit Verification has been received.

As the U.K. market is on the threshold of major commercial advances in the use of SCR for retrofit programs, such as London taxis and buses, the Company, in consultation with the Department For Transport (DFT) and EST, has moved to pull together all the resources necessary for a reliable, efficient and cost-effective infrastructure to support the implementation of its Selected Catalytic Reduction and Filter (SCRF) systems on a variety of vehicles for a number of different applications across the U.K.

U.S. testing continues of the NOxMaster<sup>TM</sup> Diesel Catalytic Converter together with the Company's NOxMaster<sup>TM</sup> Ammonia Injection System to present an integrated system for the elimination of emissions from diesel powered mobile sources. The Company has received an EO (Executive Order) certification from the CARB for off-road and stationary engine applications which will enable it to commence sales of its products in California.

The Company has now received approval from CARB for its applications for Retrofit Verification for medium heavy-duty vehicles using its NOxMaster<sup>TM</sup> NOx reduction system. Approval has also been received from the EPA to proceed with an application for certification of the combination package of its Oxidizing Particulate Trap (OPT) with the NOxMaster<sup>TM</sup> for both high particulate reduction as well as high NOx reduction. The Company has negotiated an arrangement with the EPA and CARB for a single testing protocol that would satisfy both their requirements rather than having to bear the considerable cost of running two separate test programs for the same product. Applications have been on file with both institutions for a long time. The actual Retrofit Verification Program should now commence during the first quarter of 2005.

The Company's wholly owned subsidiary, Carbon Cloth Technologies, Inc. (Carbon Cloth) of Malibu, California is a manufacturer of automotive thermal management systems. Carbon Cloth has several years of experience developing thermal solutions for such motorsports industry leaders as Ferrari, Mercedes-Benz and Penske, that has enabled development of the CarbonGuard<sup>TM</sup>, a significant addition to the battle on pollution. It has applied for patents in automotive thermal management systems.

At present, the CarbonGuard<sup>TM</sup> is used largely to enhance the effectiveness of particulate filters. These filters need to maintain 300 degrees centigrade for 30% of a vehicle's operating time. Otherwise the filters clog and create back pressure. Wherever particulate filters are currently installed (estimated to be at least 30,000 units at present), the CarbonGuard<sup>TM</sup> can improve performance and reduce maintenance costs. Filter technology has come to

prominence recently as both the EPA and the CARB have determined that particulates from vehicle emissions are a serious public health problem.

The CarbonGuard™ is already installed on over 1,000 New York City Transit Authority buses as enhancements for the operating efficiency of its installed base of particulate traps. It has been selected as a sole source product for this application.

Negotiations are continuing with a number of automotive OEM manufacturers to incorporate our CarbonGuard™ for a variety of thermal management applications.

The Company is continuing its sales activities on behalf of the SOBRIS™ system under an agency agreement signed in July 2002 with ServoTech, Inc. ServoTech is a licensee of Ford Motor Company on SCR injection technology. Its SOBRIS™ product, which is a urea based system, is under test and evaluation by a number of automotive manufacturers in the U.S. and Europe. Dr. Hamid Servati, President of ServoTech, is a director of the Company and a significant shareholder. The Company and ServoTech continue to negotiate a more permanent relationship between the two entities.

Once production and sales begin, the Company anticipates employing initially 15 to 20 employees, primarily in management, technical and administrative capacities. The Company is actively seeking sources of funding for its operating capital requirements both to complete its test and evaluation programs and to support initial sales and production.

The Company is negotiating potential licensing and other commercial arrangements with certain international companies in the automotive industry, subject to completion of satisfactory test and evaluation programs.

The Company has been actively seeking the injection of working capital to meet its commercialization and certification needs. During the first quarter of 2004, an arrangement was consummated for an exchange of shares with Jubilee Investment Trust of London UK. Those shares were sold for over \$850,000.

During the third quarter of 2004, the Company concluded an exchange of shares with Langley Park Investment Trust Plc., an entity currently trading on the London Stock Exchange. The Company received 901,700 Langley Park shares in exchange for the issuance of 10,000,000 shares of restricted common stock. Langley Park has agreed to not sell these shares for two years. This transaction was recorded in the books at \$501,079 in accordance with accounting rules. The exchange with Langley Park was made based on a stated value of approximately \$1,650,000.

The Company's U.K. affiliate, KleenAir Systems International Plc., has issued a prospectus for private equity funding of approximately \$2,750,000. This action is intended as a pre-IPO funding and is preparatory to a proposed listing on the Alternative Investment Market in London. The success of this funding would dilute the Company's ownership interest from 30% to 20%. This funding strategy is designed to provide the working capital necessary to fully exploit the commercialization opportunity in Europe for the Company's products. In addition, with a successful listing on the AIM, the Company's ownership interest can be reported at its fair value value, which is estimated to be over \$1,600,000.

#### **Disclosure Regarding Forward-Looking Statements**

Where this Form 10-QSB includes "forward-looking" statements within the meaning of Section 27A and Section 21E of the Securities Act, the Company desires to take advantage of the "safe harbor" provisions thereof. Therefore, the Company is including this statement for the express purpose of availing itself of the protections of such safe harbor provisions with respect to all of such forward-looking statements. The forward-looking statements in this Form 10-QSB reflect the Company's current views with respect to future events and financial performance. These forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ from those anticipated. These risks include, but are not limited to, economic conditions, changes in environmental regulations, the market for venture capital, etc. In this Form 10-QSB, the words "anticipates," "believes," "expects," "intends," "future" and similar expressions identify forward-looking statements. The Company undertakes no obligation to publicly revise these forward-looking statements to reflect events or circumstances that may arise after the date hereof. All subsequent written and oral forward-looking statements attributable to the Company or persons acting on its behalf are expressly qualified in their entirety by this section.

### Item 3: Controls and Procedures

- (a) Within the 90-day period prior to the date of this report, the Corporation carried out an evaluation, under the supervision and with the participation of the Company's management, including the Corporation's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Corporation's disclosure controls and procedures are effective in timely alerting him to material information relating to the Corporation (including its consolidated subsidiaries) required to be included in the Corporation's Exchange Act filings.
- (b) There have been no significant changes in the Corporation's internal controls or in other factors which could significantly affect its internal controls subsequent to the date the Corporation carried out its evaluation.

## PART II - OTHER INFORMATION

### Item 6. Exhibits and Reports on Form 8-K.

- Exhibit 23 -- Accountants' consent to incorporation by reference
  - Exhibit 31 -- Certification of President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
  - Exhibit 32 -- Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- Reports on Form 8-K -- None

## SIGNATURES

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

KLEENAIR SYSTEMS, INC.

Date: November 9, 2004

/s/ LIONEL SIMONS

By: Lionel Simons, President,  
Secretary, Principal Accounting Officer, &  
Principal Financial Officer



EXHIBIT 23 -- Consent of Robert Early & Company, P.C., Accountants

CONSENT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT

We hereby consent to the incorporation by reference into the Form S-8 Registration Statement No. 333-115285 regarding the amended Stock Compensation Plan of KleenAir Systems, Inc. of our report dated November 4, 2004, on our review of the quarterly financial statements for the period ended September 30, 2004 which is included in the quarterly report on Form 10-QSB of KleenAir Systems, Inc. for the quarter ended September 30, 2004.

/s/ ROBERT EARLY & COMPANY, P.C.

Robert Early & Company, P.C.

Abilene, Texas

November 9, 2004

EXHIBIT 31 -- Certification of President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

CERTIFICATION

I, Lionel Simons, President and Chief Financial Officer, certify that:

1. I have reviewed this quarterly report on Form 10-QSB of KleenAir Systems, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and I have:
  - (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - (c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing equivalent function):
  - (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 9, 2004

/s/ LIONEL SIMONS

Lionel Simons  
President and  
Chief Financial Officer

EXHIBIT 32 -- Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

CERTIFICATION OF CEO AND CFO PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-QSB of KleenAir Systems, Inc. (the "Company") for the quarterly period ended September 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Lionel Simons, President and Chief Financial Officer of the Company, hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to the best of his knowledge, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly represents, in all material respects, the financial condition and result of operations of the Company.

/s/ LIONEL SIMONS

Lionel Simons  
President and  
Chief Financial Officer

November 9, 2004

This certification accompanies this Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.