SONEX RESEARCH INC
Form 10QSB
August 19, 2004

UNITED STATES
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, 2004

Commission file number 0-14465

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

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 [x] NO [ ]

There were 26,932,669 shares of the Issuer's $.01 par value Common Stock outstanding at July 31, 2004.

SONEX RESEARCH, INC. FORM 10-QSB

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS (Unaudited)



SONEX RESEARCH, INC.
BALANCE SHEETS
(Unaudited)

| | June 30, | December 31, |
|---|---|---|

| ASSETS | 2004 | 2003 |
|---|---|---|
| Current assets | | |
| Cash and equivalents | $ 10,031 | $ 7,616 |
| Accounts receivable | | 161,045 |
| Prepaid expenses | 21,493 | 12,276 |
| Deferred charges | 54,000 | |
| Deferred financing costs | 32,059 | |
| Loans to officers and employees | 16,000 | 20,000 |
| Total current assets | 133,583 | 200,937 |
| Patents, net of accumulated amortization of $80,002 in 2004 and $77,140 in 2003 | 185,448 | 202,518 |
| Property and equipment, net of accumulated depreciation of $350,254 in 2004 and $465,246 in 2003 | 96,194 | 103,005 |
| Total assets | $ 415,225 | $ 506,460 |
| LIABILITIES AND STOCKHOLDERS' EQUITY/(DEFICIT) | | |
| Current liabilities | | |
| Accounts payable and other accrued liabilities | $ 42,141 | $ 23,904 |
| Short-term lines of credit | 34,910 | 22,473 |
| Deferred revenue - billings in excess of costs and estimated profits on contracts in progress | | 42,834 |
| Current portion of capital lease obligations | 21,136 | 18,413 |
| Notes and interest payable to shareholders | 108,572 | 67,751 |
| Accrued compensation and benefits | 669,386 | 657,494 |
| Total current liabilities | 876,145 | 832,869 |
| Capital lease obligations | 26,601 | 33,698 |
| Deferred compensation | 984,123 | 965,450 |
| Stockholders' equity/(deficit) | | |
| Preferred stock, $.01 par value - 2,000,000 shares issued; 1,540,001 shares outstanding | 15,400 | 15,400 |
| Common stock, $.01 par value, 48,000,000 shares authorized, shares issued and outstanding: 26,932,669 in 2004 and 21,592,669 in 2003 | 269,327 | 215,927 |
| Additional paid-in capital | 22,270,784 | 21,511,436 |
| Accumulated deficit | (24,004,681) | (23,046,389) |
| Notes receivable from officers and employees | (22,474) | (21,931) |
| Total stockholders' equity/(deficit) | (1,471,644) | (1,325,557) |
| Commitments (Note 12) | | |
| Total liabilities and stockholders' equity | $ 415,225 | $ 506,460 |

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

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

| | Three months ended June 30, 2004 | Three months ended June 30, 2003 | Six months ended June 30, 2004 | Six months ended June 30, 2003 |
|---|---|---|---|---|
| Revenue | $ 59,035 | $ 214,573 | $ 193,775 | $ 388,902 |
| Costs and expenses | | | | |
| Cost of revenue | 103,186 | 162,718 | 286,437 | 271,144 |
| Research and development | 9,831 | 44,089 | 23,283 | 119,135 |
| General and administrative | 216,092 | 89,848 | 834,433 | 180,123 |
| Interest expense | 1,653 | 1,202 | 8,503 | 3,921 |
| | 330,762 | 297,857 | 1,152,656 | 574,323 |
| Net loss from operations | (271,727) | (83,284) | (958,881) | (185,421) |
| Interest income | 302 | 363 | 589 | 762 |
| Net loss | (271,425) | (82,921) | (958,292) | (184,659) |
| Accumulated deficit | | | | |
| Beginning of period | (23,733,256) | (22,742,649) | (23,046,389) | (22,640,911) |
| End of period | (24,004,681) | (22,825,570) | (24,004,681) | (22,825,570) |
| Weighted average number of common shares outstanding | 26,635,416 | 21,592,669 | 24,737,339 | 21,592,669 |
| Net loss per share (basic and diluted) | $ (.010) | $ (.004) | $ (.039) | $ (.009) |

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

SONEX RESEARCH, INC.
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, 2002 | | 1,540,001 | $15,400 | 21,212,669 | $212,127 | $21,334,577 |
| March private placement | $.15 | | | 360,000 | 3,600 | 50,400 |
| 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 | | | | | | 90,694 |
| Balance, December 31, 2003 | | 1,540,001 | 15,400 | 21,592,669 | 215,927 | 21,511,436 |
| February per employment agreement | .01 | | | 800,000 | 8,000 | |
| February equity-based compensation per employment agreement | | | | | | 90,000 |
| February for compensation to officers and employee | .10 | | | 250,000 | 2,500 | 22,500 |
| February for consulting services | .10 | | | 1,530,000 | 15,300 | 137,700 |
| March in payment of accrued compensation | .12 | | | 200,000 | 2,000 | 22,000 |
| March in payment of accrued consulting fees | .12 | | | 200,000 | 2,000 | 22,000 |
| March in connection with issuance of note payable | .12 | | | 10,000 | 100 | 1,100 |
| March for legal fees | .12 | | | 1,000,000 | 10,000 | 110,000 |
| March for directors fees | .12 | | | 200,000 | 2,000 | 22,000 |
| April for consulting services | .10 | | | 420,000 | 4,200 | 37,800 |
| April for consulting services | .16 | | | 210,000 | 2,100 | 31,500 |
| April private placement | .25 | | | 520,000 | 5,200 | 124,800 |
| Stock option and warrant compensation | | | | | | 137,948 |
| Balance, June 30, 2004 | | 1,540,001 | $15,400 | 26,932,669 | $269,327 | $22,270,784 |

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

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

| | Six months ended June 30, 2004 | Six months ended June 30, 2003 |
|---|---|---|
| Cash flows from operating activities | | |
| Net loss | $ (958,292) | $ (184,659) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities | | |
| Depreciation | 14,750 | 13,600 |
| Amortization of patents | 18,414 | 11,200 |
| Compensation from grant of stock options & warrants | 137,948 | 51,673 |
| Charges paid in stock | 488,800 | |
| Current liabilities paid in stock | 48,000 | |
| Accrued interest on loans to/notes from employees | (543) | (544) |
| Accrued interest on notes to shareholder | 2,572 | 1,418 |
| (Increase) decrease in accounts receivable | 161,045 | (91,791) |
| (Increase) decrease in prepaid expenses | (9,217) | (4,158) |
| (Increase) decrease in deferred charges | (54,000) | |
| Increase (decrease) in accrued liabilities | 30,129 | 17,197 |
| Increase (decrease) in billings in excess of costs | (42,834) | 45,088 |
| Increase (decrease) in deferred compensation | 18,673 | 33,750 |
| Net cash provided by (used in) operating activities | (144,555) | (107,226) |
| Cash flows from investing activities | | |
| Decrease in loans to/notes from employees | 4,000 | |
| Acquisition of property and equipment | (3,383) | (13,815) |
| Additions to patents | (1,344) | (3,977) |
| Net cash provided by (used in) investing activities | (727) | (17,792) |
| Cash flows from financing activities | | |
| Issuance of stock private placement | 130,000 | |
| Issuance of stock to officer | 8,000 | |
| (Increase) decrease in deferred financing costs | (32,059) | |
| Increase (decrease) in short-term lines of credit | 12,437 | 18,357 |
| Issuance of notes payable to shareholders | 50,000 | 50,000 |
| Payment of principal on notes to shareholders | (10,000) | |
| Payment of accrued interest on notes to shareholders | (1,751) | (1,327) |
| Reduction of capital lease obligations | (8,930) | (7,989) |
| Net cash provided by (used in) financing activities | 147,697 | 59,041 |
| Increase (decrease) in cash | 2,415 | (65,977) |
| Cash | | |
| Beginning of period | 7,616 | 105,998 |

| | | |
|---|---|---|
| End of period | $ 10,031 | $ 40,021 |
| Non-cash transactions: | | |
| Equipment acquired through capital lease obligations | $ 4,556 | $ 43,002 |

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

SONEX RESEARCH, INC
NOTES TO 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. In 2004 the Company is developing and implementing an updated business plan, the primary goal of which is to transition from a research and development company into a technology and manufacturing enterprise. A key goal of the updated business plan is to expand the Company's environmentally friendly technology base into related fields such as noise and vibration control.

NOTE 2 - PRESENTATION OF FINANCIAL STATEMENTS

The accompanying unaudited 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, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004. 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, 2003.

NOTE 3 - REVENUE RECOGNITION AND MAJOR CUSTOMERS

All of the Company's revenue is derived from development and demonstration contracts issued by a United States Government or Department of Defense (the "Government") agency or prime contractor. During the second quarter of 2004, the Company had an active contract with only one such customer.

Revenue is recognized upon the Company's completion of the milestones 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.

NOTE 4 - 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.

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 until approximately September 30, 2004. The Company's prospects beyond that time 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 5 - RESTRUCTURING COSTS

During the first quarter of 2004, the Company experienced a number of significant changes. In February 2004 the Board of Directors was reconstituted and a new president was hired to fill the position that had been vacant. The Company's new president is developing and implementing an updated business plan, the primary goal of which is to transition Sonex from a research and development company into a technology and manufacturing enterprise. In connection with this change in business strategy, in February and March 2004 the Company entered into an employment agreement with its new president and executed other agreements for consulting services and legal representation, obtained a short-term loan from a shareholder, authorized additional compensation to its officers and directors, and satisfied liabilities for accrued compensation, through the issuance of a substantial number of shares of common stock. Details of these transactions are presented in Note 11.

NOTE 6 - DEFERRED CHARGES

Deferred charges of $54,000 at June 30, 2004 represent compensation recorded in connection with the issuance of common stock under the terms of the employment agreement executed with the Company's new president in February 2004 as described in detail in Note 11. The amount recorded as a current asset as of June 30, 2004 is for compensation related to shares issued or to be issued but not vested as of that date. This amount will be amortized to expense on the vesting dates of the remaining shares through February 2005.

NOTE 7 - DEBT

Short-term lines of credit

The Company has obtained business credit cards from Capital One Bank with a credit limit of $22,500 and Fleet National Bank with a credit limit of $19,000. Repayment of amounts due has been personally guaranteed by the Company's Chairman. Balances in the Capital One account accrue interest at a fixed rate of 8.9% per annum, while the Fleet account has a promotional interest rate of 1.9% through September 2004, adjusting to prime rate + 6% thereafter. As of June 30, 2004, the outstanding balance on the account with Fleet was $18,051, while the balance on the account with Capital One Bank was $16,859.

Capital Lease Obligations

During 2003 the Company incurred new capital lease obligations in the principal amount of $50,753 in connection with the acquisition of equipment. The repayment of two, four-year equipment lease obligations in the principal amount of $46,598 included in this total has been personally guaranteed by the Company's Chairman. As of June 30, 2004, the aggregate outstanding principal balance on these two lease obligations was $32,718.

Notes Payable to Shareholder

In June 2003 the Company issued a $50,000, 6% note to one of its shareholders payable initially on December 31, 2003. The due date of this note has been extended to September 30, 2004. In March 2004 the Company issued a $50,000, 6% note to this same shareholder, initially payable on June 30, 2004. The due date of this note also has been extended to September 30, 2004. Payment of both notes is secured by Company revenues.

In connection with a private financing in March 2002, the Company issued a $6,000, 6% note to this shareholder, 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, 2004.

Accrued interest on these notes of $2,572 is included in the June 30, 2004 balance shown in the accompanying balance sheet.

NOTE 8 - ACCRUED COMPENSATION AND BENEFITS

Accrued compensation consists of the following amounts:

| | June 30, 2004 | December 31, 2003 |
|---|---|---|
| Accrued wages and payroll taxes | $ 305,490 | $ 299,635 |
| Accrued consulting fees | 154,216 | 150,181 |
| Accrued bonuses | 151,076 | 154,068 |
| Accrued vacation pay | 58,604 | 53,610 |

| | | |
|---|---|---|
| | $ 669,386 | $ 657,494 |
| | =========== | =========== |

The Company has operated under severe cash flow difficulties for extended periods since 2001, prompting its 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. The total of accrued wages and payroll taxes shown above consists entirely of amounts payable to the Company's officers. The deferral of payment of such wages owed to 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 significant unpaid consulting fees, the majority of which amounts as of June 30, 2004 (a total of $148,505) are payable to three individuals, including the Company's Chairman who, as of January 2004, is being compensated as a consultant rather than as an employee. In March 2004 the Company paid $24,000 of such previously accrued consulting fees through the issuance of common stock.

The amount and timing of payments for unpaid compensation owing to the Company's officers and its consultants 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 personnel to defer payment of portions of their compensation as described in Note 9.

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 March 2004 the Company paid $24,000 of such previously accrued bonuses through the issuance of common stock. The amount of accrued bonuses included in the table above that was payable to two of the Company's officers at June 30, 2004 is $98,500. Payment of such accrued bonuses is 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 9.

In February 2004 in connection with the execution of an employment agreement, the Company awarded a bonus of $33,000 to its new president, with payment of $25,000 of this amount being deferred until February 2006 under the terms of the employment agreement. The deferred portion is included with accrued bonuses in the table above.

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, 2004 was $52,017. 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 9.

NOTE 9 - 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 for several years voluntarily deferred receipt of payment of significant portions of their authorized annual salaries 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 11. The individuals who are parties to this agreement have consented to 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.

Under the terms of an employment agreement executed in February 2004, the Company's new president is deferring annually $68,000 of his $140,000 salary until March 2006 or until such earlier date as the Board of Directors determines that the Company's cash flow is sufficient to allow payment.

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

| | June 30, 2004 | December 31, 2003 |
|---|---|---|
| Current officers | $ 662,672 | $ 641,749 |
| Current employees | 12,504 | 12,504 |
| Former officers, employees and consultants | 308,947 | 311,197 |
| | $ 984,123 | $ 965,450 |

The conditions that would require repayment of such deferred amounts have yet to occur, and it is unlikely that such conditions will occur prior to June 30, 2005. 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.

The amount reported for current officers as of June 30, 2004 also includes $20,923 owed to the Company's new president in accordance with the terms of his employment agreement executed in February 2004. The agreement requires the new president to defer annually $68,000 of his $140,000 salary until the expiration of the agreement in March 2006 or at such earlier date as the Board of Directors determines that the Company's cash flow is sufficient to allow payment.

NOTE 10 - INCOME TAXES

The Company has not incurred any federal or state income taxes since its inception due to operating losses. At December 31, 2003, the Company had net operating loss carryforwards of approximately $11.2 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 $7.9 million have expired unused. Net operating loss carryforwards of approximately $1.2 million are scheduled to expire at the end of 2004.

NOTE 11 - 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 were issued for $2 million in February 1992 (the "Preferred Stock Investment") to 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, 2004 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 transaction in late April 2004, the Company raised $130,000 through the issuance of 520,000 shares of the Company's common stock and warrants to purchase an additional 520,000 shares of common stock exercisable at $.25 per share through May 31, 2006. 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 and other equity-based compensation

The Company maintains a non-qualified stock option plan created in 1987 (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 April 2014.

From January 1, 2004 through June 30, 2004, 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, 2004 | 4,683,907 | $.41 | 4,360,407 | $.42 |
| Granted | 150,000 | .25 | 125,000 | .25 |
| Becoming exercisable | | | 30,000 | .25 |
| Exercised | | | | |
| Lapsed | (100,000) | .25 | (25,000) | .25 |

| | | | | |
|---|---|---|---|---|
| Unexercised at June 30, 2004 | 4,738,907 | $.41 | 4,490,407 | $.41 |

The Company accounts for stock options and other stock-based compensation under the fair value based method in accordance with Statement of Financial Accounting Standards (SFAS) No. 123 - "Accounting for Stock-based Compensation". 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 which takes into account weighted average assumptions for stock price volatility, average risk-free interest rate of return, expected dividend yield, and average expected term. For the six months ended June 30, 2004 and 2003, in connection with options granted under the Plan, the Company recorded stock option compensation under SFAS No. 123 totaling $25,948 and $30,965, respectively. The amount of compensation expense is also credited to additional paid-in capital.

Under the terms of an employment agreement executed in February 2004, the Company's new president was granted a ten-year option, not under the Plan, to purchase 500,000 shares of common stock, which will vest and be exercisable in accordance with the schedule presented below. For the six months ended June 30, 2004, the Company recorded compensation under SFAS No. 123 totaling $44,500 in connection with this option grant.

| Date becoming exercisable | Number of shares | Exercise price per share |
|---|---|---|
| February 23, 2004 | 100,000 | $0.25 |
| August 23, 2004 | 100,000 | $0.50 |
| February 23, 2005 | 100,000 | $1.00 |
| August 23, 2005 | 100,000 | $1.50 |
| February 23, 2006 | 100,000 | $2.00 |

Under the terms of a consulting agreement effective in February 2004, the Company issued ten-year, immediately exercisable warrants to purchase 750,000 shares of common stock at the following prices: 250,000 shares at $.35, 250,000 shares at $.55, and 250,000 shares at $.75. During the first quarter of 2004, the Company recorded compensation under SFAS No. 123 totaling $67,500 in connection with this issuance of warrants.

Compensation expense associated with the grant of options and warrants is summarized as follows:

| | Six months ended June 30, 2004 | Six months ended June 30, 2003 |
|---|---|---|
| Option grants under Plan | $ 25,948 | $ 30,965 |
| Other option grants | 44,500 | |
| Issuance of warrants | 67,500 | |
| | $ 137,948 | $ 30,965 |

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.

Also under the terms of the February 2004 employment agreement mentioned above, the Company will issue to its new president a total of 1,000,000 shares of common stock for cash of $.01 per share. Of this total, the new president currently purchased 800,000 shares, with 200,000 of these shares having been transferred to the new president upon execution of agreement, and the remaining shares being held in escrow pending vesting of 200,000 shares at a time in three, six and nine months. The Company is obligated to issue to its new president an additional 200,000 shares of common stock for cash of $.01 per in February 2005. With respect to this total of 1 million shares, the $.09 per share discount between the purchase price and the market price of the stock of $.10 per share on the effective date of the employment agreement is accounted for as compensation for a total amount of $90,000. As of June 30, 2004, the Company has charged to expense compensation of $36,000 for the shares which vested immediately, and has recorded $54,000 in deferred charges as a current asset and will amortize such charges to expense on the vesting dates of the remaining shares.

Also in connection with the consulting agreement mentioned above, in February 2004 the Company issued 1,530,000 shares and in April 2004 issued 420,000 shares of common stock. With respect to this total of 1,950,000 shares, during the first quarter of 2004 the Company charged to expense compensation of $195,000 based on the market price of the stock of $.10 per share on the effective date of the consulting agreement.

Also during the six months ended June 30, 2004, the Company recorded additional compensation through the issuance of shares of common stock as set forth below.

| Description | Price/ share | # of shares | Expense | |
|---|---|---|---|---|
| Compensation to officers and employees | $.10 | 250,000 | $ 25,000 | |
| Consulting fees | | .16 | 210,000 | 33,600 |
| Upon execution of agreement with new legal counsel | .12 | 1,000,000 | 120,000 | |
| Compensation to independent director | .12 | 200,000 | 24,000 | |
| Total | | 1,660,000 | $ 182,600 | |

In March 2004 the Company satisfied liabilities for accrued compensation and consulting fees through the issuance of shares of common stock as set forth below.

| Description | Price/ share | # of shares | Amount |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Accrued bonus compensation payable to officer | $.12 | 200,000 | $ 24,000 |
| Accrued consulting fees | .12 | 200,000 | 24,000 |
| Total | | 400,000 | $ 48,000 |

The issuance of the shares of common stock and warrants to purchase shares of common stock described above 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. Certain of the shareholders have been granted registration rights with respect to their shares.

Common stock reserved for future issuance

At June 30, 2004, a total of 13,486,832 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 |
| May 2006, exercisable at $.25 per share | 520,000 |
| March 2007, exercisable at $.25 per share | 180,000 |
| February 2014, exercisable at $.35 per share | 250,000 |
| February 2014, exercisable at $.55 per share | 250,000 |
| February 2014, exercisable at $.75 per share | 250,000 |
| | 2,262,500 |
| Currently exercisable options under Plan | 4,490,407 |
| Granted options becoming exercisable in the future under Plan | 243,500 |
| Options available for future grants under Plan | 1,330,425 |
| Currently exercisable options outside of Plan | 100,000 |
| Granted options becoming exercisable in the future outside of Plan | 400,000 |
| Reserved for issuance to president in February 2005 | 200,000 |
| Conversion of note payable | 60,000 |
| Conversion of preferred stock | 4,400,000 |
| Total shares reserved | 13,486,832 |

NOTE 12 - COMMITMENTS

Employment agreement

In February 2004 the Company entered into an employment agreement with its new president which expires in March 2006. The agreement provides for an annual salary of $140,000, of which $68,000 must be deferred annually until the expiration of the agreement or at such earlier date as the Board of Directors determines that the Company's cash flow is sufficient to allow payment.

Facility lease

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.

Legal fee dispute

On March 25, 2004, the Company executed an engagement letter with a law firm in Orlando, Florida (referred to as the "Florida firm"), for services related to securities and corporate matters, including acquisitions, mergers and financings. The engagement letter required the Company to issue to the Florida firm one million shares of common stock, which shares were deemed earned immediately upon execution of the engagement letter to insure the immediate availability of the Florida firm to perform legal services. In addition, the engagement letter required the Company by June 30, 2004 to pay to the Florida firm all fees, costs and expenses incurred through that date, and to remit to the Florida firm a cash retainer of $50,000 to insure the future availability of the Florida firm to perform legal services and the payment of fees, costs and expenses.

In May 2004 the Florida firm invoiced the Company $50,000 for fees, costs and expenses incurred through April 30, 2004. The Company did not remit the $50,000 cash retainer required by the engagement letter. In July 2004 the Florida firm invoiced the Company an additional $52,000 for the period May 1, 2004 through June 30, 2004, notified the Company that it was in default of the provisions of the engagement letter, and reserved the right to take all lawful actions to preserve, protect, defend, and prosecute its rights and remedies against the Company.

The Company disputed the Florida firm's entitlement to the fees claimed and is presently represented by another attorney on a pro bono basis in connection with this matter. The Company requested an explanation of, and the billing support for, the amounts invoiced by the Florida firm in order to evaluate the charges by services requested and performed. The Florida firm then informed the Company by letter dated August 9, 2004, that it will not provide further legal services.

The Company believes that the amounts invoiced by the Florida firm are far in excess of what is reasonable based on the limited services requested by the Company and the limited work product provided by the Florida firm. The Company has demanded the immediate return of the one million shares of common stock issued to the Florida firm in connection with the engagement letter, and has reserved its rights, including the right to pursue affirmative claims for the damage the Florida firm has caused and continues to cause.

As of the filing of this Form 10-QSB, the Company has received no further communication from the Florida firm. While the outcome of this dispute is uncertain and may have an adverse effect on the Company's financial condition, management believes that the Company has a defensible position. Accordingly, no liability for any amounts related to this dispute has been recorded in the accompanying financial statements as of June 30, 2004.

NOTE 13 - SUBSEQUENT EVENTS

In July 2004 the Company received a $192,932 follow-on task from the Defense Advanced Research Projects Agency (DARPA) to continue development of a multi-cylinder heavy fuel engine combustion process for potential Department of Defense applications such as unmanned aerial vehicles (UAVs). The first payment under this task of $56,132 was received in August 2004.

In connection with a private financing initiated in April 2004, the Company raised $45,000 in August 2004 through the issuance of 180,000 shares of the Company's common stock and warrants to purchase an additional 180,000 shares of common stock exercisable at $.25 per share through May 31, 2006. 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.

## 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.

### Company Overview

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

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

The SCS improves the combustion of fuels in engines through design modification 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 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 by using direct injection and patented Sonex designs. 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 HFEs to military and commercial markets.

As of June 30, 2004, the Company has five full-time employees and two part-time employees, and engages the part-time services of several 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

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 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 2003 the Company began taking steps to focus on business re-positioning, strengthening its internal capabilities, and planning for growth. The Company engaged consultants to assess the SCS technologies and business model, suggest approaches for strategic alliances, and provide federal marketing, government procurement assistance, and commercialization services. Management identified a need to secure strong strategic alliances for the marketing and commercialization of the SCS engine applications by leveraging technology development currently supported by U.S. Government funding as well as seeking relationships with companies which have technologies complementary to the SCS. One of the first objectives on this path was to strengthen the Company's management team.

During the first quarter of 2004, the Company experienced a number of significant changes. In February 2004 the Board of Directors was reconstituted and a new president was hired to fill the position that had been vacant. The Company's new president is developing and implementing an updated business plan, the primary goal of which is to transition Sonex from a research and development company into a technology and manufacturing enterprise. A key goal of the updated business plan is to expand the Company's environmentally friendly technology base into related fields such as noise and vibration control. There is no assurance, however, that the Company will be able to raise sufficient capital to complete and implement this updated business plan.

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 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.

- ability to generate cash flow from revenue or to secure financing necessary to fund future operations
- ability to complete technology development and demonstration programs, demonstrate commercial viability of SCS technology and execute licensing

agreements that produce significant revenue
- ability to maintain and protect the Company's patents and proprietary information
- ability to attract and retain skilled personnel
- ability to secure a long-term lease for the Company's existing facility or to secure an alternative location
- changes in general economic conditions
- 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 approximately $24 million, and anticipates incurring 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 have provided most of the necessary operating cash for the last two years.

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 with the exception of the new president hired in February 2004.

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, 2004, there were 26,932,669 shares of Common Stock issued and outstanding, with an additional 13,486,832 shares reserved for future issuance, primarily upon the conversion of preferred stock and the exercise of options and warrants.

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.

The same is true with respect to the Company's relationships with the U.S. Department of Defense (DoD) and its prime contractors. In many instances the Company is contractually prohibited from disclosing the name of the military customer and/or specific details about the work being performed unless permission has been obtained from the customer in advance.

Financial position and liquidity

The Company has operated under severe cash flow difficulties for extended periods since 2001, prompting its 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. Similarly, the Company has accumulated significant unpaid bonus and vacation compensation, as well as consulting fees. As of June 30, 2004, total such unpaid amounts, as detailed in Note 8 to the accompanying financial statements, aggregated $669,386.

The deferral of payment of current compensation owed to the Company's officers and consultants cannot be expected to continue indefinitely, and the Company will be required to pay amounts outstanding as soon as cash flow permits. The amount and timing of payments for unpaid compensation owing to the Company's officers and its consultants 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 personnel to defer payment of portions of their compensation as described in Note 9 to the accompanying financial statements.

As of June 30, 2004, the Company had available cash and equivalents of $10,031. In July 2004 the Company received a $192,932 follow-on task from the Defense Advanced Research Projects Agency (DARPA) to continue development of a multi-cylinder heavy fuel engine combustion process for potential Department of Defense applications such as unmanned aerial vehicles (UAVs). The first payment under this task of $56,132 was received in August 2004. In connection with a private financing initiated in April 2004, the Company raised $45,000 in August 2004 through the issuance of 180,000 shares of the Company's common stock and warrants to purchase an additional 180,000 shares of common stock at $.25 per share.

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. 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 until approximately September 30, 2004. The Company's prospects beyond that time 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.

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 a material 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 $958,292 was recorded for the first six months of 2004, as compared to $184,659 for the corresponding period in 2003, an increase of $771,708. Lower revenue and substantially higher total expenses, a significant portion of which expenses relate to the restructuring undertaken by the Company, accounted for the much larger net loss in the current period.

Revenue and cost of revenue:

| | Six months ended June 30, | |
|---|---|---|
| | 2004 | 2003 |
| Revenue | $ 193,775 | $ 388,902 |
| Cost of revenue | $ 286,437 | $ 271,144 |

Revenue decreased by $195,127, or 50%, from the first six months of 2003 to the first six months of 2004, as work wound down in 2004 on two major projects from branches of the U.S. government and DoD and/or their prime contractors which were awarded to the Company during the second half of 2002. Combined revenue from these two projects decreased from $333,202 in the first half of 2003 to $122,849 in the current period. In July 2004 the Company received a $192,932 follow-on task from the Defense Advanced Research Projects Agency (DARPA) to continue development of a multi-cylinder heavy fuel engine combustion process for potential Department of Defense applications such as unmanned aerial vehicles (UAVs). With respect to the second project, a subcontract for the Company's diesel emission reduction technology from Compact Membrane Systems, Inc. (CMS) under its prime contract from the U.S. Department of Energy (DOE), the Company has received an indication from the DOE that funding to Sonex for this project will not be continued.

Cost of revenue primarily consists of direct labor charges and other direct expenditures, including those for technical consulting services, attributable to funded programs, as well as allocated fringe benefits, payroll taxes, and labor overhead charges. While cost of revenue during the first half of 2003 was 70% of revenue, in the first six months of 2004 cost of revenue substantially exceeded revenue, primarily due to significant, unanticipated project cost overruns.

Research and development (R&D) expenses:

| | Six months ended June 30, 2004 | Six months ended June 30, 2003 |
|---|---|---|
| Employee compensation, taxes & benefits | $ 139,423 | $ 231,310 |
| Consulting fees | 60,437 | 60,415 |
| Other expenses | 109,860 | 98,554 |
| Total expenses | 309,720 | 390,279 |
| Less amounts classified as cost of revenue | (286,437) | (271,144) |
| Net R&D expenses | $ 23,283 | $ 119,135 |

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 expenses for the first six months of the year decreased by $80,559, or 21%, from 2003 to 2004, as a reduction in overall employee compensation was only partially offset by an increase in other expenses. Employee compensation decreased by $91,887, or 40%, as slight increases resulting from higher salary rates in 2004 were more than offset by significant decreases relating to the termination in the second half of 2003 of the employment of one engineer and the change in status as of January 2004 of the Company's chief scientist and CEO from salaried employee to consultant. Without this change in status, consulting fees would have decreased from 2003 to 2004 with the reduced level of funded work.

The increase in other expenses of $11,306, or 11%, from 2003 to 2004 reflects charges incurred in the first quarter of 2004 for outside machining and fabrication services for components for ongoing funded projects and the write-off of unamortized patent costs on certain older foreign patents abandoned by the Company.

General and administrative (G&A) expenses:

| | Six months ended June 30, 2004 | Six months ended June 30, 2003 |
|---|---|---|

| | | |
|---|---|---|
| Employee compensation, taxes & benefits | $ 252,394 | $ 83,393 |
| Consulting fees | 366,537 | 60,098 |
| Professional fees | 151,325 | 13,463 |
| Other expenses | 64,177 | 23,169 |
| Total G&A expenses | $ 834,433 | $ 180,123 |

Total G&A expenses for the first six months of the year more than quadrupled from the comparable period in the prior year, largely due to substantial charges incurred with the hiring of a new president in February 2004 who is developing and implementing an updated business plan, the primary goal of which is to transition Sonex from a research and development company into a technology and manufacturing enterprise.

Employee compensation increased by $169,001 from 2003 to 2004, as charges for the compensation of the new president totaled $156,577. This figure includes amounts related to stock and stock option compensation, the award of a cash bonus for which payment is being deferred until 2006, and salary. The Company's new president is deferring payment of nearly 50% of his annual salary. Charges in 2004 also include bonus compensation valued at $10,000 paid in stock to the Company's chief financial officer.

Consulting fees increased by $306,439 from 2003 to 2004. Charges for 2004 include $262,500 associated with a consulting agreement effective in February 2004 for services to assist in the transition of the Company into a technology and manufacturing enterprise under the updated business plan being developed. Such charges consist of $195,000 for the value of common stock issuable and $67,500 for the estimated fair value of warrants to purchase common stock.

The increase in professional fees of $137,862 from 2003 to 2004 is almost entirely due to a charge in the first quarter of 2004 for a non-refundable retainer to the Company's new securities legal counsel payable in stock valued at $120,000.

The increase in other expenses of $41,008 from 2003 to 2004 is related primarily to charges for stock-based compensation in the first quarter of 2004 for outside directors, as well as higher travel expenditures.

## ITEM 3. CONTROLS AND PROCEDURES

### Disclosure 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 the end of the period covered by this report. 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.

### Internal Control over Financial Reporting

It is the responsibility of the Company's management to establish and maintain adequate internal control over financial reporting. Due to its small size and limited financial resources, however, the Company's chief financial officer, a member of management, has been the only employee involved in accounting and financial reporting. The Board of Directors has recognized that as a result, there is no segregation of duties within the accounting function, leaving all aspects of financial reporting and physical control of cash and equivalents in the hands of the same employee. Usually, this lack of segregation of duties represents a material weakness in a company's internal control over financial reporting; however, based on the demonstrated integrity and trustworthiness of the Company's chief financial officer, the Board of Directors has had confidence that there have been no irregularities in the Company's financial reporting or in the protection of its assets as a result of this potentially material weakness in the Company's internal control over financial reporting, and that, under the circumstances, internal control over financial reporting has been as effective as is possible.

As of April 2004, the Board of Directors has implemented additional internal controls by assigning certain responsibilities for the handling of incoming receipts to the new president of the Company. There have been no other changes in the Company's internal control over financial reporting since June 30, 2004 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. As soon as is practical, the Board of Directors will consider the assignment of specific duties for various other aspects of internal control over financial reporting to its chief executive officer and its president. Once sufficient capital is secured, it is the Company's intention to increase staffing to mitigate the current lack of segregation of duties within the accounting function and to improve internal controls.

## PART II - OTHER INFORMATION

### ITEM 2. CHANGES IN SECURITIES

In the second quarter of 2004, the Company issued an aggregate of 1,150,000 shares of common stock and warrants to purchase an aggregate of 520,000 shares of common stock, without registration under the Securities Act of 1933 (the "Securities Act"), as follows:

> In April 2004 under the terms of a consulting agreement effective in February 2004, the Company issued 420,000 shares of common stock for services valued at $.10 per share.
>
> In April 2004 the Company issued an aggregate of 210,000 shares of common stock for services rendered by five consultants valued at $.16 per share.
>
> In April 2004, the Company raised $130,000 through the issuance of 520,000 shares of common stock and warrants to purchase an additional 520,000 shares of common stock exercisable at $.25 per share through May 31, 2006.

The Company views these issuances as transactions by an issuer not involving any public offering and therefore as exempt from registration under Sections 4(2) and/or 4(6) of the Securities Act. The certificates representing such shares are endorsed with a standard restrictive legend stating that the shares have not been registered under the Securities Act or in any state or other jurisdiction, and that no disposition of the shares may be made unless pursuant to an effective registration statement or upon the issuance of an opinion of the Company's legal counsel that the disposition may be made pursuant to a valid exemption from any registration requirements.

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. |
| 10.2 | Employment Agreement dated February 23, 2004 with Roger D. Posey, president - Incorporated by reference to the Company's Annual Report on Form 10-KSB for the year ended December 31, 2003. |
| 10.3 | Stock Option Agreement dated February 23, 2004 with Roger D. Posey, president - Incorporated by reference to the Company's Annual Report on Form 10-KSB for the year ended December 31, 2003. |
| 21 | Subsidiaries of the Registrant: Sonex International, B.V. - The Netherlands; Sonex Engines, Inc. - Delaware (both are inactive subsidiaries). |
| 24 | Power of Attorney - Incorporated by reference to the Company's Annual Report on Form 10-KSB for the year ended December 31, 2003. |
| 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 quarter ended June 30, 2004 pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

(b) Reports on Form 8-K.

During the second quarter of 2004, the Company filed the following Current Reports on Form 8-K:

On April 16, 2004, 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, 2003.

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)

August 19, 2004 By: /s/ Andrew A. Pouring
---------------------------------------------
Andrew A. Pouring
Principal Executive Officer

August 19, 2004 By: /s/ George E. Ponticas
---------------------------------------------
George E. Ponticas
Principal Financial and Accounting Officer

Exhibit 31.1

Certification of Chief Executive Officer Pursuant to
Securities Exchange Act Rules 13a-14(a) or 15d-14(a) as Adopted
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"), a small business issuer, for the three months ending June 30, 2004.
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-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Company and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted financial principles;
   c) Evaluated the effectiveness of the Company 's disclosure controls and procedures and presented in this report our conclusions about

the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting;

5. The Company's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, 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 control over financial reporting which are reasonably likely to adversely affect the Company 's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal control over financial reporting.

Dated: August 19, 2004

/s/ Andrew A. Pouring

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Andrew A. Pouring
Chief Executive Officer

Exhibit 31.2

Certification of Chief Financial Officer Pursuant to
Securities Exchange Act Rules 13a-14(a) or 15d-14(a) as Adopted
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"), a small business issuer, for the three months ending June 30, 2004.

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 annual 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-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Company and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted financial principles;

c) Evaluated the effectiveness of the Company 's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting;

5. The Company's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, 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 control over financial reporting which are reasonably likely to adversely affect the Company 's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal control over financial reporting.

Dated: August 19, 2004

/s/ George E. Ponticas

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George E. Ponticas<br>
Chief Financial Officer

Exhibit 32

CERTIFICATION PURSUANT TO<br>
18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO<br>
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, 2004, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), 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 | /s/ George E. Ponticas |
| Andrew A. Pouring | George E. Ponticas |
| Chief Executive Officer | Chief Financial Officer |

August 19, 2004