

AQUACELL TECHNOLOGIES INC  
Form 10KSB  
September 26, 2003

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D. C. 20549

FORM 10-KSB

(Mark One)

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

For the fiscal year ended June 30, 2003

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 1-16165

AQUACELL TECHNOLOGIES, INC.

(Name of small business issuer in its charter)

Delaware

33-0750453

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

10410 Trademark Street, Rancho Cucamonga, CA

91730

(Address of principal executive offices)

(Zip Code)

Issuer's telephone number: (909) 987-0456

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

Securities registered pursuant to Section 12(g) of the Act:  
Common Stock, par value \$.001 per share

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

Check if there is no disclosure of delinquent filers pursuant  
to Item 405 of Regulation S-B contained herein, and will not be  
contained, to the best of issuer's knowledge, in definitive proxy  
or information statements incorporated by reference in Part III  
of this Form 10-KSB or any amendment to this Form 10-KSB.

The information required in Part III by Items 9, 10, 11 and 12  
is incorporated by reference to the issuer's proxy statement in

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connection with the 2003 Annual Meeting of Shareholders, which will be filed by the issuer within 120 days after the close of its fiscal year.

State issuer's revenues for its most recent fiscal year: \$1,588,000.

As of September 15, 2003, the aggregate market value of the issuer's Common Stock (based on its reported last sale price on the American Stock Exchange) held by non-affiliates of the issuer was \$21,216,101.

At September 25, 2003 10,429,255 shares of issuer's Common Stock were outstanding.

### PART I

#### ITEM 1. BUSINESS

##### Overview

AquaCell Technologies, Inc. (the "Company") is engaged in the manufacture and sale of products for water filtration and purification through our operating subsidiaries, Global Water-Aquacell, Inc. and Water Science Technologies, Inc. (WST). Our products address various water treatment applications for industrial, commercial, institutional and residential purposes. These applications range from providing purified drinking water-through our point-of-use patented self-filling Purificr Water Cooler and production of water bottling plant equipment- to equipment for processing water for ultra-pure purposes, such as micro-chip and pharmaceutical manufacturing. The Company was incorporated in Delaware on March 19, 1997.

Our flagship product is our patented five-gallon self-refilling bottle Purific water cooler, manufactured by our Global Water-Aquacell subsidiary. The various filtration systems available on our cooler contain different combinations of systems, which utilize sediment filters, reverse osmosis, carbon block, multi-media filters and ultra-violet light. We replace traditional five-gallon bottle water coolers with a permanently installed convenient alternative where the bottle never needs changing and water bottles no longer need to be delivered, stored or replaced. In addition, we replace water fountains where users tend to have greater concerns as to sanitation and water quality.

##### Water Purification Industry Background

Warning of a mounting water crisis, the United Nations has designated 2003 as the "International Year of Freshwater", stating, "Water is likely to become a growing source of tension and fierce competition between nations if present trends continue.". The UN has reported that more than half of humanity will be living with water shortages within 50 years. However, an article appearing in the June 2003 Water Conditioning & Purification magazine, states that wars over water are unlikely since it would cost far less to build water treatment and desalination systems to produce water for a given country - giving rise to the water purification industry.

The highly fragmented water purification industry has thousands

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of companies involved in various capacities, including companies which design fully integrated systems for processing millions of gallons of water for municipal, industrial, and commercial applications, down to the independent water delivery route person.

According to an article appearing in The Wall Street Journal, water supply businesses generate approximately \$400 billion in revenue worldwide annually. Demand for water purification has continued to grow nationally and internationally due to economic expansion, scarcity of usable water, concern about water quality and regulatory requirements. One of the fastest growing segments of the industry is the drinking water segment, including point-of-use filtration systems for providing purified drinking water and bottled drinking water.

In November 2002, the Wall Street Journal reported that the new kitchen status symbol is the water cooler, and that home delivery service of water is increasing. Sales of water coolers at retail has escalated due to consumer demand, according to the June 16, 2003 Weekly of Home Products Retailing.

### U.S. Drinking Water Analysis

While many consumers use water filtration systems and drink bottled water for improved taste, there are other more important reasons to do so.

**Risks of Tap Water.** Tap water, regardless of its source, may contain certain contaminants that can affect one's health. Although municipalities are required to provide drinking water which complies with the Safe Drinking Water Act, the water supplied to homes from municipalities may contain startling levels of chlorine in addition to bacteria, toxins and parasites. Although the water may be purified upon leaving the treatment facility, impurities may be picked up from the pipes used to transfer it to the tap. Lead may also leach into the water from pipes, especially in older construction.

In the United States, water quality is being compromised by pollution, aging municipal water systems, and contaminated wells and surface water. According to an August 12, 2002 U.S. News and World Report article, researchers question whether Americans are getting sick from their drinking water far more often than is recognized. The report further states that the next five years will see more new rules than have been adopted in all the years since the enactment of the Safe Drinking Water Act in 1974.

Cost estimates for upgrading municipal water systems in the United States range from \$151 billion to \$1 trillion, with projected costs as high as \$6900 per household in some areas. Additionally, costs for protection stemming from potential terrorism will cost \$450 million for Congressional ordered vulnerability studies, with an additional \$1.6 billion needed for basic security at pumping stations and treatment plants.

The awareness level of consumers of the potential hazards of drinking tap water is continuously increasing, and we believe that more educated consumers will be seeking to minimize such potential risks through the purchase of point-of-use filtration systems. An article appearing in the September 2002 Water Technology magazine, included predictions from point-of-use

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experts on the industry's future. The article includes statements that the home water treatment market will grow from its current 15 percent penetration to near 100%, with every home having a point-of-use water drinking water system within the next 20 years, as point-of-use equipment will become a regular solution to some municipal water quality problems.

**Problems With Bottled Water.** While some people have resorted to drinking bottled water as a safe alternative to tap water, even bottled water can contain impurities. In February 1999, the Natural Resources Defense Council released an extensive four year scientific study of bottled water sold in the United States, titled "BOTTLED WATER: Pure Drink or Pure Hype?" This study included testing of more than 1000 bottles of 103 brands of bottled water. One-third of the bottled waters tested were found, in at least one test sample, to contain levels of contamination that exceeded allowable limits under either state or bottled water standards. Contaminants found in the bottled waters included synthetic organic chemicals, bacteria and arsenic. The study further revealed that, according to government and industry estimates, 25% to 40% of bottled water is just tap water- sometimes with additional treatment, sometimes not. The conclusion of the study was that bottled water is not necessarily any better regulated, purer, or safer than most tap water.

In June, 2003 the nation's largest bottled water company was charged with falsely advertising that the source of the water was a pristine protected spring, when allegedly it is actually heavily treated ground water.

The growth of bottled water sales, particularly in individual serve bottles, has lead to an environmental issue with discarded water bottles creating a crisis in landfills. These bottles remain in the landfills forever, unless they are incinerated, which releases toxic fumes into the air that harm the ozone layer. In California alone, 3 million bottles per day are tossed into landfills (1 billion per year), which is expected to increase with the popularity of bottled water.

Our Global Water-Aquacell, Inc. Subsidiary

Our flagship product is our patented PURIFICr Water Cooler. The Purific cooler is hooked up to a standard municipal water supply. The water is filtered and purified through multiple step systems and the treated water then automatically and continuously fills the permanently attached five-gallon bottle on the cooler. Our patents pertain to the attachment of the bottle to the cooler, and the float valve in the bottle, providing the automatic refilling.

The filtration systems available on the Purific cooler vary in complexity; however, each system contains the proprietary multi-stage Aquacell Multi-Media Filter set. These unique multi-media filters contain various medias known to filter certain impurities from water, including activated carbon, activated alumina, KDF r and Environmental Protection Agency (EPA) registered silver impregnated carbon, used to prohibit bacterial growth, a common problem with simple carbon filters. EPA registration is given to a product only after evidence is submitted to validate that the labeling claims are true and that it does not impart over 50 ppb of silver to the treated water. EPA registration is an

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important selling aid, as it makes the customer aware that the product is established and reliable. The Aquacell was also involved in a study performed by the EPA for effectiveness in removing various waterborne contaminants.

### Purific Cooler Models:

We manufacture five different models of Purific water coolers with varying complexity of filtration systems, designed to meet the needs of the customers to which they are sold.

Purific 2001 - The Purific 2001 is equipped with our most comprehensive triple purification and filtration system designed to protect against potentially harmful foreign contaminants in drinking water. The system features a pressure regulator and water monitor with an enclosed filtration case that also serves as a leak detector with an automatic shutoff system. The target market is a corporation seeking the best possible water purification system in light of the events of September 11, 2001.

Purific 500 - Our best selling system is equipped with the Aquacell multi media and carbon block filtration in addition to either ultraviolet light or reverse osmosis. The system includes a pressure regulator and water monitor. The target market is Fortune 1000 companies. Our filtration systems on this unit have been tested and validated by the Water Quality Association (WQA), which is a trade association comprised of 2,600 members in the household, commercial, industrial and small system water treatment industry, and has earned the WQA Gold Seal of Approval.

Purific 300 - The Purific 300 combines Aquacell multi-media filtration with either ultraviolet light or reverse osmosis. The target market is mid-size companies who have moderate monthly bottled water bills.

Purific 100 - A basic Aquacell multi-media filtration combined with a sediment filter comprises the filtration system. The target market is small companies, or those seeking to primarily just improve the taste of the tap water.

Purific 50 - Designed for the retail consumer market, the Purific 50 provides Aquacell multi-media filtration.

Replacement Filters - We also sell replacement filters for our Purific water coolers. The filtration systems on our patented water coolers require replacement after 2,000 gallons of water have passed through the system or after one year from the date of installation, whichever comes first. We contact our customers on a regular basis to facilitate timely replacement of filters. Customers with high water usage often stock replacement filters. The revenue from replacement filters will be significant and will increase from year to year as we sell more water coolers and other systems.

In order to expand the product line to new sales channels, we are offering a system that will be marketed under the AquaCell name, which will include one commercial grade filter manufactured by a large, well-established water filtration company. This filter is approved by the National Sanitation Foundation, and is used by the top fast-food, convenience stores and numerous other food service locations for the treatment of water serving beverage bars and other food and beverage applications.

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### Advantages of the Purific Water Cooler

The Purific cooler's main advantages over bottled water are Cost, Convenience and Quality. Since the tragic events of September 11, 2001 an additional benefit of the Purific cooler has emerged, and that is the Security aspect of eliminating potential risk of bottled water deliveries. Other benefits of Purific include:

- . Saves money. Our self-filling cooler has been proven to save most companies a considerable amount of money over the costs of bottled water alternatives.
- . No bottles to change. When changing water bottles, most people spill or splash the water, and often a relatively strong person must be located to change the bottle. Also the cleanliness of the hands of the person changing the bottle is an issue, since anything on their hands will end up in the water.
- . Reduce potential worker's compensation claims. Potential worker's compensation claims from injuries due to lifting the 40-pound bottle can be costly.
- . No bottles to store. Replacement water bottles are cumbersome to store, taking up a lot of valuable space in an office. The higher the rent, the more it costs to store the water.
- . Never run out of water. Since our Purific cooler continuously refills itself as water is dispensed, the cooler always has water available when needed.
- . No delivery problems. Deliveries of bottled water can disrupt office operations, as well as pose potential security risks. Additionally, in large office buildings wait time for freight elevators can delay bottled water delivery by several hours, further adding to the inconvenience of bottled water delivery.
- . Freshly filtered and purified water. The quality of bottled water varies greatly depending upon the source and whether or not it is filtered or purified. Also, water which has been stored in certain areas can absorb taste and odor through the bottle. The water in our Purific water cooler maintains its freshness as it is constantly being replenished.

### Marketing of the Purific Water Cooler

Beginning in January 2002, Corbett Water Technologies, Inc., (CWT) a company with which we had signed an agreement for the marketing and distribution of our Purific water coolers, built a sales force through the recruitment of experienced sales personnel from the largest bottled water delivery companies for sales of Purific coolers. In late September 2002, CWT made a decision to restructure its business model, reduced its sales staff and did not implement a plan for national marketing. As a result, we restructured our relationship with CWT, whereby CWT relinquished its exclusive distribution rights, but is continuing to sell Purific coolers on a non-exclusive basis.

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In June 2002, we signed a distribution agreement with Connecticut Water Service, an investor-owned public water utility. Connecticut Water markets our Purific cooler to its customers in Connecticut and other areas in New England. The program began with Connecticut Water distributing solely to its commercial customers. The program is now being rolled out to include marketing of the new AquaCell branded cooler to their residential customers.

In May 2003 we announced a successful product test that was funded by a Fortune 100 company on our Purific water cooler. The results of this test confirmed the competitive advantages of the Purific system, particularly for the residential market, the fastest growing segment of the bottled water industry.

Prior to signing these agreements, we sold our Purific coolers directly to corporations, with an emphasis on Fortune 500 headquarter locations and the US Government under a General Services Administration contract, to which we continue to sell directly. Additionally, we have an arrangement with Roto-Rooter Plumbers for the installation and sales of our Purific coolers. We intend to maintain a small in-house sales force and rely on our marketing partners for most of our sales.

Additional channels of distribution are being marketed to through our AquaCell Media subsidiary, as described below.

### Our Water Science Technologies, Inc. Subsidiary

In March 2002, AquaCell closed on its acquisition of Water Science Technologies (WST), a Tempe, Arizona based manufacturer of integrated water purification and treatment systems. WST is a wholly owned subsidiary of AquaCell.

WST operates as a manufacturer of custom designed systems to meet a variety of water purification and treatment needs. The company will continue to manufacture certain custom systems for various applications, and additionally, management intends to develop targeted product lines for four specific markets, which we believe will position WST for long-term growth.

The first area of concentration is purification and bottling systems for water bottling plants, both foreign and domestic. Bottled water is the fastest growing segment of both the beverage industry and the water industry. WST has manufactured numerous systems for bottling plants installed throughout the US, and Central and South America including systems for brands such as Culligan, O Premium, and numerous private-label supermarket brands.

The second area of concentration will be on systems to treat water for car washes, providing environmentally friendly recycling and discharge, as well as spot-free rinse. We currently supply such systems for use in car washes in a regional southwest area, and will look to expand the program throughout the US.

The third product line will encompass the restaurant and food service industry, providing protection of equipment and more consistent quality of food.

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The fourth product line will target emergency drinking water systems, including the recently designed portable system capable of converting swimming pool water into drinking water.

Given WST's experience and expertise in manufacturing water store equipment, the Company will be opening water stores in various locations, which it will own and/or operate in conjunction with strategic marketing partners.

We anticipate that these product lines will be marketed by marketing partners with expertise in the corresponding industries.

### Our AquaCell Media Inc. Subsidiary

In September 2001, we formed a new subsidiary, dedicated to the selling of advertising space on the bottle label of the permanently attached five-gallon bottle of our patented self-filling Purificr Water Cooler.

We are in effect creating a water cooler billboard. Since the water cooler is a known congregating location, we believe it is the perfect venue for advertisers. The benefits to advertising on the Purific bottle label include a high level of viewing frequency; no clutter from competing ads; and long viewing time - since pages can't be turned, there is no channel surfing or mouse clicking; and, it is inexpensive.

Since the bottle is permanently attached to the water cooler, the label - which can be changed intermittently to coincide with advertising campaigns - remains intact. The program will be rolled out to encompass targeted industries such as health care, brokerage firms, travel agencies, salons, schools and universities.

The marketing model we have set up for this company will allow us to maintain ownership of the coolers, and generate revenue stream from the sales of advertising space.

No revenues were generated by this subsidiary during the year ended June 30, 2003.

### Customers

Our Global Water customers currently include companies across a broad range of industries including investment banking, consumer products, aerospace, entertainment, banking, brokerage houses, manufacturing and insurance. Our customers also include professional service providers and governmental agencies. Our WST customers include a broad range of industries including water bottling, car washes, and various manufacturing facilities.

### Production, Raw Materials and Supplies

Our Products are manufactured in our 10,000 square foot manufacturing facility located in Rancho Cucamonga, California, and the WST 8,300 square foot facility located in Tempe, Arizona. Our California plant is located within a 100-mile radius of 95% of our suppliers allowing for just-in-time inventory. Our product has a low cost of manufacturing. In our Global Water-Aquacell subsidiary, less than 10% of product cost is in labor, allowing for high gross profit margins because our operations do not



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require a large full time employee base and, when needed, temporary employees are readily available.

Our facility utilizes manufacturing processes that follow the guidelines of the Water Quality Association. The manufacturing process of our various products includes utilization of injection-molded parts, for which we own the molds. Multiple vendors have been identified as sources for parts and supplies for our products and we do not anticipate any shortages of such materials.

We maintain a controlled low inventory of finished goods. Upon completion of manufacture, each product undergoes quality assurance testing prior to shipping and installation. The raw materials and components used in these products are commonly available commodities such as off the shelf water coolers, water bottles, various fittings, plastic tubing, wiring, valves, sediment filters, reverse osmosis membrane filters and ultra-violet lights. Our products are fabricated from these materials and assembled together with products bought from other companies to form an integrated product. We do not depend on any single supplier. If any supplier were to become unable to perform, we believe we could readily find a substitute source. We are not a party to any material long-term fixed price supply contracts.

### Government Regulation

Federal, state, local and foreign environmental laws and regulations require substantial expenditures and compliance with water quality standards and impose liabilities for noncompliance. We believe that environmental laws and regulations and their enforcement are, and will continue to be, a significant factor affecting the marketability of our products. The treatment of drinking water in the United States is governed by the Safe Drinking Water Act. The 1996 amendments to the Act emphasize risk-based standards for contaminants in drinking water, afford small water supply systems operational flexibility and provide assistance to water system infrastructures through a multi-billion-dollar Drinking Water State Revolving Fund. The Fund program assists public water systems with the financing of the costs of drinking infrastructure that is necessary to achieve or maintain compliance with the Safe Drinking Water Act requirements and to protect public health. The Fund, patterned after the State Revolving Fund contained in the Clean Water Act, provides funding to the states to establish a renewable source of financing for drinking water infrastructure projects. The Fund program is designed to ensure that the drinking water supplies in the United States remain safe and affordable, and that systems that receive funding will be properly operated and maintained. Regulations under the Safe Water Drinking Act also established maximum containment levels for a wide variety of chemicals that may be present in drinking water treatment to meet applicable standards.

Any changes in applicable regulations or their enforcement may affect our operations by imposing additional regulatory compliance costs on our customers, requiring modification of our products or affecting the market for our products. To the extent that demand for our products are created by the need to comply with such enhanced standards or their enforcement, any modification of the standards or their enforcement may reduce demand, thereby adversely affecting our business, financial

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condition or results of operations. The relaxation or repeal of any such laws or regulations or the strict enforcement thereof could also adversely affect our business and prospects. Conversely, changes in applicable environmental requirements imposing additional regulatory compliance requirements or causing stricter enforcement of these laws or regulations could increase the demand for our products.

### Competition

The drinking water purification industry is fragmented and highly competitive due to the large number of businesses within certain product areas. We compete with many companies that have greater market penetration, depth of product line, resources and access to capital, all of which could be competitive advantages. Competitors of our Global Water-Aquacell products include: bottled water brands such as Arrowhead, Deer Park, Poland Spring, and Sparkletts; water filtration system manufacturers such as Culligan, which is owned by US Filter Corporation, Brita, which is owned by Clorox and Pur, which is owned by Proctor and Gamble; and flat-top point-of-use water cooler manufacturers such as Oasis, Cordley-Temprite, and Mutual of Omaha's Iinnowave product. Competitors of our WST subsidiary include water filtration systems manufacturers such as US Filter, Ionics, and Osmonics.

While we believe that we can deliver our products on an economically competitive basis, there can be no assurance in that regard. In addition, many competitors have greater financial resources than us to finance their expansion and internal growth opportunities. Consequently, we may encounter significant competition in our efforts to achieve our strategic goals. There can be no assurance that our competitors will not develop products that are superior to ours or achieve greater market acceptance than our products. Competition could have a material adverse effect on our ability to consummate arrangements with customers or enter into strategic business alliances. Moreover, in response to changes in the competitive environment, we may make certain pricing, service or marketing decisions or enter into acquisitions or new ventures that could have a material adverse effect on our business, financial condition and results of operations.

### Intellectual Property

We own a United States and Canadian patent on our automatic-refilling purified bottle water cooler. These patents do not expire until November 20, 2006 and October 2, 2009, respectively. We have filed for two patents with the US Patent and Trademark office, which if granted, would provide exclusive rights for utilizing the water cooler bottle as an advertising mechanism. We have federally registered our Purific and Water Science Technologies International trademarks and have pending applications to federally register our "Never Change Another Bottle" logo and AquaCell marks. We also conduct business in California under the name Global Water Solutions, Inc. We intend to seek appropriate additional trademark or servicemark registrations in connection with our product and service offerings.

### Research and Development

We have not spent any material amount of money on research and

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development during the last two fiscal years.

### Employees

As of June 30, 2003, we had 19 employees. None of our employees are covered under collective bargaining agreements although we do have employment agreements with certain executives. Management believes we maintain a good relationship with our employees.

### ITEM 2. PROPERTIES

Our principal executive office and our 10,000 square foot Global Water-Aquacell manufacturing facility are located in Rancho Cucamonga, California under a five-year lease that commenced on January 1, 1999 and expires on December 31, 2003. That lease has an average annual base rent of \$69,600. We also maintain an 8300 square foot WST manufacturing facility in Tempe, Arizona under a five (5) year lease that commenced on November 1, 2001 and expires on October 31, 2006. That lease has an average annual base rent of \$55,900. We believe that, if necessary, alternative space is readily available at comparable rates and on comparable terms with respect to all of our leased properties. We also believe that we can obtain additional space necessary to support increases in our future operation. We believe that the properties described above are currently protected by adequate insurance.

### ITEM 3. LEGAL PROCEEDINGS

None.

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

None.

## PART II

### ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's Common Stock commenced quotation on the American Stock Exchange on February 12, 2001 following its initial public offering. The following table sets forth, for the periods indicated, the last sale prices for the Common Stock as reported by American Stock Exchange:

Period	High (\$)	Low (\$)
Fiscal 2004		
7/1/03 - 9/15/03 .....	\$3.05	\$2.06
Fiscal 2003		
Fourth Quarter .....	\$3.15	\$0.94
Third Quarter .....	1.30	0.60
Second Quarter .....	1.00	0.55
First Quarter .....	1.10	0.78

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### Fiscal 2002

Fourth Quarter .....	\$3.04	\$0.83
Third Quarter .....	4.18	2.95
Second Quarter .....	5.25	3.25
First Quarter .....	4.80	3.30

On September 15, 2003, the last sale price of the Common Stock as reported by AMEX was \$2.99. On September 15, 2003, there were 119 holders of record of the Company's Common Stock and, the Company believes, over 700 beneficial owners of the Company's Common Stock.

The Company presently intends to retain all earnings for the Company's continued growth. Depending upon the Company's capital resources and needs, the Company may pay cash dividends in the future. The payment of dividends, if any, in the future is within the discretion of the Board of Directors and will depend upon the Company's earnings, its capital requirements and financial condition, and other relevant factors, although this may change based upon the foregoing factors.

### Recent Sales of Unregistered Securities

During the year ended June 30, 2003, the Company made the following sales of unregistered securities:

Date of Sale	Title of Security	Number Sold	Consideration Received and Description of Underwriting or Other Discounts to Market Price Afforded to Purchasers	Exemption From Registration Claimed	If Option, Warrant or Convertible Security, Terms of Exercise or C
-----	-----	-----	-----	-----	-----
1/2/03	Options to Purchase Common Stock	184,500	Option granted under 1998 Incentive Plan- No cash received.	4 (2)	All exercisable at \$0. 1/02/10 and vesting ov
4/21/03	Options to Purchase Common Stock	12,500	Option granted under 1998 Incentive Plan- No cash received.	4 (2)	All exercisable at \$1. through 4/21/10 and ve year term.
1/22/03	Options to Purchase Common Stock	30,000	Option granted under 2002 Director's Stock Option Plan- No cash received.	4 (2)	All immediately exerci per share through 1/22
8/24/02	Warrants to Purchase Common Stock	60,000	No cash received until exercise.	4 (2)	All exercisable at \$0.
3/16/03	Warrants to Purchase Common Stock	150,000	No cash received until exercise.	4 (2)	All exercisable at \$1.
1/6/03	Common Stock	100,000	Issued as compensation in connection with financing transactions.	4 (2)	-

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4/10/03	Common Stock	25,000	Issued as compensation in connection with financing transactions.	4(2)	-
4/16/03	Preferred Stock	685,000	Issued in connection with private placement at \$0.63 per share.	4(2); 4(6)	Convertible into Common share for share basis.
4/16/03	Warrants to Purchase Common Stock	685,000	Issued in connection with private placement- No cash received until exercise.	4(2); 4(6)	All exercisable at \$1.
5/9/03	Preferred Stock	500,000	Issued in connection with private placement at \$0.75 per share.	4(2); 4(6)	Convertible into Common share for share basis.
5/9/03	Warrants to Purchase Common Stock	500,000	Issued in connection with private placement- No cash received until exercise.	4(2); 4(6)	All exercisable at \$1.

### ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

#### Forward-Looking Statements

When used in this Form 10-KSB and in future filings by the Company with the Commission, statements identified by the words "believe", "positioned", "estimate", "project", "target", "continue", "will", "intend", "expect", "future", "anticipates", and similar expressions express management's present belief, expectations or intentions regarding the Company's future performance within the meaning of the Private Securities Litigation Reform Act of 1995. Readers are cautioned not to place undue reliance on any such forward-looking statements, each of which speaks only as of the date made. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. The Company has no obligations to publicly release the result of any revisions which may be made to any forward-looking statements to reflect anticipated or unanticipated events or circumstances occurring after the date of such statements.

#### Overview

The following discussions and analysis should be read in conjunction with the Company's consolidated financial statements and the notes presented following the consolidated financial statements. The discussion of results, causes and trends should not be construed to imply any conclusion that such results or trends will necessarily continue in the future.

For the year ended June 30, 2003 we increased revenues by 51% to \$1,588,000 while cutting our per share losses by 33% and decreasing our selling, general and administrative expenses by 32% to \$3,044,000. This increase in revenues is primarily attributable to the growing acceptance of our flagship Purificer

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Water Cooler in the marketplace.

On May 30, 2003 the Company successfully completed negotiations for the return of the exclusive distribution rights for our Purific Water Cooler from Corbett Water Technologies, Inc. (CWT) and S&B Technical Products, Inc. (S&B). Under the terms of the agreement, CWT and S&B relinquished the exclusive distribution rights to AquaCell, but will continue to sell Purific coolers on a non-exclusive basis in the areas in which it achieved significant sales. As a direct result of this nine month negotiation process, during which time these entities did not purchase any additional coolers, the Company was impeded from pursuing new marketing avenues or channels of distribution. While this encumbrance had a negative effect on sales during this period, management believes that its decision to negotiate for the return of these rights will, in the long term, prove to be beneficial for the Company.

The Company is presently pursuing other opportunities for sales and distribution of its self-filling coolers and does not anticipate incurring significant marketing costs as it intends to utilize channels of distribution, including joint-venture marketing partners, where the selling groups will be responsible for payment of their own sales and marketing expenses.

During May we completed a successful product test of our Purific Water Cooler as the first phase of a project funded by a Fortune 100 company and conducted by a consultant group they hired for its implementation. Given these favorable results, we are proceeding with our plans for marketing the Purific cooler to the residential community, the fastest growing segment of the bottled water industry, as well as other opportunities.

We recently teamed up with Beau Dietl & Associates (BDA), an internationally renowned security expert for marketing and sales of our Purific cooler. BDA sees the delivery of bottled water as a major security risk that needs to be addressed, which can easily be rectified with our Purific cooler.

During September 2003 the Company commenced negotiations for a lease on a 20,000 square foot facility that will triple its existing manufacturing capabilities.

### Results of Operations

For the year ended June 30, 2003 on a consolidated basis, we increased revenues by 51% to \$1,588,000 as compared to \$1,049,000 for the similar period of the preceding year. Approximately 1,400 coolers were sold during the year ended June 30, 2003 as compared to approximately 800 for the prior year. The revenue increase is primarily attributable to an increase in sales to Corbett Water, a former distributor, in the amount of approximately \$254,000 and a sales increase by our Water Science Technologies (WST) subsidiary in the approximate amount of \$227,000, attributable to our first full year of ownership. Revenue resulting from sale of replacement filters was insignificant during the year ended June 30, 2003. Net loss on a consolidated basis, attributable to common stockholders, for the year ended June 30, 2003 was decreased by 26% to \$2,814,000 or \$0.33 per share, as compared to \$3,804,000 or \$0.47 per share for the prior year. The decrease in the loss is primarily attributable to the increase in revenues, as well as a reduction in selling, general and administrative

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expenses of \$1,470,000 or 33%. The significant decrease in the selling, general and administrative expenses was principally a result of a \$1,226,000 impairment charge impacting only the prior period.

On a consolidated basis gross margin percentage decreased to 38% for the year ended June 30, 2003 as compared to 46% for the prior year. This decrease is attributable to the 28% gross margin maintained by our WST subsidiary. Our Global Water-Aquacell subsidiary reflected a gross profit margin of approximately 51% based on material and direct labor costs reflecting a decrease of 6% from the prior year. This decrease is attributable to increased labor and related costs.

Salaries and wages increased by \$291,000 for the year ended June 30, 2003 over the prior year. This increase is primarily attributable to salaries incurred by our WST subsidiary of approximately \$203,000 for our first full year of ownership and payments to senior management in the approximate amount of \$107,000. Legal, accounting and other professional expenses decreased by approximately \$295,000 for the year ended June 30, 2003 primarily attributable to terminated consulting agreements. Stock based compensation decreased by \$429,000 to \$199,000 for the year ended June 30, 2003. Other selling, general and administrative expenses, consisting primarily of rent- \$168,000, telephone and utilities- \$75,000, travel- \$62,000, business promotion- \$153,000, insurance- \$97,000 and vehicle expenses- \$101,000 increased by approximately \$159,000 to \$1,166,000 for the year ended June 30, 2003. During the year ended June 30, 2003 the Company recorded a onetime reduction to fair value, in the amount of \$274,000, of its receivable in connection with the sale of an investment.

### Liquidity and Capital Resources

During the year ended June 30, 2003 we financed our operations primarily from the collections of receivables in the normal course of business and the sales of equity securities. During the year ended June 30, 2003 the Company received net proceeds of \$733,000, after deducting expenses of \$73,000, from the sale of 1,185,000 shares of its Series A convertible preferred stock. A net increase in loans from related parties amounted to \$51,000.

Cash used by operations during year ended June 30, 2003 amounted to \$799,000. Net loss of \$2,434,000 was reduced by non-cash stock based compensation and loan fee amortization in the amount of \$288,000, reduction of receivable to fair value and write-off of note and accrued interest in the amount of \$333,000, impairment loss on goodwill of \$72,000, depreciation and amortization of \$58,000, provision for bad debts of \$21,000 and increased by a reduction in notes receivable reserve of \$188,000. Cash used by operations was further decreased by a decrease in accounts receivable in the amount of \$96,000 and by accounts payable and accrued expenses in the amount of \$887,000. Net loss was further decreased by net changes in accrued interest receivable, prepaid expenses, customer deposits and inventories amounting to \$68,000.

Cash used in investing activities during the year ended June 30, 2003 represented expenditures for property and equipment in the amount of \$11,000 decreased by notes issued for the purchase of equipment in the amount of \$7,000, net of repayments.

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Cash provided by financing activities was approximately \$784,000. The Company borrowed \$51,000 from related parties. Sales of Series A convertible preferred stock amounted to \$733,000 net of expenses of \$48,000.

Subsequent to June 30, 2003 the Company raised an additional \$2,296,000 from the sale of equity securities, net of expenses of \$259,000.

We have granted warrants, subsequent to our initial public offering in connection with consulting, marketing and financing agreements that may generate additional capital of up to approximately \$13,900,000 if exercised. There is no assurance however, that any of the warrants will be exercised.

During the year ended June 30, 2003 principal payments of \$567,000, which consisted of contributed accrued officers' salaries, reduced the balance on the \$1,750,000 installment notes receivable to \$177,000 at June 30, 2003.

Management believes that its current cash position and cash flows expected to be generated from future operations will be sufficient to meet presently anticipated needs for working capital and capital expenditures through at least the next 12 months; however, there can be no assurance in that regard. The Company presently has no material commitments for future capital expenditures.

### ITEM 7. FINANCIAL STATEMENTS

See Financial Statements beginning on page F-1.

### ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

### ITEM 8A. CONTROLS AND PROCEDURES

Within the 90 days prior to the date of this Report the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's chief executive officer and chief financial officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-14 adopted under the Securities Exchange Act of 1934. Based upon that evaluation, the chief executive officer and chief financial officer concluded that the Company's disclosure controls and procedures are effective. There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

## PART III

### ITEM 9. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT



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See Item 12.

ITEM 10. EXECUTIVE COMPENSATION.

See Item 12.

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

See Item 12.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by Items 9, 10, 11, and 12 is incorporated by reference to the information included in the Company's definitive proxy statement in connection with the 2003 Annual Meeting of Stockholders.

ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K

None.

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.

Dated: September 25, 2003 AQUACELL TECHNOLOGIES, INC. (Registrant)

By: /s/ JAMES C. WITHAM
Name: James C. Witham
Title: Chief Executive Officer

In accordance with the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Table with 3 columns: Signatures, Title, Date. Rows include James C. Witham (Chairman of the Board of Directors and Chief Executive Officer) and Karen B. Laustsen (Director and President), both dated September 25, 2003.



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REPORT OF INDEPENDENT AUDITORS

The Board of Directors of  
Aquacell Technologies, Inc.

We have audited the accompanying consolidated balance sheet of Aquacell Technologies, Inc. and Subsidiaries as of June 30, 2003, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the two years in the period ended June 30, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Aquacell Technologies, Inc. and Subsidiaries as of June 30, 2003, and the results of their operations and their cash flows for each of the two years in the period ended June 30, 2003 in conformity with accounting principles generally accepted in the United States of America.

WOLINETZ, LAFAZAN & COMPANY, P.C.

Rockville Centre, New York  
September 15, 2003

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AQUACELL TECHNOLOGIES, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEET  
June 30, 2003

ASSETS

Current assets:

Cash .....	\$	32,000
Notes receivable, including accrued interest of \$69,000 .....		160,000
Accounts receivable, net of allowance of \$25,000 .....		74,000
Inventories .....		84,000
Prepaid Expenses .....		123,000

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Total current assets .....	473,000
Property and equipment, net .....	38,000
Other assets:	
Goodwill .....	1,042,000
Patents, net .....	98,000
Security deposits .....	14,000
Total other assets.....	1,154,000
	\$1,665,000
	=====
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Accounts payable .....	\$ 735,000
Accrued expenses .....	502,000
Preferred stock dividend payable.....	12,000
Customer deposits .....	23,000
Current portion of long term note .....	4,000
Loans payable - related parties .....	80,000
Total current liabilities .....	1,356,000
Long term note, net of current portion .....	3,000
Total liabilities .....	1,359,000
	-----
Commitments and contingencies	
Stockholders' equity:	
Preferred stock - Class A, par value \$.001;	
1,870,000 shares authorized;	
1,185,000 issued and outstanding .....	
	1,000
Preferred stock, par value \$.001;	
8,130,000 shares authorized;	
no shares issued .....	
	-
Common stock, par value \$.001;	
40,000,000 shares authorized;	
8,726,224 shares issued and outstanding .....	
	9,000
Additional paid-in capital .....	13,544,000
Accumulated deficit .....	(12,909,000)
	-----
	645,000
Unamortized deferred compensation .....	(339,000)
Total stockholders' equity .....	306,000
	-----
	\$1,665,000
	=====

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

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## CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended June 30,	
	2003	2002
Revenue:		
Net sales .....	\$ 1,582,000	\$ 1,042,000
Rental income .....	6,000	7,000
	-----	-----
	1,588,000	1,049,000
Cost of sales .....	990,000	565,000
	-----	-----
Gross profit .....	598,000	484,000
	-----	-----
Selling, general and administrative expenses:		
Salaries and wages .....	1,290,000	999,000
Legal, accounting and other professional expenses .....	172,000	467,000
Stock based compensation.....	199,000	628,000
Other .....	1,166,000	1,007,000
Impairment loss on investment.....	-	1,226,000
Impairment loss on goodwill.....	72,000	187,000
Reduction of receivable to fair value.....	274,000	-
Write-off of note receivable and accrued interest .....	59,000	-
Recovery of notes-receivable reserve.....	(188,000)	-
	-----	-----
	3,044,000	4,514,000
	-----	-----
Loss from operations before other income (expense).....	(2,446,000)	(4,030,000)
	-----	-----
Other income (expense):		
Interest expense .....	(41,000)	-
Interest income .....	53,000	126,000
Other income .....	-	100,000
	-----	-----
	12,000	226,000
	-----	-----
Net loss for the year .....	\$ (2,434,000)	\$ (3,804,000)
	=====	=====
Weighted average common shares outstanding- basic and diluted .....	8,655,000	8,149,000
	=====	=====
Loss attributable to common stockholders:		
Net loss .....	\$ (2,434,000)	\$ (3,804,000)
Preferred stock dividends.....	380,000	-
	-----	-----
Loss attributable to common stock holders....	\$ (2,814,000)	\$ (3,804,000)
	=====	=====
Net loss per common share.....	\$ (0.33)	\$ (0.47)
	=====	=====

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

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AQUACELL TECHNOLOGIES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

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	Preferred Stock		Common Stock		Additional Paid-in Capital	Unamortized Deferred Compensation	Ac De
	Number of Shares	Par Value	Number of Shares	Par Value			
Balances- July 1, 2001 .....			7,733,250	\$7,000	\$ 9,441,000	\$ (308,000)	\$
Issuance of common stock for consulting services to the Company .....			240,000	-	324,000	(324,000)	
Issuance of common stock warrants for services to the Company ....					589,000	(589,000)	
Amortization of deferred costs ....						628,000	
Issuance of common stock for investment in Corbett Water Technologies, Inc. ....			451,807	1,000	1,499,000		
Issuance of common stock for acquisition of Water Science Technologies, Inc., including 55,337 shares issued to vendors of acquired company ....			258,589	1,000	1,188,000		
Surrender of 82,422 shares of common stock by officers in payment of principal and interest on notes receivable ...							
Net loss for the year ended June 30, 2002 .....							
Balances- June 30, 2002 .....			8,683,646	9,000	13,041,000	(593,000)	(
Sale of 1,185,000 shares of preferred stock in private placements, net of costs of \$73,000 .....	1,185,000	\$1,000			732,000		
Amortization of deferred costs ....						199,000	
Write-off of unamortized deferred compensation .....					(110,000)	110,000	
Issuance of 125,000 shares of common stock in connection with financing arrangement .....			125,000	-	89,000		
Issuance of 160,000 common stock warrants in connection with credit facility agreement .....					43,000	(43,000)	
Retirement of 82,422 shares of common stock held in the treasury .....			(82,422)	-	(251,000)		

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Issuance of 150,000 common stock warrants in connection with consulting agreement .....							12,000	(12,000)
Deemed dividends on beneficial conversion feature of preferred stock offerings .....							368,000	(368,000)
Dividends on Class A preferred stock .....							(12,000)	
Net loss for the year ended June 30, 2003 .....								
Balances- June 30, 2003 .....	1,185,000	\$1,000	8,726,224	\$9,000	\$13,544,000	\$	(339,000)	\$
	=====	=====	=====	=====	=====	=====	=====	=====

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

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AQUACELL TECHNOLOGIES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended June 30,	
	2003	2002
	-----	-----
Cash flows from operating activities:		
Net loss .....	\$ (2,434,000)	\$ (3,804,000)
Adjustment to reconcile net loss to net cash used in operating activities:		
Issuance of common stock in connection with financing transactions .....	89,000	-
Impairment loss on investment .....	-	1,226,000
Impairment loss on goodwill .....	72,000	187,000
Reduction of reserve on notes receivable .....	(188,000)	-
Reduction of receivable to fair value .....	274,000	-
Write-off of note receivable and accrued interest .....	59,000	-
Stock based compensation .....	199,000	628,000
Provision for bad debts .....	21,000	1,000
Depreciation and amortization .....	58,000	57,000
Changes in:		
Accounts receivable .....	96,000	(120,000)
Accrued interest receivable .....	(53,000)	-
Prepaid expenses and other current assets .....	93,000	80,000
Inventories .....	18,000	55,000
Security deposits .....	3,000	-
Accounts payable .....	17,000	457,000
Accrued expenses .....	870,000	487,000
Customer deposits .....	7,000	(43,000)
Net cash used in operating activities ....	(799,000)	(789,000)
	-----	-----
Cash flows from investing activities:		
Notes issued for purchase of property and equipment, net of payments .....	7,000	-
Collections on notes receivable .....	-	498,000

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Purchase of property and equipment .....	(11,000)	(6,000)
Cash balance of acquired subsidiary .....	-	25,000
	-----	-----
Net cash provided by (used in) investing activities .....	(4,000)	517,000
	-----	-----
Cash flows from financing activities:		
Loans and advances from related parties .....	51,000	25,000
Proceeds from private placements of preferred stock .....	781,000	-
Expenses of offerings .....	(48,000)	-
	-----	-----
Net cash provided by financing activities .....	784,000	25,000
	-----	-----
Decrease in cash .....	(19,000)	(247,000)
Cash, beginning of year .....	51,000	298,000
	-----	-----
Cash, end of year .....	\$ 32,000	\$ 51,000
	=====	=====

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

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AQUACELL TECHNOLOGIES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

	Year Ended June 30,	
	2003	2002
	-----	-----
Supplemental disclosure of cash flow information:		
Cash paid for interest .....	\$ 36,000	\$ -
Supplemental schedule of non-cash investing and financing activities:		
Note receivable payments of principal and interest made by officers/ stockholders with their shares of the Company's common stock recorded as treasury stock .....	\$ -	\$ 251,000
Issuance of common stock in connection with investment .....	\$ -	\$ 1,500,000
Issuance of common stock and warrants for services .....	\$ 55,000	\$ 913,000
Issuance of common stock to acquire subsidiary .....	\$ -	\$ 1,000,000
Issuance of common stock to satisfy indebtedness to acquired subsidiary's vendors .....	\$ -	\$ 189,000
Principal payments on notes receivable by conversion of accrued officers salaries .....	\$ 567,000	\$ 349,000
Issuance of preferred stock in private placement for expenses of the offering .....	\$ 25,000	\$ -
Retirement of 82,422 shares of treasury stock .....	\$ 251,000	\$ -
Dividends payable on preferred stock .....	\$ 12,000	\$ -
Consideration received for sale of investment .....	\$ 274,000	\$ -



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Deemed dividends on preferred stock .....	\$	368,000	\$	-
Write-off of unamortized deferred compensation .....	\$	110,000	\$	-

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

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### AQUACELL TECHNOLOGIES, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2003

#### Note A - Description of Business

AquaCell Technologies, Inc. was incorporated in Delaware on March 19, 1997 and its principal business activity is the manufacture and sale of products for water filtration and purification. The Company conducts substantially all of its business in the United States.

As shown in the accompanying financial statements, the Company has incurred substantial net losses since inception and utilized substantial cash in operating activities. The Company expects its operations will provide sufficient cash flows through June 30, 2004. There is no assurance, however, that profitable operations will ever be attained or that the Company will ever attain positive cash flow.

#### Note B - Summary of Significant Accounting Policies

##### [1] Principles of consolidation:

The accompanying consolidated financial statements include the accounts of AquaCell Technologies, Inc., and its wholly owned subsidiaries (the "Company"). Such subsidiaries are Global Water Aquacell, Inc., incorporated December 21, 1998, and Water Science Technologies, Inc., acquired on March 19, 2002. AquaCell Media, Inc., formed on September 10, 2001, is a wholly owned subsidiary of the Company that had no revenues through June 30, 2003. All significant intercompany accounts and transactions have been eliminated in consolidation.

##### [2] Inventories:

Inventories are carried at the lower of cost, determined using the FIFO (first-in, first-out) method or market.

##### [3] Property and equipment:

Property and equipment is stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets which approximates three to five years.

##### [4] Goodwill:

Goodwill represents the excess of the purchase price over the fair value of net assets of a business acquired. The Company has adopted Statements of Financial Accounting Standards No. 142 (SFAS 142), "Goodwill and Other Intangible Assets". The Company operates as a single integrated business, and as such has one operating segment which is also the reportable unit. Fair value of the reporting unit is determined by comparing the fair value of the unit with its carrying

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value, including goodwill. Impairment tests are performed using discounted cash flow analysis and estimates of sales proceeds. The annual evaluation of goodwill is performed at June 30th, the end of the Company's fiscal year.

### [5] Patents:

The value of patents is amortized over nine years, their remaining useful lives at date of acquisition, using the straight-line method. Patents at June 30, 2003, are stated net of accumulated amortization of approximately \$99,000. Amortization expense was \$22,000 for the years ended June 30, 2003 and 2002, respectively.

### [6] Revenue recognition:

Revenues are recorded at the time our products are shipped unless we agreed to install the products, in which case we recognize revenue at the time of installation. Rental income from coolers is recognized on a straight-line basis over the term of the rental agreement.

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AQUACELL TECHNOLOGIES, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
June 30, 2003

### Note B - Summary of Significant Accounting Policies (continued)

### [7] Advertising:

Advertising costs are expensed as incurred. Advertising expense for the years ended June 30, 2003 and 2002, was approximately \$3,000 and \$42,000, respectively.

The costs of direct response advertising, whose primary purpose is to elicit sales to customers and that should result in probable future benefits are capitalized. Advertising costs capitalized at June 30, 2003, and included in prepaid expenses were approximately \$93,000. These costs will be written off when first placed into service.

### [8] Use of estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### [9] Income taxes:

The Company accounts for income taxes using the asset and liability method described on SFAS No. 109, "Accounting For Income Taxes, the objective of which is to establish deferred tax assets and liabilities for the temporary differences between the financial reporting and the tax bases of the Company's assets and liabilities at enacted tax rates expected to be in effect when such amounts are realized or settled. A valuation allowance related to deferred tax

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assets is recorded when it is more likely than not that some portion or all of the deferred tax assets will not be realized.

### [10] Net loss per common share:

Loss per common share is based upon the weighted average number of common shares outstanding during the year. Diluted loss per common share is the same as basic loss per share, as the effects of potentially dilutive securities (see Notes H [2] and H [4]) are antidilutive. Losses attributable to common stock have been adjusted for the preferred stock dividends.

### [11] Long-lived assets:

The Company accounts for the impairment and disposition of long-lived assets in accordance with SFAS No. 121, "Accounting for the Impairment of Long-lived Assets to Be Disposed Of." In accordance with SFAS No. 121, long-lived assets to be held are reviewed whenever events or changes in circumstances indicate that their carrying value may not be recoverable. The Company periodically reviews the carrying value of long-lived assets to determine whether or not an impairment to such value has occurred, and has determined that as of June 30, 2003, that impairment, where appropriate, was recorded in the financial statements.

### [12] Concentrations of credit risk:

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of trade accounts receivables and notes receivable. The Company performs ongoing credit evaluations of its customers' financial condition, but does not require collateral to support such receivables.

The Company utilizes a limited number of suppliers for certain components used in its products but has no long-term supply contracts with them.

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AQUACELL TECHNOLOGIES, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
June 30, 2003

### Note B - Summary of Significant Accounting Policies (continued)

#### [13] Financial instruments:

The carrying amounts of the Company's cash, notes receivables, accounts receivable, accounts payable, customer deposits and loans payable to related parties, approximate fair value.

#### [14] Stock compensation plans:

The Company applies Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees", and related interpretations in accounting for its stock-based compensation plans. The Company does not recognize compensation expense for stock options granted under the plans as the exercise price of the option on the date of grant is equal to the fair market value as of that date.

#### [15] New accounting pronouncements:

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In July 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets."

SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001 as well as all purchase method business combinations completed after June 30, 2001. SFAS No. 141 also specifies criteria that intangible assets acquired in a purchase method business combination must meet to be recognized and reported apart from goodwill. The Company has adopted SFAS 141 for the year ended June 30, 2002.

SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually. SFAS No. 142 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 121. The Company has adopted SFAS No. 142 for the year ended June 30, 2002.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS 144 amends existing accounting guidance on asset impairment and provides a single accounting model for long-lived assets to be disposed of. Among other provisions, the new rules change the criteria for classifying an asset as held-for-sale. The standard also broadens the scope of business to be disposed of that qualify for reporting as discontinued operations, and changes the timing of recognizing losses on such operations. The Company has adopted SFAS 144 for the year ended June 30, 2003.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure". SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation" to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The provisions of SFAS No. 148 are effective for financial statements for the year ended June 30, 2003. SFAS No. 148 did not have a material impact on the Company's consolidated financial statements, as the adoption of this standard does not require the Company to change, and the Company does not plan to change, to the fair value based method of accounting for stock-based compensation.

### Note C - Inventories:

Inventories consist of the following at June 30, 2003:

Raw materials.....	\$ 69,000
Work in progress.....	15,000
	-----
	\$84,000
	=====

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June 30, 2003

## Note D - Property and Equipment:

Property and equipment is summarized as follows at June 30, 2003:

Furniture and fixtures.....	\$	35,000
Equipment office.....		95,000
Machinery and equipment.....		122,000
Leasehold improvements.....		10,000
Rental units.....		9,000
Truck.....		11,000
		-----
		282,000
Less accumulated depreciation.....		244,000
		-----
		\$ 38,000

Depreciation expense was \$36,000 and \$35,000 for the year ended June 30, 2003 and 2002, respectively.

## Note E - Notes Receivable

At June 30, 2003, the notes receivable consisted of the balances of notes aggregating \$268,000 due from non-director/employee stockholders and entities owned by them bearing an annual interest rate of 8%.

The first note, with a balance of \$91,000, is unsecured and matured October 2002. The note that matured in October 2002 was extended for one year. In July 2003 the Company received a \$68,000 principal payment plus accrued interest on this note and extended the remaining balance to June 30, 2004.

The remaining notes, aggregating \$177,000, were in the original principal amount of \$1,750,000, maturing August 16, 2001 and were extended to September 16, 2001. At September 16, 2001 the notes were restructured into twelve-month installment notes collateralized by marketable securities with the first installment due October 16, 2001. The Company recorded an adjustment to reflect a reduction in the estimated fair value of these notes of \$365,000 at June 30, 2001. Officers/stockholders of AquaCell have personally guaranteed up to \$1,750,000 of the notes and have offered as collateral designated assets. Installment payments of \$438,000 were received by the Company and the officer/stockholders have paid \$1,135,000 of the remaining principal balance of \$1,312,000 and \$32,000 in interest through June 30, 2003. These payments were made through contribution of salaries in the amount of \$916,000 and surrender of 82,422 shares of the Company's common stock, valued at \$251,000 through June 30, 2003. Such shares were recorded as treasury stock and retired by the Company at December 31, 2002. In January 2003 the collateral underlying the guarantees was released.

Interest receivable at June 30, 2003 amounted to \$69,000.

At June 30, 2003, the adjustment for reduction in the reserve against these notes was decreased by \$188,000 from \$365,000 to \$177,000. Such decrease has been reported in the statement of operations for the year ended June 30, 2003.

## Note F - Receivable from Sale of Investment

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At June 30, 2003, the receivable of \$274,000 represented the consideration received for the sale by the Company of its 15% interest in a privately held corporation. The receivable is payable over three years and bears interest at the rate of 4% per annum. Interest is payable on a semi-annual basis. Principal payments will be made from proceeds received from the sale of their AquaCell common stock in excess of \$1,339,000 and, if required, from 5% of future revenues to be generated by our Global Water-Aquacell subsidiary.

At June 30, 2003 the Company recognized a fair value reduction of \$274,000 on this receivable. Such reduction has been charged to operations during the year ended June 30, 2003.

### Note G - Loans Payable - Related Parties

At June 30, 2003 loans payable to related parties consist of unsecured demand interest free loans of \$55,000 and an unsecured demand loan with nominal interest in the amount of \$25,000.

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AQUACELL TECHNOLOGIES, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
June 30, 2003

### Note H - Equity Transactions

#### [1] Series A Convertible Preferred Stock:

During March 2003 the Company completed a private placement of 685,000 shares of newly designated Series A Convertible Preferred Stock. The offering consisted of one share of class A convertible preferred stock at a price of \$0.63 per share and one Class A common stock purchase warrant exercisable at \$1.16 per share. Both the preferred stock and warrant contain certain call features. The Series A Convertible Preferred Stock carries an 8% dividend and is convertible into the Company's common stock on a one for one basis. Based on the effective conversion price of the preferred stock using relative fair value of \$154,000 attributable to the warrants the Company recognized a beneficial conversion feature of \$158,000 as a deemed dividend to the holders of the convertible preferred stock. In connection with this offering the Company received gross proceeds of \$406,000. As part of this offering 40,000 shares, valued at \$25,200, were issued to the Company's attorney as consideration for expenses of the offering.

During May 2003 the Company completed an additional private placement of 500,000 shares of its newly designated Series A Convertible Preferred Stock. The offering consists of one share of class A convertible preferred stock at a price of \$0.75 per share and one Class A common stock purchase warrant exercisable at \$1.60 per share. Both the preferred stock and warrant contain certain call features. Based on the effective conversion price of the preferred stock using a relative fair value of \$208,000 attributable to the warrants the Company recognized a beneficial conversion feature of \$210,000 as a deemed dividend to the holders of the convertible preferred stock. In connection with this offering the Company received gross proceeds of \$375,000. Expenses of the offering amounted to \$48,000.

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[2] Stock option plans:

During August 1998, the Company adopted the 1998 Incentive Stock Plan (the "Plan") under which options (either incentive or nonqualified), stock appreciation rights, stock and other awards, covering an aggregate amount of 1,000,000 shares of common stock, may be granted to officers, directors, employees and consultants of the Company. The exercise price established for any awards granted under the Plan, shall be determined by a Compensation Committee appointed by the Company's Board of Directors. The exercise price of incentive stock options cannot be less than 100% (110% for 10% or greater shareholder employees) of the fair market value ("FMV") at the date of grant and the exercise price of nonqualified options cannot be less than 85% of the FMV at the date of grant. The exercise period of incentive options cannot extend beyond 10 years from the date of grant and nonqualified options cannot extend beyond 15 years from the date of grant.

During January 2002, the Board of Directors adopted a Director's Option Plan covering an aggregate amount of 500,000 shares of common stock. As of June 30, 2003, 30,000 options have been granted from this plan.

A summary of stock option activity under both plans is as follows:

	Year Ended June 30,			
	2003		2002	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Balance, July 1.....	551,000	\$ 2.41	148,000	\$ 3.06
Options granted.....	227,000	.64	406,000	2.17
Options cancelled...	(272,000)	3.74	(3,000)	2.59
	-----		-----	
Balance, June 30.....	506,000	\$ .90	551,000	\$ 2.41
	=====		=====	
Exercisable, June 30.....	188,000	\$ 1.02	196,000	\$ 2.60
	=====		=====	

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AQUACELL TECHNOLOGIES, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
June 30, 2003

Note H - Equity Transactions (continued)

[2] Stock option plans (continued)

The following table presents information relating to stock options outstanding at June 30, 2003:

Options Outstanding			Options Exercisable		
Exercise Price	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Life in Years	Shares	Weighted-Average Exercise Price
-----	-----	-----	-----	-----	-----

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0.60	185,000		6.5		
0.65	30,000		9.6	30,000	
1.00	75,000		1.2	69,000	
1.14	12,000		6.8		
1.15	60,000		1.9	60,000	
1.15	60,000		3.8	12,000	
1.16	84,000		5.9	17,000	
	-----		-----	-----	
	506,000	\$0.90	4.9	188,000	\$1.02
	=====		=====	=====	

If the options had been accounted for under SFAS 123, net loss attributable to common stockholders for the years ended June 30, 2003 and 2002, would have been \$(2,876,000) OR \$(0.33) per common share, and \$(4,064,000) or \$(0.50) per common share, respectively. The fair value of options granted during the years ended June 30, 2003 and June 30, 2002, was \$0.27 and \$0.64 per share on the date of grant, respectively. The options were valued utilizing the Black-Scholes valuation method using the following assumptions: risk-free interest rate of 3.1% and 4.99%, volatility of 33% and 42% and expected lives of five and three years, respectively.

[3] Issuances of common stock:

In connection with a six-month consulting agreement (see Note H (4)) the Company issued 10,000 shares of its common stock valued at \$34,000. The value of the stock was amortized over the six-month life of the agreement. Amortization amounted to \$34,000 during the year ended June 30, 2002.

In connection with a six-month consulting agreement (see Note H (4)) the Company issued 10,000 shares of its common stock valued at \$42,000. The value of the stock was amortized over the six-month life of the agreement. Amortization amounted to \$42,000 during the year ended June 30, 2002.

In connection with a five-year consulting agreement (see Note H (4)) the Company issued 120,000 shares of its common stock valued at \$150,000. The value of the stock is being amortized over the five-year life of the agreement. Amortization amounted to \$30,000 during the year ended June 30, 2003, and \$4,000 during the year ended June 30, 2002.

In connection with a five-year consulting agreement (see Note H (4)) the Company issued 100,000 shares of its common stock valued at \$98,000. The value of the stock is being amortized over the five-year life of the agreement. Amortization amounted to \$20,000 during the year ended June 30, 2003, and \$2,000 during the year ended June 30, 2002.

In connection with financing transactions, during January and April 2003, the Company issued 125,000 shares of its common stock valued at \$89,000. Amortization amounted to \$89,000 during the year ended June 30, 2003.

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Note H - Equity Transactions (continued)

[4] Issuances of common stock purchase warrants:

In connection with a financial consulting agreement, the Company issued a warrant to purchase 200,000 shares of the Company's common stock to be exercisable for a five-year period at \$4.20 per share. The Company estimated the fair value of these warrants to be \$370,000, utilizing the Black-Scholes valuation method using the following assumptions: a risk-free interest rate of 4.99%, volatility of 42% and a term of five years. Such amount was amortized over six months. Amortization amounted to \$308,000 during the year ended June 30, 2002.

In connection with a three-year consulting agreement, entered into in August 2001, the Company issued a warrant to purchase 75,000 shares of the Company's common stock to be exercisable for a three-year period at \$4.40 per share. The Company estimated the fair value of these warrants to be \$110,000, utilizing the Black-Scholes valuation method using the following assumptions: a risk-free interest rate of 4.58%, volatility of 42%, and a term of three years. Such amount is being amortized to expense over three years. Amortization amounted to \$37,000 and \$31,000 during the years ended year June 30, 2003 and 2002, respectively.

In connection with a six-month consulting agreement, entered into in September 2001, the Company issued warrants to purchase 100,000 shares of the Company's common stock to be exercisable for a three-year period (50,000 at \$4.50 per share and 50,000 at \$5.50 per share). The Company estimated the fair value of these warrants to be \$79,000, utilizing the Black-Scholes valuation method using the following assumptions: a risk-free interest rate of 5.99%, volatility of 42%, and a term of three years. Such amount was amortized to expense over six months. Amortization amounted to \$79,000 during the year ended June 30, 2002.

In connection with a six-month consulting agreement, entered into in October 2001, the Company issued warrants to purchase 100,000 shares of the Company's common stock to be exercisable for a three-year period (50,000 at \$4.50 per share and 50,000 at \$5.50 per share). The Company estimated the fair value of these warrants to be \$83,000, utilizing the Black-Scholes valuation method using the following assumptions: a risk-free interest rate of 3.1%, volatility of 33.33%, and a term of three years. Such amount is being amortized to expense over six months. Amortization amounted to \$83,000 during the year ended June 30, 2002.

In connection with a distribution agreement (See Note K), the Company issued warrants to purchase 300,000 shares of the Company's common stock to be exercisable for a five-year period (100,000, 100,000, and 100,000 at exercise prices of \$5.00, \$6.00, and \$7.00, per share respectively). The Company estimated the fair value of these warrants to be \$283,000, utilizing the Black-Scholes valuation method using the following assumptions: a risk-free interest rate of 3.1%, volatility of 33.33%, and a term of five years. Such amount is being amortized to expense over five years. During the year ended June 30, 2003 the agreement was amended and the 100,000 warrants exercisable at \$6.00 per share and the 100,000 warrants exercisable at \$7.00 per share were to be returned to the Company and cancelled. The unamortized portion of these warrants, in the amount of \$110,000, was written off to additional paid in capital. Amortization amounted to \$54,000 and \$42,000 during the years ended June 30, 2003 and 2002 respectively.

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In connection with a five-year consulting agreement, entered into in May 2002, the Company issued a warrant to purchase 100,000 shares of the Company's common stock to be exercisable for a five-year period at \$3.30 per share. The Company estimated the fair value of these warrants to be \$9,000, utilizing the Black-Scholes valuation method using the following assumptions: a risk-free interest rate of 3.1%, volatility of 33.33%, and a term of five years. Such amount is being amortized to expense over five years. Amortization amounted to \$2,000 during the year ended June 30, 2003 and was insignificant during the year ended June 30, 2002.

In connection with a one-year consulting agreement, entered into in May 2002, the Company issued a warrant to purchase 50,000 shares of the Company's common stock to be exercisable for a five-year period at \$1.05 per share. The Company estimated the fair value of these warrants to be \$18,000, utilizing the Black-Scholes valuation method using the following assumptions: a risk-free interest rate of 3.1%, volatility of 33.33%, and a term of five years. Such amount is being amortized to expense over one year. Amortization amounted to \$16,000 and \$2,000 during the years ended June 30, 2003, and 2002 respectively.

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AQUACELL TECHNOLOGIES, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
June 30, 2003

Note H - Equity Transactions (continued)

[4] Issuances of common stock purchase warrants (continued)

In connection with a five-year consulting agreement, entered into in June 2002, the Company issued warrants to purchase 200,000 shares of the Company's common stock to be exercisable for a five-year period (100,000 and 100,000 at exercise prices of \$3.00 and \$5.00, per share, respectively). The Company estimated the fair value of these warrants to be \$6,000, utilizing the Black-Scholes valuation method using the following assumptions: a risk-free interest rate of 3.1%, volatility of 33.33%, and a term of five years. Such amount is being amortized to expense over five years. Amortization was \$1,000 during the year ended June 30, 2003 and was insignificant during the year ended June 30, 2003.

In connection with a one-year credit facility agreement, entered into in August 2002, the Company issued warrants to purchase 160,000 shares of common stock to be exercisable for a five-year period at \$.78 per share. The Company estimated the fair value of these warrants to be \$43,000 utilizing the Black-Scholes valuation method using the following assumptions: a risk-free interest rate of 3.1%, volatility of 33.33% and a term of five years. Such amount is being amortized to expense over one year. Amortization amounted to \$36,000 during the year ended June 30, 2003.

In connection with a one-year consulting agreement, entered into in March 2003, the Company issued a warrant to purchase 150,000 shares of common stock to be exercisable for a two-year period at \$1.00 per share. The Company estimated the fair value of this warrant to be \$12,000 utilizing the Black-Scholes valuation method using the following assumptions: a risk-free interest rate of 3.1%, volatility

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of 33.33% and a term of two years. Such amount is being amortized to expense over one year. Amortization amounted to \$3,000 during the year ended June 30, 2003.

In connection with a private placement of series A convertible preferred stock completed in March 2003, the Company issued warrants to purchase 685,000 shares of common stock to be exercisable for a five-year period at \$1.16 per share (See Note H (1) above).

In connection with a private placement of series A convertible preferred stock completed on May 2003, the Company issued warrants to purchase 500,000 shares of common stock to be exercisable for a five-year period at \$1.60 per share (See Note H (1) above).

At June 30, 2003, the Company had warrants outstanding as follows:

Exercise Price -----	Shares -----	Expiration Date -----
.78	160,000	August 2007
1.00	150,000	March 2005
1.16	685,000	March 2008
1.60	500,000	May 2008
4.40	75,000	August 2004
4.50	50,000	September 2004
5.50	50,000	September 2004
4.50	50,000	October 2004
5.00	100,000	October 2006
5.50	50,000	October 2004
4.20	200,000	May 2006
8.25	120,000	February 2006
3.30	100,000	May 2007
1.05	50,000	May 2007
3.00	100,000	June 2007
5.00	100,000	June 2007
	-----	
	2,540,000	
	=====	

At June 30, 2003, the weighted average exercise price of the outstanding warrants was \$2.64 and the weighted average remaining contractual life of the warrants was 3.58 years.

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AQUACELL TECHNOLOGIES, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
June 30, 2003

Note H - Equity Transactions (continued)

[5] Shares reserved:

At June 30, 2003, the Company has reserved 5,225,000 shares of common stock for issuance upon conversion of preferred stock and exercise of options and warrants.

Note I - Acquisition:

On March 19, 2002, the Company completed the acquisition of 100% of the issued and outstanding common stock of Water Science

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Technologies, Inc., a privately owned Arizona Corporation ("WST"). The purchase price was the issuance of 203,252 shares at a price of \$4.92 per share, for a total of \$1,000,000, as calculated by taking the average closing price of AquaCell common stock on the five business days immediately preceding the signing of the agreement of October 23, 2001. In addition, the Company issued 55,337 shares of its common stock at \$3.43 per share to WST vendors as calculated by taking the average closing price of AquaCell common stock for five days immediately preceding the closing on March 19, 2002.

The primary reasons for the acquisition of WST were the synergy with our existing business and the addition of new capabilities to our presence in the water industry with its history as a manufacturer of integrated water purification and treatment systems. The purchase price was a negotiated price between the parties based upon comparable industry valuations. There are no contingent payments, options, or commitments as part of this acquisition.

The transaction has been accounted for under the purchase method. Accordingly, the consolidated balance sheet includes the assets and liabilities of WST at June 30, 2002 and the consolidated statements of operations include the results of WST from March 19, 2002. The acquisition resulted in excess cost over fair value of net assets acquired of \$1,301,000. Pursuant to the provisions of SFAS 142, the Company recorded an impairment loss of \$72,000 for the year ended June 30, 2003 and an impairment loss of \$187,000, for the year ended June 30, 2002. Such impairment losses resulted from the Company's determination of fair value using present value cash flow analysis.

On the basis of a pro forma consolidation of the results of operations as if the acquisition had taken place at July 1, 2000, unaudited consolidated net revenues, net loss, and loss per share for the year ended June 30, 2002, would have been approximately \$1,516,000, \$(3,938,000), and \$(0.48); and for the year ended June 30, 2001, would have been approximately \$1,344,000, \$(3,042,000), and \$(0.45), respectively.

A condensed unaudited balance sheet of WST at the date of acquisition is presented below:

ASSETS	
Current assets	\$ 131,000
Property and equipment, net	13,000
Deposits	5,000
	-----
	\$ 149,000
	=====
LIABILITIES AND STOCKHOLDERS DEFICIENCY	
Current liabilities	\$ 450,000
Stockholders' deficiency	(301,000)
	-----
	\$ 149,000
	=====

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AQUACELL TECHNOLOGIES, INC. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
 June 30, 2003

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### Note J - Income Taxes:

At June 30, 2003, the Company had available federal net operating loss carryforwards to reduce future taxable income, if any of approximately \$8,200,000. The net operating loss carryforwards expire at various dates through 2023.

At June 30, 2003, the Company has a deferred tax asset of approximately \$3,526,000, representing the benefit of its net operating loss carryforwards. The Company has not recorded a tax benefit because realization of the benefit is uncertain and therefore a valuation allowance has been fully provided against the deferred tax asset. The difference between the federal statutory rate of 34% and the Company's effective tax rate of 0% is due to an increase in the valuation allowance of \$686,000 and \$720,000 in 2003 and 2002, respectively.

### Note K - Commitments and Contingencies

#### [1] Lease commitments:

The Company occupies office space in California and Arizona, under noncancellable operating leases. As of June 30, 2003, future minimum commitments under office and equipment leases are as follows:

Year Ending June 30,	
-----	
2004	\$ 107,000
2005	70,000
2006	65,000
2007	20,000
	-----
	\$ 262,000
	=====

Rent expense under office and equipment leases amounted to \$175,000 and \$131,000 for the years ended June 30, 2003 and 2002, respectively.

#### [2] Distribution agreement:

On October 9, 2001, the Company entered into distribution (See Note N) and joint venture agreements with two privately held companies. In connection with the distribution agreement, which grants exclusive North American distribution and marketing rights, excluding existing customers and existing distribution agreements, the Company acquired 15% of a privately held company in exchange for 451,807 shares of common stock of the Company. The Company applied the cost method of accounting in connection with this 15% investment (See Note M). The Company granted warrants (100,000, 100,000, and 100,000 at exercises prices of \$5.00, \$6.00, and \$7.00 per share, respectively) in connection with the distribution agreement. In connection with the joint-venture agreement, the agreement was modified and AquaCell's initial ownership of 45% was reduced to 19% ownership of all net profits, with no responsibility for funding any of the manufacturing or marketing costs, with the remaining 81% owned by the other privately held company.

On May 30, 2003 the Company negotiated the return and cancellation of all exclusive distribution and marketing rights under

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the distribution agreement and joint venture agreement, the return of 100,000 warrants exercisable at \$6.00 per share and the return of 100,000 warrants exercisable at \$7.00 per share. In exchange AquaCell granted the private company the right to continue to sell Global Water-Aquacell's products on a non-exclusive basis in those areas in which it retains salesmen. It was agreed that the private company would realize a return of \$1,339,000 from sales of the 451,807 shares of AquaCell common stock that it owns and, if required, from 5% of future revenues to be generated by our Global Water-Aquacell subsidiary.

### [3] Employment agreements

The Company has employment agreements with various executives and employees of the Company which expire at various dates through February, 2006. These agreements provide for aggregate minimum salaries of \$677,000 for the year ending June 30, 2004. The agreements also provide for incentive bonuses based upon achievement of certain milestones. No bonuses have been paid under these agreements as of June 30, 2003.

Effective July 2002 the Company entered into a five-year employment contract with one of the officers of WST. The contract calls for a minimum annual salary of \$100,000.

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AQUACELL TECHNOLOGIES, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
June 30, 2003

### Note L - Long Term Note

At June 30, 2003 the long term note consists of an installment note, secured by a truck, payable in monthly payments of \$342 through February 2005. Maturities on the note follows:

Year Ending	June 30, 2004	\$ 4,000
	June 30, 2005	3,000
		-----
		\$ 7,000
		=====

### Note M - Impairment Loss On Investment

In connection with a 15% investment in Corbett Water Technologies, Inc., the Company recognized an impairment loss of \$1,226,000 during the year ended June 30, 2002 in accordance with generally accepted accounting principles (GAAP), as contained in the provisions of SFAS-121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of". The investment was sold during the year ended June 30, 2003 (See Note F).

### Note N - Related Party Transactions

Included in net sales are sales to a former affiliate, pursuant to a distribution agreement, aggregating approximately \$706,000 for the year ended June 30, 2003 and \$452,000 for the year ended June 30, 2002. (See Note K (2)).

### Note O - Major Customers and Suppliers

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During the years ended June 30, 2003 and June 30, 2002, the Company sold approximately 44% and 43% respectively, of its products to a former affiliate (See Note K (2)).

During the years ended June 30, 2003 and 2002, the Company purchased approximately 27% and 39% respectively, of its materials from one vendor, the supplier of its raw cooler.

### Note P - Subsequent Events

(1) During July through September 2003 the Company completed a private placement of 1,703,000 shares of its common stock. The offering consists of one share of common stock at a price of \$1.50 per share and one common stock purchase warrant exercisable at \$4.00 per share. The warrant contains a call feature. The Company received proceeds of \$2,296,000 net of expenses of \$259,000. In connection with the offering the placement agent received 341,000 common stock purchase warrants exercisable at \$4.00 per share.

(2) During August 2003 the Company entered into marketing and consulting agreements with five separate entities. Consideration for these agreements included cash fees of \$45,000 and 1,250,000 warrants to purchase shares of common stock of the Company at a price of \$.01 per share. These warrants were valued at \$2,564,000 utilizing the Black-Scholes valuation method. Such amount will be amortized to expense over the term of the agreements.

(3) During September 2003 the Board of Directors adopted a resolution, subject to shareholders' approval, to amend the 1998 Stock Option Plan to increase the number of shares issuable thereunder from 1,000,000 to 2,000,000.

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