

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-QSB**

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

For the quarterly period ended **JUNE 30, 2005**

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 #)

27121 Aliso Creek Road Ste 120, Aliso Viejo, CA 92656  
(Address of principal executive offices and zip code)

(949) 831-1045  
(Registrant's telephone number)

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

There were 60,543,923 shares of common stock, \$0.001 Par Value,  
outstanding as of July 30, 2005.

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

KLEENAIR SYSTEMS, INC.

FORM 10-QSB

INDEX

	<u>Page</u>
Part I. Financial Information	
Item 1. Financial Statements	
Report on Review by Independent Certified Public Accountants .....	3
Consolidated Balance Sheet .....	4
Consolidated Statement of Operations .....	5
Consolidated Statement of Stockholders' Equity .....	6
Consolidated Statement of Cash Flows .....	9
Selected Information Regarding the Financial Statements .....	10
Item 2. Management's Discussion and Analysis and Plan of Operations .....	12
Item 3: Controls and Procedures .....	15
Part II: Other information	
Item 6: Exhibits and Reports on Form 8-K .....	15
Signatures .....	16
Exhibits	

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

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

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

Board of Directors,  
KleenAir Systems, Inc.  
Aliso Viejo, CA

We have reviewed the accompanying consolidated balance sheet of KleenAir Systems, Inc. (a development stage enterprise) (the "Company") as of June 30, 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows for the three and six months ended June 30, 2005 and 2004. We have also reviewed the cumulative statements of operations, stockholders' equity and cash flows for the period from January 1, 1995 through June 30, 2005. These financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of Company personnel responsible for financial and accounting matters. It is substantially less in scope than an audit in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States), 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 accounting principles generally accepted in the United States.

We have previously audited, in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of the Company as of December 31, 2004, and the related statements of operations, stockholders' equity and cash flows for the year and cumulative period then ended (not presented herein); and, in our report dated March 31, 2005, we expressed an opinion on those financial statements which was qualified based on the Company's ability to continue as a going concern. In our opinion, the information set forth in the accompanying interim consolidated balance sheet as of December 31, 2004, 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

August 17, 2005

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

	June 30, 2005 Unaudited	December 31, 2004
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash	\$ 57,527	\$ 87,696
Accounts receivable (net)	14,801	2,970
Accounts receivable from related parties	27,579	105,074
Inventory-raw materials (at cost)	24,503	24,352
Prepaid expenses	14,407	38,094
Marketable securities (net)	96,995	195,202
Total Current Assets	235,812	453,388
PROPERTY AND EQUIPMENT (net)	76,654	112,296
<b>OTHER ASSETS:</b>		
Patent license (net)	1,420,614	1,469,076
TOTAL ASSETS	\$ 1,733,080	\$ 2,034,760
<b>LIABILITIES AND STOCKHOLDER'S EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 121,109	\$ 111,155
Accounts payable to related parties	176,845	149,912
Accrued expenses	33,570	25,698
Notes payable to related entities	226,244	231,000
Advances from directors	68,922	76,000
Total Current Liabilities	626,690	593,765
<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, 60,104,706 and 58,100,206 outstanding, respectively)	60,105	58,100
Additional paid-in capital	10,003,101	9,955,716
Deficit accumulated during the development stage	(8,956,816)	(8,572,821)
Total Stockholder's Equity	1,106,390	1,440,995
TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY	\$ 1,733,080	\$ 2,034,760

See accompanying accountants' report and selected information.

## KLEENAIR SYSTEMS, INC.

(A Development Stage Company)

### CONSOLIDATED STATEMENTS OF OPERATIONS

For the Three and Six Months Ended June 30, 2005 and 2004

	Three Months		Six Months		Cumulative During Development Stage
	2005	2004	2005	2004	
REVENUES	\$ 40,930	\$ 4,319	\$ 49,384	\$ 4,319	\$ 1,020,754
Cost of goods sold	32,814	9,359	39,624	9,359	776,113
Gross Profit	8,116	(5,040)	9,760	(5,040)	244,641
PRODUCT DEVELOPMENT COSTS	20,853	20,853	72,390	85,063	1,484,077
OPERATING EXPENSES:					
Personnel costs and director fees	32,310	96,645	65,570	122,288	1,495,779
Consultants	6,250	197,554	12,250	391,479	3,242,096
Professional fees	14,242	28,538	25,492	32,973	582,751
Office expenses	2,486	2,426	4,676	3,625	65,706
Depreciation	9,125	12,338	20,166	24,495	183,277
Amortization of intangible assets	32,575	31,454	65,298	62,507	376,391
Advertising and promotion	685	(2,112)	1,690	5,090	266,412
Rent	13,751	22,885	37,622	46,748	395,486
Travel	18,654	34,597	24,796	48,131	371,681
Other expenses	28,238	16,065	39,262	25,546	255,418
Bad debts	-	-	-	5,993	221,000
Unknown sources prior to current ownership	-	-	-	-	171,378
Total operating expenses	158,316	440,390	296,822	768,875	7,627,375
(LOSS) FROM OPERATIONS	(171,053)	(466,283)	(359,452)	(858,978)	(8,866,811)
OTHER INCOME AND (EXPENSES):					
Interest income	-	-	-	-	2,526
Interest expense	(4,725)	(4,878)	(9,480)	(10,268)	(49,073)
Management fees	15,750	-	31,500	-	141,978
Foreign exchange loss	-	-	-	(4,715)	(7,670)
Unrealized gain/(loss) on marketable securities	44,461	-	32,069	-	(159,808)
Loss on sale of stock	(78,632)	-	(78,632)	(92,747)	(180,519)
Amortization of discount on receivables	-	-	-	-	20,259
(Loss) before income taxes	(194,199)	(471,161)	(383,995)	(966,708)	(9,099,118)
Benefit from deferred taxes	-	-	-	-	397,852
<b>(Loss) Before Extraordinary Item</b>	<b>(194,199)</b>	<b>(471,161)</b>	<b>(383,995)</b>	<b>(966,708)</b>	<b>(8,701,266)</b>
Extraordinary Item:					
Costs of terminated acquisition	-	-	-	-	(255,550)
Net (Loss)	<u>\$ (194,199)</u>	<u>\$ (471,161)</u>	<u>\$ (383,995)</u>	<u>\$ (966,708)</u>	<u>\$ (8,956,816)</u>
Basic and Diluted Earnings Per Share:					
(Loss) per share before extraordinary item	\$ (0.00)	\$ (0.01)	\$ (0.01)	\$ (0.02)	\$ (0.60)
(Loss) per share from extraordinary item	-	-	-	-	(0.02)
Net (Loss) Per Share	<u>\$ (0.00)</u>	<u>\$ (0.01)</u>	<u>\$ (0.01)</u>	<u>\$ (0.02)</u>	<u>\$ (0.61)</u>
Weighted Average Shares Outstanding	<u>59,046,761</u>	<u>43,800,847</u>	<u>58,576,098</u>	<u>39,778,233</u>	<u>14,600,051</u>

See accompanying accountants' report and selected information.

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

	Preferred Stock		Common Stock		Additional Paid-In Capital	Unearned Compen- sation	Accumulated Deficit During Development Stage
	Shares	Amount	Shares	Amount			
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)

(Continued on next page)

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 Paid-In Capital	Unearned Compen- sation	Accumulated Deficit During Development Stage
	Shares	Amount	Shares	Amount			
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)
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)

(Continued on next page)

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 Paid-In Capital	Unearned Compen- sation	Accumulated Deficit During Development Stage
	Shares	Amount	Shares	Amount			
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 investments	-	-	20,527,999	20,528	1,387,706	-	-
For services	-	-	4,200,046	4,200	408,945	-	-
For services-officers and directors	-	-	1,200,000	1,200	78,519	-	-
Net loss	-	-	-	-	-	-	(1,604,617)
BALANCES, 12/31/04	-	-	58,100,206	58,100	9,955,716	-	(8,572,821)
Stock issued:							
For cash	-	-	1,000,000	1,000	24,000	-	-
For services	-	-	1,004,500	1,005	23,385	-	-
Net loss	-	-	-	-	-	-	(383,995)
BALANCES, 06/30/05	-	\$ -	60,104,706	\$ 60,105	\$ 10,003,101	\$ -	\$ (8,956,816)

See accompanying accountants' report and selected information.

**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Company)  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
For the Six Months Ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>	<u>Cumulative During Devel- opment Stage</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net loss	\$ (383,995)	\$ (966,708)	\$ (8,956,816)
Adjustments to reconcile net loss to net cash provided by operations:			
Losses prior to current ownership	-	-	151,518
Depreciation	20,166	24,495	183,277
Amortization of:			
Intangibles	65,297	62,508	376,390
Prepaid expenses	12,450	5,425	1,266,093
Stock issued for services	24,390	364,048	3,279,126
Stock issued for extraordinary loss	-	-	140,550
Deferred income taxes	-	-	(397,852)
Bad debts	-	5,993	221,000
Loss on disposition of assets	7,431	-	7,431
Loss on sale of marketable securities	78,631	92,747	372,395
Unrealized loss/(gain) on marketable securities	(32,069)	-	(32,069)
Changes in operating assets and liabilities:			
Accounts and note receivable	65,664	(36,318)	70,803
Inventory	(151)	(870)	(1,965)
Prepaid expenses	11,237	(11,000)	(255,763)
Accounts payable and accrued expenses	44,759	(253,923)	163,594
Net Cash Used by Operating Activities	<u>(86,190)</u>	<u>(713,603)</u>	<u>(3,412,288)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Property and equipment	(1,705)	(8,276)	(267,419)
Patent licensing costs	(16,835)	(26,897)	(245,601)
Proceeds from disposition of assets	9,750	-	9,750
Business acquisition	-	-	(44,820)
Proceeds from sale of stock	51,645	814,408	970,913
Notes receivable and advances	-	(105,206)	(220,000)
Net Cash Provided/(Used) by Investing Activities	<u>42,855</u>	<u>674,029</u>	<u>202,823</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from issuing stock	25,000	75,000	2,971,826
Capital lease obligation	-	-	7,765
Payments on capital lease	-	(372)	(7,765)
Foreign currency translation adjustment	-	745	-
Proceeds from loans from related parties	2,922	21,000	434,521
Advances from directors	-	4,933	-
Repayments to related parties	(14,756)	(36,436)	(139,355)
Net Cash Provided/(Used) by Financing Activities	<u>13,166</u>	<u>64,870</u>	<u>3,266,992</u>
Net Increase/(Decrease) in Cash	(30,169)	25,296	57,527
Cash at Beginning of Year	<u>87,696</u>	<u>28,739</u>	<u>-</u>
<b>CASH AT END OF PERIOD</b>	<u><u>\$ 57,527</u></u>	<u><u>\$ 54,035</u></u>	<u><u>\$ 57,527</u></u>

**SUPPLEMENTAL CASH FLOW INFORMATION:**

See Note 2.

See accompanying accountants' report and selected information.

**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Enterprise)  
**SELECTED INFORMATION FOR CONSOLIDATED FINANCIAL STATEMENTS**  
June 30, 2005  
(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, 2004. 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 six-month period ended June 30, 2005, are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

**NOTE 2: SUPPLEMENTAL CASH FLOW DISCLOSURES**

The following table sets forth supplemental cash flow disclosures.

	<u>2005</u>	<u>2004</u>	<u>Cumulative During Devel- opment Stage</u>
Cash payments for:			
Interest	\$ 1,608	\$ 3,431	\$ 15,503
Income taxes	-	-	-
Non-cash investing and financing transactions:			
Stock issued for:			
Compensation and directors' fees	\$ -	\$ 79,545	\$ 1,417,850
Services and prepaid services	24,390	284,503	3,180,790
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 security	-	907,155	1,408,234

**NOTE 3: STOCK TRANSACTIONS**

During the first quarter of 2005, the Company issued 1,500 unrestricted S-8 common shares valued at \$150 for clerical services.

During the second quarter of 2005, the Company issued 1,000,000 restricted common shares valued at \$24,000 to Servotech for product development costs. Another 3,000 unrestricted S-8 common shares valued at \$240 were issued for clerical services. An investor purchased 1,000,000 restricted common shares for \$25,000.

**NOTE 4: 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 two quarters of 2005 and 2004 was \$20,166 and \$24,495, respectively.

Office furniture and equipment	\$ 61,814
Test vehicles	28,928
Analysis equipment	<u>162,208</u>
	282,950
Accumulated depreciation	<u>(176,296)</u>
Net property and equipment	<u>\$ 76,654</u>

During the second quarter of 2005, the Company reached the end of its lease and moved its offices. As part of the move, certain fixed assets were sold or otherwise disposed of. Proceeds from the sales totaled \$9,750. The cost of the assets sold and disposed of totaled \$26,277 and accumulated depreciation on these assets totaled \$9,096.

**NOTE 5: ACCOUNTS RECEIVABLE FROM RELATED PARTIES**

Accounts receivable from related parties consists of amounts due from the Company's affiliate in England. KleenAir Systems International, Plc (trading symbol KSIP.L) is partially owned by the Company. The Company's President also serves as Chairman of the board and President of KSIP.

**NOTE 6: MARKETABLE SECURITIES**

During 2004, the Company acquired an investment in Langley Park Investments Trust in England in exchange for the issuance of a large block of its stock. (See the financial statements for the year ended 12/31/04, Note 13.) The Langley Park investment was partially sold during 2004 and partially held at the end of the year.

During the second quarter of 2005, the Company sold an additional block of these shares and received proceeds of \$51,645. A net loss of \$9,964 was recognized after adjusting for previous unrealized losses.

The following table presents information regarding the Company's investments in marketable securities at June 30, 2005. This security is being held as a trading security.

Aggregate cost basis	\$ 256,803
Unrealized gain/(loss)	<u>(159,808)</u>
Aggregate fair value (carrying value)	<u>\$ 44,461</u>

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

### RESULTS OF OPERATIONS

Revenues for the three month period of the second quarter of 2005 were \$40,930 compared to \$4,319 with cost of goods sold at \$32,814 and \$9,359 respectively for the same period last year. Revenue for the first six months amounted to \$49,384 compared to \$4,319 during the first six months of 2004, with cost of goods at \$39,624 and \$9,359. This revenue was primarily related to sales of Carbon Cloth Technology with more units being installed on New York City Transit buses.

Gross profit for the quarter was \$8,116 compared to a loss of \$5,040 last year and for the year-to-date was \$9,760 compared to a loss of \$5,040 for the same period in the previous year.

Operating expenses for the 2nd quarter of 2005 were reduced from \$296,822 in 2004 to \$158,316 in 2005. For the six month period expenses have been reduced from \$768,875 to \$440,390. The main areas of saving have been in consultant fees and rent. As of April, the company moved into smaller facilities and moved its dynamometer and testing equipment into a Dinex facility where the two companies can share our testing capability.

Loss for the quarter was down from \$383,995 in 2004 to \$194,199 for 2005. For the year-to-date the cumulative loss has been \$383,995, down from a loss of \$966,708 in the same period last year.

### LIQUIDITY AND SOURCE OF CAPITAL

The Company has continued to make private placements of stock to meet its working capital needs and has arrangements in place to sell more stock as and when needed. It has also sold part of its stock in Langley Park Investment Trust in London, the proceeds from which have been utilized to meet current working capital requirements. In addition, various officers and directors have made short-term loans to the company as needed. In 2004, private placements plus the sale of the Company's investment in Jubilee Investment Trust met the working capital requirement for the year in the absence of cash generated from sales revenue.

### GENERAL DISCUSSION AND PLAN OF OPERATIONS

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 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 toward the completion of the development and testing of the NOxMaster(TM) technology. The Company owns U.S. Patent #5,224,346 - Engine NOx Reduction System issued in 1993 and 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(TM) 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, and anticipated soon for Japan, Brazil, and China.

The Company occupies 2,000 square foot facility at 27121 Aliso Creek Road, Suite 120, Aliso Viejo, CA 92656. The Company has loaned its R & D testing equipment to its strategic partner, Dinex Exhausts, Inc., which is occupying a several thousand square foot facility in the City of Industry. The arrangement calls for Dinex to conduct tests and evaluations on this equipment of systems to be presented to the California Air Resource Board (CARB) and the Environment Protection Agency (EPA). The Company and Dinex will jointly apply for Retrofit Verification to these agencies for certain applications of its technology. KleenAir will, from time to time, continue to use the equipment, of which it has retained ownership, for its own exclusive testing and development programs.

As a result of an extensive test and evaluation program funded by the Energy Savings Trust (EST) and implemented on a variety of vehicles over the last four 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 SCR category for retrofit. In addition, the Company's Selected Catalytic Reduction and Filter (SCR/F) systems, which combine high levels of emission reduction for both NO<sub>x</sub> and PM (particulates) together with CO and HC, has become the sole entry for light and medium duty vehicles in a new especially-created category called SCR/F, which has the highest level of funding grants. The Eminox is the only other SCR/F product for heavy duty and has recently been added to the Clean Up. 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.

This opens the door to product launches in a variety of market segments in the UK, and subsequently in other European countries such as Germany and Denmark, where SCR/F systems have been installed on eight buses in Copenhagen.

Distribution and supply agreements have been concluded through the Company's U.K. affiliate with Dinex A/S of Denmark and Dinex Exhaust Systems Ltd of the U.K. for the KleenAir product line. Dinex specializes in after-market sales of particulate filters, silencers and exhaust system components for medium and heavy-duty diesel-powered vehicles. The supply agreement 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 is in negotiation with a number of fleet operators with a view to retrofitting and upgrading vehicles to Euro 3 requirements.

Distribution and supply agreements for the KleenAir product line have been concluded with Dinex Exhaust Systems, Inc., a wholly owned US subsidiary of Dinex A/S of Denmark, with which the Company has European distributorship and supply agreements. It is expected that Dinex will be applying for CARB and EPA Retrofit Verification Programs for various types and sizes of vehicles for both NO<sub>x</sub> and particulate reduction.

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. Orders for systems 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. It is hoped that some of the bus applications applied for will be processed.

The Public Carriage Office (PCO) has announced 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 July 2006. It is expected that there will be 3,500 upgrades for 2006, for which Company deliveries from the US to Europe would need to commence during the first quarter of 2005. The estimated number for 2007 is 9,000 with a further 5,000 in 2008. 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 is estimated that this will impact 100,000 to 200,000 vehicles by the end of 2007 and a further 500,000 to 600,000 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 Energy savings Trust for such applications.

The Company has formed a consortium together with Dinex, ATS Euromaster (a subsidiary of Michelin), Air Products Plc and Terra Nitrogen(UK) 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 US infrastructure once EPA and CARB Retrofit Verification has been received.

As the UK 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 Energy Savings Trust (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 UK.

U.S. testing continues of the NOxMaster(TM) Diesel Catalytic Converter together with its NOxMaster(TM) Ammonia Injection System to present an integrated system for the elimination of emissions from diesel powered mobile sources. The Company has received an EO certification from the California Air Resources Board (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(TM) 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(TM) for both high particulate reduction as well as high NOx reduction. However, 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 2006.

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(TM), a significant addition to the battle on pollution. It has applied for patents in automotive thermal management systems.

At present the CarbonGuard(TM) is used 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(TM) can improve performance and save maintenance expense. Filter technology has come to prominence recently as both the Environmental Protection Agency (EPA) and the California Air Resource Board (CARB) have determined that particulates from vehicle emissions are a serious public health problem.

The CarbonGuard(TM) 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.

The Company is continuing its sales activities on behalf of the SOBRIS(TM) system under an agency agreement signed in July 2002. Servotech is a licensee of Ford Motor Company on SCR injection technology. It's SOBRIS(TM) product 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 initially employing 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 UK affiliate, KleenAir Systems International Plc, has successfully raised approximately \$1,500,000 in private equity funding. This funding diluted the Company's ownership interest to approximately 23%. The funding strategy is designed to provide the working capital necessary to fully exploit the commercialization opportunity in Europe for the Company's products.

In June 2005, the Company signed with Airtek, Inc. of Habart, IN, an exclusive distribution agreement for China of certain products of its CATCO catalyst manufacturing wholly owned subsidiary. It also signed a contract with Chongqing Qinchuan Industrial Group requiring the purchase of 150,000 catalysts and substrates over a three-year period, with a value amounting to approximately \$10,000,000.

## **OFF-BALANCE SHEET ARRANGEMENTS**

As of June 30, 2005, the Company had no off-balance sheet arrangements.

## **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.

Date: August 22, 2005

KLEENAIR SYSTEMS, INC.

/s/ LIONEL SIMONS  
By: Lionel Simons, President,  
Secretary, Principal Accounting Officer, and  
Principal Financial Officer

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 August 17, 2005, on our review of the quarterly financial statements for the period ended June 30, 2005 which is included in the quarterly report on Form 10-QSB of KleenAir Systems, Inc. for the quarter ended June 30, 2005.

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

August 22, 2005

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-15(e) and 15d-15(e)) 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) (this paragraph omitted pursuant to SEC Release Nos. 33-8238 and 34-47986;)
  - (c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially effected, or is reasonably likely to materially effect, the registrant's internal control over financial reporting; and
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

Date: August 22, 2005

/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 June 30, 2005 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

August 22, 2005

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.