

LITHIUM TECHNOLOGY CORP  
Form 10QSB  
May 22, 2006  
Table of Contents

---

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

---

**FORM 10-QSB**

---

(Mark One)

**QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the Quarterly Period ended March 31, 2006

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 1-10446

---

**LITHIUM TECHNOLOGY CORPORATION**

(Name of Small Business Issuer in Its Charter)

---

**DELAWARE**  
(State or Other Jurisdiction of

Incorporation or Organization)

**5115 CAMPUS DRIVE, PLYMOUTH MEETING, PENNSYLVANIA 19462**

(Address of Principal Executive Offices) (Zip Code)

**13-341148**  
(I.R.S. Employer

Identification No.)

Edgar Filing: LITHIUM TECHNOLOGY CORP - Form 10QSB

(610) 940-6090

(Issuer's Telephone Number, Including Area Code)

---

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

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

**APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY**

**PROCEEDINGS DURING THE PAST FIVE YEARS**

Check whether the issuer has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Exchange Act after the distribution of securities under a plan confirmed by a court. Yes  No

**APPLICABLE ONLY TO CORPORATE ISSUERS**

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: As of May 5, 2006, 387,397,176 shares of common stock.

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

SEC2334(9-05) **Persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a current valid OMB control number.**

---

Table of Contents

LITHIUM TECHNOLOGY CORPORATION AND SUBSIDIARIES

FORM 10-QSB

FOR THE QUARTER ENDED MARCH 31, 2006

INDEX

	PAGE	
<b><u>PART I FINANCIAL INFORMATION</u></b>		
ITEM 1.	<u>FINANCIAL STATEMENTS</u>	
	<u>Condensed Consolidated Balance Sheets March 31, 2006 and December 31, 2005</u>	3
	<u>Condensed Consolidated Statements of Operations and Comprehensive Loss-Three Months Ended March 31, 2006 and 2005, and period from February 12, 1999 (inception of development stage) to March 31, 2006</u>	4
	<u>Condensed Consolidated Statements of Changes in Stockholders' Equity (Deficit) Three Months Ended March 31, 2006</u>	5
	<u>Condensed Consolidated Statements of Cash Flows Three Months Ended March 31, 2006 and 2005, and period from February 12, 1999 (inception of development stage) to March 31, 2006</u>	6
	<u>Notes to Consolidated Financial Statements March 31, 2006</u>	7
ITEM 2.	<u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	21
ITEM 3.	<u>CONTROLS AND PROCEDURES</u>	34
<b><u>PART II OTHER INFORMATION</u></b>		
ITEM 1.	<u>LEGAL PROCEEDINGS</u>	35
ITEM 2.	<u>CHANGES IN SECURITIES AND USE OF PROCEEDS</u>	35
ITEM 3.	<u>DEFAULTS UPON SENIOR SECURITIES</u>	36
ITEM 4.	<u>SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS</u>	36
ITEM 5.	<u>OTHER INFORMATION</u>	36
ITEM 6.	<u>EXHIBITS AND REPORTS ON FORM 8-K</u>	36

**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****LITHIUM TECHNOLOGY CORPORATION AND SUBSIDIARIES****(DEVELOPMENT STAGE COMPANIES)****CONDENSED CONSOLIDATED BALANCE SHEETS****(UNAUDITED)**

	March 31, 2006	December 31, 2005 (Unaudited)
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 164,000	\$ 46,000
Accounts receivable	313,000	241,000
Inventories	885,000	569,000
Prepaid expenses and other current assets	485,000	488,000
<b>Total current assets</b>	<b>1,847,000</b>	<b>1,344,000</b>
Property and equipment, net	5,423,000	5,419,000
Intangibles, net	7,163,000	7,378,000
Other assets	284,000	201,000
<b>Total assets</b>	<b>14,717,000</b>	<b>14,342,000</b>
<b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 2,798,000	\$ 2,699,000
Accrued salaries	179,000	175,000
Accrued interest	636,000	464,000
Current portion of long term debt	2,791,000	3,541,000
Deferred Revenue	1,000,000	
Other current liabilities and accrued expenses	1,263,000	1,186,000
<b>Total current liabilities</b>	<b>8,667,000</b>	<b>8,065,000</b>
<b>LONG-TERM LIABILITIES, LESS CURRENT PORTION</b>		
Subordinated loans from related party	5,391,000	3,387,000
Other long-term liabilities, less current portion	3,416,000	3,084,000
Convertible debt securities	83,000	749,000
<b>Total long-term liabilities</b>	<b>8,890,000</b>	<b>7,220,000</b>
<b>Total liabilities</b>	<b>17,557,000</b>	<b>15,285,000</b>
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS DEFICIT</b>		
Preferred stock, par value \$0.01 per share, Authorized 100,000,000 shares		
Series A Convertible Preferred Stock, par value \$0.01 per share, authorized, issued and outstanding: 1,000 shares	1,000,000	1,000,000

## Edgar Filing: LITHIUM TECHNOLOGY CORP - Form 10QSB

Series B Convertible Preferred Stock, par value \$0.01 per share, authorized, issued and outstanding:		
100,000 shares	8,822,000	8,822,000
12% convertible debentures	981,000	907,000
Common stock, par value \$.01 per share, Authorized 750,000,000 shares; Issued and outstanding:		
350,230,744 and 266,335,979 shares	3,502,000	2,664,000
Additional paid-in capital	76,297,000	71,534,000
Cumulative translation adjustments	(5,182,000)	(4,001,000)
Accumulated deficit	(200,000)	(200,000)
Deficit accumulated during development stage	(88,060,000)	(81,769,000)
Total stockholders' deficit	(2,840,000)	(943,000)
Total liabilities and stockholders' deficit	\$ 14,717,000	\$ 14,342,000

See accompanying notes to consolidated financial statements.

Table of Contents**LITHIUM TECHNOLOGY CORPORATION AND SUBSIDIARIES****(DEVELOPMENT STAGE COMPANIES)****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS****(UNAUDITED)**

	<b>THREE MONTHS ENDED</b>		<b>PERIOD FROM</b>
	<b>MARCH 31,</b>		<b>FEBRUARY 12, 1999</b>
			<b>(INCEPTION OF</b>
			<b>DEVELOPMENT STAGE)</b>
			<b>TO MARCH 31,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>
<b>REVENUES</b>			
Development contracts and prototype sales	\$ 525,000	\$ 142,000	\$ 3,588,000
<b>COSTS AND EXPENSES</b>			
Cost of goods sold	464,000		2,872,000
Engineering, research and development	677,000	1,570,000	22,543,000
General and administrative	962,000	1,120,000	19,165,000
Sales and marketing	82,000		561,000
Depreciation and amortization	464,000	450,000	12,361,000
Intangibles expensed			3,700,000
Loss (gain) on sale of assets			108,000
	2,649,000	3,140,000	61,310,000
<b>OTHER INCOME (EXPENSE)</b>			
Foreign government subsidies		1,000	2,842,000
Interest expense, net of interest income	(813,000)	(725,000)	(11,700,000)
Interest expense related to amortization of discount on convertible debt	(2,404,000)	(848,000)	(12,719,000)
	(3,217,000)	(1,572,000)	(21,578,000)
<b>NET LOSS</b>	<b>\$ (5,341,000)</b>	<b>\$ (4,570,000)</b>	<b>\$ (79,443,000)</b>
Charge for embedded derivatives, warrants and beneficial conversion, preferred shares	(74,000)	(845,000)	(8,100,000)
Dividends on preferred shares	(20,000)	(113,000)	(517,000)
<b>NET LOSS TO COMMON SHAREHOLDERS</b>	<b>(5,435,000)</b>	<b>(5,528,000)</b>	<b>(88,060,000)</b>
<b>OTHER COMPREHENSIVE INCOME (LOSS)</b>			
Currency translation adjustments	(1,181,000)	246,000	(5,182,000)
<b>COMPREHENSIVE LOSS</b>	<b>\$ (6,616,000)</b>	<b>\$ (5,282,000)</b>	<b>\$ (93,242,000)</b>
Weighted average number of common shares outstanding:	569,327,514	59,259,391	

Edgar Filing: LITHIUM TECHNOLOGY CORP - Form 10QSB

Basic and diluted net loss per share:	\$	(0.01)	\$	(0.09)
---------------------------------------	----	--------	----	--------

See accompanying notes to consolidated financial statements.

**Table of Contents**

**LITHIUM TECHNOLOGY CORPORATION AND SUBSIDIARIES**

**(DEVELOPMENT STAGE COMPANIES)**

**CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)**

**(UNAUDITED)**

	Convertible Preferred Class A Stock		Convertible Preferred Class B Stock		Common Stock		Additional Paid-in Capital	12% Convertible Debentures	Cumulative Transactions Adjustments	Deficit Accumulated Deficit	Deficit During Development	Total Equity
	Shares	Amount	Shares	Amount	Shares	Amount	Capital	Debt	Adjustments	Deficit	Development	Equity
Balances at December 31, 2004	1,000	\$ 1,000,000	100,000	\$ 8,822,000	266,335,979	\$ 2,664,000	\$ 72,490,000	\$ 907,000	\$ (4,001,000)	\$ (200,000)	\$ (82,625,000)	\$ (943,000)
Issuance of common stock					83,894,765	838,000	867,000					1,205,000
Conversion of convertible preferred stock								74,000			(74,000)	
Investment on December 2005							2,640,000					2,640,000
Grants of stock options							300,000					300,000
Conversion of convertible preferred stock											(20,000)	(20,000)
Translation adjustments									(1,181,000)			(1,181,000)
Loss											(5,341,000)	(5,341,000)
Balances at December 31, 2005	1,000	\$ 1,000,000	100,000	\$ 8,822,000	350,230,744	\$ 3,502,000	\$ 76,297,000	\$ 981,000	\$ (5,182,000)	\$ (200,000)	\$ (88,060,000)	\$ (2,840,000)

See accompanying notes to consolidated financial statements.





**Table of Contents****LITHIUM TECHNOLOGY CORPORATION AND SUBSIDIARIES****(DEVELOPMENT STAGE COMPANIES)****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

	<b>THREE MONTHS ENDED</b>		<b>PERIOD FROM</b>
	<b>MARCH 31,</b>		<b>FEBRUARY 12, 1999</b>
			<b>(INCEPTION OF</b>
			<b>DEVELOPMENT</b>
			<b>STAGE) TO</b>
	<b>2006</b>	<b>2005</b>	<b>MARCH 31, 2006</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net loss per common shareholder	\$ (5,341,000)	\$ (4,570,000)	\$ (79,443,000)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	464,000	450,000	12,361,000
Warrants issued for services provided			241,000
In-process research and development expensed			3,700,000
Loss on sale of assets			108,000
Non cash financing and interest charges	2,404,000	1,533,000	21,831,000
Change in operating assets and liabilities, net of business acquisitions:			
Accounts receivable	(72,000)	47,000	(312,000)
Accounts receivable, related parties			187,000
Inventories	(316,000)	31,000	(852,000)
Prepaid expenses and other current assets	3,000	13,000	(95,000)
Other assets	(140,000)		132,000
Deferred revenue	1,000,000		1,000,000
Accounts payable and accrued expenses	353,000	363,000	4,159,000
Net cash used in operating activities	(1,645,000)	(2,133,000)	(36,983,000)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Purchases of property and equipment	(91,000)	(10,000)	(4,963,000)
Investment in intangibles	(36,000)	(3,000)	(412,000)
Cash received in connection with Share Exchanges			20,000
Deposit on equipment		(119,000)	(371,000)
Proceeds from sale of assets			154,000
Net cash used in investing activities	(127,000)	(132,000)	(5,572,000)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Repayments of loans from financial institutions	(55,000)	(131,000)	(2,924,000)
Repayments of March 2005 12% debentures			(500,000)
Proceeds (repayment) of silent partnership loans			102,000
Proceeds (repayments) from related party loans	823,000		16,908,000
Proceeds from 10% convertible debentures, net of cost of issue			1,686,000
Proceeds from 12% convertible debentures, net of cost of issue		2,500,000	1,164,000
Proceeds from March 2005 12% debentures			2,500,000
Proceeds from series A & B units, net of cost of issue		476,000	4,026,000

Edgar Filing: LITHIUM TECHNOLOGY CORP - Form 10QSB

Proceeds from sale of 2005 units			298,000
Proceeds from sale of common stock	1,705,000		2,463,000
Proceeds (repayments) received from bridge notes	(350,000)		35,000
Proceeds from October 8% Convertible Debenture			2,765,000
Proceeds (repayments) from Portfolio Lenders	(200,000)		200,000
Proceeds received from non-convertible promissory notes from related party		908,000	14,211,000
Net cash provided by financing activities	1,923,000	3,753,000	42,934,000
Effect of exchange rate changes on cash	(33,000)	(3,000)	(218,000)
Net increase (decrease) in cash and cash equivalents	118,000	1,485,000	161,000
Cash and cash equivalents, beginning of period	46,000	226,000	3,000
Cash and cash equivalents, end of period	\$ 164,000	\$ 1,711,000	\$ 164,000

**SUPPLEMENTAL CASH FLOW INFORMATION**

Cash paid for interest	\$	\$ 40,000	\$ 678,000
Conversion of convertible debt into common stock			37,927,000
Conversion of convertible debt into preferred stock			3,545,000
Stock issued as dividend on convertible preferred stock			126,000
Warrants issued for services		178,000	952,000
Conversion bridge notes to debentures			3,000,000
Conversion of Series A and B notes into common stock		555,000	6,327,000
Conversion of January 2004 10% debentures into common stock		761,000	4,009,000
Capital contribution by affiliate of Arch Hill in lieu of debt payment			1,734,000
Exchange of preferred stock for convertible notes			4,545,000
Stock issued for interest			397,000
Stock issued for conversion of 8% convertible debentures			251,000
Conversion of October 2005 8% debenture into class A preferred stock			4,410,522
Exchange of subordinate loans related party for convertible debentures and warrants			4,410,522
Conversion of Series A preferred stock into common stock			575,000
Conversion price adjustment on October 2005 8% debenture	2,640,000		2,640,000

See accompanying notes to consolidated financial statements.

**Table of Contents**

**LITHIUM TECHNOLOGY CORPORATION**

**AND SUBSIDIARIES**

**(DEVELOPMENT STAGE COMPANIES)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and rules and regulations of the Securities and Exchange Commission (the "SEC") applicable to interim periods. In the opinion of management, all adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation have been included. These financial statements should be read in conjunction with the Company's financial statements included in the Company's Annual Report on Form 10-KSB filed with the Securities and Exchange Commission for the year ended December 31, 2005. Operating results for three months ended March 31, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006 or any interim period.

The accompanying unaudited condensed consolidated financial statements have not been reviewed by an independent public accountant. The audit of the Company's financial statements for the year ended December 31, 2005 has not yet been completed. After such audit is completed the accompanying financial statements for the quarter ended March 31, 2006 will be reviewed by the Company's independent public accountant.

**NOTE 2 ORGANIZATION, BUSINESS OF THE COMPANY AND RECENT DEVELOPMENTS**

In 2002, Lithium Technology Corporation ("LTC" or the "Company") closed share exchanges in which LTC acquired ownership of 100% of GAIA Holding B.V. ("GAIA Holding") from Arch Hill Ventures, NV, a private company limited by shares, incorporated under the laws of the Netherlands ("Arch Hill Ventures"), which is controlled by Arch Hill Capital NV ("Arch Hill Capital"), a private company limited by shares, incorporated under the laws of the Netherlands (the "Share Exchanges"). In November 2004, Arch Hill Capital and Arch Hill Ventures transferred all LTC securities owned by such entities to Stichting Gemeenschappelijk Bezit GAIA ("Stichting GAIA") and Stichting Gemeenschappelijk Bezit LTC ("Stichting LTC"), entities controlled by Arch Hill Capital.

Subsequent to the Share Exchanges, Arch Hill Capital effectively controls LTC. As a result, the Share Exchanges have been accounted for as a reverse acquisition, whereby for financial reporting purposes, GAIA Holding is considered the acquiring company. Hence, the historical financial statements of GAIA Holding became the historical financial statements of the Company and include the results of operations of LTC only from the acquisition date of October 4, 2002.

GAIA Holding, a private limited liability company incorporated under the laws of the Netherlands, is the 100% beneficial owner of GAIA Akkumulatorenwerke GmbH ("GAIA"). GAIA Holding was incorporated in 1990 and only had limited operations until the acquisition of GAIA on February 12, 1999 (inception of development stage). GAIA is a private limited liability company incorporated under the laws of Germany. GAIA Holding's ownership interest in GAIA is held through certain trust arrangements (see Note 3).

The date of inception of the Company's development stage is February 12, 1999. Prior to inception of development stage activities, the Company incurred accumulated losses of \$200,000, and these losses have been segregated from the Company's deficit accumulated during the development stage in the consolidated financial statements.

The Company considers itself to have one operating segment. The Company is a development and pilot-line production stage company that develops large format lithium-ion rechargeable batteries to be used as a new power source for emerging applications in the automotive, stationary power, and national security markets.

**NOTE 3 SIGNIFICANT ACCOUNTING POLICIES**

**BASIS OF CONSOLIDATION**

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated.



## **Table of Contents**

The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or classification of liabilities that might be necessary should the Company be unable to operate in the normal course of business.

GAIA Holding is the beneficial owner of all of the issued and outstanding shares of GAIA. Legal ownership of the outstanding shares of GAIA are held pursuant to certain Dutch and German trust agreements by two Netherlands entities (the Nominal Stockholders ) for the risk and account of GAIA Holding. Based on the Dutch and German trust agreements, the Nominal Stockholders are obligated to transfer the legal ownership of the shares in GAIA without any further payments to GAIA Holding. Pursuant to the trust agreements, GAIA Holding has the right to vote the shares of GAIA held by the Nominal Stockholders. The results of GAIA are included in the results of GAIA Holding as of the date of acquisition.

## **ESTIMATES AND UNCERTAINTIES**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ( generally accepted accounting principles ) requires management to make estimates and assumptions that 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 reporting period. Actual results, as determined at a later date, could differ from these estimates.

## **FAIR VALUE OF FINANCIAL INSTRUMENTS**

Fair value estimates, assumptions and methods used to estimate fair value of the Company s financial instruments are made in accordance with the requirements of SFAS No. 107, Disclosures about Fair Value of Financial Instruments. The Company has used available information to derive its estimates. However, because these estimates are made as of a specific point in time, they are not necessarily indicative of amounts the Company could realize currently. The use of different assumptions or estimating methods may have a material effect on the estimated fair value amounts.

The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable, accrued expenses and short-term notes payable approximate fair value due to the short-term nature of the instruments.

Long-term liabilities are comprised of the loans from financial institutions, related party loans and other long-term loans. The Company s long-term loans from financial institutions and other long-term loans approximate fair value.

## **CASH AND CASH EQUIVALENTS**

The Company considers all highly liquid investment instruments purchased with an initial remaining maturity of three months or less to be cash equivalents.

## **INVENTORIES**

Inventories primarily include raw materials and auxiliary materials required for the production process. Inventories are valued at the lower of cost or net realizable value. The cost of inventories is determined by using the weighted average method. Cost elements included in inventories comprise all costs of purchase and other costs incurred to bring the inventories to their present location and condition.

## **PROPERTY AND EQUIPMENT**

Property and equipment are recorded at cost and primarily consist of buildings, technical and lab equipment, furniture and office equipment and leasehold improvements. In the period assets are retired or otherwise disposed of, the costs and accumulated depreciation are removed from the accounts, and any gain or loss on disposal is included in results of operations. Property and equipment are depreciated using the straight-line method over their estimated useful lives as follows:

Buildings	25 years
Technical and laboratory equipment	7-14 years
Office equipment and other	1-5 years



## **Table of Contents**

### **INTANGIBLES**

Intangibles consist of amounts capitalized by GAIA for patents, which are recorded at cost and are amortized using the straight-line method over their estimated useful lives of 13 to 17 years commencing upon final approval by the foreign regulatory body. Intangibles also include amounts relating to the core patented technology of LTC, as determined by an independent valuation, in connection with the allocation of the purchase price resulting from the Share Exchanges. These intangibles are being amortized using the straight-line method over their estimated useful lives of 12 years commencing October 4, 2002.

### **CONVERTIBLE SECURITIES WITH BENEFICIAL CONVERSION FEATURES**

The Company accounts for debt with embedded conversion features and warrant issuances in accordance with EITF 98-5: Accounting for convertible securities with beneficial conversion features or contingency adjustable conversion and EITF No. 00-27: Application of issue No. 98-5 to certain convertible instruments. Conversion features determined to be beneficial to the holder are valued at fair value and recorded to additional paid in capital. The Company determines the fair values to be ascribed to detachable warrants issued with the convertible debentures utilizing the Black-Scholes method. Any discount derived from determining the fair value of the beneficial conversion features and the warrants is amortized to financing costs over the remaining life of the debenture. The unamortized discount, if any, upon the conversion of the debentures is expensed to financing cost on a pro-rata basis.

Debt issued with variable conversion features are considered to be embedded derivatives and are accountable for in accordance with FASB 133 Accounting for Derivative Instruments and Hedging Activities . The fair value of the embedded derivative is recorded to derivative liability. Thus liability is required to be marked each reporting period. The resulting discount on the debt is amortized to interest expense over the life of the related debt.

### **LONG-LIVED ASSETS**

The Company periodically evaluates the carrying value of long-lived assets when events and circumstances indicate the carrying amounts may not be recoverable. The carrying value of a long-lived asset is considered impaired when the anticipated undiscounted cash flows expected to result from the use and eventual disposition from such assets are less than the carrying value. If the sum of the expected cash flows (undiscounted and without finance charges) is less than the carrying amount of the asset, the Company recognizes an impairment loss on the asset. In that event, a loss is recognized for the amount by which the carrying value exceeds the fair value of the long-lived asset. Fair value is determined by quoted market prices in active markets, if available, or by using the anticipated cash flows discounted at a rate commensurate with the risks involved. The Company conducted an evaluation of the carrying values of its long-lived assets, specifically its patents, at the end of 2005. In performing this evaluation, the Company analyzed and confirmed the continued applicability of these patented technologies in the Company's products and their recoverability from projected future cash flows of the Company as embodied in the Company's internal strategic forecast.

### **INCOME TAXES**

Deferred tax assets and liabilities are computed for temporary differences between the financial statement and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates applicable to the periods in which the temporary differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

### **REVENUES**

The Company performs certain research and development for other companies and sells prototypes to third parties. Revenue is recognized as services are rendered or products are delivered, the price to the buyer is fixed and determinable, and collectibility is reasonably assured.



**Table of Contents****OTHER INCOME**

The Company receives subsidies from foreign governmental agencies to reimburse the Company for certain research and development expenditures. Subsidies are recorded as other income.

**FOREIGN CURRENCY TRANSLATION**

The functional currency for foreign operations is the local currency. For these foreign entities, the Company translates assets and liabilities at end-of-period exchange rates. The Company records these translation adjustments in cumulative other comprehensive income (loss), a separate component of equity in the consolidated balance sheet. For revenues, expenses, gains and losses, the weighted average exchange rate for the period is used to translate those elements.

**STOCK OPTIONS**

In accordance with Statement of Financial Accounting Standard ( SFAS ) No. 123, Accounting for Stock-based Compensation (SFAS No. 123), the Company has elected to account for stock option grants to employees using the intrinsic value based method prescribed by APB Opinion No. 25.

**NET LOSS PER COMMON SHARE**

The Company has presented net loss per common share pursuant to SFAS No. 128, Earnings Per Share . Net loss per common share is based upon the weighted average number of outstanding common shares. The Company has determined that the as-if converted common shares related to the preferred shares should be included in the weighted average shares outstanding for purposes of calculating basic earnings per share. These shares were converted to Common Stock during 2004. The Company made such determination because: 1) Arch Hill Capital, which controls the Company, has the ability to authorize the necessary shares for conversion; 2) the preferred shares have no significant preferential rights above the common shares; and 3) the preferred shares will automatically convert at a later date upon proper share authorization. As a result, weighted average shares outstanding included in the calculation of basic and diluted net loss per common share for the three months ended March 31, 2006 and 2005 was as follows:

	<b>Three Months Ended</b>	<b>Three Months Ended</b>
	<b>March 31, 2006</b>	<b>March 31, 2005</b>
Series B Preferred Stock	264,103,114	
Common Stock	350,230,744	59,259,391
<b>Total</b>	<b>614,333,858</b>	<b>59,259,391</b>

Due to net losses in the three months ended March 31, 2006 and 2005, the effect of the potential common shares resulting from convertible promissory notes payable, stock options and warrants in those years were excluded, as the effect would have been anti-dilutive.

The Company does not have enough shares of common stock authorized to issue shares of common stock to all holders of its convertible securities upon conversion of such securities. The Company intends to seek stockholder approval of an increase in the authorized number of shares of its common stock during the second fiscal quarter of 2006 to make available that number of shares of common stock as will be required for the conversion of all of the Company's outstanding convertible securities and securities which may be issued as part of a new financing. Although the Company's controlling stockholder has indicated its willingness to vote in favor of an increase in the authorized number of shares of Company common stock, no assurance can be given that the Company will be able to obtain a stockholder vote in favor of such an increase in a timely manner.

**Table of Contents**

**RECENT ACCOUNTING PRONOUNCEMENTS**

On December 16, 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 123(R), *Share-Based Payment* , which is a revision of SFAS No. 123 and supersedes APB Opinion 25. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be valued at fair value on the date of grant, and to be expensed over the applicable vesting period. Pro forma disclosure of the income statement effects of share-based payments is no longer an alternative. SFAS No. 123(R) is effective for all stock-based awards granted on or after January 1, 2006. In addition, companies must also recognize compensation expense related to any awards that are not fully vested as of the effective date. Compensation expense for the unvested awards will be measured based on the fair value of the awards previously calculated in developing the pro forma disclosures in accordance with the provisions of SFAS No. 123.

The Company plans to adopt SFAS No. 123(R) on January 1, 2006. This change in accounting is not expected to materially impact its financial position. The Company has not completed the calculation of this impact. However, because the Company currently accounts for share-based payments to its employees using the intrinsic value method, its results of operations have not included the recognition of compensation expense for the issuance of stock option awards.

On December 16, 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets* , which is an amendment to APB Opinion No. 29. It states that the exchanges on nonmonetary assets should be measured based on the fair value of the assets exchanged. Further, FSAS No. 153 eliminates the narrow exception for nonmonetary exchanges of similar productive assets and replaces it with a broader exception for exchanges of nonmonetary assets that do not have commercial substance . FSAS No. 153 is effective for financial statements for fiscal years beginning after June 15, 2005. The Company does not normally enter into exchanges that could be considered nonmonetary, accordingly, we do not expect the adoption of SFAS 153 to have a material impact on the Company s financial statements.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* a replacement of APB Opinion No. 20 and FASB Statement No. 3 ( SFAS No. 154 ). SFAS No. 154 requires retrospective application as the required method for reporting a change in accounting principle, unless impracticable or a pronouncement includes specific transition provisions. SFAS No. 154 also requires that a change in depreciation, amortization or depletion method for long-lived, nonfinancial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. This statement carries forward the guidance in APB Opinion No. 20, *Accounting Changes*, for the reporting of the correction of an error and a change in accounting estimate. SFAS No. 154 is effective beginning January 1, 2006. SFAS No. 154 is not expected to have a significant impact on our financial position, results of operations or cash flows.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* an amendment of FASB Statements No. 133 and 140 . SFAS No. 155 resolves issues addressed in SFAS No. 133 Implementation Issue No. D1, *Application of Statement 133 to Beneficial Interests in Securitized Financial Assets* . SFAS No. 155 will become effective for the Company s fiscal year after September 15, 2006. The impact of SFAS No. 155 will depend upon the nature and extent of any new derivative instruments entered into after the effective date.

In June 2005, the FASB ratified Emerging Issues Task Force ( EITF ) Issue No. 05-2, *The Meaning of `Conventional Convertible Debt Instrument` in EITF No. 00-19, `Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock` ( EITF No. 05-2 )*, which addresses when a convertible debt instrument should be considered `conventional` for the purpose of applying the guidance in EITF No. 00-19. EITF No. 05-2 also retained the exemption under EITF No. 00-19 for conventional convertible debt instruments and indicated that convertible preferred stock having a mandatory redemption date may qualify for the exemption provided under EITF No. 00-19 for conventional convertible debt if the instrument s economic characteristics are more similar to debt than equity. EITF No. 05-2 is effective for new instruments entered into and instruments modified in periods beginning after June 29, 2005. The Company has applied the requirements of EITF No. 05-2 since the required implementation date. The adoption of this pronouncement did not have an impact on the Company s consolidated financial position, results of operations or cash flows.

---

**Table of Contents**

EITF Issue No. 05-4 The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to EITF Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock (EITF No. 05-4) addresses financial instruments, such as stock purchase warrants, which are accounted for under EITF 00-19 that may be issued at the same time and in contemplation of a registration rights agreement that includes a liquidated damages clause. The consensus for EITF No. 05-4 has not been finalized. The adoption of this pronouncement is not expected to have an impact on the Company's consolidated financial position, results of operations, or cash flows.

In September 2005, the FASB ratified the EITF's Issue No. 05-7, Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues (EITF 05-7), which addresses whether a modification to a conversion option that changes its fair value effects the recognition of interest expense for the associated debt instrument after the modification, and whether a borrower should recognize a beneficial conversion feature, not a debt extinguishment, if a debt modification increases the intrinsic value of the debt (for example, the modification reduces the conversion price of the debt). The adoption of this pronouncement did not have an impact on the Company's consolidated financial position, results of operations or cash flows.

In September 2005, the FASB ratified the following consensus reached in EITF Issue 05-8: a) The issuance of convertible debt with a beneficial conversion feature results in a basis difference in applying FASB Statement of Financial Accounting Standards SFAS No. 109. This consensus is effective in the first interim or annual reporting period commencing after December 15, 2005, with early application permitted. The effect of applying the consensus should be accounted for retroactively to all debt instruments containing a beneficial conversion feature that are subject to EITF Issue 00-27 (and thus is applicable to debt instruments converted or extinguished in prior periods but which are still presented in the financial statements). The adoption of this pronouncement did not have an impact on the Company's consolidated financial position, results of operations or cash flows.

**NOTE 4 OPERATING AND LIQUIDITY DIFFICULTIES AND MANAGEMENT'S PLANS TO OVERCOME**

Over the past four years, the Company has refocused its unique extrusion-based manufacturing process, cell technology, large battery assembly expertise, and market activities to concentrate on large-format, high rate battery applications. The Company's commercialization efforts are focused on applying its lithium-ion rechargeable batteries in the national security, transportation and stationary power markets.

The Company's operating plan seeks to minimize its capital requirements, but expansion of its production capacity to meet increasing sales and refinement of its manufacturing process and equipment will require additional capital. The Company expects that operating and production expenses will increase significantly as it continues to ramp up its production and continues its battery technology and develops, produces, sells and licenses products for commercial applications.

The Company has recently entered into a number of financing transactions (see Notes 7, 9 and 12). The Company is continuing to seek other financing initiatives. The Company needs to raise additional capital to meet its working capital needs, for the repayment of debt and for capital expenditures. Such capital is expected to come from the sale of securities, including the sale of common stock under the Standby Equity Distribution Agreement. (See Note 9) The Company believes that if it raises approximately \$15 million in debt and equity financings, including, under the Standby Equity Distribution Agreement, it would have sufficient funds to meet its needs for working capital and repayment of debt (approximately \$11 million) and for capital expenditures (approximately \$4 million) over the next twelve months.

No assurance can be given that the Company will be successful in completing any financings at the minimum level necessary to fund its capital equipment, debt repayment or working capital requirements, or at all. If the Company is unsuccessful in completing these financings, it will not be able to meet its working capital, debt repayment or capital equipment needs or execute its business plan. In such case the Company will assess all available alternatives including a sale of its assets or merger, the suspension of operations and possibly liquidation, auction, bankruptcy, or other measures.

**Table of Contents****NOTE 5 PROPERTY AND EQUIPMENT**

Property and equipment at March 31, 2006 and December 31, 2005 is summarized as follows:

	March 31	December 31 (Unaudited)
Land and buildings	2,617,000	2,617,000
Technical and laboratory equipment	5,774,000	5,710,000
Asset under construction and equipment deposit	145,000	201,000
Office equipment and other	647,000	638,000
	9,183,000	9,166,000
Less: Accumulated depreciation and amortization	(3,760,000)	(3,747,000)
	5,423,000	5,419,000

Assets under construction at March 31, 2006 included equipment being constructed that was not yet placed into service.

**NOTE 6 INTANGIBLES**

Intangibles at March 31, 2006 and December 31, 2005 are summarized as follows:

	March 31	December 31 (Unaudited)
Patents	\$ 10,066,000	\$ 10,148,000
Less: Accumulated amortization	(2,903,000)	(2,770,000)
Total	\$ 7,163,000	\$ 7,378,000

Intangibles consist primarily of amounts relating to the core patented technology of LTC, as determined by an independent valuation, in connection with the allocation of the excess purchase price resulting from the Share Exchanges (see Note 2). Intangibles also include patents held by GAIA Holding.

Amortization expense on intangible assets was \$208,000 and \$849,000, respectively, in the three months ended March 31, 2006 and the year ended December 31, 2005. Estimated future amortization expense on intangible assets for the next five years, at March 31, 2006, is approximately \$840,000 per year.

**NOTE 7 LONG-TERM DEBT**

	March 31, 2006
Long-term debt is summarized as follows:	
March 2005 12% Convertible Debenture	\$ 2,000,000
8% Convertible Notes	47,000
Derivative Liability	1,000
Bridge Notes	35,000
October 2005 8% Debenture	120,000
Portfolio Lenders Convertible Note	166,000
Loans from Financial Institutions	1,574,000
Subordinated Loans from related party	5,391,000
Silent Partner Loans	2,347,000

Edgar Filing: LITHIUM TECHNOLOGY CORP - Form 10QSB

Total Debt	\$ 11,681,000
Less: Current maturities	(2,791,000)
Total Long-term debt	\$ 8,890,000

---

**Table of Contents**

**MARCH 2005 12% DEBENTURE**

On March 11, 2005, the Company entered into a debenture purchase agreement with a third party lender, pursuant to which the Company issued debentures in the principal amount of \$2,500,000. Pursuant to an amendment dated January 31, 2006, the original maturity date of June 15, 2006 was amended to December 31, 2006 and the original interest rate of 12% per year was amended to 15% per year effective as of October 15, 2005. No monthly payments of principal or interest are due and owing by the Company prior to December 31, 2006.

In connection with the debenture purchase agreement, the Company entered into an escrow agreement under which put notices under the standby equity distribution agreement were deposited and certain monies received under that agreement will be received and forwarded to the debentureholder if the Company does not repay the debenture from other sources of capital. As of March 31, 2006 \$2,000,000 in principal of the debentures was outstanding.

**8% CONVERTIBLE NOTES**

During the year ended December 31, 2005, the Company sold \$298,000 of equity units (the 2005 Units ) in a private placement. Each 2005 Unit, with a purchase price of \$1,000 per Unit, consists of a convertible promissory note in the principal amount of \$1,000 (the 8% Notes ) and one warrant for each share of common stock issued upon conversion of the 8% Notes to purchase one-half share of Company common stock. The 8% Notes are entitled to receive an 8% annual interest payment payable in shares of Company common stock.

During the year ended December 31, 2005, \$251,000 principal of 8% Notes were converted into an aggregate of 5,020,000 shares of common stock at a conversion price of \$0.05 per share and 1,198 shares of common stock were issued to the convertible Noteholders for interest payable in shares. The converting Noteholders were issued warrants to purchase 2,510,000 shares of common stock in the aggregate, at \$0.0675 per share. As of March 31, 2006, \$47,000 in principal of 8% Notes were outstanding.

The 8% Notes are convertible at the election of the holder thereof, at any time commencing from and after their date of issuance and for a period of three years thereafter at a price equal to 85% of the average closing price of Company common stock on the OTC-BB for the 20 trading days immediately preceding the day upon which the Company receives a conversion notice from the Noteholder. The per share exercise price of the warrant will be 135% of the conversion price of the 8% Notes.

The conversion feature resulted in the units being issued with an embedded derivative. Accordingly, the Company recorded \$53,000 as a derivative liability and a corresponding deemed dividend.

**OCTOBER 2005 8% DEBENTURE**

On October 7, 2005, the Company entered into a Securities Purchase Agreement with Cornell Capital Partners LP pursuant to which the Company issued convertible debentures in the principal amount of \$3,000,000 with an original conversion price equal to \$0.06 per share. The debentures have a one-year term and accrue interest at 8% per year.

On January 31, 2006, the Company entered into an amendment of the debenture held by Cornell Capital (the First Amendment ) which provided that all payments of principal and accrued interest on the debenture otherwise due on or before March 15, 2006 were due on March 15, 2006. The First Amendment also provided that in the event the Company closes on any debt or equity financing, the Company must use fifty percent of the proceeds of the new financing (net of placement fees and commissions) to repay principal and interest outstanding under the debenture.

The First Amendment further provided that in the event the Company did not repay all outstanding principal and accrued interest on the debenture on March 15, 2006, (i) the Company must repay \$900,000 of principal and accrued interest on March 15, 2006 and repay the balance of the outstanding principal and interest on the debenture over seven equal payments commencing April 1, 2006 until October 1, 2006, and (ii) the exercise price of the 20,000,000 Warrants issued to Cornell Capital in connection with the debenture would be reduced to \$0.0128 on a pro-rata basis in relation to the amount of principal of the debenture not repaid by the Company as of March 15, 2006.

---

**Table of Contents**

The First Amendment also provided that at any time prior to March 15, 2006 the Company could at its option with three business days advance written notice redeem a portion or all amounts outstanding under the debenture in an amount equal to the principal amount outstanding and accrued interest being redeemed. No redemption premium was due by the Company for a redemption of the debenture prior to March 15, 2006. The debenture was not convertible from January 31, 2006 through March 15, 2006 provided the Company was current on its payment obligations under the debenture. In consideration of the First Amendment of the debenture and related agreements, the Company paid Cornell Capital a fee of \$100,000 and recorded this fee as a debt issue cost to be amortized over the life of the debenture. As of March 15, 2006, \$3,000,000 in principal plus accrued interest was outstanding on the debenture.

On March 21, 2006, the Company entered into a second amendment with Cornell Capital (the **Second Amendment**) whereby the Company amended the following provisions of the debenture. All payments of principal and accrued interest on the debenture otherwise due on or before March 15, 2006 are due on June 15, 2006. In the event the Company closes on any debt or equity financing the Company must use fifty percent (50%) of the proceeds of the new financing (net of placement fees and commissions) to repay principal and interest outstanding under the debenture. In the event the Company does not repay all outstanding principal and accrued interest on the debenture on June 15, 2006, the Company must repay \$1,800,000 of principal and accrued interest on June 15, 2006 and repay the balance of the outstanding principal and interest on the debenture over four equal monthly payments commencing July 1, 2006 until October 1, 2006.

The Second Amendment further provides that the debenture is convertible from March 21, 2006 with four business days advance written notice (the **Advance Conversion Notice**) and after June 15, 2006, the debentures are convertible without delivery of an Advance Conversion Notice. The conversion price of the debenture was reduced from \$0.06 to \$0.03 per share as of March 21, 2006, provided, however, if there is an Event of Default under the debenture the conversion price will be reduced to \$0.0128. The Company calculated the additional beneficial conversion feature to be \$2,640,000 under EITF 00-27: Application of Issue 98-5 to Certain Convertible Instruments. \$1,364,000 of this beneficial conversion feature was recorded as additional debt discount with the remainder carried to earnings in the current period. At any time from March 21, 2006, including after receipt of an Advance Conversion Notice and before the expiration of the four business day advance notice period, the Company may, at its option, redeem a portion or all amounts outstanding under the debenture in an amount equal to the principal amount outstanding and accrued interest being redeemed and a payment of a premium by the Company equal to fifteen percent (15%) of the redemption amount subject to two (2) business days advanced written notice for any redemption on or before June 15, 2006 and subject to three (3) business days advanced written notice for any redemption after June 15, 2006.

In the Second Amendment, the Company amended the Warrants issued to Cornell Capital in connection with the debenture to purchase an additional 20,000,000 shares of common stock for a total of 40,000,000 shares. The exercise price of the 40,000,000 warrant shares was reduced to \$0.03 per share, provided, however that in the event the Company does not repay all outstanding principal and accrued interest on the debenture on June 15, 2006, then on June 15, 2006 the exercise price of the Warrants will be reduced to \$0.0128 on a pro-rata basis in relation to the amount of principal of the debenture not repaid by the Company as of June 15, 2006. The Company recorded an additional charge to earnings upon the issuance of the additional 20,000,000 warrants of \$300,000 during the current period. In addition, the Company determined that the warrant price reset resulted in no additional incremental value being attributable to the debenture.

The Company entered into a Pledge and Escrow Agreement pursuant to which the Company agreed to issue to Cornell Capital shares of common stock in the event of default under the debenture as security for its obligations thereunder. The Company also granted Cornell Capital a security interest in the assets of LTC. In the event of default, Cornell Capital, in addition to any other remedies, may convert any or all of the outstanding principal of the debentures into common stock at a fixed conversion price equal to \$0.0128 per share (234,375,000 million shares).

Commissions paid to Cornell Capital in connection with this transaction at the time of execution of the Securities Purchase Agreement included 7.5% cash compensation in the form of a discount to the purchase price of the debentures, or \$225,000, and five-year warrants to purchase 20,000,000 shares of common stock at the following exercise prices: 10,000,000 at \$0.06 per share, 5,000,000 at \$0.07 per share and 5,000,000 at \$0.10 per share. The Company also paid structuring fees to Yorkville Advisors Management of \$10,000. The convertible debenture was issued with a \$3,000,000 discount due to the fair value ascribed to the detachable warrants utilizing the Black

**Table of Contents**

Scholes method and the related beneficial conversion feature. The discount is being amortized as interest expense over the one year life of the debenture and \$777,000 is reflected in interest expense related to beneficial conversion for the three months ended March 31, 2006.

As of March 31, 2006, \$3,000,000 in principal of the debentures was outstanding.

**PORTFOLIO LENDERS II, LLC CONVERTIBLE NOTE**

On December 6, 2005, the Company entered into a Bridge Loan Agreement pursuant to which the Company issued convertible notes in the principal amount of \$400,000 (the Notes) to Portfolio Lenders II, LLC (the Noteholder) in a private placement. The Notes are convertible at the option of the Noteholder any time up to maturity at a conversion price equal to \$0.50 per share. The Notes bear interest at 15% per annum, of which \$22,500, representing ninety days of interest, was prepaid by the Company on the closing date. During the quarter ended March 31, 2006, \$200,000 in principal and \$1,726 of interest was repaid on the Notes. As of March 31, 2006, there was \$200,000 in principal outstanding under the Notes, which is repayable on the earliest of June 14, 2006 or two business days of the closing date of an investment of at least \$3 million in the Company.

In connection with the issuance of the Notes, the Company entered into an escrow agreement under which put notices under the Standby Equity Distribution Agreement were deposited and certain monies received under that agreement will be received and forwarded to the Noteholder. As additional security, the Company has agreed to pledge to the Noteholder 14,000,000 shares of Company common stock once the Company has sufficient shares of common stock available for issuance.

Commissions to the Noteholder in connection with this transaction included 5% cash compensation in the form of a discount to the purchase price of the notes, or \$20,000, and five-year warrants to purchase 2,000,000 shares of Company common stock at \$0.03 per share. The convertible note was issued with a \$80,000 discount due to the fair value ascribed to the detachable warrants utilizing the Black Scholes method. The discount is being amortized as financing costs over the six month life of the debenture and is reflected in interest expense beneficial conversion feature on the accompanying consolidated statement of operation.

**DERIVATIVE LIABILITY**

The following table summarizes the activity within the derivative liability for the three months ended March 31, 2006:

Balance as of December 31, 2005	1,000
Issuances:	
Conversions:	
Balance as of March 31, 2006	1,000

**BRIDGE NOTES**

The bridge notes were issued under a Bridge Financing Agreement, as amended, between LTC and Arch Hill Capital (the Bridge Financing Agreement). As of March 31, 2006, \$35,000 of advances were outstanding under the Bridge Financing Agreement. The Notes bear interest at 6% per annum. The Bridge Financing Agreement does not contain a maximum amount of funding that may be advanced under such Agreement. The amount of any additional notes provided will be related to the working capital advances made by Arch Hill Capital to the Company.

**LOANS FROM FINANCIAL INSTITUTIONS**

GAIA has loans from financial institutions, which totaled \$1,574,000 as of March 31, 2006, that are collateralized by the following assets of GAIA: (i) land and buildings in an amount up to \$1,140,000 and (ii) machinery, equipment and patents in an amount of \$2,436,000 as collateral for the mortgage loan. The loans bear interest between 5.75% and 6.75% per annum and are scheduled to be repaid by December 31, 2014.



---

**Table of Contents**

**SUBORDINATED LOANS FROM RELATED PARTY**

GAIA has received subordinated loans from Arch Hill Ventures, a related party, which totaled \$5,391,000 as of March 31, 2006. The loans bear cumulative interest at 6% per annum. Under the subordinated loan agreement (the Subordinated Loan Agreement ) terms, the loans can be called when GAIA does not have negative stockholders equity. The loans are subordinated to all other creditors of GAIA.

**SILENT PARTNERSHIP LOANS-NON-RELATED PARTIES**

Two other parties have provided silent partnership loans to GAIA which remain outstanding at March 31, 2006. Frankendael Participatiemaatschappij NV ( Frankendael ) has provided a partnership loan of \$481,000, which bears interest at 6% per annum. Technologie-Beteiligungs-Gesellschaft GmbH der Deutschen Ausgleichsbank ( TBG ) has provided a partnership loan of \$1,850,000, which bears interest at 6% per annum. GAIA is not required to pay the interest under the Frankendael Partnership Agreement until GAIA has generated an accumulated profit amounting to \$4,627,000. The total amount payable to Frankendael and TBG under the Partnership Agreements at March 31, 2006 is \$2,347,000.

Frankendael and TBG are entitled to receive an annual 12% share in profits related to its contributions under the Frankendael Partnership Agreement and the TBG Partnership Agreement. The 12% share in profits under the Frankendael Partnership Agreement is not payable until GAIA has generated an accumulated profit amounting to \$4,627,000. The TBG Partnership Agreement provides that should GAIA receive additional injections of capital in the course of further financing rounds, TBG shall adjust its profit sharing to the capital ratio applicable at such time. Management believes that based upon subsequent equity received by GAIA that the present profit sharing that TBG is entitled to under the Agreement is approximately 4.4%. Management further believes that it is unlikely that Frankendael or TBG will receive any profit sharing under the Partnership Agreement at any time in the near future.

From March 8, 2005 under the TBG Partnership Agreement, TBG is entitled to demand a non-recurrent remuneration of 30% of the amount invested plus 6% of the amount invested at the end of the period of participation for each year after the expiration of the fifth full year of participation under certain circumstances relating to the economic condition of GAIA.

The Frankendael Partnership Agreement and the TBG Partnership Agreement each terminates in December 2008, unless terminated prior to such time for good cause as defined in the applicable partnership agreement.

The principal, accrued and unpaid interest, and unpaid profits, if any, are due on the termination of the Frankendael Partnership Agreement and the TBG Partnership Agreement.

**NOTE 8 COMMITMENTS AND CONTINGENCIES**

**BUILDING LEASE**

The Company leases a 12,400 square foot research facility and corporate headquarters in a freestanding building at 5115 Campus Drive in Plymouth Meeting, Pennsylvania pursuant to a Lease Agreement dated July 22, 1994, as amended, between PMP Whitemarsh Associates and the Company. The Company is currently leasing the facility under a one-year lease extension that ends on March 31, 2007. The annual rent under the lease is \$156,000 from April 1, 2006 to March 31, 2007.

**EMPLOYMENT AND CONSULTING AGREEMENTS**

On June 20, 2005, the Board of Directors approved the employment of Andrew J. Manning for a period of three years as the President and Chief Operating Officer of Lithium Technology Corporation at a salary of \$275,000 per year retroactive to January 1, 2005.

On June 20, 2005, the Board of Directors approved the employment of William F. Hackett for a period of three years as the Chief Financial Officer, Executive Vice President and Treasurer of Lithium Technology Corporation at a salary of \$275,000 per year, with an annual discretionary bonus of up to 25% of Mr. Hackett s salary (with a minimum of \$34,375 for 2005).

## **Table of Contents**

GAIA entered into an Agreement with Dr. Klaus Brandt providing for an annual salary of 170,000 (\$253,545) from April 1, 2005 through December 31, 2007 with respect to the services of Dr. Brandt as the Managing Director of GAIA.

GAIA had entered into a four year Consultancy Agreement with RTU Ralf Tolksdorf Unternehmensberatung GmbH (the RTU Consultancy Agreement) effective September 1, 2002 with respect to the services of Ralf Tolksdorf as the Managing Director of Finances, Organization etc. of GAIA. RTU represented Mr. Tolksdorf. The RTU Consultancy Agreement was terminated and GAIA and Mr. Tolksdorf entered into a Services Agreement pursuant to which Mr. Tolksdorf has been employed as a Managing Director of GAIA. The agreement has a term of June 1, 2005 through May 31, 2008 and provides for an annual salary of 168,000 (\$250,562).

LTC had a services agreement with Bridgehead Partners as extended, from June 1, 2004 to June 30, 2005 pursuant to which Bridgehead Partners performed financial reporting and related services. John J. McGovern, Chief Financial Officer of LTC from June 25, 2004 through June 20, 2005, is the Chairman and Managing Director of Bridgehead Partners. From January 1, 2005 through June 30, 2005 the Company paid a \$15,000 per month retainer to Bridgehead Partners. Mr. McGovern also received a \$35,000 performance bonus and five year fully vested warrants for 200,000 shares of LTC common stock with an exercise price of \$0.064. The original Bridgehead Partners services agreement provided for a \$10,000 per month retainer from June 1, 2004 through December 31, 2004 and five year warrants for 100,000 shares of LTC common stock with an exercise price of \$1.91. Mr. McGovern resigned as Chief Financial Officer of LTC as of June 20, 2005.

## **FINANCIAL ADVISORY AGREEMENT**

On February 1, 2006, the Company entered into a Financial Advisory and Investment Banking Agreement with North Coast Securities Corporation ( North Coast ) for a term of one year. North Coast will provide the Company with advice regarding investor and public relations, shareholder communications, corporate structure and finance and acquisitions, dispositions and other similar transactions for a 12-month period pursuant to the agreement. For its services under the agreement, North Coast received an initial payment of \$15,000 and is entitled to a monthly fee of \$10,000 and five year warrants to purchase 500,000 shares of Company common stock at an exercise price of \$0.04 per share, which was issued on May 12, 2006.

## **NOTE 9 STOCKHOLDER S EQUITY**

### **AUTHORIZED SHARES**

The Company is authorized to issue 750 million shares of the common stock and 100 million shares of preferred stock. Of the 100 million authorized shares of preferred stock, the Company designated 1,000 shares as Series A Convertible Preferred Stock, which the Company delivered to an investor in the private placement of A Units which concluded in January 2005 and 100,000 shares of Series B Convertible Preferred Stock which the Company delivered to Arch Hill Capital in connection with a debt exchange in October 2005.

### **SERIES A PREFERRED STOCK**

The Company has authorized and outstanding 1,000 shares of Series A Preferred Stock, which were issued on August 1, 2005. The shares of Series A Preferred Stock are entitled to receive an 8% annual cumulative dividend payable in shares of Company common stock at the conversion price of the stock.

The Series A Preferred Stock is convertible at the election of the holder thereof, at any time until November 19, 2007 at a conversion price equal to 80% of the average closing price of Company common stock on the OTC Bulletin Board for the 20 trading days immediately preceding the day upon which the Company receives a conversion notice from the Series A Preferred Stockholder. The Series A Preferred Stock will be automatically converted into Company common stock on November 19, 2007 if not converted by the holder prior to that date.

---

**Table of Contents**

**SERIES B PREFERRED STOCK**

The Company has authorized and outstanding 100,000 shares of Series B Convertible Preferred Stock, which were issued on November 14, 2005. The shares of Series B Convertible Preferred Stock are not entitled to receive dividends in shares of the Company's common stock. The 100,000 shares of convertible preferred stock are convertible into an aggregate of 264,103,114 shares of common stock and have voting rights equal to 264,103,114 shares of common stock.

**12% DEBENTURES**

On June 9, 2005, the Company entered into a Debenture Purchase Agreement with an investor, pursuant to which the Company issued \$1,200,000 of convertible debentures and \$150,000 of convertible debentures as compensation for the transaction (together, the 12% Debentures). The 12% Debentures have a two year term and accrue interest at 12% per year payable in arrears in shares of Company stock at the conversion price at conversion or maturity.

Commencing on December 9, 2005 until June 9, 2007, the 12% Debentures are convertible at the option of the holder into shares of Company common stock at a conversion price equal to \$0.05 per share. The 12% Debentures are not repayable in cash and will be automatically converted into shares of Company common stock at maturity at the conversion price. In no event is the holder entitled to convert the debentures for a number of shares of Company common stock in excess of that number of shares of common stock which, upon giving effect to such conversion, would cause the aggregate number of shares of common stock beneficially owned by the holder and its affiliates to exceed 4.99% of the outstanding shares of Company common stock following such conversion (unless the holder provides the Company with sixty five (65) days prior written notice that this provision shall not apply). Since these debentures are not repayable in cash, they are reflected as equity (12% convertible debentures) in the financial statements of the Company.

The 12% Debenture holder received 4,532,836 warrants to purchase Company common stock at exercise prices ranging from \$0.66 to \$0.024 per share. The warrants were originally issued to the finder in the January 2004 debenture financing and subsequently transferred to the 12% Debenture holder. The warrants are exercisable until January 20, 2009.

The conversion feature resulted in the debentures being issued with an embedded derivative. Accordingly, the Company has recorded approximately \$405,000 of the proceeds received to additional paid-in capital based on the fair value of the embedded beneficial conversion feature. The \$405,000 discount will be recognized as a deemed dividend over the six month period to the earliest conversion date. Additionally, the discount related to the \$150,000 of compensation plus \$36,000 of fees and \$30,000 (4,532,836 warrants) of warrants issued in connection with issuing the debentures will be recognized as a deemed dividend over the two year life of the debentures or the conversion date, whichever ever is earlier.

**STANDBY EQUITY DISTRIBUTION AGREEMENT**

On March 11, 2005, the Company entered into a Standby Equity Distribution Agreement with Cornell Capital pursuant to which it may, at its discretion, periodically sell to Cornell Capital shares of Company common stock for a total purchase price of up to \$15,000,000. Subject to certain conditions, the Company is entitled to draw down under on the Standby Equity Distribution Agreement now that the common stock to be issued thereunder is registered with the Securities and Exchange Commission and the registration statement has been declared effective. The purchase price for the shares is equal to 98% of the lowest volume weighted average price of Company common stock for the five days following the date the Company delivers a notice requiring Cornell Capital to purchase Company shares under the Standby Equity Distribution Agreement. Cornell Capital is entitled to retain a fee at each advance of 5% of the gross proceeds.

Cornell Capital Partner's obligation to purchase shares of Company common stock under the Standby Equity Distribution Agreement is subject to certain conditions, including the Company maintaining an effective registration statement for shares of common stock sold under the Standby Equity Distribution Agreement and is limited to \$200,000 per weekly advance and \$800,000 per 30 days.

**Table of Contents**

During the period January 1, 2006 through March 31, 2006, the Company sold 83,894,765 shares of common stock to Cornell Capital for \$1,800,000 pursuant to the Standby Equity Distribution Agreement at prices ranging from \$0.0161 to \$0.0280. Of such proceeds, the Company paid commitment fees to Cornell Capital of 5% of the gross proceeds, or \$90,000 in the aggregate and the Company paid structuring fees to Yorkville Advisors Management aggregating \$5,000, with net proceeds to the Company of \$1,705,000 from such sales.

As of March 31, 2006, the Company sold an aggregate of 102,099,366 shares of common stock to Cornell Capital for \$2,600,000 pursuant to the Standby Equity Distribution Agreement since August 2005 at prices ranging from \$0.0161 to \$0.0647 per share. Of such proceeds, the Company paid commitment fees to Cornell Capital of 5% of the gross proceeds, or \$130,000 in the aggregate and the Company paid structuring fees to Yorkville Advisors Management aggregating \$6,500, with net proceeds to the Company of \$2,132,000, net of 373,000 of debt issue costs, from such sales.

**NOTE 11 SEGMENTS****Segment Information**

SFAS No. 131, Disclosure About Segments of an Enterprise and Related Information (SFAS 131), defines operating segments as components of an enterprise for which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Based on the way it organizes its business for making operating decisions and assessing performance, the Company has determined that it has two separable reportable operating segments.

Management reviews its Domestic Operations and its European Operations to evaluate performance and resources. Management has aggregated its operations into one industry segment since its Domestic and European Operations are similar and meet the aggregation criteria of SFAS 131, Disclosures about segments of an enterprise and related information .

Geographic information is as follows:

	<b>Three Months Ended</b>	
	<b>March 31, 2006</b>	
<b>Revenues</b>		
Domestic Operations	\$	310,000
European Operations		358,000
Long-lived assets, net	\$	668,000
Domestic Operations		7,312,000
European Operations		5,274,000
	\$	12,586,000

**NOTE 12 SUBSEQUENT EVENTS****STANDBY EQUITY DISTRIBUTION AGREEMENT**

During the period April 1, 2006 through May 5, 2006, the Company sold 36,166,432 shares of common stock to Cornell Capital for \$600,000 pursuant to the Standby Equity Distribution Agreement at prices ranging from \$0.0166 to \$0.0130. Of such proceeds, the Company paid commitment fees to Cornell Capital of 5% of the gross proceeds, or \$30,000 in the aggregate and the Company paid structuring fees to Yorkville Advisors Management aggregating \$1,500, with net proceeds to the Company of \$586,500 from such sales.

**MAY 2006 12% CONVERTIBLE DEBENTURES**

On May 4, 2006, the Company sold \$500,000 of equity units (the 2006 Units ) in a private placement. Each 2006 Unit, with a purchase price of \$100,000 per unit, consists of (i) a 12% convertible debenture in the principal amount of \$100,000 (the 12% Debentures ), (ii) 100,000 warrants

Edgar Filing: LITHIUM TECHNOLOGY CORP - Form 10QSB

to purchase Company common stock at an exercise price of \$0.20 per share (the .20 Warrants ), (iii) 100,000 warrants to purchase Company common stock at an exercise

---

**Table of Contents**

price of \$0.25 per share (the ".25 Warrants"), and (iv) 50,000 warrants to purchase Company common stock at an exercise price equal to the Conversion Price (as defined below) of the 12% Debentures (the "Conversion Price Warrants"). The 12% Debentures are entitled to receive a 12% annual interest payment payable semi-annually at the option of the Company in cash or shares of Company common stock valued at the then applicable conversion price of the 12% Debentures on June 30 and December 31 of each year beginning on December 31, 2006 or at the time of conversion of the principal to which such interest relates.

The holder of the 12% Debentures has a one-time conversion right during the period from May 4, 2006 through the date 30 days after the registration statement covering the shares of common stock underlying the 2006 Units is declared effective with the United States Securities and Exchange Commission (the "First Conversion Period") to convert the 12% Debentures at a price equal to 100% of the average closing price of Company common stock on the OTC-BB for the 30 trading days immediately preceding the day upon which the Company receives a conversion notice from such Debentureholder (the "First Conversion Period Price"). After the First Conversion Period the 12% Debentures are convertible at the election of the holder, at any time after November 4, 2007 and through May 3, 2010 (the "Second Conversion Period") at a price equal to 100% of the average closing price of Company common stock on the OTC-BB for the 30 trading days immediately preceding the day upon which the Company receives a conversion notice from the 12% Debentureholder, provided however, the conversion price during the Second Conversion Period will not be lower than \$0.25 per share or higher than \$0.50 per share (the "Second Conversion Period Price").

The unpaid principal amount of the Debentures plus accrued and unpaid interest will be due on May 4, 2010 if the Debentures have not been converted by the holder or redeemed by the Company prior to that date (the "Maturity Date"). The Debentures are redeemable by the Company at any time prior to the Maturity Date of May 4, 2010 by payment of the unpaid principal amount of the Debentures plus accrued and unpaid interest plus a redemption premium equal to 50% of the principal amount of the Debentures being redeemed (the "Redemption Price"). No redemption premium is due on the repayment of the Debentures on the Maturity Date of May 4, 2010.

The \$0.20 and \$0.25 Warrants are exercisable for a period of five years commencing on November 4, 2007. The Conversion Price Warrants are exercisable by the Debentureholder for a period of five years commencing on or after the date subsequent to November 3, 2007 on which all of the Debentures have been converted and through November 4, 2012. If the Debentureholder does not convert all of the Debentures by the Maturity Date of May 4, 2010, the Conversion Price Warrants will be cancelled on that date. The \$0.20 Warrants, the \$0.25 Warrants and the Conversion Price Warrants each contain cash-less exercise provisions.

The 2006 Unitholder has the following registration rights with respect to the shares of common stock into which the Debentures are convertible and warrants are exercisable. The Company has agreed to file with the SEC a registration statement covering the underlying shares of common stock on or before the 90<sup>th</sup> day after the last closing of the sale of 2006 Units and to use its best efforts to have the registration statement declared effective within 60 days of filing.

No commissions were paid in connection with the issuance of the 2006 Units.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis should be read together with the financial statements and the accompanying notes thereto included elsewhere in this Report.

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements. This report contains certain forward-looking statements and information that are based on the beliefs of management as well as assumptions made by and information currently available to management. The statements contained in this Report relating to matters that are not historical facts are forward-looking statements that involve risks and uncertainties, including, but not limited to, the successful commercialization of our batteries, future demand for our products, general economic conditions, government and environmental regulation, competition and customer strategies, technological innovations in the battery industries, changes in our business strategy or development plans, capital deployment, business disruptions, our ability to consummate future financings and other risks and

## **Table of Contents**

uncertainties, certain of which are beyond our control. Additional factors that could affect the Company's forward-looking statements include, among other things: the delay of the audit of the financial statements for the fiscal year ended December 31, 2005; negative reactions from the Company's stockholders, creditors, customer or employees to the delay in providing audited financial information; the impact and result of any litigation (including private litigation), or of any investigation by the Securities and Exchange Commission or any investigation by any other governmental agency related to the Company; and the Company's ability to ensure timely, effective and accurate financial reporting. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may differ materially from those described herein as anticipated, believed, estimated or expected.

Forward-looking statements are based on management's current views and assumptions and involve known and unknown risks that could cause actual results, performance or events to differ materially from those expressed or implied in those statements.

## **GENERAL**

We are engaged in continuing contract development and limited volume production, in both the United States and Germany, of large format lithium-ion rechargeable batteries used as power sources in advanced applications in the national security, transportation and stationary power markets. We have moved from a development and pilot-line production company to a small production business with our lithium-ion rechargeable batteries.

## **RESULTS OF OPERATIONS**

### **THREE MONTHS ENDED MARCH 31, 2006 COMPARED TO**

### **THREE MONTHS ENDED MARCH 31, 2005**

**REVENUES FROM DEVELOPMENT CONTRACTS AND PROTOTYPE SALES** increased by \$383,000 or 270% in the three months ended March 31, 2006 from \$142,000 in the same period in 2005. We also had income from foreign government subsidiaries of \$1,000 in 2005. The increase in revenues from development contracts and prototypes sales and decrease in income from foreign government subsidiaries is a result of our movement during the last two years from the product and process development and refinement stage to the early production stage of our products.

**COST OF GOODS SOLD** was \$464,000 for the three months ended. In the year ended December 31, 2004, the costs of manufacturing pre-production and scale up units were reported as part of Engineering, Research and Development Expenses.

**ENGINEERING, RESEARCH AND DEVELOPMENT EXPENSES** during the three months ended March 31, 2006 decreased by 57% to \$677,000 from \$1,570,000 in the same period in 2005. These expenses are primarily from our advancement of technology in large high rate battery applications. These expenses relate to material consumed in the continued refinement of production process, as well as increased engineering and development time dedicated to advancement of manufacturing processes as well as time associated with the installation of new production equipment.

**GENERAL AND ADMINISTRATIVE EXPENSES** during the three months ended March 31, 2006 decreased by \$158,000 or approximately 14% to \$962,000 from \$1,120,000 in the same period in 2005.

**SALES AND MARKETING EXPENSES** were \$82,000 for the three months ended March 31, 2006. Sales and marketing expenses represents costs incurred from sales associates and participation in trade shows relating to the sale of cells and/or batteries.

**DEPRECIATION AND AMORTIZATION** during the three months ended March 31, 2006 increased by \$14,000 or 3% to \$464,000 from \$450,000 in the same period in 2005.

**Table of Contents****INTEREST EXPENSE, NET OF INTEREST INCOME AND INTEREST EXPENSE RELATED TO BENEFICIAL CONVERSION**

for the three months ended March 31, 2006 increased by \$1,644,000 or 10.5% to \$3,217,000 from \$1,573,000 in the same period in 2005. Interest expense mainly represents interest accrued on the March, June and October 2005 debentures, as well as the amortization of the discount on the October 2005 debenture and charges related to the conversion price reset of the October 2005 debentures. See Note 7 within the Condensed Consolidated Financial Statements contained herein.

**CHARGE FOR EMBEDDED DERIVATIVE AND WARRANTS PREFERRED SHARES AND DIVIDENDS ON PREFERRED SHARES** were \$74,000 and \$845,000, respectively, in the three months ended March 31, 2006 and 2005.

**NET LOSS TO COMMON SHAREHOLDERS** \$5,341,000 or \$.01 per share for the three months ended March 31, 2006 as compared to a net loss of \$4,570,000 or \$(0.09) per share for the three months ended March 31, 2005. The increase in net loss for the quarter was principally due to the increase in interest expense related to the conversion price reset on the October 2005 8% Debenture.

**ACCUMULATED DEFICIT.** Since inception, we have incurred substantial operating losses and expect to incur substantial additional operating losses over the next several years. As of March 31, 2006, our accumulated deficit was \$88,060,000.

**LIQUIDITY AND FINANCIAL CONDITION****GENERAL**

At March 31, 2006, cash and cash equivalents were \$164,000. Total liabilities at March 31, 2006 were \$17,557,000 consisting of current liabilities in the aggregate amount of \$8,667,000 and long-term liabilities in the amount of \$8,890,000. At March 31, 2006, assets included \$885,000 in inventories, property and equipment, net, of \$5,423,000, net intangibles of \$7,163,000, and prepaid expenses and other assets of \$769,000. As of March 31, 2006, our working capital deficit was \$6,820,000 as compared to \$6,721,000 at December 31, 2005. We expect to incur substantial operating losses as we continue our commercialization efforts.

Our debt at March 31, 2006 was as follows:

	<b>March 31, 2006</b>
March 2005 12% Convertible	\$ 2,000,000
8% Convertible Notes	47,000
Derivative Liability	1,000
Bridge Notes	35,000
October 2005 8% Debenture	120,000
Portfolio Lenders Convertible Note	166,000
Loans from Financial Institutions	1,574,000
Subordinated Loans from related party	5,391,000
Silent Partner Loans	2,347,000
Total Debt	\$ 11,681,000
Less: Current maturities	(2,791,000)
Total Long-term debt	\$ 8,890,000

For more detailed information on long-term liabilities, see Note 7 to our financial statements contained herein.

**FINANCING TRANSACTIONS**

We have financed our operations since inception primarily through equity and debt financings, loans from shareholders and other related parties, loans from silent partners and bank borrowings secured by assets. During 2005, we entered into a \$15 million standby equity distribution agreement with Cornell Capital Partners, L.P.





---

**Table of Contents**

We have recently entered into a number of financing transactions and are continuing to seek other financing initiatives. We will need to raise additional capital to meet our working capital needs and to complete our product commercialization process. Such capital is expected to come from the sale of securities, including the sale of common stock under the standby equity distribution agreement described below. No assurances can be given that such financing will be available in sufficient amounts or at all. If such financing is not available there can be no assurance that Arch Hill Capital will provide any further funding under the bridge financing agreement described below.

The following is a general description of our most recent financing transactions. See also the Notes to Consolidated Financial Statements included with this Report.

**MAY 2006 12% CONVERTIBLE DEBENTURES**

On May 4, 2006, we sold \$500,000 of equity units (the 2006 Units ) in a private placement. Each 2006 Unit, with a purchase price of \$100,000 per unit, consists of (i) a 12% convertible debenture in the principal amount of \$100,000 (the 12% Debentures ), (ii) 100,000 warrants to purchase our common stock at an exercise price of \$0.20 per share (the .20 Warrants ), (iii) 100,000 warrants to purchase our common stock at an exercise price of \$0.25 per share (the .25 Warrants ), and (iv) 50,000 warrants to purchase Company common stock at an exercise price equal to the Conversion Price (as defined below) of the 12% Debentures (the Conversion Price Warrants ). The 12% Debentures are entitled to receive a 12% annual interest payment payable semi-annually at our option in cash or shares of our common stock valued at the then applicable conversion price of the 12% Debentures on June 30 and December 31 of each year beginning on December 31, 2006 or at the time of conversion of the principal to which such interest relates.

The holder of the 12% Debentures has a one-time conversion right during the period from May 4, 2006 through the date 30 days after the registration statement covering the shares of common stock underlying the 2006 Units is declared effective with the United States Securities and Exchange Commission (the First Conversion Period ) to convert the 12% Debentures at a price equal to 100% of the average closing price of our common stock on the OTC-BB for the 30 trading days immediately preceding the day upon which we receive a conversion notice from such Debentureholder (the First Conversion Period Price ). After the First Conversion Period the 12% Debentures are convertible at the election of the holder, at any time after November 4, 2007 and through May 3, 2010 (the Second Conversion Period ) at a price equal to 100% of the average closing price of our common stock on the OTC-BB for the 30 trading days immediately preceding the day upon which we receive a conversion notice from the 12% Debentureholder, provided however, the conversion price during the Second Conversion Period will not be lower than \$0.25 per share or higher than \$0.50 per share (the Second Conversion Period Price ).

The unpaid principal amount of the Debentures plus accrued and unpaid interest will be due on May 4, 2010 if the Debentures have not been converted by the holder or redeemed by us prior to that date (the Maturity Date ). The Debentures are redeemable by us at any time prior to the Maturity Date of May 4, 2010 by payment of the unpaid principal amount of the Debentures plus accrued and unpaid interest plus a redemption premium equal to 50% of the principal amount of the Debentures being redeemed (the Redemption Price ). No redemption premium is due on the repayment of the Debentures on the Maturity Date of May 4, 2010. No commissions were paid in connection with the issuance of the 2006 Units.

The \$0.20 and \$0.25 Warrants are exercisable for a period of five years commencing on November 4, 2007. The Conversion Price Warrants are exercisable by the Debentureholder for a period of five years commencing on or after the date subsequent to November 3, 2007 on which all of the Debentures have been converted and through November 4, 2012. If the Debentureholder does not convert all of the Debentures by the Maturity Date of May 4, 2010, the Conversion Price Warrants will be cancelled on that date. The \$0.20 Warrants, the \$0.25 Warrants and the Conversion Price Warrants each contain cash-less exercise provisions.

The 2006 Unitholder has the following registration rights with respect to the shares of common stock into which the Debentures are convertible and warrants are exercisable. The Company has agreed to file with the SEC a registration statement covering the underlying shares of common stock on or before the 90<sup>th</sup> day after the last closing of the sale of 2006 Units and to use its best efforts to have the registration statement declared effective within 60 days of filing.

## **Table of Contents**

No commissions were paid in connection with the issuance of the 2006 Units.

### **PORTFOLIO LENDERS BRIDGE FINANCING**

On December 6, 2005, we entered into a Bridge Loan Agreement pursuant to which we issued convertible notes in the principal amount of \$400,000 (the Notes ) to Portfolio Lenders II, LLC (the Noteholder ) in a private placement. The Notes are convertible at the option of the Noteholder any time up to maturity at a conversion price equal to \$0.50 per share. The Notes bear interest at 15% per annum, of which \$22,500, representing ninety days of interest, was prepaid by us on the closing date.

During the quarter ended March 31, 2006, \$200,000 in principal and \$1,726 of interest was repaid on the Notes. As of March 31, 2006, there was \$200,000 in principal outstanding under the Notes, which is repayable on the earliest of June 14, 2006 or two business days of the closing date of an investment of at least \$3 million in the Company.

In connection with the issuance of the Notes, we entered into an escrow agreement under which put notices under the standby equity distribution agreement were deposited and certain monies received under that agreement will be received and forwarded to the Noteholder. As additional security, we have agreed to pledge to the Noteholder 14,000,000 shares of our common stock once we have sufficient shares of common stock available for issuance.

Commissions to the Noteholder in connection with this transaction included 5% cash compensation in the form of a discount to the purchase price of the notes, or \$20,000, and five-year warrants to purchase 2,000,000 shares of our common stock at \$0.03 per share.

### **ARCH HILL BRIDGE FINANCING**

Arch Hill Capital and LTC entered into a bridge financing agreement in December 2001 and Arch Hill Ventures and GAIA entered into a bridge financing agreement in December 2000. At various times during 2005 and 2006, Arch Hill Capital advanced funds to LTC under the bridge financing agreement. As of March 31, 2006, \$35,000 of advances were outstanding under the Arch Hill Capital bridge financing agreement.

### **OCTOBER 2005 8% CONVERTIBLE DEBENTURE (CORNELL CAPITAL)**

On October 7, 2005, the Company entered into a Securities Purchase Agreement with Cornell Capital Partners LP pursuant to which the Company issued convertible debentures in the principal amount of \$3,000,000 with an original conversion price equal to \$0.06 per share. The debentures have a one-year term and accrue interest at 8% per year.

On January 31, 2006, the Company entered into an amendment of the debenture held by Cornell Capital (the First Amendment ) which provided that all payments of principal and accrued interest on the debenture otherwise due on or before March 15, 2006 were due on March 15, 2006. The First Amendment also provided that in the event the Company closes on any debt or equity financing, the Company must use fifty percent of the proceeds of the new financing (net of placement fees and commissions) to repay principal and interest outstanding under the debenture.

The First Amendment further provided that in the event the Company did not repay all outstanding principal and accrued interest on the debenture on March 15, 2006, (i) the Company must repay \$900,000 of principal and accrued interest on March 15, 2006 and repay the balance of the outstanding principal and interest on the debenture over seven equal payments commencing April 1, 2006 until October 1, 2006, and (ii) the exercise price of the 20,000,000 Warrants issued to Cornell Capital in connection with the debenture would be reduced to \$0.0128 on a pro-rata basis in relation to the amount of principal of the debenture not repaid by the Company as of March 15, 2006.

The First Amendment also provided that at any time prior to March 15, 2006 the Company could at its option with three business days advance written notice redeem a portion or all amounts outstanding under the debenture in an amount equal to the principal amount outstanding and accrued interest being redeemed. No redemption premium was due by the Company for a redemption of the debenture prior to March 15, 2006. The debenture was not convertible from January 31, 2006 through March 15, 2006 provided the Company was current on its payment obligations under the debenture. In consideration of the First Amendment of the debenture and related agreements,

---

**Table of Contents**

the Company paid Cornell Capital a fee of \$100,000 and recorded this fee as a debt issue cost to be amortized over the life of the debenture. As of March 15, 2006, \$3,000,000 in principal plus accrued interest was outstanding on the debenture.

On March 21, 2006, the Company entered into a second amendment with Cornell Capital (the "Second Amendment") whereby the Company amended the following provisions of the debenture. All payments of principal and accrued interest on the debenture otherwise due on or before March 15, 2006 are due on June 15, 2006. In the event the Company closes on any debt or equity financing the Company must use fifty percent (50%) of the proceeds of the new financing (net of placement fees and commissions) to repay principal and interest outstanding under the debenture. In the event the Company does not repay all outstanding principal and accrued interest on the debenture on June 15, 2006, the Company must repay \$1,800,000 of principal and accrued interest on June 15, 2006 and repay the balance of the outstanding principal and interest on the debenture over four equal monthly payments commencing July 1, 2006 until October 1, 2006.

The Second Amendment further provides that the debenture is convertible from March 21, 2006 with four business days advance written notice (the "Advance Conversion Notice") and after June 15, 2006, the debentures are convertible without delivery of an Advance Conversion Notice. The conversion price of the debenture was reduced from \$0.06 to \$0.03 per share as of March 21, 2006, provided, however, if there is an Event of Default under the debenture the conversion price will be reduced to \$0.0128. The Company calculated the additional beneficial conversion feature to be \$2,640,000 under EITF 00-27: Application of Issue 98-5 to Certain Convertible Instruments. \$1,364,000 of this beneficial conversion feature was recorded as additional debt discount with the remainder carried to earnings in the current period. At any time from March 21, 2006, including after receipt of an Advance Conversion Notice and before the expiration of the four business day advance notice period, the Company may, at its option, redeem a portion or all amounts outstanding under the debenture in an amount equal to the principal amount outstanding and accrued interest being redeemed and a payment of a premium by the Company equal to fifteen percent (15%) of the redemption amount subject to two (2) business days advanced written notice for any redemption on or before June 15, 2006 and subject to three (3) business days advanced written notice for any redemption after June 15, 2006.

In the Second Amendment, the Company amended the Warrants issued to Cornell Capital in connection with the debenture to purchase an additional 20,000,000 shares of common stock for a total of 40,000,000 shares. The exercise price of the 40,000,000 warrant shares was reduced to \$0.03 per share, provided, however that in the event the Company does not repay all outstanding principal and accrued interest on the debenture on June 15, 2006, then on June 15, 2006 the exercise price of the Warrants will be reduced to \$0.0128 on a pro-rata basis in relation to the amount of principal of the debenture not repaid by the Company as of June 15, 2006. The Company recorded an additional charge to earnings upon the issuance of the additional 20,000,000 warrants of \$300,000 during the current period. In addition, the Company determined that the warrants price reset resulted in no additional incremental value being attributable to the debenture.

The Company entered into a Pledge and Escrow Agreement pursuant to which the Company agreed to issue to Cornell Capital shares of common stock in the event of default under the debenture as security for its obligations thereunder. The Company also granted Cornell Capital a security interest in the assets of LTC. In the event of default, Cornell Capital, in addition to any other remedies, may convert any or all of the outstanding principal of the debentures into common stock at a fixed conversion price equal to \$0.0128 per share (234,375,000 million shares).

Commissions paid to Cornell Capital in connection with this transaction at the time of execution of the Securities Purchase Agreement included 7.5% cash compensation in the form of a discount to the purchase price of the debentures, or \$225,000, and five-year warrants to purchase 20,000,000 shares of common stock at the following exercise prices: 10,000,000 at \$0.06 per share, 5,000,000 at \$0.07 per share and 5,000,000 at \$0.10 per share. The Company also paid structuring fees to Yorkville Advisors Management of \$10,000. The convertible debenture was issued with a \$3,000,000 discount due to the fair value ascribed to the detachable warrants utilizing the Black Scholes method and the related beneficial conversion feature. The discount is being amortized as interest expense over the one year life of the debenture and \$777,000 is reflected in interest expense related to beneficial conversion for the three months ended March 31, 2006.

As of March 31, 2006, \$3,000,000 in principal of the debentures was outstanding.

---

**Table of Contents**

**STANDBY EQUITY DISTRIBUTION AGREEMENT (CORNELL CAPITAL)**

On March 11, 2005, we entered into a standby equity distribution agreement with Cornell Capital pursuant to which we may, at our discretion, periodically sell to Cornell Capital shares of our common stock for a total purchase price of up to \$15,000,000. For each share of common stock purchased under the standby equity distribution agreement, Cornell Capital will pay us 98% of the lowest volume weighted average price of our common stock as quoted by on the Over-the-Counter Bulletin Board or other principal market on which our common stock is traded for the five days immediately following the date we deliver a notice requiring Cornell Capital to purchase our shares under the standby equity distribution agreement. Further, Cornell Capital will retain a fee of 5% of each advance under the standby equity distribution agreement for a total effective discount to the market price of our common stock of 7%. This 7% discount is an underwriting discount.

The volume weighted average price is calculated automatically by Bloomberg L.P., a reporting service, and is calculated by multiplying the number of our shares sold on a given day by the actual sales prices and adding up the totals.

Pursuant to the standby equity distribution agreement, we may periodically sell shares of common stock to Cornell Capital to raise capital to fund our working capital needs. The periodic sale of shares is known as an advance. We may request an advance every five trading days. A closing will be held one trading day after the end of each pricing period at which time we will deliver shares of common stock and Cornell Capital will pay the advance amount requested by us.

We may request advances under the standby equity distribution agreement now that the underlying shares are registered with the SEC. Thereafter, we may continue to request advances until Cornell Capital has advanced \$15.0 million or August 12, 2007, whichever occurs first.

The amount of each advance is limited to a maximum draw down of \$200,000 every five trading days and the aggregate amount of advances may not exceed \$800,000 in any 30-day period. The amount available under the standby equity distribution agreement is not dependent on the price or volume of our common stock. We may not request advances if the shares to be issued in connection with such advances would result in Cornell Capital owning more than 9.9% of our outstanding common stock. As of May 5, 2006, we had 366,615,359 shares outstanding so Cornell Capital could not own in excess of 33,443,030 shares. We will be unable to sell additional shares of our common stock to the investor under the standby equity distribution agreement if it is unable to reduce its holdings so as to remain below the 9.9% threshold.

During the period January 1, 2006 through March 31, 2006, the Company sold 83,894,765 shares of common stock to Cornell Capital for \$1,800,000 pursuant to the Standby Equity Distribution Agreement at prices ranging from \$0.0161 to \$0.0280. Of such proceeds, the Company paid commitment fees to Cornell Capital of 5% of the gross proceeds, or \$90,000 in the aggregate and the Company paid structuring fees to Yorkville Advisors Management aggregating \$5,000, with net proceeds to the Company of \$1,715,000 from such sales.

As of March 31, 2006, the Company sold an aggregate of 102,099,366 shares of common stock to Cornell Capital for \$2,600,000 pursuant to the Standby Equity Distribution Agreement since August 2005 at prices ranging from \$0.0161 to \$0.0647 per share. Of such proceeds, the Company paid commitment fees to Cornell Capital of 5% of the gross proceeds, or \$130,000 in the aggregate and the Company paid structuring fees to Yorkville Advisors Management aggregating \$6,500, with net proceeds to the Company of \$2,132,000, net of \$373,000 of debt issue costs, from such sales.

As of May 5, 2006, we sold 138,265,798 shares of common stock to Cornell Capital for \$3,200,000 pursuant to the standby equity distribution agreement at prices ranging from \$0.0166 to \$0.0647. Of such proceeds, we paid commitment fees to Cornell Capital of 5% of the gross proceeds, or \$160,000 in the aggregate and we paid structuring fees to Yorkville Advisors Management aggregating \$6,500, with net proceeds to us of \$3,033,500 from such sales.

Cornell Capital is an underwriter within the meaning of the Securities Act of 1933 in connection with the sale of common stock issuable under the standby equity distribution agreement.

---

**Table of Contents**

**DEBT EXCHANGE (ARCH HILL)**

On October 21, 2005, pursuant to a Debt Exchange Agreement between us, GAIA Holding, GAIA, Arch Hill Capital and Arch Hill Ventures, we exchanged \$4,411,000 of debt owed by LTC and GAIA to Arch Hill Capital and Arch Hill Ventures for \$4,411,000 of our 10% convertible debentures and warrants to purchase 2,205,262 shares of our common stock with an exercise price of \$0.28 per share (the Debt Exchange ). As further consideration for the exchange of the debt, Arch Hill Ventures agreed in the Debt Exchange Agreement to transfer to us its 100% ownership interest in Tamarchco. As a condition of the closing of the Debt Exchange, we received from our financial advisor, an opinion that the debt exchange is fair from a financial point of view to our stockholders.

The 10% convertible debentures issued to Arch Hill Ventures in the Debt Exchange (the October 2005 debentures ) had a maturity date of October 21, 2007 at which time the principal amount and all accrued interest on the October 2005 debentures was due and payable. Interest payments on the October 2005 debentures due and payable in cash quarterly, or at the option of Arch Hill Ventures, in our common stock at a price equal to the conversion price of our common stock commencing December 31, 2005. The October 2005 debentures were convertible at any time at the option of the holder into shares of our common stock at the lesser of \$2.00 and the average of the lowest 3 intra-day trading prices during the 20 trading days immediately prior to the conversion date discounted by 50%. The Company recorded \$4,411,000 as a derivative liability representing the fair value of the variable conversion feature on this note.

The warrants are exercisable one year from issuance and thereafter only if the warrant holder has not sold any LTC equity securities within the prior six months and expire five years from the date of issuance. The warrants are subject to exercise price adjustments upon the occurrence of certain events including stock dividends, stock splits, mergers, reclassifications of stock or our recapitalization. The exercise price of the warrants is also subject to reduction if we issue any rights, options or warrants to purchase shares of our common stock at a price less than the market price of our shares as quoted on the OTC Bulletin Board. The convertible debenture was issued with a \$218,000 discount due to the fair value ascribed to the detachable warrants utilizing the Black Scholes method. The Company, on October 24, 2005, converted the entire amount of these debentures into 100,000 shares of the Company's Class B Preferred stock. Accordingly, the Company recorded the entire \$218,000 as a current year charge to interest expense.

On October 24, 2005, Stichting LTC delivered a conversion notice to the Company to convert all of the October 2005 debentures into Company Common Stock at a conversion price of \$0.0167 per share, for a total of 264,103,114 shares of Common Stock. In lieu of delivering such shares of Common Stock which are currently pledged as security under the Cornell debenture or reserved for issuance under the Cornell standby equity distribution agreement, on November 14, 2005, the Company authorized the issuance of 100,000 shares of Series B Convertible Preferred Stock and issued such shares to Stichting LTC. The 100,000 shares of Series B Convertible Preferred Stock are convertible into an aggregate of 264,103,114 shares of Common Stock and have voting rights equal to 264,103,114 shares of Common Stock.

The Company recorded the entire \$4,411,000 as a current year charge to earnings in connection with the conversion.

**8% CONVERTIBLE NOTES**

From May 18, 2005 to July 6, 2005, we closed on \$298,000 of equity units (the 2005 Units ) in a private placement. Each 2005 Unit, with a purchase price of \$1,000 per unit, consists of a convertible promissory note in the principal amount of \$1,000 (the 8% Notes ) and one warrant for each share of common stock issued upon conversion of the 8% Notes to purchase one-half share of our common stock. The 8% Notes are entitled to receive an 8% annual interest payment payable in shares of Company common stock.

As of March 31, 2006 \$251,000 principal of 8% Notes have been converted into an aggregate of 5,020,000 shares of common stock at a conversion price of \$0.05 per share and 1,198 shares of common stock were issued to the convertible Noteholders for interest payable in shares. The converting Noteholders were issued warrants to purchase 2,510,000 shares of common stock in the aggregate, at \$0.0675 per share. As of March 31, 2006, \$47,000 in principal of 8% Notes were outstanding.

---

**Table of Contents**

The 8% Notes are convertible at the election of the holder thereof, at any time commencing from and after their date of issuance and for a period of three years thereafter at a price equal to 85% of the average closing price of our common stock on the OTC-BB for the 20 trading days immediately preceding the day upon which we receive a conversion notice from the Noteholder. The 8% Notes are entitled to receive an 8% annual interest payment payable in shares of our common stock. The per share exercise price of the warrant will be 135% of the conversion price of the 8% Notes.

The Placement Agent in the 2005 Unit Financing and certain affiliated person were issued warrants to purchase 596,000 shares of our common stock at \$.055 per share relating to the 2005 Unit financing.

The conversion feature resulted in the units being issued with an embedded derivative. Accordingly, the Company has recorded \$53,000 as a derivative liability and a corresponding charge to earnings. In addition, the Company recorded a charge for the fair value of the warrants utilizing the Black-Scholes method issued upon conversion of \$130,000 of the 8% Notes during the 3<sup>rd</sup> quarter 2005 of \$113,000.

**JUNE 2005 DEBENTURES**

On June 9, 2005, we entered into a Debenture Purchase Agreement with an investor, pursuant to which we issued \$1,200,000 of convertible debentures and \$150,000 of convertible debentures as compensation for the transaction (together, the 12% Debentures ). The 12% Debentures have a two year term and accrue interest at 12% per year payable in arrears in shares of common stock at the conversion price at conversion or maturity. As of March 31, 2006, \$1,350,000 in principal of the 12% Debentures was outstanding.

Commencing on December 9, 2005 until June 9, 2007, the 12% Debentures are convertible at the option of the holder into shares of common stock at a conversion price equal to \$0.05 per share. The 12% Debentures are not repayable in cash and will be automatically converted into shares of common stock at maturity at the conversion price. In no event is the holder entitled to convert the debentures for a number of shares of common stock in excess of that number of shares of common stock which, upon giving effect to such conversion, would cause the aggregate number of shares of common stock beneficially owned by the holder and its affiliates to exceed 4.99% of the outstanding shares of common stock following such conversion (unless the holder provides us with sixty five (65) days prior written notice that this provision shall not apply). Since these debentures are not repayable in cash, they are reflected as equity (12% convertible debentures) in our financial statements.

The conversion feature resulted in the debentures being issued with an embedded derivative. Accordingly, the Company has recorded approximately \$405,000 of the proceeds received to additional paid-in capital based on the fair value of the embedded beneficial conversion feature. The \$405,000 discount will be recognized as a deemed dividend over the six month period to the earliest conversion date. Additionally, the discount related to the \$150,000 of compensation plus \$36,000 of fees and \$30,000 of warrants issued in connection with issuing the debentures will be recognized as a deemed dividend over the two year life of the debentures or the conversion date, which ever is earlier.

The 12% Debenture holder received 4,532,836 warrants to purchase common stock at exercise prices ranging from \$0.66 to \$0.024 per share. The warrants were originally issued to the finder in the January 2004 debenture financing and subsequently transferred to the 12% Debenture holder. The warrants are exercisable until January 20, 2009.

**MARCH 2005 12% DEBENTURE**

On March 11, 2005, we entered into a debenture purchase agreement with a third party lender, pursuant to which we issued debentures in the principal amount of \$2,500,000. The debentures contain a provision that in the event that the holder elects to waive the conversion feature of the debentures by April 15, 2005, the maturity and amortization of the debentures will be amended such that the debentures will be repaid in 10 equal monthly installments with accrued interest commencing July 15, 2005. The investor waived the conversion feature simultaneously with the closing of the transaction. Pursuant to an amendment dated January 31, 2006, the original maturity date of June 15, 2006 was amended to December 31, 2006 and the original interest rate of 12% per year was amended to 15% per year effective as of October 15, 2005. No monthly payments of principal or interest are due and owing by us prior to December 31, 2006.

## **Table of Contents**

In connection with the debenture purchase agreement, we entered into an escrow agreement under which put notices under the standby equity distribution agreement were deposited and certain monies received under that agreement will be received and forwarded to the debentureholder if we do not repay the debenture from other sources of capital. As of March 31, 2006 \$2,000,000 in principal of the debentures was outstanding.

### **MANAGEMENT S PLANS TO OVERCOME OPERATING AND LIQUIDITY DIFFICULTIES**

Over the past four years, we have refocused our unique extrusion-based manufacturing process, cell technology, large battery assembly expertise, and market activities to concentrate on large-format, high rate battery applications. Our commercialization efforts are focused on applying our lithium-ion rechargeable batteries in the national security, transportation and stationary power markets.

Our operating plan seeks to minimize our capital requirements, but expansion of our production capacity to meet increasing sales and refinement of our manufacturing process and equipment will require additional capital. We expect that operating and production expenses will increase significantly as we continue to ramp up our production and continue our battery technology and develop, produce, sell and license products for commercial applications.

We have recently entered into a number of financing transactions (see Notes 6 and 9). We are continuing to seek other financing initiatives. We need to raise additional capital to meet our working capital needs, for the repayment of debt and for capital expenditures. Such capital is expected to come from the sale of securities, including the sale of common stock under the Standby Equity Distribution Agreement. (See Note 9) We believe that if we raise approximately \$15 million in debt and equity financings, including, under the Standby Equity Distribution Agreement, we would have sufficient funds to meet our needs for working capital and repayment of debt (approximately \$11 million) and for capital expenditures (approximately \$4 million) over the next twelve months.

No assurance can be given that we will be successful in completing any financings at the minimum level necessary to fund our capital equipment, debt repayment or working capital requirements, or at all. If we are unsuccessful in completing these financings, we will not be able to meet our working capital, debt repayment or capital equipment needs or execute our business plan. In such case we will assess all available alternatives including a sale of our assets or merger, the suspension of operations and possibly liquidation, auction, bankruptcy, or other measures.

### **GOING CONCERN MATTERS**

Our accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the continuation of operations, realization of assets and liquidation of liabilities in the ordinary course of business. Since inception, we have incurred substantial operating losses and expect to incur additional operating losses over the next several years. As of March 31, 2006, we had an accumulated deficit of approximately \$88,060,000. We have financed our operations since inception primarily through equity financings, loans from shareholders and other related parties, loans from silent partners and bank borrowings secured by assets. We have recently entered into a number of financing transactions and are continuing to seek other financing initiatives. We will need to raise additional capital to meet our working capital needs and to complete our product commercialization process. Such capital is expected to come from the sale of securities, including the sale of common stock under the standby equity distribution agreement. No assurances can be given that such financing will be available in sufficient amounts or at all. Continuation of our operations in 2006 is dependent upon obtaining such further financing. These conditions raise substantial doubt about our ability to continue as a going concern. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

### **CRITICAL ACCOUNTING POLICIES**

The Securities and Exchange Commission ( SEC ) defines critical accounting policies as those that require application of management s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods. Our significant accounting policies are described in Note 3 in the Notes to the Consolidated Financial Statements. Not all of these significant accounting policies require management to make difficult, subjective or complex judgments or estimates. However, the following policies could be deemed to be critical within the SEC definition.



## **Table of Contents**

### **Revenues**

We perform certain research and development for other companies and sell prototypes to third parties. Revenue is recognized as services are rendered or products are delivered, the price to the buyer is fixed and determinable, and collectibility is reasonably assured.

### **Useful Lives of Tangible and Intangible Assets**

Depreciation and amortization of tangible and intangible assets are based on estimates of the useful lives of the assets. We regularly review the useful life estimates established to determine their propriety. Changes in estimated useful lives could result in increased depreciation or amortization expense in the period of the change in estimate and in future periods that could materially impact our financial condition and results of operations.

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

Effective January 1, 2002, we adopted Statement of Financial Accounting Standards ( SFAS ) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets ( SFAS No. 144 ). SFAS No. 144 requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. An impairment charge could materially impact our financial condition and results of operations.

### **Income Taxes**

As part of the process of preparing our consolidated financial statements, we are required to estimate our taxes in each of the jurisdictions of operation. This process involves management estimating the actual current tax expense together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within the consolidated balance sheet. We then must assess the likelihood that the deferred tax assets will be recovered from future taxable income and, to the extent recovery is not likely, we must establish a valuation allowance. Future taxable income depends on the ability to generate income in excess of allowable deductions. Significant management judgment is required in determining the provision for income taxes, deferred tax assets and liabilities and any valuation allowance recorded against net deferred tax assets. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to change our valuation allowance that could materially impact our financial condition and results of operations.

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

Fair value estimates, assumptions and methods used to estimate fair value of our financial instruments are made in accordance with the requirements of SFAS No. 107, Disclosures about Fair Value of Financial Instruments. We have used available information to derive our estimates. However, because these estimates are made as of a specific point in time, they are not necessarily indicative of amounts we could realize currently. The use of different assumptions or estimating methods may have a material effect on the estimated fair value amounts.

### **Convertible Securities With Beneficial Conversion Features**

The Company accounts for debt with embedded conversion features and warrant issuances in accordance with EITF 98-5: Accounting for convertible securities with beneficial conversion features or contingency adjustable conversion and EITF No. 00-27: Application of issue No. 98-5 to certain convertible instruments. Conversion features determined to be beneficial to the holder are valued at fair value and recorded to additional paid in capital. The Company determines the fair values to be ascribed to detachable warrants issued with the convertible debentures utilizing the Black-Scholes method. Any discount derived from determining the fair value of the beneficial conversion features and the warrants is amortized to financing costs over the remaining life of the debenture. The unamortized discount, if any, upon the conversion of the debentures is expensed to financing cost on a pro-rata basis.

---

**Table of Contents**

Debt issued with variable conversion features are considered to be embedded derivatives and are accounted for in accordance with FASB 133 Accounting for Derivative Instruments and Hedging Activities. The fair value of the embedded derivative is recorded to a derivative liability. This liability is required to be marked to market each reporting period. The resulting discount on the debt is amortized to interest expense over the life of the related debt.

**RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

On December 16, 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 123(R), Share-Based Payment , which is a revision of SFAS No. 123 and supersedes APB Opinion 25. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be valued at fair value on the date of grant, and to be expensed over the applicable vesting period. Pro forma disclosure of the income statement effects of share-based payments is no longer an alternative. SFAS No. 123(R) is effective for all stock-based awards granted on or after January 1, 2006. In addition, companies must also recognize compensation expense related to any awards that are not fully vested as of the effective date. Compensation expense for the unvested awards will be measured based on the fair value of the awards previously calculated in developing the pro forma disclosures in accordance with the provisions of SFAS No. 123.

The Company plans to adopt SFAS No. 123(R) on January 1, 2006. This change in accounting is not expected to materially impact our results of operations. We have not completed the calculation of this impact. However, because we currently account for share-based payments to our employees using the intrinsic value method, our results of operations have not included the recognition of compensation expense for the issuance of stock option awards.

On December 16, 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets , which is an amendment to APB Opinion No. 29. It states that the exchanges on nonmonetary assets should be measured based on the fair value of the assets exchanged. Further, SFAS No. 153 eliminates the narrow exception for nonmonetary exchanges of similar productive assets and replaces it with a broader exception for exchanges of nonmonetary assets that do not have commercial substance . SFAS No. 153 is effective for financial statements for fiscal years beginning after June 15, 2005. The Company does not normally enter into exchanges that could be considered nonmonetary, accordingly, we do not expect the adoption of SFAS 153 to have a material impact on the Company 's financial statements.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 ( SFAS No. 154 ). SFAS No. 154 requires retrospective application as the required method for reporting a change in accounting principle, unless impracticable or a pronouncement includes specific transition provisions. SFAS No. 154 also requires that a change in depreciation, amortization or depletion method for long-lived, nonfinancial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. This statement carries forward the guidance in APB Opinion No. 20, Accounting Changes, for the reporting of the correction of an error and a change in accounting estimate. SFAS No. 154 is effective beginning January 1, 2006. SFAS No. 154 is not expected to have a significant impact on our financial position, results of operations or cash flows.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 . SFAS No. 155 resolves issues addressed in SFAS No. 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets . SFAS No. 155 will become effective for the Company 's fiscal year after September 15, 2006. The impact of SFAS No. 155 will depend upon the nature and extent of any new derivative instruments entered into after the effective date.

In June 2005, the FASB ratified Emerging Issues Task Force ( EITF ) Issue No. 05-2, The Meaning of `Conventional Convertible Debt Instrument ' in EITF No. 00-19, `Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company 's Own Stock ( EITF No. 05-2 ), which addresses when a convertible debt instrument should be considered `conventional ' for the purpose of applying the guidance in EITF No. 00-19. EITF No. 05-2 also retained the exemption under EITF No. 00-19 for conventional convertible debt instruments and indicated that convertible preferred stock having a mandatory redemption date may qualify for the exemption provided under EITF No. 00-19 for conventional convertible debt if the instrument 's economic characteristics are more similar to debt than equity. EITF No. 05-2 is effective for new instruments entered into and instruments modified in periods beginning after June 29, 2005. The Company has applied the requirements of EITF No. 05-2 since the required implementation date. The adoption of this pronouncement did not have an impact on the Company 's consolidated financial position, results of operations or cash flows.

---

**Table of Contents**

EITF Issue No. 05-4 The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to EITF Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock ( EITF No. 05-4 ) addresses financial instruments, such as stock purchase warrants, which are accounted for under EITF 00-19 that may be issued at the same time and in contemplation of a registration rights agreement that includes a liquidated damages clause. The consensus for EITF No. 05-4 has not been finalized. The adoption of this pronouncement is not expected to have an impact on the Company's consolidated financial position, results of operations, or cash flows.

In September 2005, the FASB ratified the EITF's Issue No. 05-7, Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues ( EITF 05-7 ), which addresses whether a modification to a conversion option that changes its fair value effects the recognition of interest expense for the associated debt instrument after the modification, and whether a borrower should recognize a beneficial conversion feature, not a debt extinguishment, if a debt modification increases the intrinsic value of the debt (for example, the modification reduces the conversion price of the debt). The adoption of this pronouncement did not have an impact on the Company's consolidated financial position, results of operations or cash flows.

In September 2005, the FASB ratified the following consensus reached in EITF Issue 05-8: a) The issuance of convertible debt with a beneficial conversion feature results in a basis difference in applying FASB Statement of Financial Accounting Standards SFAS No. 109. This consensus is effective in the first interim or annual reporting period commencing after December 15, 2005, with early application permitted. The effect of applying the consensus should be accounted for retroactively to all debt instruments containing a beneficial conversion feature that are subject to EITF Issue 00-27 (and thus is applicable to debt instruments converted or extinguished in prior periods but which are still presented in the financial statements). The adoption of this pronouncement did not have an impact on the Company's consolidated financial position, results of operations or cash flows.

**RISK FACTORS AFFECTING OUR COMPANY**

Investors should carefully consider the following risk factors, in addition to the other information concerning the factors affecting forward-looking statements. Each of the risk factors could adversely affect business, operating results and financial condition as well as adversely affect the value of an investment in us.

**WE ARE SUBJECT TO VARIOUS RISKS THAT MAY MATERIALLY HARM OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATIONS. IF ANY OF THESE RISKS OR UNCERTAINTIES ACTUALLY OCCURS, OUR BUSINESS, FINANCIAL CONDITION OR OPERATING RESULTS COULD BE MATERIALLY HARMED. IN THAT CASE, THE TRADING PRICE OF OUR COMMON STOCK COULD DECLINE AND YOU COULD LOSE ALL OR PART OF YOUR INVESTMENT.**

**IN ADDITION TO THE RISK FACTORS SET FORTH IN OUR FORM 10KSB FOR THE YEAR ENDED DECEMBER 31, 2005, INVESTORS SHOULD BE AWARE OF THE FOLLOWING RISKS:**

**WE HAVE A WORKING CAPITAL LOSS, WHICH MEANS THAT OUR CURRENT ASSETS ON MARCH 31, 2006 WERE NOT SUFFICIENT TO SATISFY OUR CURRENT LIABILITIES.** We had a working capital deficit of approximately \$6,820,000 at March 31, 2006, which means that our current liabilities exceeded our current assets on March 31, 2006. Current assets are assets that are expected to be converted to cash within one year and, therefore, may be used to pay current liabilities as they become due.

**WE HAVE SUBSTANTIAL INDEBTEDNESS AND ARE HIGHLY LEVERAGED.** At March 31, 2006, we had total consolidated long-term indebtedness of approximately \$8,890,000, plus current portion of approximately \$2,291,000. We also had at March 31, 2006, current liabilities of approximately \$8,667,000.

The level of our indebtedness and related debt service requirements could negatively impact our ability to obtain any necessary financing in the future for working capital, capital expenditures or other purposes. A substantial portion of our future cash flow from operations, if any, may be dedicated to the payment of principal and interest on our indebtedness. Our high leverage may also limit our flexibility to react to changes in business and may

---

**Table of Contents**

place us at a competitive disadvantage to less highly leveraged competitors. In addition, creditors who remain unpaid may initiate collection proceedings, which could hamper our operations due to our short-term cash needs or the effect on our assets subject to debt.

WE HAVE A HISTORY OF OPERATING LOSSES AND HAVE BEEN UNPROFITABLE SINCE INCEPTION. We incurred net losses of approximately \$88,060,000 from February 12, 1999 (date of inception) to March 31, 2006, including approximately \$5,341,000 of net loss to common shareholders in the quarter ended March 31, 2006. We expect to incur substantial additional operating losses in the future. During the three months ended March 31, 2006 and 2005, we generated revenues from development contracts and prototype sales in the amounts of \$525,000 and \$142,000, respectively. We cannot assure you that we will continue to generate revenues from operations or achieve profitability in the near future or at all.

WE NEED SIGNIFICANT FINANCING TO CONTINUE TO DEVELOP AND COMMERCIALIZE OUR TECHNOLOGY. We have recently entered into a number of financing transactions and are continuing to seek other financing initiatives. We will need to raise additional capital to meet our working capital needs and to complete our product commercialization process. Such capital is expected to come from the sale of securities, including the sale of common stock under the Standby Equity Distribution Agreement. We believe that if we raise approximately \$10 to 11 million in debt and equity financings including under the Standby Equity Distribution Agreement, we would have sufficient funds to meet our operating and capital expenditures needs for at least twelve months. If we do not raise such additional capital, we will assess all available alternatives including a sale of our assets or merger, the suspension of operations and possibly liquidation, auction, bankruptcy, or other measures.

Except as described herein, we have not entered into any definitive agreements related to a new financing as of May 5, 2006, and no assurance can be given that we will be successful in completing these or any other financings at the minimum level necessary to fund our capital equipment requirements, current operations or at all. If we are unsuccessful in completing these financings at such minimum level, we will not be able to fund our capital equipment requirements or current expenses or execute our business plan. If we are unsuccessful in completing these financings at or near the maximum level or an additional financing, we will not be able to pursue our business strategy. Additional financing may not be available on terms favorable to us or at all. Even if we do obtain financing, it may result in dilution to our stockholders.

WE FACE RISKS RELATED TO THE DELAY IN THE COMPLETION OF OUR AUDIT. The audit of our financial statements for the year ended December 31, 2005 and the review of our financial statements for the quarter ended March 31, 2006 have not yet been completed. We have been working diligently with our auditors to complete the audit of our year end financial statements and review of our first quarter financial statements. We have also engaged outside expertise to assist us in this process. Nevertheless, the delay in the completion of the audit of the year end financial statements and review of the first quarter financial statements may lead to litigation claims and/or regulatory proceedings against us and may negatively impact our financing agreements. This delay may also impact the ability to trade our shares on the OTC Bulletin Board, although in such case our shares would continue to trade and be reported in the Pink Sheets Electronic Quotation Service. The defense of any such claims or proceedings may cause the diversion of management's attention and resources, and we may be required to pay damages if any such claims or proceedings are not resolved in our favor. Any litigation or regulatory proceeding, even if resolved in our favor, could cause us to incur significant legal and other expenses. We also may have difficulty raising equity capital or obtaining other financing. We may not be able to effectuate our current business strategy. The occurrence of any of the foregoing could harm our business and reputation and cause the price of our securities to decline.

**ITEM 3. CONTROLS AND PROCEDURES**

As of March 31, 2006, an evaluation was carried out under the supervision and with the participation of management, including the Chief Operating Officer and Chief Financial Officer, of the effectiveness of disclosure controls and procedures. Based on that evaluation, the Chief Operating Officer and Chief Financial Officer have concluded that disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that the Company file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. No changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting, including any corrective actions with regard to significant deficiencies and material weaknesses, occurred during the first quarter of fiscal 2006 or subsequent to the date of the evaluation by its management thereof.

**Table of Contents**

**PART II.**

**OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

None.

**ITEM 2. UNREGISTERED SALES OF SECURITIES AND USE OF PROCEEDS**

On May 4, 2006, we sold \$500,000 of equity units (the 2006 Units ) in a private placement. Each 2006 Unit, with a purchase price of \$100,000 per unit, consists of (i) a 12% convertible debenture in the principal amount of \$100,000 (the 12% Debentures ), (ii) 100,000 warrants to purchase our common stock at an exercise price of \$0.20 per share (the .20 Warrants ), (iii) 100,000 warrants to purchase our common stock at an exercise price of \$0.25 per share (the .25 Warrants ), and (iv) 50,000 warrants to purchase Company common stock at an exercise price equal to the Conversion Price (as defined below) of the 12% Debentures (the Conversion Price Warrants ). The 12% Debentures are entitled to receive a 12% annual interest payment payable semi-annually at our option in cash or shares of our common stock valued at the then applicable conversion price of the 12% Debentures on June 30 and December 31 of each year beginning on December 31, 2006 or at the time of conversion of the principal to which such interest relates.

The holder of the 12% Debentures has a one-time conversion right during the period from May 4, 2006 through the date 30 days after the registration statement covering the shares of common stock underlying the 2006 Units is declared effective with the United States Securities and Exchange Commission (the First Conversion Period ) to convert the 12% Debentures at a price equal to 100% of the average closing price of our common stock on the OTC-BB for the 30 trading days immediately preceding the day upon which we receive a conversion notice from such Debentureholder (the First Conversion Period Price ). After the First Conversion Period the 12% Debentures are convertible at the election of the holder, at any time after November 4, 2007 and through May 3, 2010 (the Second Conversion Period ) at a price equal to 100% of the average closing price of our common stock on the OTC-BB for the 30 trading days immediately preceding the day upon which we receive a conversion notice from the 12% Debentureholder, provided however, the conversion price during the Second Conversion Period will not be lower than \$0.25 per share or higher than \$0.50 per share (the Second Conversion Period Price ).

The unpaid principal amount of the Debentures plus accrued and unpaid interest will be due on May 4, 2010 if the Debentures have not been converted by the holder or redeemed by us prior to that date (the Maturity Date ). The Debentures are redeemable by us at any time prior to the Maturity Date of May 4, 2010 by payment of the unpaid principal amount of the Debentures plus accrued and unpaid interest plus a redemption premium equal to 50% of the principal amount of the Debentures being redeemed (the Redemption Price ). No redemption premium is due on the repayment of the Debentures on the Maturity Date of May 4, 2010. No commissions were paid in connection with the issuance of the 2006 Units.

The \$0.20 and \$0.25 Warrants are exercisable for a period of five years commencing on November 4, 2007. The Conversion Price Warrants are exercisable by the Debentureholder for a period of five years commencing on or after the date subsequent to November 3, 2007 on which all of the Debentures have been converted and through November 4, 2012. If the Debentureholder does not convert all of the Debentures by the Maturity Date of May 4, 2010, the Conversion Price Warrants will be cancelled on that date. The \$0.20 Warrants, the \$0.25 Warrants and the Conversion Price Warrants each contain cash-less exercise provisions.

The 2006 Unitholder has the following registration rights with respect to the shares of common stock into which the Debentures are convertible and warrants are exercisable. The Company has agreed to file with the SEC a registration statement covering the underlying shares of common stock on or before the 90<sup>th</sup> day after the last closing of the sale of 2006 Units and to use its best efforts to have the registration statement declared effective within 60 days of filing.

**Table of Contents**

No commissions were paid to any brokers in connection with this transaction or the issuance of the securities. Issuance of the securities was exempt from registration pursuant to Section 4(2) of the Securities Act. The underlying securities were issued to an accredited investor in a private transaction without the use of any form of general solicitation or advertising. The underlying securities are restricted securities subject to applicable limitations on resale.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

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

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

(a) The following Exhibits are filed as part of this Report or incorporated herein by reference:

- 10.61 Letter Agreement with Cornell Capital Partners, LP dated January 31, 2006 <sup>(1)</sup>
- 10.62 Letter Agreement with Cornell Capital Partners, LP dated March 21, 2006 <sup>(2)</sup>
- 10.63 Fifth Amendment to Lease, dated March 31, 2006, between PMP Whitemarsh and LTC <sup>(2)</sup>
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002 +
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 +
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 +
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 +

---

(1) Incorporated by reference to LTC's Registration Statement on Form SB-2 (No. 333-131530) filed on February 3, 2006.

(2) Incorporated by reference to LTC's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2005.

+ Exhibit filed herewith in this Report.

(b) Reports on Form 8K. During the quarter ended March 31, 2006, the Company filed the following Reports on Form 8-K.

On February 2, 2006, the Company filed a Report on Form 8-K reporting on an amendment of the debenture with Cornell Capital and related agreements.

On March 21, 2006, the Company filed a Report on Form 8-K reporting on a second amendment of the debenture with Cornell Capital and related agreements.

**Table of Contents**

**SIGNATURES**

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

LITHIUM TECHNOLOGY CORPORATION

Date: May 22, 2006

BY: /s/ Andrew J. Manning  
Andrew J. Manning

Chief Operating Officer  
(Principal Executive Officer)

BY: /s/ William F. Hackett  
William F. Hackett

Chief Financial Officer  
(Principal Financial and Accounting Officer)