RiceBran Technologies
Form 10-K
April 01, 2013

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

FORM 10-K

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

For the year ended December 31, 2012

o 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 0-32565

RiceBran Technologies
(Exact name of registrant as specified in its Charter)

| | |
|---|---|
| California<br>(State of Incorporation) | 87-0673375<br>(I.R.S. Employer Identification No.) |
| 6720 N. Scottsdale Road, Suite # 390<br>Scottsdale, AZ<br>(Address of Principal Executive Offices) | 85253<br>(Zip Code) |

Registrant's Telephone Number, Including Area Code: (602) 522-3000

Securities registered under Section 12(b) of the Exchange Act:
NONE

Securities registered under Section 12(g) of the Exchange Act:
Common Stock, no par value
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of

the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark if disclosure of delinquent filers in response to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

| Large accelerated filer | | | Smaller reporting |
|---|---|---|---|
| o | Accelerated filer o | Non-accelerated filer o | company x |

Indicate by check mark if the registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934, as amended). YES o NO x

As of June 30, 2012, the aggregate market value of our common stock held by non-affiliates was $12,882,263.

As of March 15, 2013, there were 209,378,597 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the registrant's Definitive Proxy Statement for its annual meeting of shareholders, which Definitive Proxy Statement will be filed with the Commission not later than 120 days after the registrant's fiscal year ended December 31, 2012, are incorporated by reference into Part III of this Annual Report on Form 10-K.

FORM 10-K

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## FORWARD-LOOKING STATEMENTS

This Annual Report includes forward-looking statements that involve substantial risks and uncertainties. These forward-looking statements are not historical facts, but are based on current expectations, estimates and projections about our industry, our beliefs and our assumptions. Words such as “believes,” “anticipates,” “expects,” “intends” and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements. These forward-looking statements are not guarantees of future performance and concern matters that could subsequently differ materially from those described in the forward-looking statements. Actual events or results may also differ materially from those discussed in this Annual Report. These risks and uncertainties include those described in “Risk Factors” and elsewhere in this Annual Report. Except as required by law, we undertake no obligation to revise any forward-looking statements in order to reflect events or circumstances that may arise after the date of this Annual Report.

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PART I

ITEM 1. BUSINESS

General

RiceBran Technologies ("we," "us," "our," or the "Company"), a California corporation, is a human food ingredient and animal nutrition company focused on the procurement, bio-refining and marketing of numerous products derived from rice bran. We have proprietary and patented intellectual property that allows us to convert rice bran, one of the world's most underutilized food sources, into a number of highly nutritious human food and animal nutrition products. Our target markets are human food and animal nutrition manufacturers and retailers, as well as natural food, functional food and nutraceutical supplement manufacturers and retailers, both domestically and internationally. We have developed a bio-refining approach to processing raw rice bran into various value added constituents such as stabilized rice bran (SRB), rice bran oil (RBO), defatted rice bran (DRB) and a variety of other valuable derivative products from each of these core products.

The report of our independent registered public accounting firm that accompanies the audited consolidated financial statements for the years ended December 31, 2012 and 2011, contains a going concern explanatory paragraph in which our independent registered public accounting firm expressed substantial doubt about our ability to continue as a going concern. We have experienced significant losses and negative cash flows and have an accumulated deficit of $204.4 million as of December 31, 2012. Further, although we are focusing on raising additional funds to operate our business, there can be no assurances that these efforts will prove successful (see Note 1 to the consolidated financial statements included herein).

We have three reportable business segments: (1) Corporate; (2) USA, which manufactures and distributes SRB in various granulations along with other products derived from rice bran via proprietary and patented enzyme treatment processes; and (3) Brazil, which extracts crude RBO and DRB from rice bran, which are then further processed into a number of valuable human food and animal nutrition products. The Corporate segment includes selling, general and administrative expenses including public company expenses, litigation, and other expenses not directly attributable to other segments. No Corporate allocations are made to the other segments. General corporate interest is not allocated. For further information on segment results see Note 18 to the consolidated financial statements included herein.

The USA segment consists of two locations in California and two locations in Louisiana all of which can produce SRB. One of the two Louisiana SRB facilities, located in Lake Charles, has been idle since May 2009 (see Note 8 to the consolidated financial statements included herein). The USA segment also includes our Dillon, Montana Stage II facility which produces RiSolubles (a highly nutritious, carbohydrate and lipid rich fraction of SRB), RiFiber (a fiber rich derivative of SRB) and RiBalance (a complete rice bran nutritional package derived from further processing SRB). The manufacturing facilities included in our USA segment have proprietary and patented processing equipment and technology for the stabilization and further processing of rice bran into finished products. In 2012, approximately 50% of USA segment revenue was from sales of human food products and approximately 50% was from sales of animal nutrition products.

The Brazil segment consists of our Irgovel operations located in Pelotas, Brazil. Irgovel manufactures RBO and DRB products for both the human and animal food markets in Brazil and internationally. In refining RBO to an edible grade, several co-products are obtained. One such product is distilled fatty acids, a valuable raw material for the detergent industry. DRB is sold in bulk as animal feed and compounded with a number of other ingredients to produce complex animal nutrition products which are packaged and sold under Irgovel brands in the Brazilian market. In 2012, approximately 46% of Brazil segment product revenue was from sales of RBO products and 54%

was from sales of DRB products.

Our combined company is a vertically integrated manufacturer, product developer, and marketer of products based on bio-refining rice bran for use in a broad range of human food and animal nutrition products. We generated revenues of $37.7 million in 2012 compared to $37.0 million in 2011. We reported a net loss of $11.1 million for 2012, compared to a net loss of $10.9 million reported for 2011. We have domestic net operating loss carry forwards, or NOLs, in excess of $100 million for federal tax purposes that are available to offset future taxable income. These NOLs expire at various dates from 2018 through 2032 (see Note 13 to the consolidated financial statements included herein).

We hold the U.S. registered trademarks RiSoluble and RiBalance. We also hold the Irgovel trade name. In addition to our trade names and trademarks, we hold 23 issued patents and have several patents pending related to usage of and therapeutic endpoints for rice bran products and derivatives, including patents to a method to treat high cholesterol, to a method to treat diabetes and on a process for producing higher value fractions (HVF) from SRB (see Patents and Trademarks section below).

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Our corporate headquarters is currently located at 6720 N. Scottsdale Rd., Scottsdale, AZ 85253. As of December 31, 2012, we occupy approximately 9,000 square feet of corporate office space in Scottsdale, and 28,000 square feet of laboratory, warehouse and production facilities in West Sacramento, California. Additionally, we own SRB manufacturing facilities in Mermentau and Lake Charles, Louisiana and a Stage II production facility in Dillon, Montana. Two other rice bran stabilization facilities are co-located within supplier rice mills in Arbuckle and West Sacramento, California. Our Irgovel subsidiary is comprised of several facilities on approximately 19 acres in Pelotas, Brazil. These facilities include a plant for extraction of RBO from rice bran, RBO refining processes, compounded animal nutrition manufacturing, consumer RBO bottling, distilled fatty acid manufacture and support systems including steam generation, maintenance, administrative offices and a quality assurance laboratory. Our Irgovel facility is currently undergoing a major expansion that is expected to be fully operational in the second half of 2013.

History

We originally incorporated on March 18, 1998, in California, as Alliance Consumer International, Inc. and beginning in December 2001 were operating as NutraStar Incorporated. In October 2003, NutraStar Incorporated changed its name to “NutraCea” and the common stock began trading on the OTCBB.

In October 2005, we acquired The RiceX Company (RiceX) in a merger transaction with RiceX surviving the merger as our wholly-owned subsidiary. In the merger, the shareholders of RiceX received shares of our common stock in exchange for 100% of the shares of RiceX common stock. Our acquisition of RiceX provided us with our first SRB manufacturing plant in West Sacramento, California, and our Stage II facility in Dillon, Montana.

In December 2007, we formed Rice Rx, LLC, and Rice Science, LLC, in which we held a 50% and 80% interest, respectively, at December 31, 2010. We formed Rice Rx, LLC and Rice Science, LLC with a partner, to develop, acquire, and commercialize certain SRB isolates. Effective in March 2011, Rice Rx LLC and Rice Science, LLC became our wholly-owned subsidiaries.

In February 2008, we acquired Irgovel, our rice bran oil processing plant in Pelotas, Brazil. In January 2011, we sold approximately 35.6% of our ownership of Nutra SA, LLC (Nutra SA), the 100% owner of Irgovel, to AF Bran Holdings-NL LLC and AF Bran Holding LLC (Investors) (see Note 5 to the consolidated financial statements included herein). During the remainder of 2011, the Investors exercised their rights to acquire additional membership interests in Nutra SA and at December 31, 2012 and 2011, held a 49.0% interest in Nutra SA.

In November 2009, NutraCea (the Parent Company) filed a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code. The Parent Company managed its assets and operated its business as “debtor-in-possession” under the jurisdiction of the bankruptcy court from November 2009 until NutraCea exited Chapter 11 proceedings in November 2010, under an amended plan of reorganization. In January 2012, we made the final distributions to our unsecured creditors under the amended plan of reorganization and all creditors under the amended plan were paid all amounts due to them, including interest.

In October 2012, NutraCea changed its name to “RiceBran Technologies.” Our common stock is currently trading over-the-counter under the symbol “RIBT.”

Products & Industry Background

We have developed a bio-refining approach to processing rice bran, which is the portion of the rice kernel that lays beneath the hull (also known as the husk) and envelopes the endosperm (white rice). Rice bran contains about 65% of the nutritional value of rough rice. However, without stabilization, the nutritional value of rice bran is lost shortly after the milling process. This is due to the lipase enzyme-induced rancidity that is activated during the rice milling

process. Without stabilization, this nutrient rich resource – rice bran - has historically been sold as low value animal feed or disposed of as waste.

In our rice bran bio-refining processes, we first stabilize the rice bran and then sequentially extract core and derivative products from rice bran with the goal of converting feed to food to nourish a global population expected to grow from 7 billion people at the end of 2011 to more than 9 billion people by 2050. Application of our bio-refining approach has enabled us to develop a variety of nutritional food products, including our primary products SRB, RBO and DRB. Our customers include major global companies that produce, market and sell products into the following domestic and international market sectors - consumer food products, animal nutrition, functional food ingredients, nutritional supplements and healthcare.

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In the SRB bio-refining stream, we use proprietary and patented machinery and technologies to deactivate the lipase enzyme and stabilize the rice bran while preserving the nutritional value of the bran, giving it a minimum shelf life of one year and allowing for further processing of derivative products. Other competing stabilization processes have the ability to inactivate the lipase enzymes to various degrees and therefore provide some level of stability. However, unlike these other competing processes, our SRB stabilization process thoroughly inactivates these enzymes leading to extended shelf stability while preserving the large array of antioxidants and other nutrients found in raw rice bran. We believe our SRB equipment and related stabilization technology is the best available globally.

In the RBO bio-refining stream, the process begins with a non-proprietary stabilization process followed by the extraction of RBO, leaving DRB as the initial co-product. The RBO extraction process utilized at our Brazilian facility uses a solvent extraction process to separate the oil from the raw rice bran resulting in crude RBO and DRB. Rice bran oil (RBO) is a vegetable oil that has many uses. In crude form, it has multiple industrial and animal nutrition applications. Additional refinement of the oil can involve degumming, neutralization, bleaching, de-waxing and deodorizing. This subsequent refining process yields a variety of valuable human food and animal nutrition products including distilled fatty acids and other high value products. Refined to human edible grade level, RBO becomes a high quality cooking oil and human food ingredient.

In the DRB bio-refining stream, the core product is used as animal feed and sold in bulk form. In addition, DRB can be compounded with other ingredients such as corn and soy to produce high quality, branded animal nutrition products sold under the Irgovel brand in Brazil. Further processing of DRB produces a human food ingredient that has functional properties in baked goods and meats as well as use in frying applications that result in reduced oil uptake. We believe that bio-refining of DRB is one of several processes with potential for concentrating protein from rice bran.

By definition, nutraceuticals are products from natural sources that have biologically therapeutic effects in humans and animals. Our overall bio-refining approach produces core products (SRB, RBO and DRB) that are good sources of these compounds. Such compounds would include vitamins, antioxidants, polyphenols, phytosterols, oryzanols, macro and trace minerals, tocotrienols - a highly potent antioxidant form of vitamin E, and gamma-oryzanol, which is found in significant amounts in rice bran. Among other things, these compounds act as potent antioxidants. SRB and its derivatives also contain high levels of B-complex vitamins and beta-carotene, a vitamin A precursor. SRB also contains high levels of carotenoids and phytosterols, a balanced amino acid profile and soluble and insoluble fiber which promote colon health.

As the market becomes more aware of the value of our ingredients and proprietary formulations we believe demand for our products will increase materially. Since SRB, RBO and DRB are approved food products, we believe that their benefits can be obtained through multiple avenues as food products, dietary supplements and nutricosmetics. Many nutrition and health professionals have taken an interest in our nutritional ingredients as a means of offering alternative or complementary approaches for maintaining a healthy and active lifestyle. The health benefits of our products have been demonstrated through extensive research and clinical studies, and we are committed to supporting evidence-based studies that demonstrate the nutritional and health benefits of our products.

Detailed explanations and product sheets with specifications for our complete product range are available on our websites at www.ricebrantech.com and www.irgovel.com.br.

The Importance of Rice

Rice is the staple food for over half of the world's population, and is the staple food source for several of the world's most populous countries. Asia accounts for roughly 90% of global rice production, with its primary producer being

China. China is the world's number one rice producer, outputting approximately 197 million metric tons of paddy rice annually. Globally, the United States ranks about 10th in production of rice at approximately 11 million metric tons annually. World rice production constitutes more than one quarter of all cereal grains produced worldwide. The United States accounts for less than 2% of the world's rice production. The vast majority of world rice tonnage (approximately 90%) is produced in 13 countries with aggregate populations of 3.2 billion people (according to the USA Rice Federation, Rice Notes). Approximately 75% of all rice production occurs in China, India, South East Asia, Africa and South America. Combined, these regions have a population of 2.3 billion people (nearly 50% of the world's population), and an average per capita gross domestic product of $2,000 (less than one tenth of the U.S. average).

Malnutrition is a common problem in this group of nations, particularly for people located in rural villages where subsistence rice farming is a primary livelihood. Transportation and storage are poor. Consequently, locally grown rice is consumed locally and the amount of food available varies widely over time with changes in seasons and weather. Children are especially susceptible to variations in local agricultural output due to their heightened nutritional needs and dependency on others for food. Per capita rice consumption in many of the poorer rice belt countries exceeds one pound per day.

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Rice Processing and Rice Bran Stabilization

When harvested from the field, individual rice kernels are stored in common receiving locations such as farm silos for future delivery to grain dryers or area rice mills. At this stage, large quantities of individual rice kernels are collectively called “paddy rice,” or “rough” rice. In this form, the rice kernel is fully enveloped by the rice hull, which serves as a protective cover, shielding the inner rice kernel from damage.

After storage and drying, if necessary, paddy rice is cleaned of foreign material (scalping, de-stoning and aspiration) just before it enters the first stage of milling, or paddy husking. In the paddy husker, the hull is removed from rough rice by differential speed rubber rollers. Loosened hulls are carried off by aspiration. After husking, a paddy separator uses a reciprocating motion to separate normal brown rice kernels (caryopsis) from unhusked kernels which are returned to the paddy husker.

In the second stage of milling, the outer brown layers of bran are removed from the inner white starch endosperm by an abrasive or frictional milling process which produces a milled, white rice kernel. After milling, white rice is typically sorted by size to remove broken pieces of rice kernels from whole kernels, as well as color sorting to remove discolored kernels. Additional stages may be required (per customer specifications) to polish the white rice to a smooth surface.

Raw rice bran collected from the milling process is composed of rice germ and several sub-layers (pericarp, testa, nucellus and aeurone) surrounding the white starchy endosperm. Commercial rice bran makes up approximately 10% of rough rice by weight. Rice germ, an especially nutrient rich material, makes up approximately 10% of commercial rice bran by weight.

As brown rice is milled into white rice, the oils present in raw rice bran come into intimate contact with native lipase enzymes that are naturally present in the rice kernel. These lipase enzymes initiate a rapid hydrolysis of the oil, converting oils (triglycerides) into monoglycerides, diglycerides and free fatty acids (FFA). As the FFA content builds in raw rice bran, the bran becomes unpalatable and off flavors (rancidity) begin to develop. If left unchecked, enzymatic degradation at normal room temperatures can increase the FFA levels to 5-8% within 24 hours and can continue at a rate of approximately 4-5% per day thereafter. Enzymatic degradation is the most serious form of degradation of raw rice bran. Rice bran stabilization is the process of carefully deactivating native enzymes to prevent the increase of FFA otherwise caused by lipase enzyme activity. Stabilization is critical in the preservation of the nutritional value of the bran, an important nutrient source that is largely used as animal feed or otherwise wasted.

There have been a number of attempts to develop rice bran stabilization techniques, including the use of chemicals, microwave heating, or variations of existing extrusion technology. We believe each of these efforts results in an inferior product that either does not remain stable for a commercially reasonable period of time, or the nutrients in the bran are lost to processing, thereby significantly reducing the nutritional value in the bran.

The Stabilization Process

Our stabilization process uses proprietary innovations to create a combination of temperature, pressure and other conditions necessary to thoroughly deactivate enzymes without significantly damaging the structure or nutrient content of bran. This means that higher value compounds in bran, such as oils, proteins and phytonutrients are left undamaged and are available for utilization. Our process does not use chemicals to stabilize raw rice bran.

Our stabilizers are designed to be installed on the premises of any conventional rice mill so that pneumatic conveyor systems can immediately carry the freshly milled, raw rice bran to our stabilizer. Process logic controllers maintain exact process conditions within the prescribed pressure/temperature regime. In case of power failure or interruption of

the flow of fresh bran into the system, the electronic control system is designed to purge the equipment of materials in process and resume production only after proper operating conditions are re-established.

Stabilized bran (SRB) leaving our system is then discharged onto cooling units specifically designed to control air pressure and humidity. Cooled SRB can be loaded into bulk hopper trucks for large volume, local customers, or sent by pneumatic conveyor to a bagging unit for packaging into 50 lb and 2,000 lb sacks.

Each stabilization module can process approximately 2,000 pounds of bran per hour and has a capacity of over 5,700 tons per year. Stabilization production capacity can be doubled or tripled by installing additional units sharing a common conveyor and stage system, which we believe can handle the output of the world's largest rice mills. We have developed and tested a smaller production unit, which has a maximum production capacity of 840 tons per year, for installation in countries or locations where rice mills are substantially smaller than those in the United States.

Additional patented processes involve enzyme treatment of SRB to effect separation of a lipid and carbohydrate rich water soluble fraction and a fiber and protein rich water insoluble fraction. In this process SRB, in an aqueous slurry, is treated with amylase enzyme, centrifugally separated and the two fractions dried on drum driers.

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The Bio-Refining Process

In the bio-refining process, raw bran is obtained from a number of rice mills and transported to a facility within which it is first stabilized via extrusion and then solvent extracted to produce crude RBO and DRB. Crude RBO is subsequently processed in a number of steps designed to sequentially remove non-oil constituents. The final outcome of these steps is a highly refined, edible RBO that has superior flavor and functional properties. In addition, the various co-products of crude RBO processing, distilled fatty acids for example, are refined and sold as products in their own right. DRB is finely ground and packaged for use as a versatile food ingredient in many applications. DRB may also be compounded with other ingredients such as a vegetable proteins, carbohydrates, vitamin premixes and minerals to produce an array of nutritionally targeted animal feeds for various species. The bio-refining process is being continuously researched as we examine the technical and commercial feasibility of producing additional products derived from both RBO and DRB.

Benefits of Our SRB, DRB and Rice Bran Oil

Stabilized Rice Bran (SRB) is a rich source of protein, oil, vitamins, antioxidants, dietary fiber and other nutrients. The approximate composition and caloric content of our SRB is as follows:

| | |
|---|---|
| Fat | 18-23% |
| Protein | 12-16% |
| Total Dietary Fiber | 20-30% |
| Soluble Fiber | 2-6% |
| Moisture | 4-8% |
| Ash | 6-14% |
| Calories | 3.2 kcal/gram |

Rice bran is unique in the plant kingdom. Its protein is hypoallergenic and contains all of the essential amino acids, the necessary building blocks of protein in the body. Rice bran contains approximately 15-20% oil, which has a favorable fatty acid composition and excellent heat stability. Rice bran oil contains essential fatty acids and a broad range of nutraceutical compounds that have been demonstrated to have therapeutic properties.

Defatted Rice Bran (DRB) contains many of the same nutritional and functional benefits as SRB, except that the oil has been removed. This is important for several ingredient applications where SRB's oil content could present food formulation challenges. By removing oil from SRB, nutritionists have greater options to formulate DRB into breakfast bars, calorie reduced foods, low fat baking applications and batter and breadings for frying applications. Additionally, DRB is ideally suited for downstream enzymatic processing, transforming DRB into an ideal feedstock for protein concentrates and fiber concentrates.

Rice bran oil (RBO) as extracted from stabilized rice bran can be utilized in a variety of edible and industrial oil applications. With proper processing, RBO becomes high quality cooking oil possessing beneficial high temperature frying characteristics. RBO has a unique fatty acid content that imparts improved oxidative stability as compared to other vegetable oils such as soy or cottonseed giving it advantages when used in food applications. The RBO extraction process utilized at our Brazilian facility uses a conventional solvent extraction process to separate oil from raw bran, resulting in crude RBO available for sale to industrial markets or other processors. Additional refining processes done in Brazil can involve degumming, neutralization, bleaching, de-waxing and deodorizing. A bio-refining process approach results in numerous marketable co-products in addition to the actual end product.

Nutraceuticals are food constituents that have human therapeutic effects. Some of these compounds include a highly potent anti-oxidant form of Vitamin E called "tocotrienols," and gamma oryzanol, which is found in rice bran in large

quantities. These compounds are potent antioxidants that have been shown to aid in reducing damage from free radicals in the body. Our SRB also contains very high levels of B-complex vitamins, betacarotene (a vitamin A precursor), other carotenoids and phytosterols, as well as both soluble and insoluble fiber.

Business Strategy

Our goal is to become a significant global producer and marketer of SRB, DRB, RBO and their derivatives. We produce these products in manufacturing facilities we own or through other arrangements (see Supply and Manufacturing section below). We intend to vigorously protect our process and products through both trade secret protection and through patent and trademark protection (see Patents and Trademarks section below). We believe that clinical support for SRB, RBO and DRB products will further enhance the value of our products as nutraceuticals and functional food ingredients. Finally, we intend to aggressively market our products in multiple market segments including human food ingredients, nutraceuticals, animal nutrition and functional foods and beverages. In pursuit of these goals, we have focused and will continue to focus our marketing and development efforts worldwide.

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Sales and Marketing

As of December 31, 2012, we have a senior vice-president of sales, a vice-president of animal nutrition sales, one sales director and five domestic sales representatives. Our senior vice-president of business development assists the sales team with technical application issues. In addition, we have exclusive and non-exclusive distributor relationships with distribution and channel partners in several major markets around the world. In September 2011, we entered into an exclusive, co-branded distribution agreement with BENEO-Remy N.V. (Beneo) covering our SRB products in Western Europe, Middle East, Africa, Russia, Turkey, India, Australia and New Zealand, among other markets. That agreement grants rights to distribute our other products in those same markets on a non-exclusive basis.

Because of the potential significance for SRB and DRB inclusion in meat and poultry, we have engaged specialized meat and poultry consultants in the U.S. to assist in meat and poultry application research and development, make potential qualified customer introductions, provide marketing support and conduct customer training programs. In addition, we have enlisted the services of a strategic protein application expert from Europe to help research and establish manufacturing processes, identify new SRB and DRB meat applications, and assist our international distributors in key international markets.

In 2012, approximately 8.1% of revenues from the USA segment were to regions outside of the United States while approximately 27.2% of our Brazil segment revenues were to regions outside of Brazil.

Functional Food Ingredients

The global functional food market may be as much as $60 billion, depending on how this market is defined, and we believe that it represents a significant opportunity for us. Premium ingredient manufacturers are in high demand and we are strategically positioned to take advantage of this growing and sustainable market opportunity. Our proprietary technology and product patents represent extremely valuable assets for achieving strategic leverage in this industry segment.

Our SRB, DRB, RBO and derivatives are economical, natural food products that contain a unique combination of oil, protein, carbohydrates, vitamins, minerals, fibers, and antioxidants that enhance the nutritional value of popular consumer products. Foods that are ideally suited for the addition of our SRB and DRB to their products include processed meats, cereals, baked goods, breadings, and batters. The inclusion of DRB in breadings and batters results in a reduction in oil uptake, higher moisture retention, improved nutritional profiles, and reduced costs.

In 2008, we received USDA/FSIS approval to include SRB and DRB as enhancers in meat products such as meat and poultry sausages that contain binders, nugget-shaped patties, meatballs, meatloaf, and meat and poultry patties. Our products replace functional ingredients like soy protein isolate, soy protein concentrate, modified food starch, pea protein and mustard flour at a significantly reduced cost. With strong application benefits such as reduced cost per unit, increased product yield, and reduced purge, our SRB has a strong marketing position in the US meat market and an even stronger position outside the US where non-meat ingredients make up a larger percentage of meat products.

Nutraceuticals

Nutraceuticals are plant-derived substances with pharmaceutical-like properties, including vitamins and dietary supplements. Our products can be used to provide certain specific nutrients or food components (including antioxidants, oryzanols, vitamin E, vitamin B, and fiber) and general nutritional supplementation. Our ingredient products are primarily sold to consumer nutrition and healthcare companies, nutritional supplement retailers, and multi-level personal product marketers.

Animal Nutrition

Our SRB and DRB are marketed as feed ingredients in the U.S. and international animal nutrition markets. Our SRB and DRB are used as equine feed ingredients and have proven to provide a safe, all natural energy source which assists in lowering glycemic response, improving stamina through being a ready available low starch energy component, and improving overall coat bloom through its essential fatty acid and amino acid profiles. Show and performance horses represent the premium end of the equine market and are a key target for our animal nutrition products.

In our Brazil segment, we also blend DRB with other ingredients to produce a variety of feed formulations targeted to certain animal species such as horses, beef cattle, dairy cows, pigs and sheep.

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Rice Bran Oil Processing Derivatives

Raw rice bran contains approximately 15-20% oil. Through a solvent extraction process, the oil is removed from bran resulting in crude RBO and defatted rice bran (DRB). Crude RBO is further refined to a finished grade edible oil that is primarily sold as a high end vegetable oil for cooking, as well as a human food ingredient for various products. Virtually every refining step produces valuable co-products that are of great interest to industrial customers. One of the more important co-products is known as distilled fatty acids which are being sold to several industrial customers. In 2012, we began drying wet gums to produce food grade lecithin, unique in that it is free of genetically modified organisms (GMOs) and non soybean based. We continue to expand our marketing of RBO both domestically in Brazil and globally. We estimate that the global market for vegetable oils is approximately 160 million tons annually and will continue to grow as the world's underdeveloped societies move towards westernized eating habits and populations increase in general.

Customers

In 2012, three customers accounted for approximately 40% of USA segment revenues. In our Brazil segment, three customers accounted for approximately 38% of segment revenues. Although the loss of a customer could have a material adverse effect on our revenues and results of operations, we continue to diversify our customer base in an attempt to mitigate the concentration of customers. Financial instruments that potentially subject us to significant concentrations of credit risk consist primarily of trade accounts receivable and notes receivable. We perform ongoing credit evaluations on our customers' financial conditions and generally do not require collateral.

Supply and Manufacturing

Initial production of SRB

In the U.S. we purchase raw rice bran from three suppliers. These include Farmers' Rice Cooperative in West Sacramento, California, ADM Rice in Arbuckle, California, and Louisiana Rice Mill in Mermentau, Louisiana. We idled the plant located adjacent to Farmers' Rice Milling Company in Lake Charles, Louisiana in May 2009. Pursuant to our agreements, our stabilization machinery is physically located within or adjacent to the rice processing plants and the rice bran is directly transferred to our machinery for stabilization without the need for shipping. The relationship with the rice mills are symbiotic, as the rice manufacturer searches for raw rice bran marketing channels while we have ready access to raw bran. We believe suitable alternative supply arrangements are available if needed.

Stage II Production of SRB

Based on product demand, we ship SRB from one of our California facilities to our plant in Dillon, Montana for further processing into RiSolubles, RiBalance and RiFiber. We have equipment at the Dillon, Montana facility with capacity to produce 5,000 tons per year of RiSolubles and RiFiber.

Every human food product that we manufacture is produced under published FDA and USDA regulations for "Good Manufacturing Practices." We have extensive processes and programs to oversee product quality. Product samples for each product code are frequently analyzed for adherence to a predetermined set of product microbiological and attribute specifications and each lot is released only when it demonstrates its compliance with specifications.

Production of RBO and DRB

In Brazil, we purchase raw and par-boiled rice bran from a number or rice mills located short distances from our processing facility in Pelotas. Timing of delivery for raw bran to an RBO bio-refinery is not as stringent as for an

SRB bio-refining process, although we make every effort to process bran as soon as possible after milling to maintain the quality of our crude RBO. We currently process a relatively small percentage of the raw rice bran available in the adjacent rice growing regions in Brazil and contiguous rice growing regions of Uruguay and Argentina.

Results of Trials and Scientific Research

The beneficial attributes of SRB, including our RiSolubles and RiFiber nutritional supplements, have been studied and reported by several laboratories, including Medallion Laboratories, Craft's Technologies, Inc., Southern Testing & Research Laboratories, and Ralston Analytical Laboratories. We have no affiliation with any of the laboratories that performed these studies but did pay for certain portions of these studies. These analyses have verified the presence of antioxidants, polyphenols, and phytosterols, as well as beneficial macro and trace minerals, in our SRB products. Antioxidants are compounds which scavenge or neutralize damaging compounds called free radicals. Polyphenols are organic compounds which potentially act as direct antioxidants. Phytosterols are plant-derived sterol molecules that help improve immune response to fight certain diseases.

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A 57-subject clinical trial conducted by Advanced Medical Research, with our funding, suggested that consumption of our RiSolubles nutritional supplements may lower blood glucose levels of type 1 and type 2 diabetes mellitus patients and may be beneficial in reducing high blood cholesterol and high blood lipid levels. If warranted, we may develop products which address the use of SRB products as medical foods for, and to potentially make health benefit claims relating to, the effects of dietary rice bran on diabetes and cardiovascular disease.

Through several consulting physicians, we have relationships with several medical institutions and practicing physicians who may continue to conduct clinical trials and beta work for our products. Some of these previous clinical trials are reviewed in an article published in the March 2002 issue of the Journal of Nutritional Biochemistry. The trials produced positive results by showing that the levels of blood lipids and glycosylated hemoglobin were reduced. Subsequently, three domestic and six international patents were issued to us on the strength of these clinical trials.

In December 2007, we formed Rice Science, LLC (RS), a Delaware limited liability company, with Herbal Science Singapore PTe. Ltd. (HS) to develop nutraceutical extracts and pharmaceutical chemistries from our SRB. HS utilizes sophisticated methodologies in the identification and isolation of specific biologically active compounds that have been tested for effectiveness against specific disease conditions. In March 2011, our partnership with HS ended with us acquiring the membership interest formerly owned by HS, leaving RS as our wholly owned subsidiary. We are hopeful that the research already performed will result in 29biologically active SRB extracts for use in the nutraceutical and functional food industry.

In 2008, RS conducted a significant amount of research. The initial thrust of this work was the development of extracts from SRB that would be effective in addressing inflammation and pain. A number of SRB extracts have been tested with two identified as having significant in vitro activities. A blend of these two extracts was created to produce a third extract that exhibits a high level of in vitro inhibition of Cox 1, Cox 2 and Lox 5 enzymes. This extract was used in a pharmacokinetic study to determine uptake kinetics of key bioactives into human serum. Results indicated that the bioactive compounds were rapidly assimilated. The next step would be to conduct a human clinical trial if funds were available. A number of active compounds were identified and modeled. RS filed patent applications for the extracts along with each of the specific active compounds.

Late in 2007, the Cancer Biomarkers Group in the Department of Cancer Studies and Molecular Medicine, University of Leicester in Leicester, UK published a research paper evaluating the effect of our SRB in ApcMin mice (British Journal of Cancer (2007) 96, 248-254). The mice were genetically modified to serve as models for mammary, prostate and intestinal carcinogenesis. They reported that consumption of SRB (30% in the diet) reduced the numbers of intestinal adenomas in these mice by 51% compared to the same mice on a control diet. The results suggest that SRB might be further evaluated as a chemo-preventative intervention in humans. These results led to us filing a patent application on “Methods for Treatment of Intestinal Carcinogenesis with Rice Bran.”

Patents and Trademarks

We hold eight U.S. patents relating to the production or use of Nutraceutical or HVF products. The patents are:

1. Patent Number 5,512,287 “PRODUCTION OF BETA-GLUCAN AND BETA-GLUCAN PRODUCT,” which issued on April 30, 1996 and expires in 2014.

2. Patent Number 5,985,344 “PROCESS FOR OBTAINING MICRONUTRIENT ENRICHED RICE BRAN OIL,” which issued November 16, 1999 and expires in 2018.

3.

Patent Number 6,126,943 “METHOD FOR TREATING HYPERCHOLESTEROLEMIA, HYPERLIPIDEMIA, AND ATHEROSCLEROSIS,” which issued October 3, 2000 and expires in 2018.

4. Patent Number 6,303,586 B1 “SUPPORTIVE THERAPY FOR DIABETES, HYPERGLYCEMIA AND HYPOGLYCEMIA,” which issued October 16, 2001 and expires in 2018.

5. Patent Number 6,350,473 B1 “METHOD FOR TREATING HYPERCHOLESTEROLEMIA, HYPERLIPIDEMIA AND ATHEROSCLEROSIS,” which issued February 26, 2002 and expires in 2020.

6. Patent number 6,558,714 B2 “METHOD FOR TREATING HYPERCHOLESTEROLEMIA, HYPERLIPIDEMIA AND ATHEROSCLEROSIS” which issued May 06, 2003 and expires in 2021.

7. Patent number 6,733,799 “METHOD FOR TREATING HYPERCHOLESTEROLEMIA, HYPERLIPIDEMIA AND ATHEROSCLEROSIS” which issued May 11, 2004 and expires in 2023.

8. Patent number 6,902,739 “METHODS FOR TREATING JOINT INFLAMMATION, PAIN AND LOSS OF MOBILITY” which issued June 07, 2005 and expires in 2021.

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In addition to the previously identified issued U.S. patents, we have been issued fifteen additional International patents covering the subject areas. We intend to apply for additional patents in the future as new products, treatments and uses are developed. We have three pending patent applications.

Our bio-refining and related stabilization activities are an adaptation and refinement of standard food processing technology applied to rice bran. We have chosen to treat our methods and processes as a trade secret and not to pursue process or process equipment patents on the original processes. However, process improvements will be reviewed for future patent protection. We believe that the unique products, and their biological effects, resulting from our SRB are patentable.

We endeavor to protect our intellectual property rights through patents, trademarks, trade secrets and other measures. However, there can be no assurance that we will be able to protect our technology adequately or that competitors will not develop similar technology. There can be no assurance that any patent application we may file will be issued or that foreign intellectual property laws will protect our intellectual property rights. Other companies and inventors may receive patents that contain claims applicable to our systems and processes. The use of our systems covered by such patents could require licenses that may not be available on acceptable terms, if at all. In addition, there can be no assurance that patent applications will result in issued patents.

Although there currently are no pending claims or lawsuits against us regarding possible infringement claims, there can be no assurance that infringement claims by third parties, or claims for indemnification resulting from infringement claims, will not be asserted in the future or that such assertions, if proven to be true, will not have a materially adverse effect on our financial condition and results of operations. In the future, litigation may be necessary to enforce our patents, to protect our trade secrets or know-how or to defend against claimed infringement of the rights of others and to determine the scope and validity of the proprietary rights of others. Any such litigation could result in substantial cost and diversion of our resources, which could have a material adverse effect on our financial condition and results of operations. Adverse determinations in such litigation could result in the loss of our proprietary rights, subject us to significant liabilities to third parties, require us to seek licenses from third parties or prevent us from manufacturing or selling our systems or products, any of which could have a material adverse effect on our financial condition and results of operations. In addition, there can be no assurance that a license under a third party's intellectual property rights will be available on reasonable terms, if at all.

Government Regulations

The U.S. Food and Drug Administration (FDA), The U.S. Department of Agriculture (USDA) and The Federal Trade Commission (FTC) are the Government entities that regulate the manufacture, marketing and advertizing of our products sold in the U.S.

The FDA enforces Federal Food Drug and Cosmetic Act (FFDCA) and Dietary Supplement Health and Education Act (DSHEA) regulations as they pertain to foods, food ingredients and dietary supplement production and marketing. The FDA has broad authority to enforce the provisions of federal law applicable to dietary supplements, including the power to seize adulterated or misbranded products or unapproved new drugs, to request product recall, to enjoin further manufacture or sale of a product, to issue warning letters, and to institute criminal proceedings. In the future, we may be subject to additional laws or regulations administered by the FDA or other regulatory authorities, the repeal of laws or regulations that we might consider favorable or more stringent interpretations of current laws or regulations. We are not able to predict the nature of such future laws or regulations, nor can we predict the effect of such laws or regulations on our operations. We may be required to reformulate certain of our products, recall or withdraw those products that cannot be reformulated, keep additional records, or undertake expanded scientific substantiation. Any or all of such requirements could have a material adverse effect on our business and financial condition.

The FTC regulates the advertising of dietary supplement and other health-related products. Their primary concern is that any advertising must be truthful and not misleading, and that a company must have adequate substantiation for all product claims. The FTC actively enforces requirements that companies possess adequate substantiation for product claims. FTC enforcement actions may result in consent decrees, cease and desist orders, judicial injunctions, and the payment of fines with respect to advertising claims that are found to be unsubstantiated.

The USDA retains jurisdiction over meat products and food ingredients intended for use in meats. Therefore, the use of SRB and DRB as meat enhancers is regulated by this agency. Both SRB and DRB have USDA approval for use in meat products.

In addition to the foregoing, our operations will be subject to federal, foreign, state, and local government laws and regulations, including those relating to zoning, workplace safety, and accommodations for the disabled, and our relationship with our employees are subject to regulations, including minimum wage requirements, anti-discrimination laws, overtime and working conditions, and citizenship requirements.

We believe that we are in substantial compliance with all material governmental laws and regulations.

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Competition

Although we believe that we are the only company to produce stabilized all natural rice bran with a shelf life of over one year, we compete with other companies that produce stabilized rice bran, as well as companies producing other food ingredients and nutritional supplements. We believe that our only significant competitors currently for rice bran products for feed applications are Producer's Rice Mill, located in Stuttgart, Arkansas and Harvest Rice Milling, in McGehee, Arkansas. We are also aware of one small scale producer of food ingredient SRB in Italy, Riso Scotti. We believe that our major nutritional supplement competitors include producers of isolated soy protein, wheat bran and oat bran, particularly in the functional food ingredients market segment.

We compete with other companies that offer products incorporating SRB as well as companies that offer other food ingredients and nutritional supplements. We also face competition from companies providing products that use oat bran and wheat bran as nutritional supplements as well as for health and beauty aids. Many consumers may consider such products to be a replacement for the products we manufacture and distribute. Many of our competitors have greater marketing, research, and capital resources than we do, and may be able to offer their products at lower costs because of their greater purchasing power or the lower cost of oat and wheat bran ingredients. There are no assurances that our products will be able to compete successfully.

Beginning in 2008 with the purchase of Irgovel, we also compete in the world's edible oil market. Our competition for exports of rice bran oil resides primarily in Southeast Asia. There are several small scale producers of crude RBO in that region although few produce an edible grade oil. There are also a number of crude RBO producers in India but most of these produce inferior grade oil destined for soap manufacture.

Research and Development Expenditures

Beginning in 2008, we contracted the services of PHD Technologies (Ames, Iowa) to developed application methods for the use of SRB and SRB derivatives in comminuted meats and in breadings and coatings. PHD continues to develop application methods and supports our sales efforts through technical presentations.

In 2011, we entered into a joint research and development agreement with DSM Innovation Center, a subsidiary of Royal DSM N.V., to develop methods for extracting and concentrating high quality vegetable protein from rice bran. In March 2013, the agreement was terminated and both parties have equal rights to commercialize and further develop the technology pursuant to a license agreement between the parties.

Although our 2012 and 2011 research and development expenditures were not significant, we expect to continue research and development to further develop application methods and technologies. In March 2013, we announced the development of an improved fiber protein product and a separate soluble rice bran protein product.

Seasonality

Our business is not materially affected by seasonal factors.

Environment

We believe that our operations comply in all material respects with applicable laws and regulations concerning the environment. While it is impossible to predict accurately the future costs associated with environmental compliance and potential remediation activities, compliance with environmental laws is not expected to require significant capital expenditures and has not had, and is not expected to have, a material adverse effect on our results of operations or competitive position.

Employees

As of December 31, 2012, the USA and Corporate segments had 36 employees located in the U.S. The Brazil segment had 252 employees. Our employee count may change periodically. From year to year we experience normal variable labor fluctuation at our production facilities. We believe relations with our employees are good. None of our U.S. based employees are covered by collective bargaining agreements. All of the employees at our Irgovel facility in Brazil are represented by a labor union and are covered by a collective bargaining agreement.

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Securities and Exchange Commission Reports

We maintain an Internet website at the following address: www.ricebrantech.com. We make available on or through our Internet website certain reports and amendments to those reports that we file with the Securities and Exchange Commission (SEC) in accordance with the Securities Exchange Act of 1934 (Exchange Act). These include our annual reports on Form 10-K, our quarterly reports on Form 10-Q and our current reports on Form 8-K. We make this information available on our website free of charge as soon as reasonably practicable after we electronically file the information with, or furnish it to, the SEC. The contents of our website are not incorporated by reference in this report on Form 10-K and shall not be deemed "filed" under the Securities Exchange Act of 1934. The public may also read and copy any materials that we file with the SEC at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information about the Public Reference Room by contacting the SEC at 1-800-SEC-0330. Reports filed with the SEC are also made available on the SEC website (www.sec.gov).

ITEM 1A. RISK FACTORS

Our operations and financial results are subject to various risks and uncertainties, including those described below, which could adversely affect our business, financial condition, results of operations, cash flows, and the trading price of our common stock. Investors or potential investors in our stock should carefully consider the risks described below.

Risks Related to Our Business

Our significant losses and negative cash flow raise questions about our ability to continue as a going concern.

Our net cash used in operating activities was $4.8 million in 2012 and $9.2 million in 2011. We cannot assure you that we will be able to achieve revenue growth, profitability or positive cash flow, on either a quarterly or annual basis, or that profitability, if achieved, will be sustained. No adjustments have been made to the financial statements that might result from the outcome of this uncertainty. If we are unable to achieve or sustain profitability, we may not be financially viable in the future and may have to curtail, suspend, or cease operations, restructure existing operations to attempt to ensure future viability, or pursue other alternatives such as re-filing for bankruptcy, pursuing dissolution and liquidation or seeking to merge with another company or sell all or substantially all of our assets. Because of our recurring losses and negative cash flows from operations, the audit report of our independent registered public accountants on our consolidated financial statements for 2012 contains an explanatory paragraph stating that there is substantial doubt about our ability to continue as a going concern.

We have not yet achieved positive cash flows.

We have generate negative operating cash flows since our inception. We continue to assess the business to identify core and non-core assets. To raise additional cash funding we may be required to sell non-core assets and/or business units. Additionally, we will need to reduce operating expenses and increase cash flow to fund current operations in our SRB segment if we are not able to fund these operations by raising capital.

We will require additional funding to implement our business plan and if we are unable to obtain financing on acceptable terms, or at all, we may be forced to reduce or cease operations.

We will require additional financing to fund our operations. Our ability to meet long-term business objectives likely will be dependent upon our ability to raise additional financing through public or private equity financings, establish increasing cash flow from operations, enter into collaborative or other arrangements with corporate sources, or secure other sources of financing to fund long-term operations. There is no assurance that external funds will be available on

terms acceptable to us in sufficient amount to finance operations until we achieve sufficient positive cash flow. Any issuance of securities to obtain such funds would dilute percentage ownership of our shareholders. Such dilution could also have an adverse impact on our earnings per share and reduce the price of our common stock. Incurring additional debt may involve restrictive covenants and increased interest costs that will strain our future cash flow. If we are unable to obtain sufficient financing, we may need to delay, scale back or eliminate some or all of our product development and marketing programs, eliminate or restructure portions of our operations, restructure existing operations to attempt to ensure future viability, or pursue other alternatives including dissolution and liquidation or seeking to merge with another company or sell all or substantially all of our assets.

We have generated significant losses since our inception in 2000.

Since we began operations in February 2000, we have incurred significant losses. There can be no assurance that we will be able to achieve or maintain profitable operations. If our losses continue, our liquidity may be severely impaired, our stock price may fall and our shareholders may lose all or a significant portion of their investment.

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We may identify material weaknesses in the future that could adversely affect investor confidence, impair the value of our common stock and increase our cost of raising capital.

Any failure to remedy deficiencies in our internal control over financial reporting that may be discovered in the future or to implement new or improved controls, or difficulties encountered in the implementation of such controls, could harm our operating results, cause us to fail to meet our reporting obligations or result in material misstatements in our financial statements. Any such failure could, in turn, affect the future ability of our management to certify that internal control over our financial reporting is effective. Inferior internal control over financial reporting could also subject us to the scrutiny of the SEC and other regulatory bodies which could cause investors to lose confidence in our reported financial information and could subject us to civil or criminal penalties or shareholder litigation, which could have an adverse effect on the trading price of our common stock.

In addition, if we or our independent registered public accounting firm identify deficiencies in our internal control over financial reporting, the disclosure of that fact, even if quickly remedied, could reduce the market's confidence in our financial statements and harm our share price. Furthermore, deficiencies could result in future non-compliance with Section 404 of the Sarbanes-Oxley Act of 2002. Such non-compliance could subject us to a variety of administrative sanctions, including review by the SEC or other regulatory authorities.

There are significant market risks associated with our business.

We have formulated our business plan and strategies based on certain assumptions regarding the size of the rice bran market, our anticipated share of this market, the estimated price and acceptance of our products and other factors. These assumptions are based on our best estimates, however there can be no assurance that our assessments will prove to be correct. Any future success may depend upon factors including changes in the dietary supplement industry, governmental regulation, increased levels of competition, including the entry of additional competitors and increased success by existing competitors, changes in general economic conditions, increases in operating costs including costs of production, supplies, personnel, equipment, and reduced margins caused by competitive pressures. Many of these factors are beyond our control.

We may face difficulties integrating businesses we acquire.

As part of our strategy, we expect to review opportunities to buy other businesses or technologies that would complement our current products, expand the breadth of our markets or enhance technical capabilities, or that may otherwise offer growth opportunities. In the event of any future acquisitions, we could:

- issue stock that would dilute current shareholders' percentage ownership;
- incur debt; or
- assume liabilities.

These purchases also involve numerous risks, including:

- problems combining the purchased operations, technologies or products;
- unanticipated costs;
- diversion of management's attention from our core business;
- adverse effects on existing business relationships with suppliers and customers;
- risks associated with entering markets in which we have no or limited prior experience; and
- potential loss of key employees of purchased organizations.

We cannot assure you that we will be able to successfully integrate any businesses, products, technologies or personnel that we might acquire in the future.

We intend to pursue significant foreign operations and there are inherent risks in operating overseas.

An important component of our business strategy is to build rice bran stabilization and rice bran oil facilities in foreign countries and to market and sell our products internationally. For example, we have an operation in Brazil which manufactures rice bran oil. There are risks in operating facilities in developing countries because, among other reasons, we may be unable to attract sufficient qualified personnel, intellectual property rights may not be enforced as we expect, and legal rights may not be available as contemplated. Should any of these risks occur, our ability to expand our foreign operations may be materially limited and we may be unable to maximize the output from these facilities and our financial results may decrease from our anticipated levels. The inherent risks of international operations could materially adversely affect our business, financial condition and results of operations. The types of risks faced in connection with international operations and sales include, among others:

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- cultural differences in the conduct of business;
- fluctuations in foreign exchange rates;
- greater difficulty in accounts receivable collection and longer collection periods;
- challenges in obtaining and maintaining financing;
- impact of recessions in economies outside of the United States;
- reduced protection for intellectual property rights in some countries;
- unexpected changes in regulatory requirements;
- tariffs and other trade barriers;
- political conditions in each country;
- management and operation of an enterprise spread over various countries;
- the burden and administrative costs of complying with a wide variety of foreign laws; and
- currency restrictions.

The capital expansion project and planned temporary shutdown at our Irgovel facility could adversely affect our business, financial condition or results of operations.

Irgovel is currently undergoing a capital expansion project involving installation of new equipment and improvements to existing infrastructure. As a result of the project, we expect production at the Irgovel facility to shut down for approximately 4-6 weeks while certain new equipment is brought on line. The timing of this shut down is subject to change based on availability of funds, the timing of the delivery of equipment from suppliers, the availability of installers and other factors. Where possible, we intend to stockpile certain inventory for sale during the period the plant is shutdown. However, this inventory may not be adequate to timely fulfill all outstanding orders during this period. In addition, during such shutdown, we will have to continue to expend capital to maintain the Irgovel facility and equipment. Facility shut-down and subsequent restart expenses may adversely affect periodic results when these events occur.

The installation of new equipment at the Irgovel facility involves significant uncertainties. For example our new equipment may not perform as expected or may differ from design and/or specifications. If we are required to redesign or modify the equipment to ensure that it performs as expected, we may need to further shutdown the facility until the equipment has been redesigned or modified as necessary. The costs related to the capital expansion project are uncertain and the costs may increase beyond those projected.

If we fail to fund the Irgovel capital expansion project, the investors of Nutra SA may obtain certain rights with respect to Irgovel, including the right to participate in the operations of Irgovel.

Irgovel will need additional financing and/or capital to complete the capital expansion project and meet working capital needs during the planned shutdown. We have certain commitments to provide funds to Irgovel to meet these funding requirements under our agreements with the investors in Nutra SA. If the investors fund the cash shortfall at Irgovel they may obtain certain rights, including the right to force the sale of all of Nutra SA's assets and the right to substantively participate in the operations of Irgovel and Nutra SA. For further description of these funding obligations and the rights that the Nutra SA investors will acquire if we are unable to satisfy these obligations, see Note 5 to the consolidated financial statements included herein. Any of the foregoing risks associated with the capital expansion project could lead to lower revenues or higher costs or otherwise have a negative impact on our future results of operations and financial condition.

We have financial performance obligations related to Irgovel.

Under the limited liability company agreement for Nutra SA, Irgovel must satisfy certain financial performance requirements in order for us to maintain control over Irgovel. Nutra SA owns Irgovel. The Parent Company and the

investors in Nutra SA entered into the limited liability company agreement for Nutra SA in connection with the investors purchasing membership interests in Nutra SA pursuant to a membership interest purchase agreement effective January 2011 (see Note 5 to the consolidated financial statements included herein). These financial performance requirements include Irgovel's satisfaction of revenue, earnings and net debt targets described in the membership interest purchase agreement. If Irgovel fails to meet these financial requirements, we could lose management control over Irgovel's operations, and management control would transfer to the other investors in Nutra SA. Any such change in management control would cause us to no longer consolidate Irgovel's financial results with the Parent Company's financial results. Instead, we would be required to account for Irgovel as an equity investment on our balance sheets.

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Our business could be affected adversely by labor disputes, strikes or work stoppages in Brazil.

All of our employees at our Irgovel facility in Brazil are represented by a labor union and are covered by a collective bargaining agreement. As a result, we are subject to the risk of labor disputes, strikes, work stoppages and other labor-relations matters. Our collective bargaining agreement in Brazil typically has a one-year term and requires that we provide wage adjustments each year. We may be unable to negotiate new collective bargaining agreements on similar or more favorable terms and may experience work stoppages or other labor problems in the future. We could experience a disruption of our operations or higher ongoing labor costs, which could have a material adverse effect on our operating results and financial condition, potentially resulting in cancelled orders by customers, unanticipated inventory accumulation or shortages and reduced revenues and net income.

Fluctuations in foreign currency exchange could adversely affect our financial results.

We earn revenues, pay expenses, own assets and incur liabilities in countries using currencies other than the U.S. dollar, including primarily the Brazilian Real. Currently, a significant portion of our revenues and expenses occur in our Brazilian subsidiary, Irgovel. Because our consolidated financial statements are presented in U.S. dollars, we must translate revenues, income and expenses, as well as assets and liabilities, into U.S. dollars at exchange rates in effect historically, during or at the end of each reporting period. Therefore, increases or decreases in the value of the U.S. dollar against the Brazilian real and any other currency which affects a material amount of our operations, will affect our revenues, cost of sales, gross profit (loss), operating expenses, or other income and expenses and the value of balance sheet items denominated in foreign currencies. These fluctuations may have a material adverse effect on our financial results. Disruptions in financial markets may result in significant changes in foreign exchange rates in relatively short periods of time which further increases the risk of an adverse currency effect. Since we plan to expand our international operations, we will likely increase our exposure to foreign currency risks. We do not hedge our currency risk, and do not expect to, as currency hedges are expensive and do not necessarily reduce the risk of currency fluctuations over longer periods of time.

We depend on a limited number of customers.

In 2012, three customers accounted for 40% of USA segment revenues. In our Brazil segment, three customers accounted for 38% of segment revenues. As of December 31, 2012, our top ten USA segment customers accounted for 77% of segment accounts receivables and 63% of segment revenues. In our Brazil segment, our top ten customers accounted for 75% of segment accounts receivables and 57% of segment revenues

Although we continue to expand our customer base in an attempt to mitigate the concentration of customers, the loss of any one of these customers could have an adverse effect on our revenues and results of operations.

We may encounter difficulties in maintaining relationships with distributors and customers while enforcing our credit policies.

We define credit risk as the risk of loss from obligors or counterparty default. Our credit risks arise from both distributors and consumers. Many of these risks and uncertainties are beyond our control. Our ability to forecast future trends and spot shifts in consumer patterns or behavior even before they occur are vital for success in today's economy. In managing risk, our objective is to protect our profitability, but also protect, to the extent we can, our ongoing relationship with our distributors and customers. However, as part of our credit risk policies, we occasionally must, among other things, cancel certain accounts, reduce credit limits and place cash only requirements for certain questionable accounts. These credit risk policies may negatively impact our relationships with our distributors and customers, which could adversely affect our results of operations.

The inability of our significant customers to meet their obligations to us may adversely affect our financial results.

We are subject to credit risk due to concentration of our trade accounts receivables. As of December 31, 2012, two customers accounted for 42% of the $1.0 million in USA segment net accounts receivable. In our Brazil segment, one customer accounted for 30% of our $2.5 million net accounts receivable. The inability of our significant customers and obligors to meet their obligations to us, may adversely affect our financial condition and results of operations.

We rely upon a limited number of product offerings.

The majority of the products that we have sold through 2012 have been based on SRB produced at our US facilities and extracted rice bran oil from Irgovel. Although we will market SRB as a dietary supplement, as an active food ingredient in other companies' products, and in other ways, a decline in the market demand for our SRB products, as well as the products of other companies utilizing our SRB products, would have a significant adverse impact on us.

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We are dependent upon our marketing efforts.

We are dependent on our ability to market products to animal food producers, food manufacturers, mass merchandise and health food retailers, and to other companies for use in their products. We must increase the level of awareness of dietary supplements in general and our products in particular. We will be required to devote substantial management and financial resources to these marketing and advertising efforts and there can be no assurance that it will be successful. Further, because of our current cash position, we may face difficulties maintaining a sales force sufficient to effectively market our products as intended.

We rely upon an adequate supply of raw rice bran.

Many of our current products depend on our proprietary technology using raw rice bran, which is a by-product from milling paddy rice to white rice. Our ability to manufacture SRB is currently limited to the production capability of our production equipment at Farmers' Rice Co-operative and Archer Daniels Midland in California and our own plant located next to Louisiana Rice Mill in Mermentau, Louisiana. Along with our value-added product plants in Dillon, Montana and our facility in Pelotas, Brazil, we currently are capable of producing enough finished products to meet current demand. If demand for our products were to increase dramatically in the future, we would need additional production capacity.

There can be no assurance that we will continue to secure adequate sources of raw rice bran to meet our future demand. Since rice bran has a limited shelf life, the supply of rice bran is affected by the amount of rice planted and harvested each year. If economic or weather conditions adversely affect the amount of rice planted or harvested, the cost of rice bran products that we use may increase. We are not always able to immediately pass cost increases to our customers and any increase in the cost of SRB products could have an adverse effect on our results of operations.

We face competition.

Competition in our targeted industries, including nutraceuticals, functional food ingredients, rice bran oils, animal feed supplements and companion pet food ingredients is vigorous, with a large number of businesses engaged in the various industries. Many of our competitors have established reputations for successfully developing and marketing their products, including products that incorporate bran from other cereal grains and other alternative ingredients that are widely recognized as providing similar benefits as rice bran. In addition, many of our competitors have greater financial, managerial, and technical resources than us. If we are not successful in competing in these markets, we may not be able to attain our business objectives.

We must comply with our contractual obligations.

We have numerous ongoing contractual obligations under various purchase, sale, supply, production and other agreements which govern our business operations. We also have contractual obligations which require ongoing payments such as various debt agreements and lease obligations and the agreement of Irgovel to pay tax obligations to the Brazilian government. While we seek to comply at all times with these obligations, there can be no assurance that we will be able to comply with the terms of all contracts during all periods of time, especially if there are significant changes in market conditions or our financial condition. If we are unable to comply with our material contractual obligations, there likely would be a material adverse affect on our financial condition and results of operations.

We have a high concentration of credit risk.

We currently depend on a limited number of customers. This results in a concentration of credit risk with respect to our outstanding accounts receivable. We consider the financial strength of the customer, the remoteness of the

possible risk that a default event will occur, the potential benefits to our future growth and development, possible actions to reduce the likelihood of a default event and the benefits from the transaction before entering into a large credit limit for a customer. Although we analyze these factors, there can be no assurance that the ultimate collection of the obligation from the customer will occur. Although we continue to expand our customer base in an attempt to mitigate the concentration of credit risk, the writing off of an accounts receivable balance could have an adverse effect on our results of operations. Financial instruments that potentially subject us to concentration of credit risk consist primarily of cash and cash equivalents and trade receivables. Historically, we have not experienced any loss of our cash and cash equivalents, but we have experienced losses to our trade receivables.

Our products could fail to meet applicable regulations which could have a material adverse affect on our financial performance.

The dietary supplement and cosmetic industries are subject to considerable government regulation, both as to efficacy as well as labeling and advertising. There is no assurance that all of our products and marketing strategies will satisfy all of the applicable regulations of the Dietary Supplement, Health and Education Act, the Federal Food, Drug and Cosmetic Act, the U.S. Food and Drug Administration and/or the U.S. Federal Trade Commission. Failure to meet any applicable regulations would require us to limit the production or marketing of any non-compliant products or advertising, which could subject us to financial or other penalties.

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We may be subject to product liability claims and product recalls.

We sell food and nutritional products for animal and human consumption, which involves risk such as product contamination or spoilage, product tampering and other adulteration of food products. We may be subject to liability if the consumption of any of our products causes injury, illness or death. In addition, we may voluntarily recall products in the event of contamination or damage. A significant product liability judgment or a widespread product recall may cause a material adverse affect on our financial condition. Even if a product liability claim is unsuccessful, there may be negative publicity surrounding any assertion that our products caused illness or injury which could adversely affect our reputation with existing and potential customers.

Many of the risks of our business have only limited insurance coverage and many of our business risks are uninsurable.

Our business operations are subject to potential product liability, environmental, fire, employee, manufacturing, shipping and other risks. Although we have insurance to cover some of these risks, the amount of this insurance is limited and includes numerous exceptions and limitations to coverage. Further, no insurance is available to cover certain types of risks, such as acts of God, war, terrorism, major economic and business disruptions, and similar events. In the event we were to suffer a significant uninsured claim, our financial condition would be materially and adversely affected.

Our success depends in part on our ability to obtain patents, licenses and other intellectual property rights for our products and technology.

Our success is dependent upon our ability to protect the patents, trade secrets and trademarks that we have and to develop new patents and trademarks for future processes, machinery, compounds and products that we develop. The process of seeking patent protection may be long and expensive, and there can be no assurance that patents will be issued, that we will be able to protect our technology adequately, or that competition will not be able to develop similar technology.

There currently are no claims or lawsuits pending or threatened against us regarding possible infringement claims, but there can be no assurance that infringement claims by third parties, or claims for indemnification resulting from infringement claims, will not be asserted in the future or that such assertions, if proven to be accurate, will not have a material adverse affect on our business, financial condition and results of operations. In the future, litigation may be necessary to enforce our patents, to protect our trade secrets or know-how or to defend against claimed infringement of the rights of others and to determine the scope and validity of the proprietary rights of others. Any litigation could result in substantial cost and diversion of our efforts, which could have a material adverse affect on our financial condition and results of operations. Adverse determinations in any litigation could result in the loss of our proprietary rights, subjecting us to significant liabilities to third parties, require us to seek licenses from third parties or prevent us from manufacturing or selling our systems, any of which could have a material adverse affect on our financial condition and results of operations. There can be no assurance that a license under a third party's intellectual property rights will be available to us on reasonable terms, if at all.

We are dependent on key employees and consultants.

Our success depends upon the efforts of our top management team, including the efforts of John Short (Chief Executive Officer), Dale Belt (Chief Financial Officer), Dave Hutchinson (Senior Vice President of Operations), Robert Smith, PhD (Senior Vice President of Business Development) and Colin Garner (Senior Vice President of Sales and Marketing). Although we have written employment agreements with our CEO and CFO, there is no assurance that such individuals will not die, become disabled, or resign. In addition, our success is dependent upon

our ability to attract and retain key management persons for positions relating to the marketing and distribution of our products. There is no assurance that we will be able to recruit and employ such executives at times and on terms acceptable to us.

Our products may require clinical trials to establish efficacy and safety.

Certain of our products may require clinical trials to establish our benefit claims or their safety and efficacy. Such trials can require a significant amount of resources and there is no assurance that such trials will be favorable to the claims we make for our products, or that the cumulative authority established by such trials will be sufficient to support our claims. Moreover, both the findings and methodology of such trials are subject to challenge by the FDA and scientific bodies. If the findings of our trials are challenged or found to be insufficient to support our claims, additional trials may be required before such products can be marketed.

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Risks Related to Our Stock

Our Stock Price is Volatile.

The market price of our common stock has fluctuated significantly in the past and may continue to fluctuate significantly in the future. Our common stock trades on the OTCQB. Our common stock is thinly traded and subject to volatility in price and demand. The high and low closing sales prices of our common stock for the following periods were:

| | Low | High |
|---|---|---|
| Year Ended December 31, 2012 | | |
| Fourth Quarter | $ 0.05 | $ 0.08 |
| Third Quarter | 0.04 | 0.08 |
| Second Quarter | 0.06 | 0.15 |
| First Quarter | 0.11 | 0.15 |
| | | |
| Year Ended December 31, 2011 | | |
| Fourth Quarter | $ 0.10 | $ 0.20 |
| Third Quarter | 0.13 | 0.19 |
| Second Quarter | 0.16 | 0.31 |
| First Quarter | 0.18 | 0.38 |

The market price of a share of our common stock may continue to fluctuate in response to a number of factors, including:

- announcements of new products or product enhancements by us or our competitors;
- fluctuations in our quarterly or annual operating results;
- developments in our relationships with customers and suppliers;
- our ability to obtain financing;
- the loss of services of one or more of our executive officers or other key employees;
- announcements of technological innovations or new systems or enhancements used by us or our competitors;
- developments in our or our competitors' intellectual property rights;
- adverse effects to our operating results due to impairment of goodwill;
- failure to meet the expectation of securities analysts' or the public;
- general economic and market conditions;
- our ability to expand our operations, domestically and internationally;
- the amount and timing of expenditures related to any expansion;
- litigation involving us, our industry or both;
- actual or anticipated changes in expectations by investors or analysts regarding our performance; and
- price and volume fluctuations in the overall stock market from time to time.

In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been brought against that company. Our stock price is volatile and we have been the target of securities litigation. Any securities litigation brought against us in the future could result in substantial costs and divert our management's attention and resources from our business. In addition, volatility, lack of positive performance in our stock price or changes to our overall compensation program, including our equity incentive program, may adversely affect our ability to retain key employees.

We have significant “equity overhang” which could adversely affect the market price of our common stock and impair our ability to raise additional capital through the sale of equity securities.

As of March 15, 2013, we had 209,378,597 shares of common stock outstanding. Additionally, as of March 15, 2013, approximately 289,179,802 shares of our common stock were issuable upon exercise or conversion of outstanding options, warrants and convertible debt. The possibility that substantial amounts of our outstanding common stock may be sold by investors or the perception that such sales could occur, often called “equity overhang,” could adversely affect the market price of our common stock and could impair our ability to raise additional capital through the sale of equity securities in the future.

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Our outstanding options, warrants and convertible notes may dilute current shareholders.

As of March 15, 2013, there were outstanding options, warrants and convertile="DISPLAY: inline; FONT-FAMILY: times new roman; FONT-SIZE: 10pt">

11,440

Common stock issued for services
$0.138 per share – January 13, 2011

--

--

452,900

453

62,047

--

--

--

62,500

$0.137 per share – January 27, 2011

--

--

325,000

325

44,200

--

--

--

44,525

$0.135 per share – March 9, 2011

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | | -- |
| | | | | | | | | -- |
| | | | | | | | | 2,000,000 |
| | | | | | | | | 2,000 |
| | | | | | | | | 268,000 |
| | | | | | | | | -- |
| | | | | | | | | -- |
| | | | | | | | | -- |
| | | | | | | | | 270,000 |
| $0.135 per share – March 21, 2011 | | | | | | | | |
| | | | | | | | | -- |
| | | | | | | | | -- |
| | | | | | | | | 2,000,000 |
| | | | | | | | | 2,000 |
| | | | | | | | | 268,000 |
| | | | | | | | | -- |
| | | | | | | | | -- |
| | | | | | | | | -- |
| | | | | | | | | 270,000 |
| Accrued interest | | | | | | | | |
| | | | | | | | | -- |
| | | | | | | | | -- |
| | | | | | | | | -- |
| | | | | | | | | -- |
| | | | | | | | | -- |
| | | | | | | | | -- |

(4,988
)

--

(4,988
)

Debt Discount

--

--

--

--

103,132

--

--

--

103,132

Amortization of warrants and options for employees and non-employees

4,050

4,050

Net loss

--

--

--

--

--

--

(1,331,341
)

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | (1,331,341 ) |
| BALANCE – March 31 2011 | | | | | | | | | |
| | | | | | | | | | 184,144 |
| $ | | | | | | | | | 184 |
| | | | | | | | | | 327,240,037 |
| $ | | | | | | | | | 327,239 |
| $ | | | | | | | | | 38,213,954 |
| $ | | | | | | | | | (5,768 ) |
| $ | | | | | | | | | (395,496 ) |
| $ | | | | | | | | | (40,168,065 ) |
| $ | | | | | | | | | (2,027,952 ) |

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

PureSafe Water Systems Inc. and Subsidiary
(A Development Stage Company Commencing January 1, 2002)
Consolidated Statements of Cash Flows
(unaudited)

| | Three Months Ended March 31, | | For the Period From January 1, 2002 through March 31, 2011 |
|---|---|---|---|
| Cash Flows from Operating Activities: | 2011 | 2010 | |
| Net loss | $ (1,331,341) | (1,095,507) | $ (25,636,469) |
| Adjustments to reconcile net loss to net cash used in operating activities - | | | |
| Loss on Sale of Property and Equipment | -- | -- | 8,177 |
| Depreciation and amortization | 21,231 | 5,450 | 96,221 |
| Amortization of patents and trademarks | 1,526 | 1,526 | 29,752 |
| Interest expense - amortization of deferred financing | -- | -- | 22,530 |
| Stock based compensation | 651,075 | 496,917 | 4,933,153 |
| Interest expense - conversion provision | -- | -- | 113,000 |
| Interest receivable | (4,988) | (5,058) | (58,296) |
| Accretion of debt discount | 75,515 | 55,582 | 1,228,858 |
| Change in fair value of warrants and embedded conversion option | -- | 25,500 | 2,157,249 |
| (Gain)/loss on settlement of debt | -- | -- | 1,888,926 |
| Non-dilution agreement termination cost | -- | -- | 2,462,453 |
| Inventory reserve | -- | -- | 159,250 |
| Write-off of stock subscription receivable | -- | -- | 21,800 |
| Financing costs - warrant extension | -- | -- | 74,700 |
| Change in assets and liabilities - | | | |
| Prepaid expenses and other current assets | (18,204) | 64,140 | (49,657) |
| Inventories | (64,309) | (121,653) | (507,124) |
| Other assets | -- | -- | (27,861) |
| Accounts payable, accrued expenses, accrued dividends, accrued compensation, accrued consulting and director fees, customer deposits and other current liabilities | 93,570 | 249,058 | 3,276,079 |
| Net Cash Used in Operating Activities | (575,925) | (324,045) | (9,807,259) |
| | | | |
| Cash Flows from Investing Activities: | | | |
| Purchase of property and equipment | -- | (9,656) | (288,689) |
| Patent costs | (7,400) | -- | (73,829) |
| Proceeds from sale of property & equipment | -- | -- | 4,350 |
| Net Cash Used in Investing Activities | (7,400) | (9,656) | (358,168) |
| | | | |
| Cash Flows from Financing Activities: | | | |
| Reduction of stock subscription receivable | -- | -- | 65,700 |
| Proceeds from sale of preferred stock | -- | -- | 1,130,127 |
| Proceeds from sale of common stock | 100,000 | 100,000 | 5,793,999 |
| Proceeds from exercise of warrants | 42,922 | -- | 547,269 |

| | | | |
|---|---|---|---|
| Proceeds from sale of common stock to be issued | -- | -- | 300,000 |
| Deferred financing costs | -- | -- | (22,530) |
| Proceeds from convertible promissory note | 100,000 | 175,000 | 1,870,000 |
| Proceeds from officers and directors convertible loans | 225,000 | -- | 975,000 |
| Repayment of officers and directors loans | -- | -- | (200,000) |
| Repayment of notes payable | (1,497) | -- | (279,791) |
| Net Cash Provided by Financing Activities | 466,425 | 275,000 | 10,179,774 |
| | | | |
| Net increase (decrease) in cash | (116,900) | (58,701) | 14,347 |
| | | | |
| Cash at beginning of period | 166,758 | 107,423 | 35,511 |
| | | | |
| Cash at end of period | 49,858 | 48,722 | 49,858 |
| | | | |
| Supplemental Disclosure of Cash Flow Information: | | | |
| Cash paid during the year for interest | 4,555 | 335 | 395,139 |
| | | | |
| Non-Cash Investing Activities: | | | |
| Notes Receivable for common stock issued | | -- | |
| | | | |
| Non-Cash Financing Activities: | | | |
| Compensation satisfied by issuance of common stock | -- | 84,000 | 229,250 |
| Common stock issued in satisfaction of liabilities | 121,842 | 144,615 | 8,095,792 |
| Reclassification of derivative liabilities | -- | -- | 3,645,166 |
| Reclassification of equity instrument to derivative liabilities | -- | (80,000) | 48,600 |
| Cancellation of debt for no consideration | -- | -- | 1,327,321 |
| Debt discount for conversion and warrant rights | 103,132 | -- | 103,132 |

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

PureSafe Water Systems Inc. and Subsidiary
(A Development Stage Company Commencing January 1, 2002)
Notes to Condensed Consolidated Financial Statements
(Unaudited)

NOTE 1: DESCRIPTION OF BUSINESS.

PureSafe Water Systems, Inc. (the "Company") is a Delaware corporation engaged in the design, development, manufacturing and sales of the PureSafe™ First Response Water System (the “FRWS”), both within and outside of the United States. The Company's corporate headquarters and factory are located in Plainview, New York.

NOTE 2: BASIS OF PRESENTATION AND ACCOUNTING POLICIES.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information. Accordingly, these interim financial statements do not include all of the information and footnotes required for annual financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary to make the financial statements not misleading have been included.

The operating results for the three month period ended March 31, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. These financial statements should be read in conjunction with the financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010, filed with the Securities and Exchange Commission on April 15, 2011.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period.

Management bases its estimates on historical experience and on various assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. The most significant estimates, among other things, are used in accounting for allowances for deferred income taxes, expected realizable values for long-lived assets (primarily intangible assets and property and equipment), contingencies, as well as the recording and presentation of its common stock. Estimates and assumptions are periodically reviewed and the effects of any material revisions are reflected in the consolidated financial statements in the period that they are determined to be necessary. Actual results could differ from those estimates and assumptions.

Principles of Consolidation

The consolidated financial statements of PureSafe Water Systems, Inc. include accounts of the Company and its wholly-owned subsidiary, PureSafe Manufacturing and Research Corporation. Intercompany transactions and balances are eliminated in consolidation.

Inventories

Inventory amounts are stated at lower of first-in, first-out ("FIFO") cost or market.

Stock-Based Compensation

The Company reports stock-based compensation under Accounting Standard Codification ("ASC") 718 "Compensation – Stock Compensation". ASC 718 requires all share-based payments to employees, including grants of employee stock options, to be recognized in the consolidated financial statements based on their fair values.

The Company accounts for equity instruments issued to non-employees as compensation in accordance with the provisions of ASC 718, which require that each such equity instrument is recorded at its fair value on the measurement date, which is typically the date the services are performed.

The Black-Scholes option valuation model is used to estimate the fair values of options. The model includes subjective input assumptions that can materially affect the fair value estimates. The model was developed for use in estimating the fair value of traded options or warrants. The expected volatility is estimated based on the most recent historical period of time equal to the weighted average life of the subject options or warrants.

NOTE 3: GOING CONCERN.

The accompanying unaudited condensed consolidated financial statements have been prepared assuming that the Company will continue as a going concern. The Company has incurred recurring losses from operations, has an accumulated deficit since its inception of approximately $40,168,000 and $38,837,000 as of March 31, 2011 and December 31, 2010, respectively, and has a working capital deficiency of approximately $2,319,000 and $2,021,000 as of March 31, 2011 and December 31, 2010, respectively. These conditions raise substantial doubt about the Company's ability to continue as a going concern.

The Company’s plans with respect to these matters include restructuring its existing debt and raising additional capital through future issuances of stock and/or debt. The Company is seeking to raise an additional $5 million in the next twelve months to fund the following activities: to manufacture 45 commercialized PureSafe FRWS units within the next twelve months; to expand production capability by increasing the inventory level of components used in the manufacturing process; by re-engineering the assembly process and outsourcing production where appropriate; continue to implement our established marketing program, to establish a sales and marketing network which includes hiring a Vice President of Sales. Provided the Company obtains such financing, the Company believes that there will be revenue recognition by the third quarter of 2011.

For the first two quarters of 2011, management’s main focus is to produce PureSafe FRWS standardized commercial units and continue our marketing plan including participation in tradeshows, concluding agreements with strategic partners for international marketing and manufacturing, entering field testing programs for PureSafe FRWS unit. The Company expects to recognize the first sales of the PureSafe FRWS by the third quarter of 2011. The Company will cease being a development stage enterprise when it recognizes significant revenue from the sale of PureSafe FRWS units. The extent of these initiatives will be contingent upon the amount of capital raised.

The Company can give no assurance that such financing will be available on terms advantageous to us, or at all. Should the Company not be successful in obtaining the necessary financing to fund its operations, the Company would need to curtail certain or all of its operational activities. The accompanying unaudited condensed consolidated financial statements do not include any adjustments that might be necessary should the Company be unable to continue as a going concern.

NOTE 4: RECENT ACCOUNTING PRONOUNCEMENTS.

Recent accounting pronouncements issued by the FASB and the SEC did not have, or are not believed by management to have, a material impact on the Company's present or future consolidated financial statements.

NOTE 5 – INVENTORIES

Inventories consist of the following at March 31, 2011,

| | |
|---|---|
| Raw materials | $254,614 |
| Finished Goods | 252,510 |
| Total | $507,124 |

NOTE 6: NET LOSS PER SHARE OF COMMON STOCK.

Basic loss per share was computed using the weighted average number of outstanding common shares. Diluted loss per share includes the effect of dilutive common stock equivalents from the assumed exercise of options, warrants,

convertible preferred stock and convertible notes. Common stock equivalents were excluded in the computation of diluted loss per share since their inclusion would be anti-dilutive.

In accordance with ASC 260 “Earnings per Share”, the Company has given effect to the issuance of 847,461 warrants exercisable at $0.001 issued by the Company. These warrants have been included in computing the basic net loss per share for the three months period ended March 31, 2011.

Total shares issuable upon the exercise of warrants and conversion of preferred stock and convertible promissory notes for the three months ended March 31, 2011 and 2010 were as follows:

| | March 31, | |
|---|---|---|
| | 2011 | 2010 |
| Warrants | 27,705,817 | 39,103,516 |
| Convertible promissory notes | 11,702,778 | 13,857,904 |
| Convertible preferred stock | 1,545,760 | 1,545,760 |
| Total | 40,954,355 | 54,507,180 |

NOTE 7: STOCKHOLDERS' DEFICIENCY.

Debt

During the three months ended March 31, 2011, the Company issued total 1,998,343 shares of common stock upon the requests from three convertible note holders to convert their notes plus accrued interest totaling $110,402 into the Company’s common stock based on the term set forth in the loan. The conversion rates were from $0.055 to $0.056.

On January 25, 2011, the Company issued 86,670 shares of common stock to a former consultant in settlement of accrued compensation of $11,440 pursuant to the settlement agreement the Company entered with the consultant on December 29, 2010.

Cash

Through Equity Financing:
During the three months ended March 31, 2011, for gross proceeds of $100,000 the Company sold an aggregate of 708,465 shares of common stock and warrants to purchase additional 141,694 shares of common stock at exercise prices from $0.1648 to $0.1740. The warrants have a term of three years and were fully vested on the grant date.

Through Warrant Exercise
During the three months ended March 31, 2011, the Company received gross proceeds of $42,922 through warrant exercise. The Company issued aggregate of 641,933 shares of common stock in connection with warrant exercises.

Through Debt Financing
During the three months ended March 31, 2011, the Company received gross proceeds of $100,000 through debt financing. The Company issued the lender a convertible promissory note bearing interest at a rate of 10% per annum with a term of one year. In connection with the placement, the Company also issued a warrant to purchase 127,389 shares of common stock at an exercise price of $0.1884. The warrants have a term of five years and were fully vested on the grant date.

Services

On January 13, 2011, the Company issued a total of 452,900 shares of common stock to its five directors, including shares issued to the Chief Executive Officer and Chief Financial Officer, each of which received 90,580 shares for their first quarter of 2011 director fees. The issuance is part of the annual compensation that was authorized by the Company’s Board of Directors on May 26, 2010, when the Board approved the annual director fees to be $50,000, paid in shares of common stock, payable quarterly, and valued at the beginning of each quarter. The Company incurred stock-based compensation of $62,500 in connection with the January 2011 issuance.

On January 27, 2011, the Company issued an aggregate 325,000 shares of common stock to multiple employee and contractors per grant that was approved by the Company's Board of Directors on January 24, 2011. The shares were fully vested on the date of the grant and accordingly, Company recorded $44,525 of stock-based compensation in connection with this issuance.

On March 9, 2011, the Company issued 2,000,000 shares of common stock to the Company's Chief Financial Officer per grant that was approved by the Company's Board of Directors on January 21, 2011. The shares were fully vested on the date of the grant and accordingly, the Company recorded $270,000 of stock-based compensation in connection with this issuance.

On March 21, 2011, the Company issued 2,000,000 shares of common stock to the Company's Chief Executive Officer per grant that was approved by the Company's Board of Directors on January 21, 2011. The shares were fully vested on the date of the grant and accordingly, the Company recorded $270,000 of stock-based compensation in connection with this issuance.

NOTE 8 - CONVERTIBLE PROMISSORY NOTES PAYABLE

(a) On February 7, 2011, the Company's Chief Executive Officer and the Company's Chief Financial Officer each made loans of $50,000 to the Company. The loans accrue interest at the rate of 10% per annum. In addition, the Company issued warrants to each officer to purchase 89,928 shares of common stock at an exercise price of $0.139 per share. The loans are due and payable by or on February 7, 2012. The loan and accrued interest are to be paid on the maturity date. The loans were evidenced by the promissory notes the Company issued to the two officers which each contain a conversion clause that allow the officers at the officer's sole option to convert the loan amount plus all accrued and unpaid interest due under the note into common stock. The conversion price was set at $0.139 per share, which was the closing market price of the common stock as of the closing date of the loans.

The gross proceeds from the sale of the notes $100,000 were recorded net of a discount of $33,612. The debt discount is being charged to interest expense ratably over the term of the convertible notes.

(b) On February 14, 2011, the Company sold and issued a convertible promissory note in the principal amount of $100,000 bearing interest at 10% per annum and warrants to purchase 127,389 shares of common stock at an exercise price of $0.1884 per share. The convertible note matures on February 14, 2012. The holder of the note is entitled to convert all or a portion of the convertible note plus any unpaid interest, at the lender's sole option, into shares of common stock at a conversion price of $0.157 per share.

The gross proceeds from the sale of the note $100,000 was recorded net of a discount of $27,438. The debt discount is being charged to interest expense ratably over the term of the convertible note.

(c) On March 16, 2011, the Company's Chief Financial Officer made a loan of $85,000 to the Company. The loan accrues interest at the rate of 10% per annum. In addition, the Company issued warrants to purchase 174,180 shares of common stock at an exercise price of $0.122 per share. The loan is due and payable by or on March 16, 2012. The loan and accrued interest are to be paid on the maturity date. The loan is evidenced by the promissory note the Company issued to the officer which contains a conversion clause that allow the officer at the officer's sole option to convert the loan amount plus all accrued and unpaid interest due under the note into common stock. The conversion price was set at $0.122 per share, which was the closing market price of the common stock as of the closing date of the loans.

The gross proceeds from the sale of the notes $85,000 were recorded net of a discount of $28,610 The debt discount is being charged to interest expense ratably over the term of the convertible notes.

(d) On March 28, 2011, the Company's Chief Financial Officer made a loan of $40,000 to the Company. The loan pays interest monthly at the rate of 10% per annum. In addition, the Company issued warrants to purchase 83,333 shares of common stock at an exercise price of $0.12 per share. The loan is due and payable by or on March 28, 2012. The loan and accrued interest are to be paid on the maturity date. The loan is evidenced by the promissory note the Company issued to the officer which contains a conversion clause that allow the officer at the officer's sole option to convert the loan amount plus all accrued and unpaid interest due under the note into common stock. The conversion price was set at $0.12 per share, which was the closing market price of the common stock as of the closing date of the loans.

The gross proceeds from the sale of the notes $40,000 were recorded net of a discount of $13,472. The debt discount is being charged to interest expense ratably over the term of the convertible notes.

NOTE 9: RELATED PARTY TRANSACTIONS.

(a) On January 13, 2011, the Company issued a total of 452,900 shares of common stock to its five directors, including shares issued to the Chief Executive Officer and Chief Financial Officer, each of which received 90,580 shares for their first quarter of 2011 director fees. The issuance is part of the annual compensation that was authorized by the Company's Board of Directors on May 26, 2010, when the Board approved the annual director fees to be $50,000, paid in shares of common stock, payable quarterly, and valued at the beginning of each quarter. The Company incurred stock-based compensation of $62,500 in connection with the January 2011 issuance.

(b) On March 9, 2011, the Company issued 2,000,000 shares of common stock to the Company's Chief Financial Officer per grant that was approved by the Company's Board of directors on January 21, 2011. The shares were fully vested on the date of the grant and accordingly, the Company recorded $270,000 of stock-based compensation in connection with this issuance.

(c) On March 21, 2011, the Company issued 2,000,000 shares of common stock to the Company's Chief Executive Officer per grant that was approved by the Company's Board of directors on January 21, 2011. The shares were fully vested on the date of the grant and accordingly, the Company recorded $270,000 of stock-based compensation in connection with this issuance.

(d) On February 7, 2011, the Company's Chief Executive Officer and the Company's Chief Financial Officer each made loans of $50,000 to the Company. The loans accrue interest at the rate of 10% per annum. In addition, the Company issued warrants to each officer to purchase 89,928 shares of common stock at an exercise price of $0.139 per share. The loans are due and payable by or on February 7, 2012. The loan and accrued interest are to be paid on the maturity date. The loans were evidenced by the promissory notes the Company issued to the two officers which each contain a conversion clause that allow the officers at the officer's sole option to convert the loan amount plus all accrued and unpaid interest due under the note into common stock. The conversion price was set at $0.139 per share, which was the closing market price of the common stock as of the closing date of the loans.

The gross proceeds from the sale of the notes $100,000 were recorded net of a discount of $33,612. The debt discount is being charged to interest expense ratably over the term of the convertible notes.

(e) On March 16, 2011, the Company's Chief Financial Officer made a loan of $85,000 to the Company. The loan accrues interest at the rate of 10% per annum. In addition, the Company issued warrants to purchase 174,180 shares of common stock at an exercise price of $0.122 per share. The loan is due and payable by or on March 16, 2012. The loan and accrued interest are to be paid on the maturity date. The loan is evidenced by the promissory note the Company issued to the officer which contains a conversion clause that allow the officer at the officer's sole option to convert the loan amount plus all accrued and unpaid interest due under the note into common stock. The conversion price was set at $0.122 per share, which was the closing market price of the common stock as of the closing date of the loans.

The gross proceeds from the sale of the notes $85,000 were recorded net of a discount of $28,610 The debt discount is being charged to interest expense ratably over the term of the convertible notes.

(f) On March 28, 2011, the Company's Chief Financial Officer made a loan of $40,000 to the Company. The loan pays interest monthly at the rate of 10% per annum. In addition, the Company issued warrants to purchase 83,333 shares of common stock at an exercise price of $0.12 per share. The loan is due and payable by or on March 28, 2012. The loan and accrued interest are to be paid on the maturity date. The loan is evidenced by the promissory note the Company issued to the officer which contains a conversion clause that allow the officer at the officer's sole option to convert the loan amount plus all accrued and unpaid interest due under the note into common stock. The conversion price was set at $0.12 per share, which was the closing market price of the common stock as of the closing date of the loans.

The gross proceeds from the sale of the notes $40,000 were recorded net of a discount of $13,472. The debt discount is being charged to interest expense ratably over the term of the convertible notes.

NOTE 10: LEGAL PROCEEDINGS.

Current legal proceedings to which the Company is a party are as follows:

On June 21, 2009 the Company was served with a complaint filed in the Supreme Court of the State of New York, County of Nassau, in which suit State Farm Fire & Casualty Company is the plaintiff. The suit is for approximately $202,000 in damages, resulting from a fire that occurred on or about December 16, 2008, allegedly as a result of a defective water cooler sold either by the Company or by Water Splash LLC, to which the Company had sold its water cooler business and related liabilities in November 2001. An amended complaint was filed on August 19, 2009, adding Water Splash LLC as a defendant. The claim by State Farm is on the basis that, as the insurance carrier, it is subrogated to the claim for damages of the owner of the property where the fire allegedly started by reason of a defect in the water cooler. Under the complaint, alternative claims for damages are made in negligence, breach of warranty, placing on the market a product in a defective and unreasonably dangerous condition and not fit for its intended use, failure to warn State Farm's subragor of the risks and defects associated with the water cooler which were not discoverable by reasonable inspection, and strict liability. As of April 29, 2011, the Company does not believe that it has any potential exposure by reason of this lawsuit and, in any event, any recovery by the plaintiff would be covered under the existing liability insurance policy. However, the Company cannot provide assurance that the outcome of this matter will not have a material effect on the Company's financial condition or results of operations.

In addition to the above, the Company may be involved in legal proceedings in the ordinary course of business. Such matters are subject to many uncertainties, and outcomes are not predictable with assurance.

NOTE 11: SUBSEQUENT EVENTS.

(a)

From April 1 through May 18, 2011, for gross proceeds of $167,000 the Company sold an aggregate of 1,828,935 shares of common stock and warrants to purchase an additional 457,228 shares of common stock at an exercise price of $0.1032 to $0.1152. The warrants have a term of three years and were fully vested on the grant date.

(b) On April 26, 2011, the Company received gross proceeds of $12,000 through warrant exercise. The Company issued aggregate of 175,941 shares of common stock in connection with warrant exercises.

(c) On April 28, 2011, the Company issued a total of 558,035 shares of common stock to its five directors, including shares issued to the Chief Executive Officer and Chief Financial Officer, each of which received 111,607 shares for their second quarter of 2011 director fees. The issuance is part of the annual compensation that was authorized by the Company's Board of Directors on May 26, 2010, when the Board approved the annual director fees to be $50,000, paid in shares of common stock, payable quarterly, and valued at the beginning of each quarter. The Company incurred stock-based compensation of $62,500 in connection with the April 2011 issuance.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Introductory Comment

The following Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our financial statements and related notes contained elsewhere in this Quarterly Report on Form 10-Q, as well as our audited financial statements and related notes at and for the year ended December 31, 2010 contained in our Annual Report on Form 10-K for the year ended December 31, 20010 filed with the Securities and Exchange Commission (the "SEC") on April 15, 2011.

Note Regarding Forward-Looking Statements

This quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934 (the "Exchange Act"). To the extent that any statements made in this Form 10-Q contain information that is not historical, these statements are essentially forward-looking. Forward-looking statements can be identified by the use of words such as "anticipate," "believe," "continue," "could," "estimate" "expect," "hope," "intend," "may," "plan," "potential," "product," "would" and variations of such words. Forward-looking statements are subject to risks and uncertainties that cannot be predicted or quantified and, consequently, actual results may differ materially from those expressed or implied by such forward-looking statements. Such risks and uncertainties include, without limitation:

- our ability to raise capital to finance our research and development and operations, when needed and on terms advantageous to us;
- our ability to manage growth, profitability and marketability of our products;
- general economic and business conditions;
- the effect on our business of recent credit-tightening throughout the United States and the world, especially with respect to federal, state, local and foreign government procurement agencies, as well as quasi-public, charitable and private emergency response organizations;
- the effect on our business of recently reported losses within the financial, banking and other industries and the effect of such losses on the income and financial condition of our potential clients;
- the impact of developments and competition within the industries in which we intend to compete
- adverse results of any legal proceedings;
- the impact of current, pending or future legislation and regulation on water safety, including, but not limited to, changes in zoning and environmental laws and regulations within our target areas of operations;
- our ability to maintain and enter into relationships with suppliers, vendors and contractors of acceptable quality of goods and services on terms advantageous to us;
- the volatility of our operating results and financial condition;
- our ability to attract and retain qualified senior management personnel; and
- the other risks and uncertainties detailed in this Form 10-Q and, from time to time, in our other filings with the Securities and Exchange Commission.

Readers of this Report on Form 10-Q should carefully consider such risks, uncertainties and other information, disclosures and discussions which contain cautionary statements identifying important factors that could cause our actual results to differ materially from those provided in forward-looking statements. Readers should not place undue reliance on forward-looking statements contained in this Form 10-Q. We do not undertake any obligation to publicly update or revise any forward-looking statements we may make in this Form 10-Q or elsewhere, whether as a result of new information, future events or otherwise.

General

PureSafe Water Systems, Inc. (herein referred to as the “Company”, “Puresafe”, “we”, “us” or “our”) was incorporated in Delaware in 1987. The manufacture and marketing of water coolers and filters constituted a substantial part of our business from 1993 until the fourth quarter of 2001, at which time such operations were sold and we began concentrating on the further development, manufacturing and marketing of a patented line of water purification systems. We have generated nominal revenues since we sold our water coolers and filters operations. Accordingly, we are deemed for accounting purposes to be a development stage enterprise since January 1, 2002 and are subject to a number of risks similar to those of other companies in an early stage of development. The accompanying consolidated financial statements have been prepared assuming our company will continue as a going concern.

Results of Operations

Sales. We recorded zero sales for the three months ended March 31, 2011 and 2010.

Until the fourth quarter of 2001, we were engaged in the manufacture and marketing of water coolers and water purification and filtration products. In the fourth quarter of 2001, such business was sold so that we could concentrate on the further development, manufacturing and marketing of a line of water purification systems. In 2007, new management made a strategic decision that the existing water filtration system had not produced any significant sales. New management further recognized that the existing unit required significantly more engineering. In 2007, we signed a contract with Bircon Ltd., an Israeli-based engineering consulting company, to design our new "PureSafe First Response Water System" (the "PureSafe FRWS") line of water decontamination systems. In September 2009, we set up PureSafe Manufacturing & Research Corporation, a Delaware corporation that is wholly owned subsidiary of PureSafe Water Systems, Inc., to handle the production and research. In 2010, we made significant modifications on our PSWS unit and standardized the design and manufacturing process. The first two commercialized units were completed in the fourth quarter of 2010. We are currently in the process of building three more units. We believe the PureSafe FRWS product will result in our first significant sales since 2001. We currently expect to recognize the first sales of the PureSafe product in the third quarter of 2011. We will cease being a development stage enterprise at the time of our recognition of significant revenue from sales of the PureSafe FRWS product.

Cost of sales. We recorded zero cost of sales for the three months ended March 31, 2011 and 2010.

Selling, general and administrative. We incurred selling, general and administrative expenses for the three months ended March 31, 2011 $1,171,826 compared to $934,246 for the same period in 2010, a $237,580 or 25% increase. The following is a more detailed analysis on some of the categories that have the most significant changes. Legal fees incurred in the first quarter of 2011 were $27,852, compared to $16,694 in 2010, a $11,158 or 67% increase. The 67% increase in legal fees is attributable to more legal services required in 2011 due to the expansion of operations. Manufacturing overhead incurred in the first quarter of 2011 was $78,578, compared to $65,616 in 2010, a $12,962 or 20% increase. The reason for the $12,962 increase in Manufacturing overhead is the utility cost incurred from our 160 Dupont facility of which we took possession in July 2010. The difference between marketing expense incurred in the first quarter of 2011 and 2010 is very small, though the consulting sector in overall marketing expense has decreased by $49,833 from $69,000 in the first quarter of 2010 to $19,167 in the same period of 2011 due to the termination of the Management agreement between PureSafe and Hidell International, Inc. on December 29, 2010. The funds saved from marketing consulting services were utilized to fund other marketing programs, including participation in the United Nations's World Water Day.

Rent expense incurred in the first quarter of 2011 was $39,250, compared to $22,126 in the same period of 2010, a $17,124 or 77% increase. On May 24, 2010, effective July 1, 2010, the Company entered into a two-year lease in Plainview, New York. The rent related expense in connection with our Dupont Street facility was $21,607.

Total salaries expense, including deferred compensation, was $136,786 for the first quarter of 2011 compared to $107,555 in the same period of 2010, an increase of $29,231 or 27%. The $29,231 increase in salaries in 2011 is the result of the hiring of our new Chief Operating Officer in January 2011. Stock based compensation increased to $651,075 in the first quarter of 2011 from $496,917 in the same period of 2010, an increase of $154,158 or 31% , which includes Directors' fee incurred in the first quarter of 2011 of $62,500 as compared with $2,000 in the same period of 2010, a $60,500 or 3,025% increase. We retained two independent directors in June 2010 and revised the directors' compensation schedule from $2,000 per year to $50,000 per year in May 2010 effective July 1, 2010. We awarded approximately 2 million shares less to employees and various consultants which included our Chief Executive Officer and Chief Financial Officer in the first quarter of 2011 compared to the same period of 2010. Because the fair value of our common stock in the first quarter of 2011was much higher with an average price of $0.136 per share compared to the average price of $0.05 per share in the same period of 2010, we incurred more stock based compensation in the first quarter of 2011 than in the same period of 2010.

Research and development for the three months ended March 31, 2011 and 2010 was $46,679 and $22,598, respectively, an increase of $24,081 or 107%. Since the beginning of 2010, we have spent considerable amount of funds on redesigning and modifying our FRWS unit from the prototype that was built July 2008 and have since completed two standardized commercial units. We understand the vital importance of research and development for our overall success. We are committed to continue to conduct research and development activities to ensure PureSafe FRWS has the most advanced technology within the water filtration equipment industry.

Interest expense (non-debt discount related) for the three months ended March 31, 2011 and 2010 was $37,321 and $57,581, respectively. The $20,260 or 35% decrease in interest expense (non-debt discounted related) was primarily from the reduction in debt in 2010 due to loan conversions requested by lenders in the second half of 2010.

Debt discount related interest expense for the three months ended March 31, 2011 and 2010 was $75,515 and $55,582, a $19,933 or 36% increase, respectively. We incurred a total of $103,132 in debt discount related to loans of which we received total of $325,000 in the first quarter of 2011. The debt discount is being amortized over the term of the loans. Changes in fair value of warrants and embedded conversion options for the three months ended March 31, 2011 and 2010 were $0 and $25,500, respectively. In March 2007, we issued a convertible promissory note to a former director for a $50,000 loan. The conversion price for the conversion was 50% of the average closing price of the common stock over the three previous business days preceding the date of demand for conversion was made. Since it was not a fixed conversion price, the number of conversion shares could not be determined at the time the loan was made. As a result, the embedded conversion option was presented as a derivative liability on the consolidated balance sheet.

The accounting treatment, pursuant to ASC 815 “Derivatives and Hedging”, of derivative financial instruments requires that we record the conversion option and related warrants at their fair values as of the inception date of the convertible debenture agreements and at fair value as of each subsequent balance sheet date. As a result of entering into the convertible promissory notes, we were required to reclassify all other non-employee warrants and options as derivative liabilities and record them at their fair values at each balance sheet date. Any change in fair value was recorded as non-operating, non-cash income or expense for each reporting period at each balance sheet date. We reassess the classification of the instruments at each balance sheet date. If the classification changes as a result of events during the period, the contract is reclassified as of the date of the event that caused the reclassification.

On December 31, 2010, upon the request from the former director, we converted $68,491 loan principal and accrued interest we owed him into 974,312 shares of our common stock. Subsequent to the conversion, we reclassified $2,064,500 which represented the fair value for all respective warrants and embedded conversion options previously classified as components of the derivative liabilities to equity and we are no longer required to report the issuance of certain convertible promissory notes, options and warrants as derivative instrument.

For all the above-stated reasons, the net loss for three months ended March 31, 2011 and 2010 was $1,331,341 and $1,095,507, respectively.

Liquidity and Capital Resources

As of March 31, 2011, we maintained a cash balance of $49,858 as compared to $48,722 as of the same date in 2010.

Net cash used in the operating activities in the three months ended March 31, 2011 and 2010 was $575,925 and $324,045, respectively. The $251,880 increase in cash spent in 2011 was primarily from the following factors: a.)We paid more rent in the first quarter of 2011 compared in the same period of 2010 because of the additional facility we added in July 2010; b.) we spent considerable more cash on purchasing inventories in the first quarter of 2011 compared to the same period of 2010; and c.) we paid a considerable amount of cash for various marketing programs in which we participated in the first quarter of 2011 which included approximately $20,000 paid to a marketing consultant.

We incurred $7,400 in capital expenditures in the first quarter of 2011 and $9,656 in the same period of 2010. The entire capital expenditures incurred in this quarter are related to FRWS Systems patent application.

In the three months ended March 31, 2011 and 2010, we raised $142,922 and $100,000 through sales of our common stock and warrant exercise, respectively. Funds received in the first quarter of 2011 and 2010 from convertible promissory note were $325,000 and $175,000, respectively. In the three months ended March 31, 2011 and 2010, cash used for repayment of notes payable was $1,497 and $0, respectively.

From all the above activities, net cash provided by financing activities for first quarter of 2011 and 2010 was $466,425 and $275,000, respectively.

At March 31, 2011, we had a working capital deficit of approximately $2,319,000. We continue to suffer recurring losses from operations and have an accumulated deficit since inception of approximately $40,168,000. These conditions raise substantial doubt about our ability to continue as a going concern. Our plans with respect to these matters include restructuring its existing debt and raising additional capital through future issuances of stock and/or debt. We are seeking to raise an additional $5 million in the next twelve months to fund the following activities: to manufacture 45 commercialized PureSafe FRWS units within the next twelve months; to expand production capability by increasing the inventory level of components used in the manufacturing process; by re-engineering the assembly process and outsourcing production where appropriate; continue to implement our established marketing program, to

establish a sales and marketing network which includes hiring a Vice President of Sales. Provided we obtain such financing, we believe that there will be revenue recognition by the third quarter of 2011.

For the first two quarters of 2011, our main focus is to produce PureSafe FRWS standardized commercial units and continue our marketing plan including participation in tradeshows, concluding agreements with strategic partners for international marketing and manufacturing, entering field testing programs for PureSafe FRWS unit. We expect to recognize the first sales of the PureSafe FRWS by the third quarter of 2011. We will cease being a development stage enterprise when we recognize significant revenue from the sale of PureSafe FRWS units. The extent of these initiatives will be contingent upon the amount of capital raised.

We can give no assurance that such financing will be available on terms advantageous to us, or at all. Should we not be successful in obtaining the necessary financing to fund its operations, we would need to curtail certain or all of its operational activities. The accompanying unaudited condensed consolidated financial statements do not include any adjustments that might be necessary should we be unable to continue as a going concern.

Recent Accounting Pronouncements

Recent accounting pronouncements issued by the FASB and the SEC did not have, or are not believed by management to have, a material impact on the Company's present or future consolidated financial statements.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America. Preparation of the statements in accordance with these principles requires that we make estimates, using available data and our judgment, for such things as valuing assets, accruing liabilities and estimating expenses. We are currently in development stage as defined by Accounting Standard Codification (“ASC”) 915. The following is a list of what we believe are the most critical estimations that we make when preparing our consolidated financial statements.

Stock-Based Compensation

We reports stock-based compensation under ASC 718. ASC 718 requires all share-based payments to employees, including grants of employee stock options, to be recognized in the consolidated financial statements based on their fair values.

We account for equity instruments issued to non-employees as compensation in accordance with the provisions of ASC 718 and 505, which require that each such equity instrument is recorded at its fair value on the measurement date, which is typically the date the services are performed.

The Black-Scholes option valuation model is used to estimate the fair value of the options or their equivalent granted. The model includes subjective input assumptions that can materially affect the fair value estimates. The model was developed for use in estimating the fair value of traded options or warrants that have no vesting restrictions and that are fully transferable. The expected volatility is estimated based on the most recent historical period of time equal to the weighted average life of the options granted.

We have issued equity instruments in the past to raise capital and as a means of compensation to employees and for the settlement of debt.

Income taxes

We account for income taxes under guidance provided by ASC 740 “Income Taxes” which prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities. Differences between tax positions taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to the interpretation are referred to as “unrecognized benefits.” A liability is recognized (or amount of net operating loss carry forward or amount of tax refundable is reduced) for an unrecognized tax benefit because it represents an enterprise’s potential future obligation to the taxing authority for a tax position that was not recognized as a result of applying the provisions of ASC 740.

In accordance with ASC 740, interest costs related to unrecognized tax benefits are required to be calculated (if applicable) and would be classified as “Interest expense, net” in the consolidated statements of operations. Penalties would be recognized as a component of “General and administrative expenses.”

Our uncertain tax positions are related to tax years that remain subject to examination by relevant tax authorities. We file income tax returns in the United States (federal) and in various state and local jurisdictions. We are no longer subject to federal, state and local income tax examinations by tax authorities for years prior to 2006.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

This Item is not applicable to smaller reporting companies.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were not effective as of the end of the period covered by this report to provide reasonable assurance that information required to be disclosed by us in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis. Our management identified the following material weaknesses as of March 31, 2011:

Entity Level. We recognize the need to provide leadership and guidance to our employees regarding the maintenance and preparation of financial matters. There is a weakness due to the fact that there are not documented policies and procedures in place for certain procedures. An audit committee has not been established.

Financial Reporting. There needs to be a more structured mechanism for evidence of review in the financial reporting process. The following procedures have been implemented since the beginning of 2009, (a) Chief Financial Officer signs and date all financial documents upon the completion of reviewing such documents, (b) all approval or permission will be evidenced by either email or in writing. No oral approval or permission is allowed, (c) General Journal is recorded only after Chief Financial Officer approves (in writing) such entry and (d) monthly bank reconciliations must complete within 15 days after month ends and reviewed by Chief Financial Officer 5 days after the completion of bank reconciliation.

Confidential Reporting Mechanism. We recognize that we need to provide leadership and guidance to our employees, clients and vendors regarding business ethics and professional conduct. A confidential reporting mechanism must be in place for anonymous reporting of a breach to these ethics that will enable prompt and thorough investigation. In January 2009, we implemented a whistleblower program. A toll-free number, as well as an email address, were posted on the homepage of our website to encourage our employee, contractors, sub-contractors, vendors to report any unethical or illegal behavior they suspect.

The entire staff consists of two officers, one Controller and one receptionist. Therefore, we have relied heavily on entity or management review controls to lessen the issue of segregation of duties. Upon receiving adequate financing the Company plans to increase its controls in these areas by hiring more experienced employees in financial reporting, establishing an audit committee and formally documenting the controls the Company has in place.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. The design of any system of controls is also based in part on certain assumptions regarding the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Given these and other inherent limitations of control systems, there is only reasonable assurance that our controls will succeed in achieving their stated goals under all potential future conditions.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the first quarter of our 2011 fiscal year that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

Current legal proceedings to which we are a party are as follows:

On June 21, 2009 we were served with a complaint filed in the Supreme Court of the State of New York, County of Nassau, in which suit State Farm Fire & Casualty Company is the plaintiff. The suit is for approximately $202,000 in damages, resulting from a fire that occurred on or about December 16, 2008, allegedly as a result of a defective water cooler sold either by the Company or by Water Splash LLC, to which we had sold its water cooler business and related liabilities in November 2001. An amended complaint was filed on August 19, 2009, adding Water Splash LLC as a defendant. The claim by State Farm is on the basis that, as the insurance carrier, it is subrogated to the claim for damages of the owner of the property where the fire allegedly started by reason of a defect in the water cooler. Under the complaint, alternative claims for damages are made in negligence, breach of warranty, placing on the market a product in a defective and unreasonably dangerous condition and not fit for its intended use, failure to warn State Farm's subragor of the risks and defects associated with the water cooler which were not discoverable by reasonable inspection, and strict liability. As of April 29, 2011, we do not believe that it has any potential exposure by reason of this lawsuit and, in any event, any recovery by the plaintiff would be covered under the existing liability insurance policy. However, we cannot provide assurance that the outcome of this matter will not have a material effect on our financial condition or results of operations.

In addition to the above, we may be involved in legal proceedings in the ordinary course of business. Such matters are subject to many uncertainties, and outcomes are not predictable with assurance.

Item 1A. Risk Factors.

This Item is not applicable to smaller reporting companies.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

The following table sets forth the sales of unregistered securities by the Company in the quarterly period ended March 31, 2011.

| Date | Title and Amount(1) | Purchaser | Underwriter | Principal Total Offering Price/ Underwriting Discounts |
|---|---|---|---|---|
| January 4, 2011 | 493,924 shares of common stock issued through conversion of loan | Private investor | NA | $0.056 per share/NA |
| January 11, 2011 | 181,554 shares of common stock and three year warrants to purchase 36,311 shares of common stock at exercise price $0.1652 | Private investor | NA | $0.1377 per share/NA |

| | | | | |
|---|---|---|---|---|
| | through 2010 Private Placement. | | | |
| January 13, 2011 | 452,900 shares of common stock issued for compensation | Board of directors | NA | $0.138 per share/NA |
| January 13, 2011 | 182,083 shares of common stock and three year warrants to purchase 36,417 shares of common stock at exercise price $0.1648 through 2010 Private Placement. | Private investor | NA | $0.1373 per share/NA |
| January 24, 2011 | 273,974 shares of common stock issued through exercise of warrants. | Private investor | NA | $0.0876 per share/NA |
| January 25, 2011 | 49,358 shares of common stock issued through exercise of warrants | Private investor | NA | $0.1216 per share/NA |
| January 25, 2011 | 86,670 shares of common stock issued in connection with settlement of debt. | Consultant | NA | $0.132 per share/NA |
| January 27, 2011 | 325,000 shares of common stock issued as compensation. | Corporate employee | NA | $0.137 per share/NA |

| | | | | |
|---|---|---|---|---|
| February 4, 2011 | 1,002,020 shares of common stock through loan conversion. | Private investor | NA | $0.055 per share/NA |
| February 8, 2011 | 95,238 shares of common stock issued through exercise of warrants. | Private investor | NA | $0.042 per share/NA |
| February 10, 2011 | 502,399 shares of common stock issued through loan conversion. | Private investor | NA | $0.055 per share/NA |
| February 16, 2011 | 344,828 shares of common stock and three year warrants to purchase 68,966 shares of common stock at exercise price $0.174 through 2010 Private Placement. | Private investor | NA | $0.145 per share/NA |
| February 24, 2011 | 95,238 shares of common stock issued through exercise of warrants. | Private investor | NA | $0.042 per share/NA |
| February 24, 2011 | 128,125 shares of common stock issued through exercise of warrants. | Private investor | NA | $0.0384 per share/NA |
| March 9, 2011 | 2,000,000 shares of common stock issued as executive compensation. | Chief Financial Officer | NA | $0.135 per share/NA |
| March 21, 2011 | 2,000,000 shares of common stock issued as executive compensation. | Chief Executive Officer | NA | $0.135 per share/NA |
| February 7, 2011 | Five-year Warrants to purchase 89,928 shares of common stock at an exercise price of $0.139 per share issued in connection with a loan. | Chief Executive Officer | NA | $-0-/NA |
| February 7, 2011 | Five-year Warrants to purchase 89,928 shares of common stock at an exercise price of $0.139 per share issued in connection with a loan. | Chief Financial Officer | NA | $-0-/NA |

| | | | | |
|---|---|---|---|---|
| February 14 2011 | Five-year Warrants to purchase 127,389 shares of common stock at an exercise price of $0.1884 per share issued in connection with a loan. | Private investor | NA | $-0-/NA |
| March 1, 2011 | Three-year Warrants to purchase 500,000 shares of common stock at an exercise price of $0.135 per share issued as compensation. | Consultant | NA | $-0-/NA |
| March 15, 2011 | Five-year Warrants to purchase 174,180 shares of common stock at an exercise price of $0.122 per share issued in connection with a loan. | Chief Financial Officer | NA | $-0-/NA |
| March 28, 2011 | Five-year Warrants to purchase 83,333 shares of common stock at an exercise price of $0.12 per share issued in connection with a loan. | Chief Financial Officer | NA | $-0-/NA |

(1) The issuances to executives, employees, lenders, consultants and investors are viewed by the Company as exempt from registration under the Securities Act of 1933, as amended (“Securities Act”), alternatively, as transactions either not involving any public offering, or as exempt under the provisions of Regulation D or Rule 701 promulgated by the SEC under the Securities Act.

Item 3. Defaults Upon Senior Securities.

None

Item 4. Removed and Reserved

Not applicable.

Item 5. Other Information.

None

Item 6. Exhibits.

The following exhibits are being filed as part of this Quarterly Report on Form 10-Q.

| Exhibit Number | Exhibit Description |
|---|---|
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer. |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer. |
| 32.1 | Section 1350 Certification of Chief Executive Officer. |
| 32.2 | Section 1350 Certification of Chief Financial Officer. |

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: May 20, 2011

PureSafe Water Systems, Inc.

By: /s/ Leslie J. Kessler
Leslie J. Kessler
Chief Executive Officer

By: /s/ Terry R. Lazar
Terry R. Lazar
Chief Financial Officer