N-VIRO INTERNATIONAL CORP
Form 10-Q
August 14, 2008

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2008

OR

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

For the transition period from ____________ to ____________

Commission File Number: 0-21802

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N-VIRO INTERNATIONAL CORPORATION
(Exact name of small business issuer as specified in its charter)

| Delaware | 34-1741211 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |

| 3450 W. Central Avenue, Suite 328 Toledo, Ohio | 43606 |
|---|---|
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code: (419) 535-6374

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer    Accelerated filer
Non-accelerated filer    Smaller reporting company X

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

As of August 11, 2008, 4,332,256 shares of N-Viro International Corporation $ .01 par value common stock were outstanding.

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

N-VIRO INTERNATIONAL CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

| | Three Months Ended June 30 | | Six Mo |
|---|---|---|---|
| | 2008 | 2007 | 200 |
| REVENUES | $1,156,544 | $1,022,014 | $2,320 |
| COST OF REVENUES | 1,034,279 | 856,543 | 1,967 |
| GROSS PROFIT | 122,265 | 165,471 | 352 |
| OPERATING EXPENSES | | | |
| Selling, general and administrative | 553,009 | 530,444 | 948 |
| OPERATING LOSS | (430,744) | (364,973) | (595 |
| OTHER INCOME (EXPENSE) | | | |
| Interest income | 809 | 1,565 | 1 |
| Interest expense | (17,180) | (17,938) | (30 |
| Gain on legal debt forgiven | 0 | - | 84 |
| | (16,371) | (16,373) | 55 |
| LOSS BEFORE INCOME TAXES | (447,115) | (381,346) | (540 |
| Federal and state income taxes | - | - | |
| NET LOSS | $ (447,115) | $ (381,346) | $ (540 |
| Basic and diluted loss per share | $ (0.10) | $ (0.10) | $ ( |
| Weighted average common shares outstanding - basic and diluted | 4,297,125 | 3,965,706 | 4,211 |

See Notes to Consolidated Financial Statements

N-VIRO INTERNATIONAL CORPORATION
CONSOLIDATED BALANCE SHEETS

| | June 30, 2008 (Unaudited) |
|---|---|
| **ASSETS** | |
| CURRENT ASSETS | |
| Cash and cash equivalents: | |
| Unrestricted | $ 81,749 |
| Restricted | 137,336 |
| Trade Receivables, net | 642,509 |
| Prepaid expenses and other current assets | 371,712 |
| Total current assets | 1,233,306 |
| Property and Equipment, Net | 2,030,412 |
| Intangible and Other Assets, Net | 307,452 |
| | $ 3,571,170 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)** | |
| CURRENT LIABILITIES | |
| Current maturities of long-term debt | $ 332,333 |
| Line-of-credit | 350,000 |
| Accounts payable | 1,528,951 |
| Accrued liabilities | 222,236 |
| Total current liabilities | 2,433,520 |
| Long-term debt, less current maturities | 1,018,341 |
| Total liabilities | 3,451,861 |
| COMMITMENTS AND CONTINGENCIES | |
| STOCKHOLDERS' EQUITY (DEFICIT) | |
| Common stock, $.01 par value; authorized 15,000,000 shares; issued 4,446,456 in 2008 and 4,145,359 in 2007 | 44,465 |
| Additional paid-in capital | 17,777,512 |
| Accumulated deficit | (17,017,778) |
| | 804,199 |
| Less treasury stock, at cost, 123,500 shares | 684,890 |
| Total stockholders' equity (deficit) | 119,309 |
| | $ 3,571,170 |

See Notes to Consolidated Financial Statements

N-VIRO INTERNATIONAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Six Months Ended June 30 2008 | 2007 |
|---|---|---|
| NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES | $ 147,897 | $(213,392) |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Purchases of property and equipment | (911,171) | (428,834) |
| Reductions to restricted cash and cash equivalents | (1,829) | (1,906) |
| Net cash used in investing activities | (913,000) | (430,740) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Borrowings under long-term obligations | 521,519 | 267,917 |
| Principal payments on long-term obligations | (117,472) | (60,650) |
| Stock warrants exercised | 223,552 | - |
| Stock options exercised | 170,932 | 206,206 |
| Net borrowings (payments) on line-of credit | (14,000) | 166,000 |
| Net cash provided by financing activities | 784,531 | 579,473 |
| NET INCREASE (DECREASE) IN CASH & CASH EQUIVALENTS | 19,428 | (64,659) |
| CASH AND CASH EQUIVALENTS - BEGINNING | 62,321 | 162,633 |
| CASH AND CASH EQUIVALENTS - ENDING | $ 81,749 | $ 97,974 |
| Supplemental disclosure of cash flows information: | | |
| Cash paid during the six months ended for interest | $ 52,539 | $ 43,873 |

See Notes to Consolidated Financial Statements

N-VIRO INTERNATIONAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1. ORGANIZATION AND BASIS OF PRESENTATION

The accompanying consolidated financial statements of N-Viro International Corporation (the "Company") are unaudited but, in management's opinion, reflect all adjustments (including normal recurring accruals) necessary to present fairly such information for the period and at the dates indicated. The results of operations for the six months ended June 30, 2008 may not be indicative of the results of operations for the year ending December 31, 2008. Since the accompanying consolidated financial statements have been prepared in accordance with Item 310 of Regulation S-B, they do not contain all information and footnotes normally contained in annual consolidated financial statements; accordingly, they should be read in conjunction with the consolidated financial statements and notes thereto appearing in the Company's Form 10-KSB for the period ending December 31, 2007.

The financial statements are consolidated as of June 30, 2008 and December 31, 2007 for the Company. All intercompany transactions were eliminated.

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The following are certain significant estimates and assumptions made in preparation of the financial statements:

Allowance for Doubtful Accounts - The Company estimates losses for uncollectible accounts based on the aging of the accounts receivable and the evaluation of the likelihood of success in collecting the receivable. The balance of the allowance at June 30, 2008 and December 31, 2007 is $40,000.

Property and Equipment/Long-Lived Assets - Property and equipment is reviewed for impairment pursuant to the provisions of Statement of Financial Accounting Standards (or SFAS) No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." The carrying amount of an asset (group) is considered impaired if it exceeds the sum of the Company's estimate of the undiscounted future cash flows expected to result from the use and eventual disposition of the asset (group), excluding interest charges. Property, machinery and equipment are stated at cost less accumulated depreciation. Management believes the carrying amount is not impaired based upon estimated future cash flows.

Intangible Assets - Intangible assets deemed to have indefinite lives are tested for impairment by comparing the fair value with its carrying value. Significant estimates used in the determination of fair value include estimates of future cash flows. As required under current accounting standards, the Company tests for impairment when events and circumstances indicate that the assets might be impaired and the carrying value of those assets may not be recoverable.

Fair Value of Financial Instruments - The fair values of cash, accounts receivable, accounts payable and other short-term obligations approximate their carrying values because of the short maturity of these financial instruments. The carrying values of the Company's long-term obligations approximate their fair value. In accordance with SFAS No. 107, "Disclosure About Fair Value of Financial Instruments," rates available at balance sheet dates to the Company is used to estimate the fair value of existing debt.

Income Taxes - Income taxes are provided at the applicable rates on the basis of items included in the determination of income for income tax purposes for the Company. The Company adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement 109" on January 1, 2007.

Deferred Income Taxes - Deferred income tax assets and liabilities are computed annually for differences between the financial statement and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates applicable to the periods in which the differences are expected to affect taxable income, under the provision of SFAS No. 109 which requires deferred income taxes be computed on the liability method and deferred tax assets are recognized only when realization in certain. The tax effect of such differences are zero at the end of each period presented.

NOTE 2. RELATED PARTY TRANSACTIONS

During the quarter ended June 30, 2008, the Company did not have any related party transactions.

NOTE 3. LONG-TERM DEBT

Through the second quarter of 2008, the Company had a line of credit up to $400,000 at the prime rate (5% at June 30, 2008) plus 1.5% and secured by a first lien on all assets of the Company, with Monroe Bank + Trust, or the Bank. Two certificates of deposit totaling $137,336 from the Bank are held as a condition of maintaining the line of credit. As announced in a Form 8-K filing on November 7, 2007, the line of credit was renewed through October 2008. At June 30, 2008, the Company had $50,000 of borrowing capacity under the credit facility.

During the second quarter of 2008, the Company's wholly-owned subsidiary, Bio-Mineral Transportation LLC ("BMT"), borrowed a total of $308,900 from a lender to purchase four trailers and a truck that were placed into service during the quarter. A term note was issued at 7.1% interest for five years, monthly payments of $6,125 and secured by the truck and trailers. The total amount owed on all notes by BMT as of June 30, 2008 was approximately $820,000 and all notes are expected to be paid in full on the applicable maturity date, the last of which is May 2013.

During the second quarter of 2008, the Company's wholly-owned subsidiary, Florida N-Viro LP ("Florida"), did not borrow any additional funds. The total amount owed on all notes by Florida as of June 30, 2008 was approximately $52,000 and all notes are expected to be paid in full on the applicable maturity date, the last of which is May 2012.

On December 28, 2006, the Company purchased the remaining ownership interest in Florida N-Viro for $500,000 and financed $400,000 of it by delivering a note to the seller, VFL Technology Corporation. The note is at 8% interest for 10 years, to be paid in annual installments, including interest, of $59,612, subject to an offset for royalties due us under a patent license agreement from the same party. The amount owed on the note as of June 30, 2008 was approximately $372,000 and the first installment of $27,338 was paid on time in early 2008. The second installment is expected to be paid on time in early 2009, accounting for expected royalty offsets through 2008.

NOTE 4. CONTINGENCIES AND OTHER OBLIGATIONS TO RELATED PARTIES

In June 2007, the Company executed an Employment Agreement with Robert W. Bohmer as Vice-President of Business Development and General Counsel, which commenced July 1, 2007. The Company and Mr. Bohmer agreed primarily to enter into an employment arrangement for a two-year term at $150,000 per year plus a stock option grant of 100,000 shares. In addition, Mr. Bohmer is eligible for an annual cash bonus. Generally, the Agreement may be terminated by the Company with or without cause or by the Employee for any reason. In June 2008, the Company amended the Agreement and extended the employment term an additional two years, ending on July 1, 2011. Except for the extension of the term, there were no other changes to the Agreement. Details of this event were announced in a Form 8-K filed June 20, 2008.

In March 2007, the Company and Mr. Timothy R. Kasmoch, the President and Chief Executive Officer, entered into an Employment Agreement dated and commencing February 13, 2007, for a two-year term. Mr. Kasmoch is to receive an annual base salary of $150,000, subject to an annual discretionary increase. In addition, Mr. Kasmoch is eligible for an annual cash bonus. Generally, the Agreement may be terminated by the Company with or without cause or by the Employee for any reason. In April 2008, the Company amended the Agreement and extended the employment term an additional two years, ending on February 12, 2011. Except for the extension of the term, there were no other changes to the Agreement. Details of this event were announced in a Form 8-K filed April 7, 2008.

The Company maintains an office in Daytona Beach under a lease with the County of Volusia, Florida which was renewed in April, 2005 for five years. The total minimum rental commitment for the years ending December 31, 2008 through 2009 is $48,000 each year, and for 2010 is $12,000. The total rental expense included in the statements of operations for the six months ended June 30, 2008 and 2007 is $24,000. We also lease various equipment on a month-to-month basis at our Florida operation.

The Company operates in an environment with many financial risks, including, but not limited to, major customer concentrations, customer contract termination provisions, competing technologies, infringement and/or misappropriation of intellectual property rights, the highly competitive and, at times, seasonal nature of the industry and worldwide economic conditions. Various federal, state and governmental agencies are considering, and some have adopted, laws and regulations regarding environmental protection which could adversely affect the business activities of the Company. The Company cannot predict what effect, if any, current and future regulations may have on the operations of the Company.

The Company is involved in these legal proceedings and subject to claims which have arisen in the ordinary course of business. These actions, when concluded and determined, will not, in the opinion of management, have a material adverse effect upon the financial position, results of operations or cash flows of the Company.

## NOTE 5. NEW ACCOUNTING STANDARDS

In May 2008, the Financial Accounting Standards Board issued Statement of Accounting Standards No. 162, "The Hierarchy of Generally Accepted Accounting Principles". This Statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). This Statement is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity With Generally

Accepted Accounting Principles". Adoption of this Statement is not expected to have a material impact on the Company's financial statements.

In May 2008, the Financial Accounting Standards Board issued Statement of Accounting Standards No. 163, "Accounting for Financial Guarantee Insurance Contracts - an interpretation of FASB Statement No. 60". This Statement requires that an insurance enterprise recognize a claim liability prior to an event of default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation. This Statement also clarifies how Statement No. 60 applies to financial guarantee insurance contracts, including the recognition and measurement to be used to account for premium revenue and claim liabilities. Those clarifications will increase comparability in financial reporting of financial guarantee insurance contracts by insurance enterprises. This Statement is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008. Adoption of this Statement is not expected to have a material impact on the Company's financial statements.

NOTE 6. SEGMENT INFORMATION

The Company has determined that its reportable segments are those that are based on the Company's method of internal reporting, which segregates its business by product category and service lines. The Company's reportable segments are as follows:

Management Operations - The Company provides employee and management services to operate the Toledo Ohio Wastewater Treatment Facility and the Daytona/Volusia County Florida Treatment Facility.

Other Domestic Operations - Sales of alkaline admixtures, territory or site licenses and royalty fees to use N-Viro technology in the United States.

Foreign Operations - Sale of alkaline admixtures, territory or site licenses and royalty fees to use N-Viro technology in foreign operations.

Research and Development - The Company contracts with Federal and State agencies to perform or assist in research and development on the Company's technology.

The accounting policies of the segments are the same as the Company's significant accounting policies. Fixed assets generating specific revenue are identified with their respective segments and are accounted for as such in the internal accounting records. All other assets, including cash and other current assets and all long-term assets, other than fixed assets, are not identified with any segments, but rather the Company's administrative functions. All of the net nonoperating income (expense) are non-apportionable and not allocated to a specific segment. The Company accounts for and analyzes the operating data for its segments generally by geographic location, with the exception of the Management Operations and Research and Development segments. The Management Operations segment represents both a significant amount of business generated as well as specific locations and unique type of revenue.

The Domestic and Foreign operations segments differ in terms of environmental and municipal legal issues, nature of the waste disposal infrastructure, political climate and availability of funds for investing in the Company's technology. These factors have not changed significantly over the past several years and are not expected to change in the near term.

The Research and Development segment is unlike any other revenue in that it is generated as a result of a specific project to conduct initial or additional ongoing research into the Company's emerging technologies. The Company has not

recorded any revenue from this source since 2006.

For the second quarter of 2008, approximately 94% of the Company's revenue was from management operations and 6% from other domestic operations. Since the second quarter of 2006, the percentage of the Company's revenue from management fee operations has grown from 45% to 90%, primarily the result of the acquisition of the Florida operations at the end of 2006.

The table below presents information about the segment profits and segment identifiable assets used by the chief operating decision makers of the Company for the periods ended June 30, 2008 and 2007 (dollars in thousands):

| | Management Operations | Domestic Operations | Foreign Operations | Research Developme |
|---|---|---|---|---|
| | Quarter Ended June 30, 2008 | | | |
| Revenues | 1,090 | 66 | - | |
| Cost of revenues | 966 | 68 | - | |
| Segment profits | 124 | (2) | - | |
| Identifiable assets | 1,934 | 82 | - | |
| Depreciation and Amortization | 72 | 32 | - | |
| | Quarter Ended June 30, 2007 | | | |
| Revenues | 714 | 308 | - | |
| Cost of revenues | 641 | 216 | - | |
| Segment profits | 73 | 92 | - | |
| Identifiable assets | 1,126 | 93 | - | |
| Depreciation and Amortization | 48 | 25 | - | |
| | Six Months Ended June 30, 2008 | | | |
| Revenues | 2,140 | 181 | - | |
| Cost of revenues | 1,773 | 195 | - | |
| Segment profits | 367 | (14) | - | |
| Identifiable assets | 1,934 | 82 | - | |
| Depreciation and Amortization | 125 | 67 | - | |
| | Six Months Ended June 30, 2007 | | | |
| Revenues | 1,427 | 727 | - | |
| Cost of revenues | 1,235 | 509 | - | |
| Segment profits | 192 | 218 | - | |
| Identifiable assets | 1,126 | 93 | - | |
| Depreciation and Amortization | 82 | 50 | - | |

A reconciliation of total segment revenues, cost of revenues, and segment profits to consolidated revenues, cost of revenues, and segment information to the consolidated financial statements for the periods ended June 30, 2008 and 2007 is as follows (dollars in thousands):

| | Qtr. Ended June 30 | | Six Months Ended June 30 | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Segment profits: | | | | |
| Segment profits for reportable segments | $ 122 | $ 165 | $ 353 | $ 410 |
| Corporate selling, general and administrative expenses | (553) | (530) | (948) | (1,009) |
| Other income (expense) | (16) | (16) | 55 | (25) |
| Consolidated loss before taxes | $ (447) | $ (381) | $ (540) | $ (624) |
| Identifiable assets: | | | | |
| Identifiable assets for reportable segments | $2,016 | $1,219 | $2,016 | $ 1,219 |
| Corporate property and equipment | 14 | 17 | 14 | 17 |
| Current assets not allocated to segments | 1,239 | 1,190 | 1,239 | 1,190 |
| Intangible and other assets not allocated to segments | 302 | 723 | 302 | 723 |
| Consolidated assets | $3,571 | $3,149 | $3,571 | $ 3,149 |
| Depreciation and amortization: | | | | |
| Depreciation and Amortization for reportable segments | $ 104 | $ 73 | $ 192 | $ 132 |
| Corporate depreciation and amortization | 10 | 22 | 20 | 45 |
| Consolidated depreciation and amortization | $ 114 | $ 95 | $ 212 | $ 177 |

EARNINGS VARIATION DUE TO BUSINESS CYCLES AND SEASONAL FACTORS. The Company's operating results can experience quarterly or annual variations due to business cycles, seasonality and other factors. Sales of the N-Viro technology are affected by general fluctuations in the business cycles in the United States and worldwide, instability of economic conditions and interest rates, as well as other factors. In addition, operating results of some of our business segments are influenced, along with other factors such as interest rates, by particular business cycles and seasonality.

COMPETITION. The Company conducts business in a highly competitive market and has fewer resources than most of its competitors. Principal competitors are mainly from the waste management and disposal, water and alternative energy industries. Businesses from these markets compete within and outside the United States principally on the basis of price, product quality, custom design, technical support, reputation, equipment financing assistance and reliability. Competitive pressures and other factors could cause the Company to lose market share or could result in decreases in prices, either of which could have a

material adverse effect on its financial position and results of operations.

RISKS OF DOING BUSINESS IN OTHER COUNTRIES. The Company conducts business in markets outside the United States, and expects to continue to do so. In addition to the risk of currency fluctuations, the risks associated with conducting business outside the United States include: social, political and economic instability; slower payment of invoices; underdeveloped infrastructure; underdeveloped legal systems; and nationalization. The Company has not entered into any currency swap agreements which may reduce these risks. The Company may enter into such agreements in the future if it is deemed necessary to do so. Current economic and political conditions in the Asia Pacific and Middle East regions have affected the Company outlook for potential revenue there. The Company cannot predict the full impact of this economic instability, but it could have a material adverse effect on revenues and profits.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

### FORWARD-LOOKING STATEMENTS

This 10-Q contains statements that are forward-looking. We caution that words used in this document such as "expects," "anticipates," "believes," "may," and "optimistic," as well as similar words and expressions used herein, identify and refer to statements describing events that may or may not occur in the future. These forward-looking statements and the matters to which they refer are subject to considerable uncertainty that may cause actual results to differ materially from described in those statements. There are numerous factors that could cause actual results to be different than those anticipated or predicted by us, including: (i) a deterioration in economic conditions in general; (ii) a decrease in demand for our products or services in particular; (iii) our loss of a key employee or employees; (iv) regulatory changes, including changes in environmental regulations, that may have an adverse affect on the demand for our products or services; (v) increases in our operating expenses resulting from increased costs of labor and/or consulting services; (vi) our inability to exploit existing or secure additional sources of revenues or capital to fund operations; (vii) a failure to collect upon or otherwise secure the benefits of existing contractual commitments with third parties, including our customers; and (viii) other factors and risks identified in this Form 10-Q, or, as filed in Form 10-KSB for the year ending December 31, 2007 under the caption "Risk Factors." This list provides examples of factors that could affect the results described by forward-looking statements contained in this Form10-Q; however, this list is not exhaustive and many other factors could impact our business and it is impossible to predict with any accuracy which factors could result in negative impacts. Although we believe that the forward-looking statements contained in this Form10-Q are reasonable, we cannot provide you with any guarantee that the anticipated results will not be adverse and that the anticipated results will be achieved. All forward-looking statements in this Form10-Q are expressly qualified in their entirety by the cautionary statements contained in this section and you are cautioned not to place undue reliance on the forward-looking statements contained in this Form10-Q. In addition to the risks listed above, other risks may arise in the future, and we disclaim any obligation to update information contained in any forward-looking statement.

### OVERVIEW

We were incorporated in Delaware in April, 1993, and became a public company in October 1993. We own and sometimes license various N-Viro Processes, patented technologies to treat and recycle wastewater and other bio-organic wastes, utilizing certain alkaline and mineral by-products produced by the cement, lime, electric utilities and other industries. The N-Viro Process is a patented process for the treatment and recycling of bio-organic wastes, utilizing certain alkaline by-products produced by the cement, lime, electric

utilities and other industries. To date, the N-Viro Process has been commercially utilized for the recycling of wastewater sludge from municipal wastewater treatment facilities. N-Viro SoilTM, produced according to the N-Viro Process specifications, is an "exceptional quality" sludge product under the 40 CFR Part 503 Sludge Regulations under the Clean Water Act of 1987 (the "Part 503 Regs").

Our business strategy is to market our N-Viro Technologies which produces an "exceptional quality" sludge product, as defined in the Part 503 Regs, with multiple commercial uses. In this strategy, the primary focus is to identify allies, public and private, who will allow the opportunity for N-Viro build own and operate N-Viro facilities. Currently the company operates two biosolid process facilities located in Toledo Ohio and Daytona Florida. Our goal is to continue to operate these facilities and aggressively market our N-Viro BioDry and N-Viro Fuel technologies. These patented processes are best suited for current and future demands of both waste treatment as well as domestic and international pressures for clean, renewable alternative fuel sources.

RESULTS OF OPERATIONS

Total revenues were $1,157,000 for the quarter ended June 30, 2008 compared to $1,022,000 for the same period of 2007. The net increase in revenue is due primarily to an increase in facility management revenue. Our cost of revenues increased to $1,034,000 in 2008 from $857,000 for the same period in 2007, and the gross profit percentage decreased to 11% from 16% for the quarters ended June 30, 2008 and 2007, respectively. This decrease in gross profit percentage is due primarily to the decrease in the percentage of revenue derived from alkaline admixture and royalty revenue, which generate a higher gross profit margin than other sources of revenue. Operating expenses increased for the comparative period. These changes collectively resulted in a net loss of approximately $447,000 for the quarter ended June 30, 2008 compared to a net loss of $381,000 for the same period in 2007, an increase in the net loss of approximately $66,000.

COMPARISON OF THREE MONTHS ENDED JUNE 30, 2008 WITH THREE MONTHS ENDED JUNE 30, 2007

Our overall revenue increased $135,000, or 13%, to $1,157,000 for the quarter ended June 30, 2008 from $1,022,000 for the quarter ended June 30, 2007. The net increase in revenue was due primarily to the following:

a) Sales of alkaline admixture decreased $118,000 from the same period ended in 2007 - this decrease was primarily the result of the loss of revenue of $63,000 from the City of Raleigh, NC and several smaller customers in the Midwest;

b) Revenue from the service fees for the management of alkaline admixture increased $6,000 from the same period ended in 2007 - this increase was contributed primarily by the Florida operation, which increased $54,000 over the same period in 2007, but was offset by a decrease of $48,000 from Toledo-area customers;

c) Our processing revenue, including facility management revenue, showed a net increase of $247,000 over the same period ended in 2007. Of this gross facility management revenue increase, $129,000 was contributed by the Florida operation and $118,000 from the Toledo facility;

Our gross profit decreased $43,000, or 26%, to $122,000 for the quarter ended June 30, 2008 from $165,000 for the quarter ended June 30, 2007, and the gross profit margin decreased to 11% from 16% for the same periods. The

decrease in gross profit margin is primarily due to the decrease in percentage of overall gross revenue from alkaline admixture and royalties, which operate at a higher profit margin than our other types of revenue. The Toledo operation contributed approximately $134,000 of gross profit on overall revenue of $450,000, which was an increase of approximately $40,000 of gross profit over the same period in 2007. The Florida operation impacted gross profit negatively by approximately $10,000 on overall revenue of $640,000, which was a decrease of approximately $26,000 of gross profit over the same period in 2007. The net increase in gross profit from these two locations were offset by approximately $160,000 by the loss of several customers who primarily contributed royalty and alkaline admixture sales, the largest of these from Raleigh, NC.

Our operating expenses increased $23,000, or 4%, to $553,000 for the quarter ended June 30, 2008 from $530,000 for the quarter ended June 30, 2007. The increase was primarily due to an increase of approximately $44,000 in director-related expenses, $28,000 in employee payroll and related expenses and $11,000 in consulting fees and expenses, partially offset be a decrease of $39,000 in legal and professional fees, $12,000 in amortization of intangible assets and $9,000 in office-related and selling expenses.

As a result of the foregoing factors, we recorded an operating loss of $431,000 for the quarter ended June 30, 2008 compared to an operating loss of $365,000 for the quarter ended June 30, 2007, an increase in the loss of approximately $66,000.

Our net nonoperating income (expense) didn't change from the comparative quarter in 2007.

We recorded a net loss of approximately $447,000 for the quarter ended June 30, 2008 compared to a net loss of $381,000 for the same period ended in 2007, an increase in the loss of approximately $66,000. Total non-cash expenses for depreciation, amortization, stock and stock options charges, reduced by cash out on capitalized assets and debt repayments, resulted in a cash operating loss incurred of approximately $238,000. Similar non-cash expenses, cash out and debt repayments for the same period in 2007 resulted in a cash operating loss incurred of approximately $245,000, a decrease in the cash operating loss incurred of approximately $7,000.

For the quarter ended June 30, 2008 and 2007, we have not fully recognized the tax benefit of the losses incurred in prior periods. Accordingly, our effective tax rate for each period was zero.

COMPARISON OF SIX MONTHS ENDED JUNE 30, 2008 WITH SIX MONTHS ENDED JUNE 30, 2007

Our overall revenue increased $166,000, or 8%, to $2,321,000 for the six months ended June 30, 2008 from $2,154,000 for the six months ended June 30, 2007. The net increase in revenue was due primarily to the following:

a) Sales of alkaline admixture decreased $309,000 from the same period ended in 2007 - this decrease was primarily the result of the loss of revenue of approximately $200,000 from the City of Raleigh, NC and several smaller customers in the Midwest;

b) Revenue from the service fees for the management of alkaline admixture decreased $9,000 from the same period ended in 2007 - this decrease was contributed primarily by Toledo-area customers, which decreased $107,000 over the same period in 2007, but was partially offset by an increase of $98,000 from the Florida operation;

c) Our processing revenue, including facility management revenue, showed a net increase of $484,000 over the same period ended in 2007. Of this gross

facility management revenue increase, $362,000 was contributed by the Florida operation and $122,000 from the Toledo facility;

Our gross profit decreased $58,000, or 14%, to $353,000 for the six months ended June 30, 2008 from $411,000 for the six months ended June 30, 2007, and the gross profit margin decreased to 15% from 19% for the same periods. The decrease in gross profit margin is primarily due to the decrease in percentage of overall gross revenue from royalties and sales of alkaline admixture, which operate at higher profit margins than our other types of revenue. The Toledo operation contributed approximately $260,000 of gross profit on overall revenue of $846,000, which was an increase of approximately $112,000 of gross profit over the same period in 2007. The Florida operation contributed approximately $78,000 of gross profit on overall revenue of $1,264,000, which was an increase of approximately $46,000 of gross profit over the same period in 2007. The net increase of $158,000 in gross profit from these two locations were offset by approximately $216,000 by the loss of several customers who primarily contributed royalty and alkaline admixture sales, the largest of these from Raleigh, NC.

Our operating expenses decreased $61,000, or 6%, to $948,000 for the six months ended June 30, 2008 from $1,009,000 for the six months ended June 30, 2007. The decrease was primarily due to a decrease of approximately $119,000 in legal and professional fees, $24,000 in amortization of intangible assets and $16,000 in office and related expenses, partially offset by an increase of $53,000 in employee payroll and related expenses, $21,000 in director-related expenses, $15,000 in consulting fees and expenses and $9,000 in sales expenses.

As a result of the foregoing factors, we recorded an operating loss of $596,000 for the six months ended June 30, 2008 compared to an operating loss of $599,000 for the six months ended June 30, 2007, a decrease in the loss of approximately $3,000.

Our net nonoperating income increased by $81,000 to net nonoperating income of $55,000 for the six months ended June 30, 2008 from net nonoperating expense of $26,000 for the six months ended June 30, 2007. The increase in nonoperating income was primarily due to a write-off of $84,000 in legal expenses previously charged, offset by an increase of $2,000 in interest expense on higher borrowing on the line of credit for the period compared to 2007.

We recorded a net loss of approximately $540,000 for the six months ended June 30, 2008 compared to a net loss of $624,000 for the same period ended in 2007, a decrease in the loss of approximately $84,000. Total non-cash expenses for depreciation, amortization, stock and stock options charges, reduced by cash out on capitalized assets and debt repayments, resulted in a cash operating loss incurred of approximately $217,000. Similar non-cash expenses, cash out and debt repayments for the same period in 2007 resulted in a cash operating loss incurred of approximately $454,000, a decrease in the cash operating loss incurred of approximately $237,000.

For the six months ended June 30, 2008 and 2007, we have not fully recognized the tax benefit of the losses incurred in prior periods. Accordingly, our effective tax rate for each period was zero.

LIQUIDITY AND CAPITAL RESOURCES

We had a working capital deficit of approximately $1,200,000 at June 30, 2008, compared to a working capital deficit of $1,006,000 at December 31, 2007, resulting in a decrease in working capital of $195,000. Current assets at June 30, 2008 included cash and investments of approximately $219,000 (including restricted cash of approximately $137,000), which is an increase of $21,000 from December 31, 2007. The negative change in working capital from December 31,

2007 was primarily a large increase in trade accounts payable compared to other working capital items, the result of approximately $480,000 of equipment purchased in the second quarter not having secured long-term financing as of the balance sheet date.

Our cash flow provided by operations for the first six months ended June 30, 2008 was approximately $148,000, an increase in the net change of approximately $361,000 from the period ended June 30, 2007. This increase was principally due to the increase of $144,000 in the change in trade accounts receivable, offset by an increase of $367,000 in the change in trade accounts payable, a decrease in the net loss of $84,000 and an increase of $70,000 in the change in stock, warrants and stock options issued for fees and services.

The normal collection period for accounts receivable is approximately 30-60 days for the majority of customers. This is a result of the nature of the processing, alkaline admixture or license contracts, type of customer and the amount of time required to obtain the information to prepare the billing. The normal payment period for accounts payable is approximately 45-75 days for the majority of vendors. This is also a result of the customer contracts and the related cost of goods sold associated with each customer. We have periodically extended payments on certain vendors to assist us in our cash flow needs. Principal vendor types are trucking, fuel, alkaline admixture (materials) and outside professional fees.

Through the second quarter of 2008, we had a line of credit up to $400,000 at the prime rate (5% at June 30, 2008) plus 1.5% and secured by a first lien on all of our assets, with Monroe Bank + Trust, or the Bank. Two certificates of deposit totaling $137,336 from the Bank are held as a condition of maintaining the line of credit. As announced in a Form 8-K filing on November 7, 2007, the line of credit was renewed through October 2008. At June 30, 2008, we had $50,000 of borrowing capacity under the credit facility.

During the second quarter of 2008, out wholly-owned subsidiary, Bio-Mineral Transportation LLC ("BMT"), borrowed a total of $308,900 from a lender to purchase four trailers and a truck that were placed into service during the quarter. A term note was issued at 7.1% interest for five years, monthly payments of $6,125 and secured by the truck and trailers. The total amount owed on all notes by BMT as of June 30, 2008 was approximately $820,000 and all notes are expected to be paid in full on the applicable maturity date, the last of which is May 2013.

During the second quarter of 2008, our wholly-owned subsidiary, Florida N-Viro LP ("Florida"), did not borrow any additional funds. The total amount owed on all notes by Florida as of June 30, 2008 was approximately $52,000 and all notes are expected to be paid in full on the applicable maturity date, the last of which is May 2012.

On December 28, 2006, we purchased the remaining ownership interest in Florida N-Viro for $500,000 and financed $400,000 of it by delivering a note to the seller, VFL Technology Corporation. The note is at 8% interest for 10 years, to be paid in annual installments, including interest, of $59,612, subject to an offset for royalties due us under a patent license agreement from the same party. The amount owed on the note as of June 30, 2008 was approximately $372,000 and the first installment of $27,338 was paid on time in early 2008. The second installment is expected to be paid on time in early 2009, accounting for expected royalty offsets through 2008.

For the remainder of 2008, we expect to continue improvements in operating results by focusing on existing and expected new sources of revenue, especially from our N-Viro Fuel technology, and cash from equity issuances and exercises of outstanding warrants and options. We expect that market developments favoring cleaner burning renewable energy sources and ongoing discussions with companies

in the fuel and wastewater industries could provide enhanced liquidity and have a positive impact on future operations. We continue to pursue opportunities with strategic partners for the development and commercialization of the patented N-Viro Fuel technology. In addition, we are focusing on the development of regional biosolids processing facilities, and are currently in negotiations with potential partners to permit and develop independent, regional facilities.

There can be no assurance these discussions will be successful or result in new revenue sources for the company. Our failure to achieve improvements in operating results, including through these potential sources of revenue, or in our ability to adequately finance or secure additional sources of funds would likely have a material adverse effect on our continuing operations.

## OFF-BALANCE SHEET ARRANGEMENTS

At June 30, 2008, we did not have any material commercial commitments, including guarantees or standby repurchase obligations, or any relationships with unconsolidated entities or financial partnerships, including entities often referred to as structured finance or special purpose entities or variable interest entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

From time to time, during the normal course of business, we may make certain indemnities, commitments and guarantees under which we may be required to make payments in relation to certain transactions. These include: (i) indemnities to vendors and service providers pertaining to claims based on our negligence or willful misconduct and (ii) indemnities involving the accuracy of representations and warranties in certain contracts. Pursuant to Delaware law, we may indemnify certain officers and directors for certain events or occurrences while the officer or director is, or was, serving at our request in such capacity. We also have director and officer insurance coverage that limits our exposure and enables us to recover a portion of any future amounts that we may pay for indemnification purposes. We believe the applicable insurance coverage is generally adequate to cover any estimated potential liability for which we may provide indemnification. The majority of these indemnities, commitments and guarantees do not provide for any limitation of the maximum potential for future payments we could be obligated to make. We have not recorded any liability for these indemnities, commitments and other guarantees in the accompanying Consolidated Balance Sheets.

## CONTRACTUAL OBLIGATIONS

The following table summarizes our contractual cash obligations at June 30, 2008, and the effect these obligations are expected to have on liquidity and cash flow in future periods:

| | | Payments Due By Period | | | |
|---|---|---|---|---|---|
| | Note # | Total | Less than 1 year | 2 - 4 years | 5 - 6 y |
| Purchase obligations | (1) | $ 18,200 | $ 18,200 | $ - | $ |
| Long-term debt obligations and related interest | (2) | 1,640,393 | 423,982 | 847,888 | 18 |

| | | | | | |
|---|---|---|---|---|---|
| Operating leases | (3) | 140,615 | 83,808 | 56,807 | |
| Capital lease obligations | | - | - | - | |
| Line of Credit obligation | | 350,000 | 350,000 | - | |
| Other long-term debt obligations | | - | - | - | |
| Total contractual cash obligations | | $2,149,208 | $ 875,990 | $ 904,695 | $ 18 |