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SONEX RESEARCH INC
Form 10QSB
August 19, 2003

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

FORM 10-QSB

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

For the quarterly period ended June 30, 2003.

SONEX RESEARCH, INC.

Incorporated in the State of Maryland
23 Hudson Street
Annapolis, Maryland 21401

Telephone Number: (410) 266-5556
IRS Employer Identification No. 52-1188993

Commission file number 0-14465

Check whether the Issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.

YES NO

There were 21,592,669 shares of the Issuer's \$.01 par value Common Stock outstanding at August 19, 2003.

SONEX RESEARCH, INC. FORM 10-QSB

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS (Unaudited)

Balance sheets as of June 30, 2003 and December 31, 2002

Statements of operations and accumulated deficit for the three- and six-month periods ended June 30, 2003 and 2002

Statements of paid-in capital for the period January 1, 2001 through June 30, 2003

Statements of cash flows for the six-month periods ended June 30, 2003 and 2002

Notes to financial statements

SONEX RESEARCH, INC. CONDENSED BALANCE SHEETS (Unaudited)

| ASSETS | June 30, 2003 | December 31, 2002 |
|---|------------------|----------------------|
| | ----- | ----- |
| Current Assets | | |
| Cash and equivalents | \$ 40,021 | \$ 105,998 |
| Accounts receivable | 156,493 | 64,702 |
| Prepaid expenses | 29,972 | 25,814 |
| Loans to officers and employees | 22,500 | 22,500 |
| | ----- | ----- |
| Total current assets | 248,986 | 219,014 |
| Patents and technology, net of accumulated amortization of \$71,309 in 2003 and \$60,909 in 2002 | 197,200 | 203,623 |
| Property and equipment, net of accumulated depreciation of \$452,757 in 2003 and \$438,357 in 2002 | 101,225 | 58,808 |
| | ----- | ----- |
| Total assets | \$ 547,411 | \$ 481,445 |
| | ===== | ===== |

LIABILITIES AND STOCKHOLDERS' EQUITY/(DEFICIT)

| | | |
|--|-----------|-----------|
| Current liabilities | | |
| Accounts payable and other accrued liabilities | \$ 25,159 | \$ 36,322 |
| Short-term line of credit | | 18,357 |
| Deferred revenue - billings in excess of costs | | |

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| | | |
|--|--------------|--------------|
| and estimated profits on contracts in progress | 111,675 | 66,587 |
| Current portion of capital lease obligations | 15,205 | 5,657 |
| Notes and interest payable to shareholder | 87,418 | 37,327 |
| Accrued compensation and benefits | 455,757 | 427,397 |
| | ----- | ----- |
| Total current liabilities | 713,571 | 573,290 |
| | ----- | ----- |
| Capital lease obligations | 36,450 | 10,985 |
| | ----- | ----- |
| Deferred compensation | 940,606 | 906,856 |
| | ----- | ----- |
| Stockholders' equity/(deficit) | | |
| Preferred stock, \$.01 par value - 2,000,000 shares authorized and issued; 1,540,001 shares outstanding | 15,400 | 15,400 |
| Common stock, \$.01 par value - 48,000,000 shares authorized; 21,592,669 shares issued and outstanding | 215,927 | 215,927 |
| Additional paid-in capital | 21,472,415 | 21,420,742 |
| Accumulated deficit | (22,825,570) | (22,640,911) |
| Notes receivable from officers and employees | (21,388) | (20,844) |
| | ----- | ----- |
| Total stockholders' equity/(deficit) | (1,143,216) | (1,009,686) |
| Commitments | | |
| | ----- | ----- |
| Total liabilities and stockholders' equity | \$ 547,411 | \$ 481,445 |
| | ===== | ===== |

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

SONEX RESEARCH, INC.
CONDENSED STATEMENTS OF OPERATIONS AND ACCUMULATED DEFICIT
(Unaudited) Unaudited)

| | Three months ended June 30, | | Six months ended June 30, | | |
|--------------------------|--------------------------------|-----------|------------------------------|-----------|-------|
| | 2003 | 2002 | 2003 | 2002 | |
| | ----- | ----- | ----- | ----- | |
| Revenue | \$ 214,573 | \$ 50,647 | \$ 388,902 | \$ 86,517 | |
| | ----- | ----- | ----- | ----- | |
| Costs and expenses | | | | | |
| Cost of revenue | 162,718 | 21,428 | 271,144 | 54,426 | |
| Research & development | 44,089 | 51,483 | 119,135 | 115,537 | |
| General & administrative | 89,848 | 51,208 | 180,123 | 114,914 | |
| Interest expense | | 1,202 | 613 | 3,921 | 1,397 |
| | ----- | ----- | ----- | ----- | |
| | 297,857 | 124,732 | 574,323 | 286,274 | |
| | ----- | ----- | ----- | ----- | |
| Net loss from operations | 83,284 | 74,085 | 185,421 | 199,757 | |

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| | | | | |
|---|--------------|--------------|--------------|--------------|
| Investment and other income | (363) | (2,175) | (762) | (2,183) |
| | ----- | ----- | ----- | ----- |
| Net loss | 82,921 | 71,910 | 184,659 | 197,574 |
| Accumulated deficit | | | | |
| Beginning | 22,742,649 | 22,444,935 | 22,640,911 | 22,319,271 |
| | ----- | ----- | ----- | ----- |
| End | \$22,825,570 | \$22,516,845 | \$22,825,570 | \$22,516,845 |
| | ===== | ===== | ===== | ===== |
| Weighted average number of shares outstanding | 21,592,669 | 21,578,867 | 21,592,669 | 21,402,746 |
| | ===== | ===== | ===== | ===== |
| Net loss per share | \$.004 | \$.003 | \$.009 | \$.009 |
| | ===== | ===== | ===== | ===== |

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

SONEX RESEARCH, INC.
CONDENSED STATEMENTS OF PAID-IN CAPITAL
(Unaudited)

| | Price per share | Preferred stock (\$.01 par value) Shares | Amount | Common stock (\$.01 par value) Shares | Amount | Additional paid-in capital |
|---|-----------------------|---|----------|--|-----------|----------------------------------|
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Balance, January 1, 2001 | | 1,540,001 | \$15,400 | 19,479,868 | \$194,799 | \$20,927,437 |
| March private placement | \$.25 | | | 300,000 | 3,000 | 72,000 |
| March for services | .25 | | | 54,577 | 546 | 13,099 |
| April private placement | .25 | | | 125,000 | 1,250 | 30,000 |
| June private placement | .20 | | | 325,000 | 3,250 | 61,750 |
| June for services | .29 | | | 44,916 | 449 | 12,667 |
| August payment of stock subscription | .20 | | | 25,000 | 250 | 4,750 |
| September for services | .25 | | | 55,000 | 550 | 13,200 |
| October private placement | .15 | | | 750,000 | 7,500 | 105,000 |
| December for services | .25 | | | 53,308 | 533 | 12,794 |
| December forgiveness of payables | | | | | | 10,000 |
| Stock option compensation | | | | | | 42,120 |
| Amortization of deferred compensation from grant of stock options | | | | | | 29,761 |
| | | ----- | ----- | ----- | ----- | ----- |
| Balance, December 31, 2001 | | 1,540,001 | 15,400 | 21,212,669 | 212,127 | 21,334,577 |
| March private placement | .15 | | | 360,000 | 3,600 | 50,400 |

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| | | | | | |
|----------------------------|-----------|----------|------------|-----------|--------------|
| May for services | .25 | | 12,000 | 120 | 2,880 |
| July for services | .25 | | 8,000 | 80 | 1,920 |
| Stock option compensation | | | | | 30,965 |
| ----- | | | | | |
| Balance, December 31, 2002 | 1,540,001 | 15,400 | 21,592,669 | 215,927 | 21,420,742 |
| Stock option compensation | | | | | 51,673 |
| ----- | | | | | |
| Balance, June 30, 2003 | 1,540,001 | \$15,400 | 21,592,669 | \$215,927 | \$21,472,415 |
| ===== | | | | | |

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

SONEX RESEARCH, INC.
CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Six months ended June 30, | |
|--|------------------------------|--------------|
| | 2003 | 2002 |
| | ----- | ----- |
| Cash flows from operating activities | | |
| Net loss | \$ (184,659) | \$ (197,574) |
| Adjustments to reconcile net loss to net cash Provided by (used in) operating activities | | |
| Depreciation | 13,600 | 7,800 |
| Amortization of patents | 11,200 | 8,400 |
| Compensation from grant of stock options and/or issuance of stock | 51,673 | 16,125 |
| Accrued interest on notes receivable from employees | (544) | (2,175) |
| Accrued interest on notes to shareholder | 1,418 | |
| (Increase) decrease in accounts receivable | (91,791) | 30,773 |
| (Increase) decrease in prepaid expenses | (4,158) | 1,983 |
| Increase (decrease) in accounts payable and accrued liabilities | 17,197 | 80,833 |
| Increase (decrease) in billings in excess of costs and estimated profits on contracts in progress | 45,088 | |
| Increase (decrease) in deferred compensation | 33,750 | 23,550 |
| | ----- | ----- |
| Net cash used in operating activities | (107,226) | (30,285) |
| | ----- | ----- |
| Cash flows from investing activities | | |
| Acquisition of property and equipment | (13,815) | (428) |
| Additions to patents | (3,977) | (11,484) |
| | ----- | ----- |
| Net cash provided by (used in) investing activities | (17,792) | (11,912) |
| | ----- | ----- |
| Cash flows from financing activities | | |
| Issuance of notes payable to shareholder | | 50,000 |
| | | 6,000 |

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| | | | |
|---|--------------|------------|--------|
| Payment of accrued interest on notes to shareholder | (1,327) | | |
| Increase in short-term line of credit | 18,357 | | |
| Reduction of capital lease obligations | | (7,989) | |
| Issuance of stock - private placement | | | 54,000 |
| | | | |
| Net cash provided by (used in) financing activities | 59,041 | 60,000 | |
| | | | |
| Increase (decrease) in cash | (65,977) | 17,803 | |
| Cash | | | |
| Beginning of period | 105,998 | 3,355 | |
| | | | |
| End of period | \$ 40,021 | \$ 21,158 | |
| | | | |

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

SONEX RESEARCH, INC NOTES TO CONDENSED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 - THE COMPANY

Sonex Research, Inc. has developed a proprietary technology, known as the Sonex Combustion System (SCS), which improves the combustion of fuel in internal combustion engines through modification of the pistons in large engines or the cylinder heads in small engines. The SCS achieves in-cylinder control of ignition and combustion to increase fuel mileage of gasoline engines, reduce emissions of diesel engines, and permit small gasoline engines to run on safer diesel-type fuels. The Company's objective is to execute broad agreements with engine and parts manufacturers for industrial production of SCS components under license from Sonex.

NOTE 2 - PRESENTATION OF FINANCIAL STATEMENTS

The accompanying unaudited condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-QSB and Item 310(b) of Regulation S-B. Accordingly, these financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included.

Operating results for the three- and six-month periods ended June 30, 2003 are not necessarily indicative of the results that may be expected for the year ending December 31, 2003. For further information, reference is made to the financial statements and notes thereto included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2002.

Certain reclassifications have been made to the financial statements of the prior year to conform to the classifications used in 2003, most notably the reclassification of amounts in the Statement of Operations from Research and Development to Cost of Revenue.

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The costs associated with the filing of patent applications are deferred. Amortization is recorded on a straight-line basis over the remaining legal life of patents, commencing in the year in which the patent is granted. Costs related to patent applications which ultimately fail to result in the grant of a patent, as well as the unamortized costs of patents abandoned by the Company due to lack of expected commercial potential, are charged to operations at the time such determination is made.

All of the Company's revenue for 2002 and 2003 has been derived from development and demonstration contracts issued by a United States Government or Department of Defense (the "Government") agency or prime contractor. Revenue is recognized upon the Company's completion of the milestones and/or submission of progress reports specified in each contract. Revenue and costs for these contracts that require the Company to provide stipulated services for a fixed price have been recognized using the percentage-of-completion method of accounting by relating contract costs incurred to date to total estimated contract costs at completion. In connection with contracts in progress, any excess of billings over costs incurred plus estimated profits is recorded as a current liability, while any excess of costs incurred over billings is recorded as a current asset, at the financial statement date.

For fiscal year 2003, the Company changed its method of accounting for stock-based compensation, as described in Note 8.

NOTE 3 - LIQUIDITY

Management recognizes that the Company's history of operating losses, level of available funds, and revenue from current and future contracts, in relation to projected expenditures, raise substantial doubt as to the Company's ability to commence generation of significant revenues from the commercialization of the SCS and ultimately achieve profitable operations. Accordingly, the Company will continue to minimize its operating expenditures through a number of measures, including the ongoing deferral by its officers of portions of their salaries as described in Notes 5 and 6.

Based upon available resources, current and projected spending levels, and expected revenue from current and anticipated contracts, management believes the Company will have sufficient capital to fund operations through December 31, 2003. The Company's prospects beyond that date are dependent upon its ability to enter into significant funded contracts for the further development of its SCS technology, establish joint ventures or strategic partnerships with major industrial concerns, or secure a major capital infusion. There is no assurance that the Company will be able to achieve these objectives; therefore, there remains substantial doubt about the Company's ability to continue as a going concern.

NOTE 4 - DEBT

Short-term line of credit

In March 2003 the Company obtained a business credit card to facilitate purchases of materials. The account has a credit limit of \$20,000, and repayment of amounts due has been personally guaranteed by the Company's chief executive officer. Balances accrue interest at a fixed rate of 8.9% per annum. As of June 30, 2003, the outstanding balance on the credit card account was \$18,357.

Capital Lease Obligations

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During the first quarter of 2003 the Company incurred capital lease obligations totaling \$43,002 in connection with the acquisition of equipment. The repayment of a four-year equipment lease obligation in the principal amount of \$38,575 included in this total has been personally guaranteed by the Company's chief executive officer.

Notes Payable to Shareholder

In connection with a private placement in March 2002, the Company issued a \$6,000, 6% note to one of its shareholders, initially payable on June 30, 2002, that is convertible to equity at the option of the holder. The due date of the note has been extended several times and is currently due on September 30, 2003. In July 2002 the Company issued a \$30,000, 8% note to this same shareholder payable initially on January 31, 2003. The due date of the note also was extended to September 30, 2003. The Company issued a \$50,000, 6% note in June 2003 to this same shareholder payable on December 31, 2003. Payment of all three notes is secured by Company revenues.

In July 2003 the Company paid the July 2002, 8%, \$30,000 note in full, as well as all remaining interest on the note.

NOTE 5 - ACCRUED COMPENSATION AND BENEFITS

Accrued compensation and benefits consists of the following amounts:

| | June 30, 2003 | December 31, 2002 |
|---------------------------------|------------------|----------------------|
| | ----- | ----- |
| Accrued wages and payroll taxes | \$ 253,386 | \$ 235,515 |
| Accrued consulting fees | 47,880 | 31,737 |
| Accrued bonuses | 99,576 | 95,499 |
| Accrued vacation pay | 54,915 | 64,646 |
| | ----- | ----- |
| | \$ 455,757 | \$ 427,397 |
| | ===== | ===== |

The Company operated under severe cash flow difficulties for extended periods during 2001 and 2002, prompting its two officers to voluntarily and at their own discretion defer receipt of payment of significant portions of their current wages to reduce the Company's monthly cash requirements. With the generation of cash flow from revenues earned under contracts awarded to the Company during the second half of 2002, some of the amounts owed to the Company's officers were repaid. Since December 2002, the Company's chief financial officer has been receiving his current wages, while the Company's chief executive officer has been deferring all of his current wages since April 2003. Such wages payable at June 30, 2003 to the Company's chief executive and chief financial officers were \$146,404 and \$86,403, respectively.

The continued deferral of portions of current wages by the Company's officers cannot be expected to continue indefinitely, and the Company will be required to pay amounts outstanding as soon as cash flow permits. Similarly, the Company has accumulated unpaid consulting fees, the majority of which amounts are payable to the individual who serves as the Company's director of business development and technical program manager on a part-time basis. As of June 30, 2003, this individual is owed \$41,280. The amount and timing of payments for unpaid compensation owing to the Company's officers and this consultant will be determined at the discretion of the Company's officers; however, all such unpaid

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compensation is payable upon demand, as these amounts are not subject to the terms of the Company's written agreement with current and former personnel to defer payment of portions of their compensation as described in Note 6.

In December of each year, the Company awards bonuses to its officers and employees with the stipulation that payment of such bonuses is to be deferred until the Board of Directors determines that the Company's cash resources are sufficient to enable such payments. In connection with a private placement in March 2002 as detailed in Note 8, the Company paid \$22,500 of bonuses accrued as of December 31, 2001 and \$4,500 of consulting fees accrued as of that date through the conversion of such amounts to equity. The amount of accrued bonuses included in the table above that was payable to the Company's officers at June 30, 2003 is \$72,500. Payment of accrued bonuses are not subject to the terms of the Company's written agreement with current and former personnel to defer payment of portions of their compensation as described in Note 6.

The Company's only liability to employees for future compensated absences is for accrued but unused vacation pay. The amount of vacation pay earned by employees is determined by job classification and length of service. The amount of accrued vacation included in the table above that was payable to the Company's officers at June 30, 2003 is \$48,856. Accrued vacation compensation is payable upon termination of employment, and such payments are not subject to the terms of the Company's written agreement with current and former personnel to defer payment of portions of their compensation as described in Note 6.

NOTE 6 - DEFERRED COMPENSATION

In order to help conserve the Company's limited cash resources, all of the Company's current and former officers and certain of the Company's other employees and consultants for several years have voluntarily deferred receipt of payment of significant portions of their authorized compensation at the request of the Board of Directors. A written agreement between these individuals and the Company was first executed in 1992 in connection with an indispensable \$2 million private investment made by a venture capital group in exchange for the issuance of a new class of convertible preferred stock as described in Note 8. The individuals who are parties to this agreement have consented to the continued deferral, as necessary, of current compensation and the deferral of payment of amounts so accumulated until the Company has received licensing revenue of at least \$2 million or at such earlier date as the Board of Directors determines that the Company's cash flow is sufficient to allow such payment.

Deferred compensation outstanding is payable to the following classifications of personnel:

| | June 30, 2003 | December 31, 2002 |
|--|------------------|----------------------|
| | ----- | ----- |
| Current officers | \$ 607,999 | \$ 574,249 |
| Current employees | 12,504 | 12,504 |
| Former officers, employees and consultants | 320,103 | 320,103 |
| | ----- | ----- |
| | \$ 940,606 | \$ 906,856 |
| | ===== | ===== |

The amount reported above for deferred compensation payable to current officers consists of \$467,673 payable to the Company's chief executive officer and \$140,326 payable to its chief financial officer.

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The conditions that would require repayment of deferred amounts have yet to occur, and it is unlikely that such conditions will occur prior to June 30, 2004. Accordingly, such deferred compensation is reported separately in the accompanying balance sheet as a non-current liability.

At the conclusion of a legal challenge by two former officers of the Company initiated in 1993 demanding full payment of deferred salaries upon the termination of their employment, in 1996 the Maryland Court of Special Appeals rejected this demand and ruled that the written agreement to defer compensation was a valid and enforceable contract.

NOTE 7 - INCOME TAXES

The Company has not incurred any federal or state income taxes since its inception due to operating losses. At December 31, 2002, the Company had net operating loss and capital loss carryforwards of approximately \$12.5 million available to offset future taxable income. If certain substantial changes in the Company's ownership should occur, there would be an annual limitation on the amount of the carryforwards which can be utilized. Since 1995 net operating loss carryforwards aggregating approximately \$6.6 million have expired unused, as have capital loss carryforwards of approximately \$335,000. Net operating loss carryforwards of approximately \$1,345,000 and capital loss carryforwards of approximately \$365,000 are scheduled to expire at the end of 2003.

NOTE 8 - CAPITAL STOCK

Authorized capital stock

The Company is presently authorized to issue 48 million shares of \$.01 par value common stock and 2 million shares of \$.01 par value convertible preferred stock. All of the authorized shares of preferred stock, along with common stock purchase warrants, were issued in connection with an indispensable financing of \$2 million received in February 1992 (the "Preferred Stock Investment") from a small number of individuals who qualified as "accredited investors" pursuant to Rule 501 of Regulation D of the Securities Act of 1933 (the "Act") and to Proactive Partners, L.P. and certain of its affiliates ("Proactive"), who became the largest beneficial owner of the Company's common stock by virtue of the acquisition of the convertible preferred stock and common stock purchase warrants.

The preferred stock has priority in liquidation over the common stock, but it carries no stated dividend. The holders of the preferred stock, voting as a separate class, have the right to elect that number of directors of the Company which represents a majority of the total number of directors. The preferred stock is convertible at any time at the option of the holder into common stock at the rate of \$.35 per share of common stock. As of June 30, 2003, a total of 459,999 shares of preferred stock had been converted into 1,314,278 shares of common stock.

Private placement of common equity

In a private financing at the end of March 2002, the Company raised capital of \$60,000, including \$27,000 in cash investments, \$27,000 from the conversion to equity of accrued liabilities to officers, employees and consultants, and cash proceeds of \$6,000 through the issuance of a short-term note that is convertible to equity at the option of the holder. A total of 360,000 shares of the Company's common stock and five-year warrants to purchase an additional 180,000 shares of common stock at \$.25 per share were issued in this financing, and

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60,000 shares were reserved for future issuance upon the conversion of the note payable to common stock and a warrant to purchase common stock.

The offer and sale of these shares of common stock and warrants to purchase shares of common stock satisfied the conditions of Rule 506 of Regulation D of the Act and, as such, were exempt from the registration requirements of Section 5 of the Act as transactions not involving any public offering within the meaning of Section 4(2) of the Act.

Stock options

The Company maintains a non-qualified stock option plan (the "Plan") which has made available for issuance a total of 7.5 million shares of common stock. All directors, full-time employees and consultants to the Company are eligible for participation. Option awards are determined at the discretion of the Board of Directors. Upon a change in control of the Company, all outstanding options granted to employees and directors become vested with respect to those options which have not already vested. Options outstanding expire at various dates through June 2013.

From January 1, 2003 through June 30, 2003, the Company had the following activity in options to purchase shares of common stock under the Plan:

| | # of shares ----- | Weighted average exercise price ----- | # of shares exercisable ----- | Weighted average exercise price ----- |
|--------------------------------|-------------------------|---|--|---|
| Unexercised at January 1, 2003 | 4,523,058 | \$.43 | 4,129,058 | \$.45 |
| Granted | 313,415 | .25 | 150,915 | .25 |
| Becoming exercisable | | | | |
| Exercised | | | | |
| Lapsed | (225,000) | .35 | (100,000) | .75 |
| | ----- | | ----- | |
| Unexercised at June 30, 2003 | 4,611,473 | \$.40 | 4,179,973 | \$.42 |
| | ===== | ===== | ===== | ===== |

Through December 31, 2002, the Company accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion No. 25. Under APB No. 25, compensation cost is measured as the excess, if any, of the quoted market price of the Company's stock at the date of grant over the exercise price of the option granted. Compensation cost for stock options, if any, is recognized ratably over the vesting period.

As of January 1, 2003, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123 - "Accounting for Stock-based Compensation", which provides for the fair value based method of accounting to be applied to the Company's stock option grants and other stock-based compensation. SFAS No. 148 - "Accounting for Stock-based Compensation Transition and Disclosure", issued in December 2002, amends SFAS No. 123 to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock options and other stock-based employee compensation. The Company has chosen to apply the "modified prospective method" of SFAS No. 148 pursuant to which fair value based stock option compensation costs for 2003 will be recognized as if the fair value based method had been used to account for all employee stock-based awards made in prior periods as well as the current period.

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For purposes of calculating charges to expense for stock option compensation under SFAS No. 123, the Company has estimated the grant date fair value of each option using the Black-Scholes option pricing model with the following weighted average assumptions for 2003: volatility factor of 95%, average risk-free interest rate of 3.8%, zero dividend yield, and average expected term of eight years. As a result, for the six months ended June 30, 2003, the Company recorded stock option compensation under SFAS No. 123 totaling \$51,673 based on a weighted average fair value per share for options granted during 2003, 2002, 2001, and 2000 of \$.17, \$.15, \$.19, and \$.37, respectively. As was the case under APB Opinion No. 25, the amount of compensation expense is also credited to additional paid-in capital.

Had compensation cost for options granted been determined in prior periods consistent with the method of SFAS No. 123, the Company would have recorded additional compensation expense of \$61,737 for the first six months of 2002, and the Company's net loss and net loss per share for the six months ended June 30, 2002 on a pro forma basis would have been as follows:

| | |
|----------------------------------|-----------|
| Net loss - as reported | \$197,574 |
| Net loss - pro forma | \$259,311 |
| | |
| Net loss per share - as reported | \$.009 |
| Net loss per share - pro forma | \$.012 |

The Black-Scholes valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable, as opposed to the type of compensatory options granted by the Company. It also requires the input of highly subjective assumptions, such as the expected stock price volatility, changes in which can materially affect the fair value estimate. Because the options granted by the Company have characteristics significantly different from those of traded options, the amounts calculated using the Black Scholes option valuation model, in the opinion of management, do not necessarily provide a reliable single measure of the fair value of options granted by the Company.

Common stock reserved for future issuance

At June 30, 2003, a total of 11,516,832 shares of common stock were reserved by the Company for issuance for the following purposes:

| Purpose | # of shares |
|--|-------------|
| ----- | ----- |
| Currently exercisable warrants expiring in December 2005, exercisable at \$.50 per share | 387,500 |
| March 2006, exercisable at \$.50 per share | 250,000 |
| April 2006, exercisable at \$.50 per share | 175,000 |
| March 2007, exercisable at \$.25 per share | 180,000 |
| | ----- |
| | 992,500 |
| | |
| Currently exercisable options | 4,179,973 |
| Granted options becoming exercisable in the future | 431,500 |
| Options available for future grants | 1,452,859 |
| Conversion of note payable | 60,000 |
| Conversion of preferred stock | 4,400,000 |
| | ----- |

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Total shares reserved

11,516,832

NOTE 9 - COMMITMENTS

The Company occupies its office and laboratory facility on a month-to-month basis under the terms of an operating lease agreement pursuant to which the property owner is required to provide thirty days notice if he wants the Company to vacate the premises. The lease currently provides for monthly rent of \$4,000 and requires the Company to pay all property related expenses. The Company will seek to negotiate a new long-term lease for its facility or search for an alternative location in the event that a long-term agreement cannot be reached for the existing premises. Management believes that the resolution of the uncertainty with respect to the facility will not result in a significant interruption in the operations of the Company.

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

Caution regarding forward-looking statements

Sections of this document, as well as all publicly disseminated material about Sonex Research, Inc. ("Sonex" or the "Company"), contain expressions of beliefs, expectations, or intentions, in the form of "forward-looking" statements as that term is defined under applicable federal securities laws. Such statements are based on current expectations, estimates, projections and assumptions by management with respect to, among other things, trends affecting the Company's financial condition or results of operations and the impact of competition. Words such as "expects", "anticipates", "plans", "believes", "estimates",

variations of such words, and similar expressions are intended to identify such statements that include, but are not limited to, projections of revenues, earnings, cash flows and contract awards. Such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, all of which are difficult to predict and many of which are beyond the control of the Company.

Forward-looking statements contained herein speak only as of the date of this report. The Company disclaims any obligation to update these statements and cautions readers not to place undue reliance on such statements.

Risk factors

In order to obtain the benefits of the "safe harbor" provisions under applicable federal securities laws for any "forward-looking" statements of the type described previously under the heading "Caution Regarding Forward-Looking Statements", the Company cautions shareholders, investors and prospective investors about significant factors which, among other things, have in some cases affected the Company's actual results and are in the future likely to

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affect the Company's actual results and cause them to differ materially from those expressed in any such forward-looking statements.

Factors that could cause actual results to differ materially include the specific risks listed below. These risks and uncertainties are not the only ones faced by the Company or that may adversely affect its business. If any of the following risks or uncertainties actually occur, the Company's business, financial condition or results of operations could be materially adversely affected.

- o ability to generate cash flow from revenue or to secure financing necessary to fund future operations
- o ability to complete technology development and demonstration programs, demonstrate commercial viability of its technology and execute licensing agreements that produce significant revenue
- o ability to maintain and protect the Company's patents and proprietary information
- o ability to attract and retain skilled personnel
- o ability to secure a long-term lease for the Company's existing facility or to secure an alternative location
- o changes in general economic conditions
- o competition from companies which have substantially greater financial, technical and marketing resources than does the Company

Furthermore, since its inception in 1980, the Company has generated cumulative net losses of nearly \$23 million, and may continue to incur quarterly operating losses for the foreseeable future. Operating results have fluctuated significantly in the past on an annual and quarterly basis, and are expected to continue to fluctuate significantly from quarter to quarter for the foreseeable future. The business historically has not generated sufficient cash flow to fund operations without resorting to external sources of capital. The Company does not have any bank financing arrangements. Operating funds have been raised primarily through the sale of equity securities in both public and private offerings, although revenues are now providing most of the necessary operating cash.

In the event that funding from internal and external sources is insufficient, the Company would have to cut back significantly its level of spending, which could substantially curtail the Company's operations. These reductions could have an adverse effect on the Company's relations with its potential customers and government funding sponsors.

The Company's success also depends in significant part on the continued services of its key technical and senior management personnel. Losing one or more key employees, including for reasons of poor health, disability, or death, could have a material adverse effect on the Company's business, results of operations, and financial condition. Due to the expense involved, the Company does not maintain life insurance policies for any of its employees. Additionally, in order to avoid long-term financial commitments, the Company does not have employment agreements with any of its personnel.

Further, the market price of the Company's Common Stock could be affected adversely by the substantial number of shares that are reserved for, and may be issued in, the future. As of June 30, 2003, there were 21,592,669 shares of Common Stock issued and outstanding, with an additional 11,516,832 shares reserved for future issuance upon the conversion of preferred stock, the exercise of options and warrants, and the conversion of notes payable.

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Competition

The Company faces significant competition from the extensive research departments of the world's major vehicle and engine manufacturers. These companies exercise a bias toward in-house technologies over those developed by independent suppliers. Competition also comes from several independent engine testing and consulting firms around the world which are in the business of developing engine technologies. The Company's competitors have substantially greater financial, technical and marketing resources than does the Company. Accordingly, the Company cannot be sure that it will have the resources or expertise to compete successfully in the future.

Although the experience and financial resources of its competitors far exceed those of the Company, management believes that the SCS can provide significant advantages over the competition in terms of low cost, improved performance, and simplicity.

Secrecy and non-disclosure

Due to the highly competitive nature of the world's automotive and truck industries, in connection with its contracts and/or demonstration programs with such manufacturers, Sonex is required to execute joint secrecy and disclosure agreements that, in most cases, expressly prohibit the public disclosure of the names and other significant information about the participants and the current or proposed programs. Failure by Sonex to maintain this strict level of confidentiality would jeopardize its relationship with these organizations.

Overview of the Company and its technology

Sonex, incorporated in Maryland in 1980, is an engineering research and development firm that is seeking to commercialize its patented proprietary technology (the "Sonex Combustion System", "SCS" or "Ultra Clean BurnTM technology") for in-cylinder control of ignition and combustion in engines of various types. The Company was co-founded in 1980 by Dr. Andrew A. Pouring, a former Professor of Aerospace Engineering and Chairman of the Department of Aerospace Engineering at the U.S. Naval Academy. At Sonex, Dr. Pouring conducted basic research into the principle of in-cylinder control of ignition and combustion, concentrating on the piston. By the late 1980's and early 1990's, the development of the SCS had moved in the direction of chemical/turbulent enhancement of combustion through investigation of the effects of changing the chemical characteristics and fuel disbursement characteristics within the combustion chamber.

The Company seeks to commercialize its SCS technologies for a variety of engine applications for commercial and military use. To date, Sonex has engaged in development and demonstration programs with the engine industry and has received funding from the federal government for further development of the SCS technologies. The Company's primary objective is to execute broad agreements with engine and parts manufacturers for industrial production of SCS components under license from Sonex.

The SCS technology for in-cylinder control of ignition and combustion is designed to

- o reduce emissions of diesel engines
- o increase fuel mileage of a new generation of gasoline engines
- o permit gasoline engines to run on safer, kerosene-based "heavy" fuels

The SCS improves the combustion of fuels in engines through design modification

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of the pistons in four-stroke, direct injected (DI), engines or the cylinder heads in two-stroke, spark-ignited (SI), gasoline engines to achieve chemical/turbulent enhancement of combustion. The SCS process for both two- and four-stroke engines achieves in-cylinder control of ignition and combustion through the chemical/turbulent enhancement of combustion via combustion chamber modifications that change the chemical characteristics and fuel disbursement characteristics within the combustion chamber.

SCS reductions of soot in DI diesel truck engines have been confirmed by an independent international engine consulting firm. Evidence to date indicates that the SCS is a significant new engine design variable, and that the synergy of the SCS in combination with exhaust gas recirculation (EGR) can help reduce exhaust aftertreatment requirements to meet future regulatory standards. The Company believes that SCS diesel engine designs should provide reductions in the cost and complexity of future exhaust aftertreatment systems.

Sonex also is seeking to show the technical feasibility of achieving reduced fuel consumption while lowering emissions in a new class of DI gasoline engines, yet overcoming the safety concern that vehicles would need to be reduced in size and weight to improve fuel mileage. A new branch of the SCS focusing on the control of ignition may, with further development, enable DI gasoline engined automobiles, currently manufactured and sold only in markets outside the U.S. due to emissions considerations, to become emissions compliant in the U.S. while providing fuel consumption benefits. In addition, the evolution of hybrid gasoline and electric powered vehicles could be accelerated since a major improvement in engine fuel mileage would provide opportunities for tradeoff of vehicle weight versus power.

An SCS process for the conversion of reliable, lightweight, SI, two-stroke, gasoline engines to start and operate on kerosene-based "heavy" fuels has been applied successfully in a variety of applications such as small, remotely controlled military unmanned aerial vehicles (UAVs). The military now requires such engines to operate on less volatile heavy fuels to reduce the hazard associated with gasoline, making heavy fuel engines (HFES) more suitable for applications where gasoline storage and use are undesirable. Potential applications of the SCS heavy fuel conversion process can be expanded to a range of military and commercial uses. Sonex is also developing a process for the heavy fuel conversion of SI four-stroke gasoline engines, and has recently begun investigating the synergy of SCS technology with rotary engines. In addition, Sonex is examining the potential, through cooperation with one or more companies which have complementary technologies and production capabilities, of becoming a supplier of small HFES to military and commercial markets.

As of June 30, 2003, the Company had seven full-time employees and one part-time employee, and engages the part-time services of a consultant who serves as its director of business development and manager of government programs. The Company also engages the services of several other technical and business consultants as needed. The Company has never experienced a strike or work stoppage, and believes its relations with its employees are good.

Strategic planning

The Company has come to realize that it lacks the resources to address issues such as piston manufacturing processes, durability testing, and cost analysis. Present Sonex technology development is being supported by U.S. Government funding, and the Company is also seeking committed business partners for further technical development and marketing of the various SCS engine applications. Sonex believes that having one or more such partners experienced in dealing with the engine and automotive industries on state-of-the-art technological developments may accelerate commercial acceptance of the SCS technology. Development efforts taking place currently under government contracts to Sonex

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could facilitate participation by the engine and automotive industries and thereby accelerate commercialization potential of the patented SCS technology for in-cylinder control of ignition and combustion.

In January 2003 the Company engaged the Annapolis, Maryland consulting group Paradigm Technologies, LLC ("Paradigm") to assess the Company's technologies and business model and suggest approaches for strategic alliances and additional market introductions for both commercial and military applications. Presently, Company management and Paradigm are pursuing a number of initiatives. One of the first goals is to secure cooperation with one or more companies which have technologies complementary to the Sonex processes. Additionally, Paradigm will also seek further funding for Sonex to conduct technology development work necessary for addressing commercialization issues. The Company has also engaged the services of The Washington Capitol Group (TWCG), a government relations and public affairs firm in Washington, D.C., which also specializes in federal marketing, government procurement assistance, and commercialization services. The Company's Board of Directors and management are assessing other strategic alternatives, which may include a sale of part or all of the Company or other corporate transactions, to permit Sonex shareholders to maximize the return on their investments.

Primary SCS design modifications

The SCS technology for four-stroke DI engines improves the process of combustion through a combination of chemical and fluid dynamic effects that occur by modifying the engine's combustion chamber and the processes occurring within that chamber. The SCS processes for DI engines change only a single engine component (the piston) while introducing no additional parts and are self-driven by the combustion process. Patented SCS piston designs for four-stroke engines integrate cavities called micro-chambers (MCs) which form a ring around the piston bowl, with each MC positioned with respect to each spray from the fuel injector of a DI engine. The MCs are designed to function either as chemical reactors or reservoirs, depending on the specific design needs, and are connected to the piston bowl by vents. For soot reduction, the reservoirs/vents are placed to increase turbulence, while for enhanced ignition the MCs produce highly active chemical species from a fraction of the fuel-air charge that are expelled on the intake stroke of low compression ratio DI engines to fumigate incoming air and serve as an ignition source.

The SCS process for the conversion of lightweight, SI, two-stroke, gasoline engines introduces patented features which enable the combustion of heavy fuels through design modification of the cylinder heads to achieve a chemically enhanced combustion process while still relying on the spark to initiate combustion. Sonex uses a machined cylinder head and combustion chamber insert housing the proprietary SCS technology, and a glow plug-based fuel vaporizer for cold starting. For engines that have the cylinder head and cylinder in one single casting, the stock cylinder head is removed and the remaining cylinder casting is decked and machined for cylinder head screws. The SCS heavy fuel conversion maintains the gasoline engine's stock carburetion or fuel injection system, intake and exhaust systems, spark ignition system, compression ratio and weight. The SCS starting system uses commercial-off-the-shelf 12V glow plugs to directly vaporize the heavy fuel for cold starting. Once the engine has been started, the starting system is disabled.

Current funded projects

The Company seeks to commercialize its SCS technologies for a variety of engine applications for commercial and military use. To date, Sonex has engaged in development and demonstration programs with the engine industry and has received funding from the federal government for further development of the SCS

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technologies. The next few paragraphs provide an overview of the primary initiatives taking place at Sonex. Additional detailed information can be found in the Company's December 31, 2002 Annual Report on Form 10-KSB.

DARPA

In the fourth quarter of 2002 the Company was awarded a \$744,246 contract by the U.S. Defense Advanced Research Projects Agency (DARPA) to begin the design and development of a heavy fuel conversion process for a gasoline automotive engine for potential use in a developmental unmanned aerial vehicle (UAV). This project focuses on the SCS Stratified Charge, Radical Ignition (SCRI) application, an unthrottled, low compression ratio, sparkless, compression ignition process at gasoline compression ratios. The primary objective of the DARPA program is to transfer the SCS SCRI heavy fuel design achieved in the Sonex single-cylinder laboratory engine to a modern six-cylinder, gasoline automotive engine, eliminate the spark ignition system, and produce the same power the engine originally produced on gasoline. As of August 15, 2003, Sonex is nearing achievement of the laboratory configuration heavy fuel engine to begin iterative testing. Completion of this project is expected in late 2003 or early 2004.

The Company believes the availability of the resultant multi-cylinder, four-stroke heavy fuel engine from a successful outcome of the DARPA project could lead to use in other military engine programs such as small power boats, as well as having potential for use in the commercial marine market in pleasure boats for which a diesel fueled engine would be a safer alternative to the current gasoline engines which too often result in dangerous onboard fires.

In addition, results from the DARPA project could be applied later to a gasoline powered version to achieve automotive engines with reduced fuel consumption and emissions. The time required to achieve technical feasibility could be reduced since the sparkless SCRI process can advantageously employ the centrally located spark plug hole of most production 4-valve per cylinder engines for the installation of the injector.

DOE

In the fourth quarter of 2002 the Company received a subcontract from Compact Membrane Systems, Inc. (CMS) for \$458,862, of which \$100,000 is cost-shared (funded) by Sonex. CMS is a prime contractor for a U.S. Department of Energy (DOE), Small Business Innovation Research (SBIR) Program, Phase II project. Sonex and CMS are evaluating the diesel engine emissions reduction potential of combining the patented piston-based, SCS technology and the CMS polymer membrane technology for the addition of nitrogen enriched air (NEA) to the combustion process. In the second quarter of 2003 Sonex took delivery of the advanced research automotive diesel engine to be used for the testing. The engine is a state-of-the-art, three-cylinder, direct injected, turbo-charged, automotive diesel engine developed by a major international vehicle manufacturer in the joint U.S. government and automotive industry funded PNGV (Partnership for a New Generation Vehicle) program.

Early stages of the Phase II project are focusing on the emissions reduction capabilities of the SCS pistons separately, while subsequent testing in combination with the NEA membrane will demonstrate the viability for commercialization of the synergy of SCS configurations and the CMS membranes. This program would provide SCS in-cylinder emissions reduction data on a multi-cylinder diesel engine as a means for diesel engine manufacturers to evaluate the potential for SCS designs, alone and in combination with the NEA membrane, to reduce the cost and complexity of future exhaust aftertreatment systems. While the entire project is not expected to be completed until 2004, testing results on the SCS pistons alone may be available later this year.

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SAIC

In the third quarter of 2002 the Company received a subcontract, initially funded for \$200,000 and later increased to \$281,947, from Science Applications International Corporation (SAIC), a large Department of Defense prime contractor. Sonex was tasked to conduct a survey of commercially available two-stroke, spark ignited, gasoline engines of approximately 72 horsepower and, jointly with SAIC, select a candidate engine for a "best efforts" SCS conversion to start and operate on heavy fuels for use in a UAV weapon system. SAIC also awarded a subcontract to a competing firm to develop a heavy fuel conversion for a rotary engine already in production. SAIC and its military sponsor subsequently increased the targeted horsepower requirement to 100. Sonex and SAIC together selected a candidate gasoline engine, not yet in production, for conversion to heavy fuel.

Due to deficiencies found in operating the candidate engine on gasoline and concurrent fuel consumption problems experienced by the competing rotary engine operating on heavy fuel, in the first quarter of 2003 the military sponsor expressed a desire to have Sonex work with the competing rotary engine developer to focus on improving the fuel consumption of the rotary heavy fuel engine. This joint effort has yet to be formalized because work on the engine has been placed on hold while SAIC concentrates on resolving a number of technical issues with the flight vehicle.

Financial position and liquidity

The Company operated under severe cash flow difficulties for extended periods during 2001 and 2002. Its two officers voluntarily and at their own discretion deferred receipt of payment of significant portions of their current wages to reduce the Company's cash requirements. With the generation of cash flow from revenues earned under contracts awarded to the Company during the second half of 2002, some of the amounts owed to the Company's officers were repaid. Since December 2002, the Company's chief financial officer has been receiving his current wages, while the Company's chief executive officer has been deferring all of his current wages since April 2003. As of June 30, 2003, such wages payable to the Company's chief executive and chief financial officers were \$146,404 and \$86,403, respectively. The continued deferral of portions of current wages by the Company's officers cannot be expected to continue indefinitely, and the Company will be required to pay amounts outstanding as soon as cash flow permits. Similarly, the Company has accumulated unpaid consulting fees, the majority of which amounts are payable to the individual who serves as the Company's director of business development and technical program manager on a part-time basis. As of June 30, 2003, this individual was owed \$41,280. The amount and timing of payments for unpaid compensation owing to the Company's officers and this consultant will be determined at the discretion of the Company's officers; however, all such unpaid compensation is payable upon demand, as these amounts are not subject to the terms of the Company's written agreement with current and former employees to defer payment of portions of their salaries as described in Note 6 to the accompanying unaudited financial statements.

As of June 30, 2003, the Company had available cash of \$40,021 and accounts receivable of \$156,493, which amount was received during July 2003. The Company historically has derived the majority of its revenues from engineering and development funding provided by established companies willing to assist the Company in the development of its SCS technology and, more recently, from government sources. In 2002, however, revenues increased substantially, providing cash to fund the majority of the Company's operating expenditure requirements for the year. All of the Company's revenue for 2002 and 2003 has

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been derived from development and demonstration contracts issued by a United States Government or Department of Defense (DoD) agency or prime contractor. In 2003 revenues from development and demonstration contracts are again expected, although there can be no assurance, to provide most of the cash necessary to fund operations.

Based upon available resources, current and projected spending levels, and expected revenue from current and anticipated contracts, management believes the Company will have sufficient capital to fund operations through December 31, 2003. The Company's prospects beyond that date are dependent upon its ability to enter into significant funded contracts for the further development of its SCS technology, establish joint ventures or strategic partnerships with major industrial concerns, or secure a major capital infusion. There is no assurance that the Company will be able to achieve these objectives.

In the event sufficient funding is not available through the generation of revenues or from external sources, the Company would have to substantially reduce the level of its operations. Such a reduction could have an adverse effect on the Company's relationships with government funding sources, strategic partners and potential customers.

The accompanying unaudited financial statements have been prepared assuming that the Company will continue as a going concern, which contemplates continuity of operations, realization of assets and satisfaction of liabilities in the ordinary course of business. The propriety of use of the going concern basis is dependent upon, among other things, the Company's ability to generate sufficient revenue and ultimately achieve profitable operations. These uncertainties raise substantial doubt about the Company's ability to continue as a going concern. The accompanying financial statements do not include any adjustments relating to the recoverability of the carrying amounts of recorded assets or the amount of liabilities that might result from the outcome of these uncertainties.

Results of operations

A net loss of \$184,659 was recorded for the first six months of 2003, as compared to \$197,574 for the corresponding period in 2002, a decrease of \$12,915, or 7%. With the award of several significant contracts during the second half of 2002, revenue more than quadrupled in the current period versus the prior year, with related increases in expenses to support the new work.

[Note: In order to conform to the classifications used in 2003, certain amounts for 2002 presented in the prior year's financial statements as research and development expenses have been reclassified below to cost of revenue. The net loss for each period does not change as a result of these reclassifications.]

Revenue and cost of revenue:

| | Six months ended June 30, | |
|----------------------------|------------------------------|--------------------|
| | 2003 | 2002 |
| Defense/government revenue | \$ 388,902 ===== | \$ 86,517 ===== |
| Cost of revenue | \$ 271,144 ===== | \$ 54,426 ===== |

Revenue increased substantially from the first half of 2002 to the first

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half of 2003, as during the second half of 2002 the Company was awarded three significant contracts and subcontracts from branches of the U.S. government and DoD and/or their prime contractors. The following is a listing of the three major new projects, descriptions of which appear earlier in this report.

Subcontract awarded by Science Applications International Corporation (SAIC), a large DoD prime contractor. Awarded third quarter of 2002. Initial funding of \$200,000, later increased by \$81,947. Work suspended in first quarter of 2003; there is no certainty that development work will resume.

Prime contract awarded by the Defense Advanced Research Projects Agency (DARPA). Awarded fourth quarter of 2002. Total funding of \$744,246. Completion expected in late 2003 or early 2004.

Subcontract awarded by Compact Membrane Systems, Inc. (CMS) under its prime contract from the U.S. Department of Energy (DOE). Awarded fourth quarter of 2002. Total award to Sonex of \$458,862, of which \$100,000 is cost-shared (funded) by Sonex. Completion expected in 2004.

Cost of Revenue primarily consists of direct labor charges and other direct expenditures, including those for consulting services, attributable to funded programs, as well as allocated fringe benefits, payroll taxes, and labor overhead charges. Cost of Revenue as a percentage of total revenue increased from 63% in 2002 to 70% in 2003.

Research and development (R&D) expenses:

| | Six months ended June 30, | |
|--|------------------------------|------------|
| | 2003 | 2002 |
| Employee compensation, taxes & benefits | \$ 231,310 | \$ 110,144 |
| Consulting fees | 60,415 | 6,287 |
| Other expenses | 98,554 | 53,532 |
| | 390,279 | 169,963 |
| Total R&D expenses | | |
| Less amounts classified as cost of revenue | (271,144) | (54,426) |
| | \$ 119,135 | \$ 115,537 |
| Net R&D expenses | \$ 119,135 | \$ 115,537 |

The following analysis is based on a comparison of total R&D expenses as listed above before deduction of amounts classified as cost of revenue.

Total R&D expenses for the first six months of the year increased by \$220,317, or 130%, from 2002 to 2003. The largest component, employee compensation, increased by \$121,166, or 110%, as additional personnel were hired during the second half of 2002 to work on the new contracts received by the Company. As of June 30, 2003, the Company had seven full-time employees, whereas there were only three by the end of the second quarter of 2002. Consulting fees also

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increased significantly due to the efforts of specialized technical consultants needed on the new contracts. The increase in other expenses primarily relates to higher purchases of parts and supplies to support the new contracts.

General and administrative (G&A) expenses:

| | Six months ended June 30, | |
|---|------------------------------|------------|
| | 2003 | 2002 |
| Employee compensation, taxes & benefits | \$ 83,393 | \$ 50,866 |
| Consulting fees | 60,098 | 27,500 |
| Professional fees | 13,463 | 20,835 |
| Other expenses | 23,169 | 15,713 |
| Total G&A expenses | \$ 180,123 | \$ 114,914 |

Total G&A expenses for the first six months of the year increased by \$65,209, or 57%, from 2002 to 2003. The largest component, employee compensation, increased by \$32,527, or 64%, for a number of reasons. Total salaries were higher as a result of an increase in the salary (before deferral) of the Company's chief financial officer effective January 1, 2003 and the costs for a part-time administrative assistant beginning in January 2003. Another factor was the recording of charges for stock option compensation in 2003 as the Company changed its method of accounting for stock-based compensation as described in Note 8 to the accompanying unaudited financial statements. Such charges represent the amortization over the related vesting period of charges associated with option grants made in prior years as well as in the current period.

Consulting fees increased by \$32,598, or 114%, from 2002 to 2003 as the Company has expanded its marketing and commercialization capabilities in 2003 by hiring specialized consultants to provide business advisory services in areas such as strategic alliances, federal marketing, and government procurement assistance. Such expenses in 2003 include stock option compensation due to the change in accounting method mentioned above. Professional fees decreased by \$7,372, or 35%, from 2002 to 2003, reflecting the termination in early 2003 of the Company's relationship with an investor relations firm engaged in the second quarter of 2002.

ITEM 3. CONTROLS AND PROCEDURES

The Company's chief executive officer and chief financial officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934) as of an evaluation date within 90 days prior to the filing date of this Quarterly Report on Form 10-QSB. Based on such evaluation they have concluded that, as of the evaluation date, the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed in reports that the Company files or submits under the Exchange Act, is recorded, processed, summarized and reported in a timely manner.

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Since the evaluation date referred to above, there have been no significant changes in the Company's internal controls or in other factors that could significantly affect such controls.

PART II - OTHER INFORMATION

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits.

- 3 Articles of Incorporation and Bylaws (as amended) - Incorporated by reference to the Company's Annual Report on Form 10-KSB for the year ended December 31, 1992.
- 4 Instruments defining the rights of security holders (contained in Exhibit 3 hereof).
- 10.1 1987 Non-Qualified Stock Option Plan, as amended - Incorporated by reference to the Company's Registration Statement No. 33-34520 on Form S-8.
- 24 Power of Attorney - Incorporated by reference to the Company's Annual Report on Form 10-KSB for the year ended December 31, 1998.
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32 Certification of Form 10-QSB for the quarterly period ended June 30, 2003 pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K.

During the second quarter of 2003, the Company filed the following Current Reports on Form 8-K:

On April 17, 2003, to disclose the receipt of an automotive diesel engine for testing under a Department of Energy subcontract.

On April 23, 2003, to provide an update to shareholders following the filing of the Company's Annual Report on Form 10-KSB for the year ended December 31, 2002.

SIGNATURES

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

SONEX RESEARCH, INC.
(Registrant)

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/s/ George E. Ponticas

by: George E. Ponticas
Chief Financial Officer

August 19, 2003

EXHIBIT 31.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Andrew A. Pouring, Chief Executive Officer, certify that:

1. I have reviewed this Quarterly Report on Form 10-QSB of Sonex Research, Inc. (the "Company").
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this report;
4. The Company's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the Company and have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the Company, including its consolidated subsidiaries, if any, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) evaluated the effectiveness of the Company's disclosure controls and procedures as of a date within 90 days prior to the filing date of this report (the "Evaluation Date"); and
 - c) presented in this report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The Company's other certifying officer and I disclosed, based on our most recent evaluation, to the Company's auditors and the audit committee of Company's board of directors (or persons performing the equivalent functions):

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- a) all significant deficiencies in the design or operation of internal controls which could adversely affect the Company 's ability to record, process, summarize and report financial data and have identified for the Company 's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Company 's internal controls.
6. The Company's other certifying officer and I have indicated in this report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Dated: August 19, 2003

/s/ Andrew A. Pouring

Andrew A. Pouring
Chief Executive Officer

EXHIBIT 31.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, George E. Ponticas, Chief Financial Officer, certify that:

1. I have reviewed this Quarterly Report on Form 10-QSB of Sonex Research, Inc. (the "Company").
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this report;
4. The Company's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the Company and have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the Company, including its consolidated subsidiaries, if any, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) evaluated the effectiveness of the Company 's disclosure controls

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- and procedures as of a date within 90 days prior to the filing date of this report (the "Evaluation Date"); and
- c) presented in this report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The Company's other certifying officer and I disclosed, based on our most recent evaluation, to the Company 's auditors and the audit committee of Company 's board of directors (or persons performing the equivalent functions):
- a) all significant deficiencies in the design or operation of internal controls which could adversely affect the Company 's ability to record, process, summarize and report financial data and have identified for the Company 's auditors any material weaknesses in internal controls; and
- b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Company 's internal controls.
6. The Company's other certifying officer and I have indicated in this report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Dated: August 19, 2003

/s/ George E. Ponticas

George E. Ponticas
Chief Financial Officer

EXHIBIT 32

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

In connection with the Quarterly Report of Sonex Research, Inc. (the "Company") on Form 10-QSB for the quarter ending June 30, 2003, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned certify, pursuant to and for the purposes of 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

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

SONEX RESEARCH, INC.

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/s/ Andrew A. Pouring

Andrew A. Pouring
Chief Executive Officer

/s/ George E. Ponticas

George E. Ponticas
Chief Financial Officer

August 19, 2003