

BION ENVIRONMENTAL TECHNOLOGIES INC

Form 10-Q

February 12, 2009

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-Q

Quarterly report pursuant section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended December 31, 2008

Transition report pursuant section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-19333

BION ENVIRONMENTAL TECHNOLOGIES, INC.  
(Exact name of registrant as specified in its charter)

Colorado 84-1176672  
(State or Other Jurisdiction (I.R.S. Employer Identification No.)  
of Incorporation)

Box 566/1774 Summitview Way, Crestone, Colorado 81131  
(Address of Principal Executive Offices)

212-758-6622  
(Registrant's Telephone Number, Including Area Code)

Not Applicable  
(Former Name, Former Address and Former Fiscal Year,  
if Changed Since Last Report)

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  No

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

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY  
PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the issuer has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. NOT APPLICABLE

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. On February 10, 2009, there were 11,637,974 Common Shares issued and 10,933,665 Common Shares outstanding.

Indicate by check mark whether the registrant is a large accelerated filer,

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an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

## BION ENVIRONMENTAL TECHNOLOGIES, INC. FORM 10-Q

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## PART I - FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS

|  | December 31,<br>2008 | June 30,<br>2008 |
|--|----------------------|------------------|
|  | -----<br>(unaudited) | -----            |
| ASSETS   |                      |                  |
| Current assets:  |                      |                  |
| Cash and cash equivalents  | \$ 36,966            | \$ 478,899       |
| Prepaid rent and expenses  | 6,135                | 9,130            |
| Deposits and other receivables   | 11,957               | 12,068           |
|  | -----                | -----            |
| Total current assets   | 55,058               | 500,097          |
| Restricted cash (Note 9)   | 85,973               | 128,443          |
| Property and equipment, net (Note 4)   | 51,140               | 59,504           |
|  | -----                | -----            |
| Total assets   | \$ 192,171           | \$ 688,044       |
|  | =====                | =====            |
| LIABILITIES AND STOCKHOLDERS' DEFICIT  |                      |                  |
| Current liabilities:   |                      |                  |
| Accounts payable and accrued expenses  | \$ 543,738           | \$ 567,811       |
| Accrued payable - affiliate (Note 11)  | 41,647               | 41,647           |
| Notes payable - affiliates (Note 6)  | 167,495              | -                |
| Deferred compensation (Note 7)   | 241,076              | 25,000           |
|  | -----                | -----            |
| Total current liabilities  | 993,956              | 634,458          |
|  | -----                | -----            |
| Convertible promissory notes - affiliates<br>(Note 5)  | -                    | 784,122          |
| Deferred rent (Note 9)   | 72,738               | 71,865           |
|  | -----                | -----            |
| Total liabilities  | 1,066,694            | 1,490,445        |
|  | -----                | -----            |
| Minority interest (Note 3)   | 127,388              | 117,692          |
|  | -----                | -----            |
| Stockholders' deficit (Note 8):  |                      |                  |
| Preferred stock, \$.01 par value, 10,000<br>shares authorized, no shares issued and<br>outstanding   | -                    | -                |
| Common stock, no par value, 100,000,000<br>shares authorized, 11,226,658 and 11,070,658<br>shares issued, respectively, 10,522,349 and<br>10,366,349 outstanding, respectively | -                    | -                |
| Additional paid-in capital   | 73,476,577           | 73,422,195       |
| Accumulated deficit  | (74,478,488)         | (74,342,288)     |

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|   |             |            |
|---|-------------|------------|
| Total stockholders' deficit                 | (1,001,911) | (920,093)  |
| Total liabilities and stockholders' deficit | \$ 192,171  | \$ 688,044 |

See notes to unaudited consolidated financial statements.

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BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
THREE AND SIX MONTHS ENDED DECEMBER 31, 2008 AND 2007  
(UNAUDITED)

|  | Three months ended<br>December 31, |              | Six months ended<br>December 31, |             |
|--|------------------------------------|--------------|----------------------------------|-------------|
|  | 2008                               | 2007         | 2008                             | 2007        |
| Revenue  | \$ -                               | \$ -         | \$ -                             | \$ -        |
| Operating expenses:  |                                    |              |                                  |             |
| General and administrative (including stock-based compensation (Note 8)) | 158,567                            | 154,731      | 788,242                          | 308,587     |
| Research and development (including stock-based compensation (Note 8))   | 70,630                             | 544,700      | 346,970                          | 671,668     |
| Total operating expenses   | 229,197                            | 699,431      | 1,135,212                        | 980,255     |
| Loss from operations   | (229,197)                          | (699,431)    | (1,135,212)                      | (980,255)   |
| Other expense (income):  |                                    |              |                                  |             |
| Interest expense   | 15,609                             | 51,229       | 27,557                           | 103,619     |
| Interest income  | (617)                              | (10,444)     | (2,081)                          | (15,369)    |
| Minority interest (Note 3)   | (4,198)                            | 53,348       | 9,696                            | 126,865     |
| Forfeiture of deferred compensation (Note 5)                             | (959,184)                          | -            | (959,184)                        | -           |
| Other, net   | (75,000)                           | -            | (75,000)                         | (1,258,195) |
|  | (1,023,390)                        | 94,133       | (999,012)                        | (1,043,080) |
| Net income (loss)  | \$ 794,193                         | \$ (793,564) | \$ (136,200)                     | \$ 62,825   |
| Net income (loss) per basic common share                                 | \$ 0.08                            | \$ (0.10)    | \$ (0.01)                        | \$ 0.01     |
| Net income (loss) per diluted common share                               | \$ 0.08                            | \$ (0.10)    | \$ (0.01)                        | \$ 0.01     |
| Weighted-average number of common shares outstanding, Basic              | 10,418,914                         | 8,021,789    | 10,392,632                       | 7,976,993   |

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|         |            |           |            |           |
|---------|------------|-----------|------------|-----------|
| Diluted | =====      | =====     | =====      | =====     |
|         | 10,432,149 | 8,021,789 | 10,392,632 | 7,976,993 |
|         | =====      | =====     | =====      | =====     |

See notes to unaudited consolidated financial statements.

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BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' DEFICIT  
SIX MONTHS ENDED DECEMBER 31, 2008  
(UNAUDITED)

|  | Common<br>Shares | Stock<br>Amount | Additional<br>paid-in capital | Accumulated<br>deficit | Total<br>stockholders'<br>deficit |
|--|------------------|-----------------|-------------------------------|------------------------|-----------------------------------|
|  | -----            | -----           | -----                         | -----                  | -----                             |
| Balances, July 1, 2008   | 11,070,658       | \$ -            | \$73,422,195                  | \$ (74,342,288)        | \$ (920,093)                      |
| Vesting and remeasure-<br>ment of options for<br>services (Note 8) | -                | -               | (62,618)                      | -                      | (62,618)                          |
| Issuance of common<br>stock for services                           | 16,000           | -               | 12,000                        | -                      | 12,000                            |
| Sale of common stock   | 140,000          | -               | 105,000                       | -                      | 105,000                           |
| Net loss   | -                | -               | -                             | (136,200)              | (136,200)                         |
|  | -----            | -----           | -----                         | -----                  | -----                             |
| Balances, December 31,<br>2008                                     | 11,226,658       | \$ -            | \$73,476,577                  | \$ (74,478,488)        | \$ (1,001,911)                    |
|  | =====            | =====           | =====                         | =====                  | =====                             |

See notes to unaudited consolidated financial statements.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
SIX MONTHS ENDED DECEMBER 31, 2008 AND 2007  
(UNAUDITED)

|   | 2008         | 2007      |
|---|--------------|-----------|
|   | -----        | -----     |
| CASH FLOWS FROM OPERATING ACTIVITIES  |              |           |
| Net (loss) income   | \$ (136,200) | \$ 62,825 |
| Adjustments to reconcile net (loss) income to<br>net cash used in operating activities: |              |           |
| Depreciation expense  | 8,364        | 8,066     |
| Accrued interest on convertible notes and debt  | 27,557       | 103,619   |
| Stock-based compensation  | (50,618)     | 294,821   |
| Forfeiture of deferred compensation   | (959,184)    | -         |
| Decrease in fair value of convertible notes   | -            | (598,960) |
| Minority interest   | 9,696        | 126,865   |
| Decrease in prepaid rent and expenses   | 2,995        | 17,187    |
| Decrease (increase) in deposits and other<br>receivables                                | 111          | (7,085)   |
| Decrease in accounts payable and accrued expenses                                       | (24,073)     | (29,091)  |
| Increase in deferred rent   | 873          | 3,128     |
| Increase in deferred compensation   | 366,076      | 366,780   |
|   | -----        | -----     |
| Net cash (used) provided in operating activities  | (754,403)    | 348,155   |
|   | -----        | -----     |
| CASH FLOWS FROM INVESTING ACTIVITIES  |              |           |
| Decrease in restricted cash   | 42,470       | -         |
| Proceeds from refund of property and equipment  | -            | 5,258     |
| Purchase of property and equipment  | -            | (3,078)   |
|   | -----        | -----     |
| Net cash provided by investing activities   | 42,470       | 2,180     |
|   | -----        | -----     |
| CASH FLOWS FROM FINANCING ACTIVITIES  |              |           |
| Proceeds from sale of common stock  | 105,000      | -         |
| Proceeds from notes payable - affiliates  | 165,000      | -         |
|   | -----        | -----     |
| Net cash provided by financing activities   | 270,000      | -         |
|   | -----        | -----     |
| Net (decrease) increase in cash and cash equivalents                                    | (441,933)    | 350,335   |

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|   |           |            |
|---|-----------|------------|
| Cash and cash equivalents at beginning of year    | 478,899   | 373,109    |
|   | -----     | -----      |
| Cash and cash equivalents at end of year          | \$ 36,966 | \$ 723,444 |
|   | =====     | =====      |
| Supplemental disclosure of cash flow information: |           |            |
| Cash paid for interest and income taxes           | \$ -      | \$ -       |
| Non-cash investing and financing transactions:    |           |            |
| Exchange/conversion of debt to common stock       | -         | 538,509    |

See notes to unaudited consolidated financial statements.

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BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
SIX MONTHS ENDED DECEMBER 31, 2008

1. ORGANIZATION, NATURE OF BUSINESS, GOING CONCERN AND MANAGEMENT'S PLANS:

Organization and nature of business:

Bion Environmental Technologies, Inc. ("Bion" or "We" or the "Company") was incorporated in 1987 in the State of Colorado. Bion's patented and proprietary technology provides a comprehensive environmental solution to a significant source of pollution in US agriculture, Confined Animal Feeding Operations ("CAFO's"). Bion's technology produces substantial reductions of both nutrient releases to water and air emissions from livestock waste streams based upon our research to date. Because Bion's technology reduces the harmful emissions from a CAFO on which it is utilized, the CAFO can increase its herd concentration while lowering or maintaining its level of nutrient releases and atmospheric emissions.

Bion's technology produces business opportunities in two broad areas: 1) retrofit and environmental remediation of existing CAFOs (described below) and 2) development of "closed loop" Integrated Projects (defined below).

We believe that Bion's technology platform allows the integration of large-scale CAFO's and their end-product users, renewable energy production from the CAFO waste stream, on site utilization of the renewable energy generated and biofuel/ethanol production in an environmentally and economically sustainable manner while reducing the aggregate capital expense and operating costs for the entire integrated complex ("Integrated Projects" or "Projects"). In the context of Integrated Projects, Bion's waste treatment process, in addition to mitigating polluting releases, generates renewable energy from portions of the CAFO waste stream which renewable energy can be utilized by integrated ethanol plants, CAFO end-product processors (including cheese, ice cream and /or bottling plants in the case of dairy CAFOs and/or slaughter and/or processing facilities in the context of beef CAFOs) and/or other users as a natural gas replacement.

Since 2002, the Company has focused on completing development of its technology platform and business model. As such, we elected not to pursue near term revenue opportunities such as retrofitting existing CAFO's with our waste management solutions, because such efforts would have diverted scarce management and financial resources and negatively impacted our ability to complete: 1) re-development of our technology for environmentally sound

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treatment of CAFO waste streams and 2) development of our integrated technology platform in support of large-scale sustainable Integrated Projects.

Since the beginning of calendar year 2008, with the substantial completion of the technology/business model development process, Bion has begun to simultaneously pursue both retrofit/remediation and Integrated Projects opportunities.

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### BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS SIX MONTHS ENDED DECEMBER 31, 2008

#### 1. ORGANIZATION, NATURE OF BUSINESS, GOING CONCERN AND MANAGEMENT'S PLANS (CONTINUED):

Organization and nature of business (continued):

On September 27, 2008, the Company executed an agreement with Kreider Farms (and its affiliated entities) (collectively "Kreider") to design, construct and operate, through its wholly-owned subsidiary, Bion Services Group, Inc. ("Bion Services"), a Bion system to treat the waste of the milking dairy cows (milkers, dry cows and heifers) at the Kreider Dairy, located in Mannheim, Pennsylvania. In addition, the agreement provides for an integrated renewable energy facility that will provide energy for Bion's waste treatment facility through the combustion of the cellulose captured in the Bion process. The system will be owned and operated by Bion through a new entity to be formed and initially 100% owned by Bion Services, in which Kreider will have the option to purchase a minority interest. Upon completion of final design work and resolution of all building, zoning and other related pre-construction matters, it will be necessary to raise substantial capital (equity and/or debt) to construct and operate the Kreider system, which may be difficult to do on reasonable terms due to the current unsettled condition of the capital markets. Upon successful construction and operation of the system, the Company anticipates that it will receive revenue from the sale of nutrient (and other) environmental credits related to the Kreider system and through sales of renewable energy generated at the Kreider system.

On January 28, 2009 the Board of the Pennsylvania Infrastructure Investment Authority approved a \$7.8 million loan to Bion PA 1, LLC, a wholly-owned subsidiary of the Company, for the initial stage of Bion's Kreider Farms project. The Company anticipates that it will be able to complete the steps required to finalize this loan and commence this project during the current fiscal year.

Going concern and management's plans:

The consolidated financial statements have been prepared assuming the Company will continue as a going concern. The Company has incurred net losses of approximately \$1,779,000 and \$2,549,000 during the years ended June 30, 2008 and 2007, respectively, and net loss of approximately \$136,000 for the six months ended December 31, 2008. At December 31, 2008, the Company has a working capital deficiency and a stockholders' deficit of approximately \$939,000 and \$1,002,000, respectively. These factors raise substantial doubt about the Company's ability to continue as a going concern. The accompanying consolidated financial statements do not include any adjustments relating to the recoverability or classification of assets or the amounts and



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classification of liabilities that may result should the Company be unable to continue as a going concern. The following paragraphs describe management's plans with regard to these conditions.

The Company continues to explore sources of additional financing to satisfy its current operating requirements.

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### BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS SIX MONTHS ENDED DECEMBER 31, 2008

#### 1. ORGANIZATION, NATURE OF BUSINESS, GOING CONCERN AND MANAGEMENT'S PLANS (CONTINUED):

Going concern and management's plans (continued):

The Company currently faces a severe working capital shortage and it is not currently generating any revenues. The Company will need to obtain additional capital to fund its operations and technology development, to satisfy existing creditors and to develop Projects. The Company anticipates that it will seek to raise from \$3,000,000 to \$50,000,000 (debt and equity) during the next twelve months. There is no assurance, especially in the extremely unsettled capital markets that presently exist, that the Company will be able to obtain the funds that it needs to stay in business, complete its technology development or to successfully develop its business.

There can be no assurance that funds required during the next twelve months or thereafter will be generated from operations or that those funds will be available from external sources such as debt or equity financings or other potential sources. The lack of additional capital resulting from the inability to generate cash flow from operations or to raise capital from external sources would force the Company to substantially curtail or cease operations and would, therefore, have a material adverse effect on its business. Further, there can be no assurance that any such required funds, if available, will be available on attractive terms or that they will not have a significantly dilutive effect on the Company's existing shareholders. All of these factors have been exacerbated by the extremely unsettled credit and capital markets presently existing.

#### 2. SIGNIFICANT ACCOUNTING POLICIES:

Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Bion Integrated Projects Group, Inc. (formerly Bion Dairy Corporation ("Projects Group")), Bion Technologies, Inc., BionSoil, Inc., Bion Services Group, Inc., and its majority owned subsidiary, Centerpoint Corporation ("Centerpoint") (Note 3). All significant intercompany accounts and transactions have been eliminated in consolidation.

The accompanying consolidated financial statements have been prepared without audit pursuant to the rules and regulations of the Securities and Exchange Commission. The consolidated financial statements reflect all adjustments (consisting of only normal recurring entries) that, in the opinion of management, are necessary to present fairly the financial position at December 31, 2008 and the results of operations and cash flows of the Company for the three and six months ended December 31, 2008 and 2007. Operating results for the three and six months ended December 31, 2008 are

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not necessarily indicative of the results that may be expected for the year ending June 30, 2009.

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BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES  
 NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
 SIX MONTHS ENDED DECEMBER 31, 2008

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

Principles of consolidation (continued):

The unaudited consolidated financial statements should be read in conjunction with the Company's audited financial statements and footnotes thereto included in its Annual Report on Form 10-KSB for the year ended June 30, 2008.

Earnings (loss) per share:

Basic earnings (loss) per share amounts are calculated using the weighted average number of shares of common stock outstanding during the period. Diluted earnings (loss) per share assumes the conversion, exercise or issuance of all potential common stock instruments, such as options or warrants, unless the effect is to reduce the loss or increase earnings per share. The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations for the three months ended December 31, 2008 (a reconciliation of the numerators and denominators of the basic and diluted earnings per share for the six months ended December 31, 2008 are not included as they are anti-dilutive):

| Three months ended December 31, 2008 | Income    | Average<br>Shares | EPS    |
|--------------------------------------|-----------|-------------------|--------|
| -----                                | -----     | -----             | -----  |
| Net income - basic                   | \$794,193 | 10,418,914        | \$0.08 |
| Effect of dilutive securities:       |           |                   |        |
| Stock options and warrants           | -         | 13,235            | -      |
|                                      | -----     | -----             | -----  |
| Net income - diluted                 | \$794,193 | 10,432,149        | \$0.08 |
|                                      | =====     | =====             | =====  |

The following potential shares of common stock and their effect on net income were excluded from the diluted EPS calculations because their effect would have been anti-dilutive:

- a) The 8% convertible promissory note-affiliate convertible into 67,731 common shares.
- b) The convertible accrued payable-affiliate of \$41,647 convertible into 55,529 common shares.

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BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
SIX MONTHS ENDED DECEMBER 31, 2008

### 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

#### Recent accounting pronouncements:

During October 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 157, Fair Value Measurements ("SFAS 157"). This statement does not require any new fair value measurements but provides guidance on how to measure fair value and clarifies the definition of fair value under accounting principles generally accepted in the United States of America. The statement also requires new disclosures about the extent to which fair value measurements in financial statements are based on quoted market prices, market-corroborated inputs, or unobservable inputs that are based on management's judgments and estimates. This statement was effective for the Company on July 1, 2008 for all financial assets and liabilities. In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, Effective Dates of FASB Statement No. 157 (the "FSP"). The FSP amends SFAS 157 to delay its effective date for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (that is, at least annually). For items within its scope, the FSP defers the effective date of SFAS 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. As it relates to financial assets and liabilities, the adoption of SFAS 157 did not have an impact on the Company's consolidated financial statements. The Company is still in the process of evaluating the impact that SFAS 157 will have on its non-financial assets and liabilities.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115 ("SFAS 159"). This statement permits entities to choose to measure eligible items at fair value at specified election dates. SFAS 159 was effective for the Company on July 1, 2008. The Company did not apply the fair value option to any of its outstanding instruments, and therefore, SFAS 159 did not have an impact on the consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), Business Combinations ("SFAS 141R"). SFAS 141R continues to require the purchase method of accounting to be applied to all business combinations, but it significantly changes the accounting for certain aspects of business combinations. Under SFAS 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS 141R will change the accounting treatment for certain specific acquisition related items including: (1) expensing acquisition related costs as incurred; (2) valuing non-controlling interests at fair value at the acquisition date; and (3) expensing restructuring costs associated with an acquired business. SFAS 141R also includes a substantial number of new disclosure requirements. SFAS 141R is to be applied prospectively to business combinations for which the

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### 2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

Recent accounting pronouncements (continued):

acquisition date is on or after July 1, 2009 for the Company. The Company does not expect that the adoption of SFAS 141R will have an impact on its consolidated financial statements unless the Company enters into business acquisitions in the future.

In December 2007, the FASB issued SFAS No. 160, Non-controlling Interests in Consolidated Financial Statements ("SFAS 160"). SFAS 160 establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a non-controlling interest in a subsidiary (minority interest) is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements and separate from the parent company's equity. Among other requirements, this statement requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the non-controlling interest. It also requires disclosure, on the face of the consolidated statement of operations, of the amounts of consolidated net income attributable to the parent and to the non-controlling interest. This statement is effective for the Company on July 1, 2009. The Company is currently evaluating the effect the adoption of this statement may have on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133 ("SFAS 161"). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities by requiring that the objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation. The statement is effective for the Company on January 1, 2009. The Company does not expect that the adoption of SFAS 161 will have an impact on its consolidated financial statements.

### 3. MINORITY INTEREST OF CENTERPOINT CORPORATION:

In January 2002, Bion purchased a 57.7% majority interest in Centerpoint from a third party. On April 30, 2008, Centerpoint received and cancelled 126,000 shares of its previously outstanding common stock in connection with a litigation settlement, which increased Bion's ownership from 57.7% to 58.9%.

During the three and six months ended December 31, 2008 and 2007, Centerpoint had (losses) earnings of approximately \$(10,200) and \$126,100, and \$23,600 and \$(695,000), respectively. Centerpoint's minority interest holders have a minority interest of \$127,388 as of December 31, 2008.

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BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
SIX MONTHS ENDED DECEMBER 31, 2008

### 4. PROPERTY AND EQUIPMENT:

Property and equipment consists of the following as of December 31, 2008:

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|                                    |            |
|------------------------------------|------------|
| Research and development equipment | \$ 305,266 |
| Leasehold improvements             | 31,336     |
| Furniture                          | 28,932     |
| Computers and office equipment     | 31,680     |
|                                    | -----      |
|                                    | 397,214    |
| Less accumulated depreciation      | (346,074)  |
|                                    | -----      |
|                                    | \$ 51,140  |
|                                    | =====      |

Depreciation expense was \$4,077 and \$4,046 for the three months ended December 31, 2008 and 2007, respectively, and \$8,364 and \$8,066 for the six months ended December 31, 2008 and 2007, respectively.

### 5. CONVERTIBLE PROMISSORY NOTES:

In March and April 2007, the Company sold \$800,000 of its Convertible Notes (the "Notes") for cash proceeds. In addition the Company issued Notes to affiliates totaling \$986,521 in exchange for promissory notes with convertible features and deferred compensation (Note 7). The Notes were convertible into shares of the Company's common stock at the price of \$4.00 per share until maturity on July 1, 2008, or at the election of the Note holders, and accrue interest at 6% per annum. The Note holders also had the option to exchange the Notes, plus interest, for securities substantially identical to securities the Company sells in any offering prior to the completion of an offering in which the Company raises less than \$3,000,000. The Company had the right to require the Notes (principal plus interest) be converted into its common shares at the lesser of \$4.00 per share or the price of an offering in which the Company raises \$3,000,000 or more.

On May 31, 2008 all of the non-affiliate Note holders converted their Notes totaling \$856,737 including accrued interest into 428,369 restricted common shares of the Company. Also on May 31, 2008, Notes held by affiliates totaling \$650,427 including accrued interest were converted into 325,214 common shares of the Company. These Notes were converted at a price of \$2.00 per share, the price at which the Company sold common stock during the same period.

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 NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
 SIX MONTHS ENDED DECEMBER 31, 2008

### 5. CONVERTIBLE PROMISSORY NOTES (CONTINUED):

On June 18, 2008 the remaining affiliated holder of the outstanding Notes increased the principal of his Note, maturing on July 1, 2013, by \$375,000 to \$784,122, which represented the potential deferred compensation subject to forfeiture through June 30, 2008. The holder, Salvatore Zizza, Chairman of Projects Group, agreed to add his future compensation from the Company to his Note as it accrues. As of December 31, 2008, the total principal and interest on the Note totaled \$959,184. Pursuant to an agreement dated December 19, 2008, (the "Zizza Agreement" see Note 10), Mr. Zizza agreed to no longer provide services to the Company effective December 31, 2008. In conjunction with the Zizza Agreement, Mr. Zizza's Note was

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returned to the Company on December 31, 2008 and it was cancelled, which resulted in the Company's recognition of income due to forfeiture of deferred compensation of \$959,184. The deferred compensation underlying the convertible note had not yet vested at the date the Note was cancelled. In addition, the Note was subject to certain risks of forfeiture and/or cancellation.

The Notes accrued interest of \$13,172 and \$27,520 for the three months ended December 31, 2008 and 2007, respectively and \$25,062 and \$54,636 for the six months ended December 31, 2008 and 2007, respectively.

### 6. PROMISSORY NOTES PAYABLE - AFFILIATES:

During September 2008, Mr. Zizza and Dominic Bassani, Vice-President - Special Projects and Strategic Planning for the Projects Group, loaned the Company \$50,000 each under separate promissory notes. Under the terms of the promissory notes, which allow for additional monies to be loaned, the notes bear interest at 8% per annum and were payable on or before February 1, 2009. Pursuant to the Zizza Agreement, the terms of his promissory note were amended in December 2008 to allow for Mr. Zizza to convert the interest and principal of his note, in whole or in part, into shares of the Company's restricted common stock at a price of \$0.75 per share, which was equal to the fair value.

During October 2008, a major shareholder loaned the Company \$65,000 under a promissory note. Under the terms of the promissory note, which allows for additional monies to be loaned, the note bears interest at 8% per annum and is payable on or before March 1, 2009. In January 2009, an agreement was reached whereby the maturity of the \$65,000 promissory note was extended to June 30, 2009 in consideration of a) at the election by the note holder, the ability to convert the principal and interest into the Company's restricted common stock at \$0.75 per share, the fair value of the shares, at any date prior to repayment and b) the issuance of a warrant to purchase 15,000 shares of the Company's common stock at \$0.75 per share until December 31, 2018.

The promissory notes had accrued interest expense outstanding of \$2,495 as of December 31, 2008.

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## BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS SIX MONTHS ENDED DECEMBER 31, 2008

### 6. PROMISSORY NOTES - AFFILIATES (CONTINUED):

Subsequent to December 31, 2008, the promissory note held by Mr. Bassani was amended, under the terms of the Brightcap Agreement (see Note 10) to allow for the conversion of the principal and interest into shares of the Company's common stock at \$0.75 per share and extended the maturity date of the promissory notes to June 30, 2009.

### 7. DEFERRED COMPENSATION:

The Company accrued \$750,000 (\$150,000 to Mr. Smith, \$300,000 to Brightcap Capital Ltd. ("Brightcap") for services provided by Mr. Bassani, and \$300,000 to Mr. Zizza) as deferred compensation during each of the years ended June 30, 2008 and 2007. During fiscal year 2007 the Company entered into agreements converting deferred compensation amounts totaling \$975,000 into promissory notes with conversion agreements. Accrued principal and

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interest owed under the promissory notes with conversion agreements of Mr. Smith and Brightcap were converted to Convertible Promissory Notes in March 2007 (Note 5).

During fiscal year 2008, the Company entered into an agreement with Brightcap converting deferred compensation of \$350,000 owed as of May 31, 2008 into a promissory note with a conversion agreement. The convertible note plus accrued interest totaling \$350,805 was exchanged for 175,403 common shares at \$2.00 per share of the Company on June 15, 2008. In addition, the Company entered into an extension agreement with Mr. Smith which allowed for the conversion of deferred compensation accrued through June 30, 2008 of \$179,280 into 89,640 common shares of the Company at \$2.00 per share. Also during fiscal year 2008, the Company mutually agreed with Mr. Zizza to convert his deferred compensation earned through June 30, 2008 of \$375,000, and his ongoing compensation as it accrues to additional principal to his 2007 Note.

As of December 31, 2008 the Company owed Brightcap and Mr. Smith deferred compensation of \$175,000 and \$66,076, respectively. In January 2009 the Company entered into the Smith Agreement (see Note 10), whereby Mr. Smith converted his deferred compensation as of December 31, 2008 into 88,104 shares of the Company's restricted common stock at \$0.75 per share. The Company also entered into the Brightcap Agreement (see Note 10), whereby the deferred compensation of Brightcap owed as of December 31, 2008, was made convertible until December 31, 2009 into the Company's restricted common stock at a price of \$0.75 per share at Brightcap's option.

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BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
SIX MONTHS ENDED DECEMBER 31, 2008

### 8. STOCKHOLDERS' EQUITY:

#### Common stock:

Holders of common stock are entitled to one vote per share on all matters to be voted on by common stockholders. In the event of liquidation, dissolution or winding up of the Company, the holders of common stock are entitled to share in all assets remaining after liabilities have been paid in full or set aside. Common stock has no preemptive, redemption or conversion rights. The rights of holders of common stock are subject to, and may be adversely affected by, the rights of the holders of any other series of preferred stock the Company may designate in the future.

In November 2008, the Company issued 140,000 share of the Company's restricted common stock at \$0.75 per share for cash proceeds of \$105,000.

The Company also issued 16,000 shares of the Company's restricted common stock at \$0.75 per share for services valued at \$12,000 to one of its employees.

#### Warrants:

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As of December 31, 2008 the Company had the following common stock warrants outstanding:

|                  | Number of<br>Shares | Exercise<br>Price | Expiration Date    |
|------------------|---------------------|-------------------|--------------------|
|                  | -----               | -----             | -----              |
| Class SVDB 1-6   | 800,000             | \$ 3.00           | July 31, 2013      |
| Class DB-1       | 600,000             | \$ 1.00           | January 31, 2014   |
| Class A 1-3      | 600,000             | \$ 2.50           | May 14, 2015       |
| Class SVMAS-1    | 67,500              | \$ 3.50           | December 31, 2011  |
| Class SVMAS-1A   | 40,000              | \$ 3.50           | December 31, 2011  |
| Class SVMAS-2    | 32,500              | \$ 2.50           | December 31, 2011  |
| Class SVMAS-3    | 40,000              | \$ 2.50           | September 30, 2015 |
| Class SVB 1-3    | 50,000              | \$ 2.50           | April 30, 2015     |
| Class SVB-4      | 75,000              | \$ 2.50           | April 30, 2015     |
| Class SVC 1-5    | 125,000             | \$ 4.25           | December 31, 2012  |
| Class SV-SEI 1-2 | 32,292              | \$ 1.50           | December 31, 2012  |
| Class SV-SEI 3-4 | 9,375               | \$ 1.50           | June 30, 2009      |
| Class C, D, E    | 275,000             | \$ 2.50           | April 30, 2015     |
| Class O          | 100,000             | \$ 3.00           | December 31, 2010  |
| Class DM         | 150,000             | \$ 3.00           | December 31, 2011  |
| Class MAS        | 80,000              | \$ 2.50           | July 1, 2012       |
| Class GK         | 20,000              | \$ 2.00           | March 31, 2011     |
| Class BW         | 10,000              | \$ 2.20           | June 15, 2012      |
|                  | -----               |                   |                    |
|                  | 3,106,667           |                   |                    |
|                  | =====               |                   |                    |

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8. STOCKHOLDERS' EQUITY (CONTINUED):

Warrants (continued):

During December 2008, 450,000 warrants were cancelled pursuant to the terms of the Zizza Agreement (see Note 10).

The weighted average exercise price for the outstanding warrants is \$2.47 and the weighted average remaining contractual life as of December 31, 2008 is 4.96 years.

In January 2009, warrants to purchase 1,315,000 shares of the Company's common stock at \$0.75 per share were issued pursuant to various agreements with Mr. Smith, Mr. Bassani and a major shareholder (see Notes 6 and 10).

Stock options:

Effective June 2006, the Company approved the 2006 Consolidated Incentive Plan (the "2006 Plan"), which consolidated previously reserved incentive stock options plans into the 2006 Plan. On November 28, 2008, the 2006 Plan was amended to increase the maximum number of shares of the common stock of the Company issuable pursuant to the 2006 Plan from 4,200,000 to 6,000,000 shares and increases the maximum grant of stock options to a single employee/consultant from 500,000 to 1,000,000 options during a twelve month period. Terms of exercise and expiration of options granted under the 2006 Plan may be established at the discretion of the Board of Directors, but no



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option may be exercisable for more than ten years.

The Company recorded compensation expense related to employee stock options of \$84,068 and \$220,174 for the three months ended December 31, 2008 and 2007, respectively and \$146,997 and \$364,966 for the six months ended December 31, 2008 and 2007, respectively. The Company granted 75,000 and 145,000 options during the six months ended December 31, 2008 and 2007, respectively. During the six months ended December 31, 2008 and 2007, 210,000 and 45,000 options expired, respectively.

A summary of option activity under the 2006 Plan for the six months ended December 31, 2008 is as follows:

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8. STOCKHOLDERS' EQUITY (CONTINUED):

Stock options (continued):

|                                     | Options<br>-----   | Weighted-<br>Average<br>Exercise<br>Price<br>----- | Weighted-<br>Average<br>Remaining<br>Contractual<br>Life<br>----- | Aggregate<br>Intrinsic<br>Value<br>----- |
|-------------------------------------|--------------------|--|---|--|
| Outstanding at July 1, 2008         | 2,183,333          | \$ 3.06  | 4.6   | \$ 7,950                                 |
| Granted                             | 75,000             | 1.00   |   |  |
| Exercised                           | -                  | -  |   |  |
| Forfeited                           | -                  | -  |   |  |
| Expired                             | (210,000)          | 3.03   |   |  |
| Outstanding at December 31,<br>2008 | -----<br>2,048,333 | -----<br>\$ 2.99                                   | ---   | -----<br>\$ -                            |
| Exercisable at December 31,<br>2008 | =====              | =====  | ===   | =====                                    |
|                                     | 1,617,084          | \$ 2.94  | 4.6   | \$ -                                     |
|                                     | =====              | =====  | ===   | =====                                    |

The following table presents information relating to nonvested stock options as of December 31, 2008:

| Options<br>----- | Weighted Average<br>Grant-Date<br>Fair Value<br>----- |
|------------------|---|
|------------------|---|

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|                                |           |         |
|--------------------------------|-----------|---------|
| Nonvested at July 1, 2008      | 562,916   | \$ 1.29 |
| Granted                        | 75,000    | -       |
| Vested                         | (206,667) | (1.59)  |
| Forfeited                      | -         | -       |
|                                | -----     | -----   |
| Nonvested at December 31, 2008 | 431,249   | \$ 1.20 |
|                                | =====     | =====   |

The total fair value of stock options that vested during the six months ended December 31, 2008 and 2007 was \$233,377 and \$342,800, respectively. The intrinsic value of stock options exercised during the six months ended December 31, 2008 and 2007 was \$0 as there were no options exercised during these periods. As of December 31, 2008 the Company had \$289,780 of unrecognized compensation cost related to stock options that will be recorded over a weighted average period 1.5 years.

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BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES  
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8. STOCKHOLDERS' EQUITY (CONTINUED):

Stock options (continued):

The Company has issued options to non-employees to purchase shares of the Company's common stock in exchange for services. As of December 31, 2008, non-employee options represented 595,833 of the 2,048,333 options outstanding under the 2006 Plan. Of the 595,833 non-employee options outstanding, 92,500 were fully vested and contained no service conditions as of December 31, 2008. These non-employee options were valued using the Black-Scholes option-pricing model. The fully vested options have been fully amortized on the straight-line method and resulted in no expense for the six months ended December 31, 2008 and 2007.

The remaining 503,333 non-employee options outstanding include service conditions and have graded vesting schedules through November 30, 2009. As of December 31, 2008, 312,500 of these options included service conditions that were fully vested. Generally for these agreements, the measurement date of the services occurs when the options vest. In accordance with Emerging Issues Task Force ("EITF") Issue No. 96-18, recognition of compensation cost for reporting periods prior to the measurement date is based on the then current fair value of the options as of each of the interim reporting dates. Any subsequent change in fair value is recorded on the measurement date. The fair value of these options was determined using the Black-Scholes option-pricing model, using the following assumptions at December 31, 2008; a dividend yield of zero, risk-free interest rates of 1.71% to 2.25%, volatility of 151% to 153% and an expected life of 6.3 to 9.5 years. Consulting cost in connection with options that are not fully vested as of December 31, 2008 is being recognized on a straight-line basis over the requisite service period for the entire award. Non-cash fair value charges/(credits) of \$(389,803) and \$80,792 were recorded as expense during the three months ended December 31, 2008 and 2007, respectively and \$(209,615) and \$(70,146) for the six months ended December 31, 2008 and 2007, respectively.

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Stock-based compensation charges/(credits) in operating expenses in the Company's financial statements for the three and six months ended December 31, 2008 and 2007 are as follows:

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8. STOCKHOLDERS' EQUITY (CONTINUED):

Stock options (continued):

|   | Three<br>months<br>ended<br>December<br>31, 2008<br>----- | Three<br>months<br>ended<br>December<br>31, 2007<br>----- | Six<br>months<br>ended<br>December<br>31, 2008<br>----- | Six<br>months<br>ended<br>December<br>31, 2007<br>----- |
|---|---|---|---|---|
| General and administrative:                                 |   |   |   |   |
| Fair value remeasurement of convertible notes - affiliates  | \$ -  | \$ (42,921)   | \$ -  | \$ (237,383)  |
| Fair value remeasurement of options with service conditions | (389,803)   | -   | (275,075)   | -   |
| Fair value of stock options expensed under SFAS 123(R)      | 76,318  | 150,013   | 114,367   | 228,445   |
| Total   | <u>\$ (313,485)</u>                                       | <u>\$ 107,092</u>   | <u>\$ (160,708)</u>                                     | <u>\$ (8,938)</u>                                       |
| Research and development:                                   |   |   |   |   |
| Fair value remeasurement of convertible notes - affiliates  | \$ -  | \$ (95,634)   | \$ -  | \$ (361,577)  |
| Fair value remeasurement of options with service conditions | -   | 80,792  | 65,460  | (70,146)  |
| Fair value of stock options expensed under SFAS 123 (R)     | 7,750   | 70,161  | 32,630  | 136,521   |
| Total   | <u>\$ 7,750</u>   | <u>\$ 55,319</u>  | <u>\$ 98,090</u>  | <u>\$ (295,202)</u>                                     |

9. OPERATING LEASE:

The Company entered into a non-cancellable operating lease commitment for office space in New York, effective August 1, 2006 and expiring November

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30, 2013. In conjunction with the signing of the lease, the Company provided the lessor with a secured letter of credit. As of December 31, 2008 the Company has reflected \$85,973 as restricted cash related to the secured letter of credit. The Company's obligations under the lease are partially guaranteed by Mr. Zizza. The Company has entered into two separate agreements to sub-lease approximately 32% of the Company's lease obligation and the tenants have also agreed to reimburse the Company for leasehold improvements and furnishings. Because the lease contains an escalation clause, the Company is recognizing rent under the straight-line method resulting in an average monthly rent expense of \$15,820. The Company is also recognizing the sub-lease rental income from its tenants under the straight-line method, with a monthly average of \$5,250. The difference between the straight-line method, and the actual lease payments have resulted in a deferred rent liability of \$72,738 as of December 31, 2008. Rent expense, net of contractual and month to month sub-lease rental income was \$12,504 and \$20,053 and \$25,008 and \$51,234 for the three and six months ended December 31, 2008 and 2007, respectively.

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BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES  
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9. OPERATING LEASE (CONTINUED):

At December 31, 2008, future minimum rental payments due under non-cancelable leases and future minimum rental payments to be received under non-cancelable subleases are:

| Fiscal year:                   | Operating lease<br>payments | Sublease<br>rentals | Net operating<br>lease payments |
|--------------------------------|-----------------------------|---------------------|---------------------------------|
| -----                          | -----                       | -----               | -----                           |
| Six months ended June 30, 2009 | \$ 92,520                   | \$ 29,606           | \$ 62,914                       |
| 2010                           | 191,405                     | 61,249              | 130,156                         |
| 2011                           | 198,602                     | 63,553              | 135,049                         |
| 2012                           | 212,775                     | 68,088              | 144,687                         |
| 2013                           | 225,756                     | 72,242              | 153,514                         |
| Thereafter                     | 97,219                      | 31,110              | 66,109                          |
|                                | -----                       | -----               | -----                           |
| Total                          | \$1,018,277                 | \$325,848           | \$692,429                       |
|                                | =====                       | =====               | =====                           |

Effective January 1, 2009, Mr. Zizza has entered into a Master Sublease with the Company whereby Mr. Zizza will become a subleasee and will, for a one year initial period, make all payments pursuant to the lease and manage the lease premises. Rental payments from existing sub-tenants will be deposited into a Company bank account such that Mr. Zizza will have use of those funds towards the monthly lease payment. Mr. Zizza will have the option on or before November 15, 2009 to continue the Master Sublease for the entire period of the lease. If Mr. Zizza fulfills his obligations under the Master Sublease during the one year initial period, he shall receive the funds from the next release from the Company's letter of credit approximating \$28,000. If Mr. Zizza exercises the option to continue the Master Sublease for the entire term of the lease, Mr. Zizza will be entitled to the balance of funds held under the letter of credit.

10. COMMITMENTS AND CONTINGENCIES:

Employment and consulting agreements:

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The Company had an employment agreement with its president, Mr. Smith, through December 31, 2007 providing \$150,000 per year compensation. On November 7, 2007, the Company extended the employment agreement through December 31, 2008. On May 31, 2008, an agreement was reached whereby Mr. Smith would continue his services as president through December 31, 2008 and effective January 1, 2009 (or March 31, 2009 at the latest) through December 31, 2009, he would provide services to the Company in a consulting capacity at his current compensation. On January 11, 2009, the Company and Mr. Smith entered into the Smith Agreement whereby Mr. Smith will continue to hold

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BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS  
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### 10. COMMITMENTS AND CONTINGENCIES (CONTINUED):

#### Employment and consulting agreements (continued):

positions of Director, President and General Counsel of the Company and its subsidiaries. Pursuant to the Smith Agreement, Mr. Smith was granted a \$37,500 bonus in the form of a warrant (and extension of outstanding warrants previously issued to Mr. Smith), immediately vested, to purchase 300,000 shares of the Company's common stock at \$0.75 per share until December 31, 2018 and Mr. Smith shall accept pre-payment of his calendar year 2009 base compensation of \$150,000 in the form of 200,000 restricted shares of Company common stock at a price of \$0.75 per share. In addition, Mr. Smith converted his deferred compensation as of December 31, 2008 into shares of the Company's common stock (See Note 7).

Effective March 31, 2005, an agreement with Brightcap, through which the services of Dominic Bassani, are provided, was extended through March 31, 2009. Under the terms of the agreement, Brightcap will be paid \$300,000 annually for Mr. Bassani's services. On January 11, 2009, the Company entered in the Brightcap Agreement, which extends Mr. Bassani's services under the terms of the March 31, 2005 agreement for up to an additional six months. In addition, Mr. Bassani was granted a bonus of \$125,000 in the form of a) warrant, immediately vested, to purchase 1,000,000 shares of the Company's common stock at \$0.75 per share until December 31, 2018 and b) the extension of all warrants previously issued to either Brightcap or Mr. Bassani, now held by their donees, to December 31, 2018. The Brightcap Agreement also requires that upon the consummation of the next financing received by the Company in excess of \$1,000,000 net proceeds, the Company will no longer defer compensation earned by Brightcap, rather it will be paid in cash and the Brightcap Agreement grants Brightcap the right to convert its existing deferred compensation as of December 31, 2008 of \$175,000 into 233,334 shares of the Company's common stock at a price of \$0.75 per share until December 31, 2009. The Brightcap Agreement also extends the maturity date of Mr. Bassani's \$50,000 promissory note to June 30, 2009 and allows for the conversion of the principal and interest, in whole or in part, at the election of Mr. Bassani, into the Company's restricted common shares at \$0.75 per share.

Effective May 1, 2005, the Company entered into a four-year consulting/employment agreement with a former officer and director of the Company, Salvatore Zizza. As of January 1, 2006, the former officer and director assumed the position of Chairman and director of Dairy, with an annual salary of \$300,000. Pursuant to an agreement dated December 19, 2008,

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Mr. Zizza will no longer provide services to the Company as of December 31, 2008 and the following terms were agreed upon: a) Mr. Zizza's 600,000 warrants shall be returned to the Company and the Company will reissue a certificate to Mr. Zizza representing 150,000 warrants with no changes in the terms and conditions of the original warrants, b) all options currently owned

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### BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS SIX MONTHS ENDED DECEMBER 31, 2008

#### 10. COMMITMENTS AND CONTINGENCIES (CONTINUED):

##### Employment and consulting agreements (continued):

by Mr. Zizza shall vest on the existing schedule, c) the Company shall cancel the 2007 Series AB Convertible Promissory Note owned by Mr. Zizza which represented accrued deferred compensation from the Company (see Note 5), d) the \$50,000 promissory note owed to Mr. Zizza shall remain outstanding however it will be amended to include the right of Mr. Zizza to convert the principal and interest, in whole or part, into the Company's common stock at a price of \$0.75 per share at any date prior to the repayment of the Company (see Note 6), e) the Company's existing accrued payable of \$41,647 shall remain a valid obligation of the Company with the additional right of Mr. Zizza to convert the accrued payable, in whole or in part, into the Company's restricted common stock at a price of \$0.75 per share (see Note 11) and f) the Company entered into a Master Sublease as described in Note 9.

Effective May 1, 2005, the Company entered into a four-year consulting/employment agreement with Jeff Kapell. Under the terms of the agreement, Mr. Kapell provided part-time services to the Company through March 2006. In April 2006, Mr. Kapell was appointed Dairy's Vice President-Renewables at a salary of \$120,000 per year. In June 2008, the employment agreement terms were extended through July 1, 2012. Mr. Kapell left the employ of the Company effective November 1, 2008 by mutual agreement. Mr. Kapell has performed consulting services for the Company since November 2008.

Effective September 18, 2006, the Company entered into a four-year employment agreement with Jeremy Rowland whereby Mr. Rowland assumed the position of Chief Operating Officer of Dairy at an annual salary of \$150,000. In June 2008, the employment agreement terms were extended through July 1, 2012. Mr. Rowland now serves as Chief Operating Officer of the Company's Services Group subsidiary.

Effective June 1, 2007, the Company entered into an employment agreement, effective through August 31, 2009, with Craig Scott whereby Mr. Scott was appointed Vice President of Capital Markets/Investor Relations at an annual salary of \$120,000.

In May 2005 the Company declared contingent deferred stock bonuses of 690,000 shares to its key employees and consultants. The stock bonuses of 492,500 and 197,500 shares are contingent upon the Company's stock price exceeding \$10.00 and \$20.00 per share, respectively, and the grantees still being employed by or providing services to the Company at the time the target prices are reached. As of December 31, 2008, 422,500 shares remain outstanding due to the expiry of 125,000 and 62,500 shares exceeding \$10.00 and \$20.00 per share, respectively.

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In May 2008, the Company approved 250,000 stock options to certain employees that will be granted upon the execution of new employment agreements.

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### BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS SIX MONTHS ENDED DECEMBER 31, 2008

#### 10. COMMITMENTS AND CONTINGENCIES (CONTINUED):

Employment and consulting agreements (continued):

Claims contingency:

In May 2002, Arab Commerce Bank Ltd. ("ACB"), an unaffiliated party, filed a complaint against the Company in the Supreme Court of the State of New York regarding \$100,000 of the Company's convertible bridge notes ("Bridge Notes") that were issued to ACB in March 2000. The complaint includes a breach of contract claim asserting that the Company owes ACB approximately \$285,000 plus interest of \$121,028 plus interest based on ACB's interpretation of the terms of the Bridge Notes and subsequent amendments. Effective June 30, 2001, the Company issued ACB 5,034 shares of common stock in full satisfaction of the Bridge Notes based on the Company's interpretation of the Bridge Notes, as amended. The Company has filed an answer to the complaint denying the allegations. No activity has taken place on this lawsuit since early 2003. The Company believes that the ultimate resolution of this litigation will not have a material adverse effect on the Company, its operations or its financial condition.

#### 11. RELATED PARTY TRANSACTIONS:

The Company has an accrued payable of \$41,647 as of December 31, 2008, to a company controlled by Mr. Zizza for rental of office space in 2003. Pursuant to the Zizza Agreement, Mr. Zizza has the option to convert the payable into common shares of the Company's stock at \$0.75 per share at any time prior to the obligation being paid by the Company.

#### 12. SUBSEQUENT EVENT:

In January-February 2009, the Company issued 105,000 shares of its restricted common stock at \$0.75 per share for cash proceeds of \$78,750.

On January 28, 2009 the Board of the Pennsylvania Infrastructure Investment Authority approved a \$7.8 million loan to Bion PA 1, LLC, a wholly-owned subsidiary of the Company, for the initial stage of Bion's Kreider Farms project. The Company anticipates that it will be able to complete the steps required to finalize this loan and commence this project during the current fiscal year.

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

The following discussion and analysis should be read in conjunction with the Unaudited Consolidated Financial Statements and Notes to Consolidated Financial Statements filed herein and with the Company's Form 10-KSB for the year ended June 30, 2008.

BUSINESS OVERVIEW

For several years, the Company focused on completion of the development of its second-generation technology which provides a comprehensive environmental solution to a significant source of pollution in U.S. agriculture, Confined Animal Feeding Operations ("CAFO's"), which development is now substantially complete. Currently, Bion is focused on using applications of its patented waste management technology to pursue two main business opportunities: 1) to develop Integrated Projects which will include large CAFOs, such as large dairies, beef cattle feed lots and hog farms, with Bion waste treatment System modules processing the aggregate CAFO waste stream from the equivalent of 40,000 or more beef and/or dairy cows (or the waste stream equivalent of other species) while producing solids to be utilized for renewable energy production (and potentially to be marketed as feed and/or fertilizer), integrated with an ethanol plant capable of producing 40 (or more) million gallons of ethanol per year and/or with CAFO end product processors, and 2) environmental retrofit and remediation of the waste streams of existing CAFOs in selected markets.

The Company has commenced actively pursuing the opportunity presented by environmental retrofit and remediation of the waste streams of existing CAFOs. The first commercial activity in this area is the recently announced agreement with Kreider Farms in Pennsylvania. On January 28, 2009 the Board of the Pennsylvania Infrastructure Investment Authority approved a \$7.8 million loan to Bion PA 1, LLC, a wholly-owned subsidiary of the Company, for the initial stage of Bion's Kreider Farms project. The Company anticipates that it will be able to complete the steps required to finalize this loan and commence this project during the current fiscal year.

Additionally, we believe that Bion's technology platform allows the integration of large-scale CAFO's and their end-product users, renewable energy production from the CAFO waste stream, on site utilization of the renewable energy generated and biofuel/ethanol production in an environmentally and economically sustainable manner while reducing the aggregate capital expense and operating costs for the entire integrated complex ("Integrated Projects" or "Projects"). In the context of Integrated Projects, Bion's waste treatment process, in addition to mitigating polluting releases, generates renewable energy from portions of the CAFO waste stream which renewable energy can be utilized by integrated ethanol plants, CAFO end-product processors (including cheese, ice cream and /or bottling plants in the case of dairy CAFOs and/or slaughter and/or processing facilities in the context of beef CAFOs) and/or other users as a natural gas replacement. Note that an integrated ethanol plant's main by-product, called distillers grain, can be added to the feed of the animals in wet form thereby lowering

the capital expenditures, operating, marketing and shipping costs and energy usage of the ethanol production process. The ethanol plant thereby acts as a feed mill for the CAFO, thus reducing the CAFO's feeding costs and generating



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revenue to the ethanol plant, and also provides a market for the renewable energy that Bion's System produces from the CAFO waste stream. Thus, such Bion Integrated Projects can be denominated "closed loop". Bion, as developer of and participant in Integrated Projects, anticipates that it will share in the cost savings and revenue generated from these activities.

Bion is currently working with local, state and federal officials and with potential industry participants to evaluate sites in multiple states and anticipates selecting a site for its initial Project during the 2009 calendar year. At present it is possible, but not certain, that the initial Integrated Project will be located in upstate New York (although locations in other states are also under review). In addition, Bion intends to choose sites for additional Projects during the remainder of calendar years 2009-2010 to create a pipeline of Projects. Management has a 5-year development target (through calendar year 2014) of approximately 12-25 Integrated Projects. At the end of the 5-year period, Bion projects that 8 or more of these Integrated Projects will be in full operation in 3-8 states, and the balance would be in various stages ranging from partial operation to early permitting stage. No Integrated Project has been developed to date.

The financial statements for the years ended June 30, 2008 and 2007 have been prepared assuming the Company will continue as a going concern. The Company has incurred net losses of approximately \$1,779,000 and \$2,549,000 during the years ended June 30, 2008 and 2007, respectively. At June 30, 2008, the Company had a working capital deficiency and a stockholders' deficit of approximately \$134,000 and \$920,000, respectively. The financial statements for the three and six months ended December 31, 2008 and 2007 have also been prepared assuming the Company will continue as a going concern. The Company has incurred net income (loss) of approximately \$794,000 and (\$136,000) for the three and six month periods ended December 31, 2008, respectively. At December 31, 2008, the Company has a working capital deficiency and a stockholders' deficit of approximately \$939,000 and \$1,002,000, respectively. The report of the independent registered public accounting firm on the Company's consolidated financial statements as of and for the year ended June 30, 2008 includes a "going concern" explanatory paragraph which means that the accounting firm has expressed substantial doubt about the Company's ability to continue as a going concern. Management's plans with respect to these matters are described in this section and in our consolidated financial statements, and this material does not include any adjustments that might result from the outcome of this uncertainty. There is no guarantee that we will be able to raise the funds or raise further capital for the operations planned in the near future.

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### CRITICAL ACCOUNTING POLICIES

Management has identified the following policies below as critical to our business and results of operations. Our reported results are impacted by the application of the following accounting policies, certain of which require management to make subjective or complex judgments. These judgments involve making estimates about the effect of matters that are inherently uncertain and may significantly impact quarterly or annual results of operations. For all of these policies, management cautions that future events rarely develop exactly as expected, and the best estimates routinely

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require adjustment. Specific risks associated with these critical accounting policies are described in the paragraphs below.

### Revenue Recognition

While the Company has not recognized any operating revenues for the past two fiscal years, the Company anticipates that future revenues will be generated from product sales, credit sales, technology license fees, annual waste treatment fees and/or direct ownership interests in Integrated Projects. The Company expects to recognize revenue from product sales when there is persuasive evidence that an arrangement exists, when title has passed, the price is fixed or determinable, and collection is reasonably assured. The Company expects that technology license fees will be generated from the licensing of Bion's Systems. The Company anticipates that it will charge its customers a non-refundable up-front technology license fee, which will be recognized over the estimated life of the customer relationship. In addition, any on-going technology license fees will be recognized as earned based upon the performance requirements of the agreement. Annual waste treatment fees will be recognized upon receipt. Revenues, if any, from the Company's interest in Projects will be recognized when the entity in which the Project has been developed recognizes such revenue.

### Compensation Cost for Options with Service Conditions and Graded Vesting Schedules

The Company has issued non-employee options that include service conditions and have graded vesting schedules. Generally for these arrangements, the measurement date of the services occurs when the options vest. In accordance with Emerging Issues Task Force Issue No. 96-18, recognition of compensation cost for reporting periods prior to the measurement date is based on the then current fair value of the options. Fair value of the options is determined using a Black-Scholes option-pricing model. Any subsequent changes in fair value will be recorded on the measurement date. Compensation cost in connection with options that are not fully vested is being recognized on a straight-line basis over the requisite service period for the entire award.

### Stock-based compensation

On July 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123 (Revised), "Share-Based Payment" ("SFAS 123(R)"), which supersedes Accounting Principles Board Opinion No. 25 ("APB 25"), and generally requires that share-based compensation transactions be accounted and recognized in the statement of

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income based on their fair values. The Company adopted SFAS 123(R) using the modified prospective application under which all share based awards granted on or after the adoption date and modifications, repurchases or cancellation of prior awards made after the adoption date shall be accounted for under SFAS 123(R). The modified prospective application does not require the Company to restate prior period's financial results to reflect the adoption.

### RECENT ACCOUNTING PRONOUNCEMENTS

During October 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 157, Fair Value Measurements ("SFAS 157"). This statement does not require any new fair value measurements but provides guidance on how to measure fair value and clarifies the definition of fair value under accounting principles

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generally accepted in the United States of America. The statement also requires new disclosures about the extent to which fair value measurements in financial statements are based on quoted market prices, market-corroborated inputs, or unobservable inputs that are based on management's judgments and estimates. This statement was effective for the Company on July 1, 2008 for all financial assets and liabilities. In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, Effective Dates of FASB Statement No. 157 (the "FSP"). The FSP amends SFAS 157 to delay its effective date for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (that is, at least annually). For items within its scope, the FSP defers the effective date of SFAS 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. As it relates to financial assets and liabilities, the adoption of SFAS 157 did not have an impact on the Company's consolidated financial statements. The Company is still in the process of evaluating the impact that SFAS 157 will have on its non-financial assets and liabilities.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115 ("SFAS 159"). This statement permits entities to choose to measure eligible items at fair value at specified election dates. SFAS 159 was effective for the Company on July 1, 2008. The Company did not apply the fair value option to any of its outstanding instruments, and therefore, SFAS 159 did not have an impact on the consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), Business Combinations ("SFAS 141R"). SFAS 141R continues to require the purchase method of accounting to be applied to all business combinations, but it significantly changes the accounting for certain aspects of business combinations. Under SFAS 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS 141R will change the accounting treatment for certain specific acquisition related items including: (1) expensing acquisition related costs as incurred; (2) valuing non-controlling interests at fair value at the acquisition date; and (3) expensing restructuring costs associated with an acquired business. SFAS

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141R also includes a substantial number of new disclosure requirements. SFAS 141R is to be applied prospectively to business combinations for which the acquisition date is on or after July 1, 2009 for the Company. The Company does not expect that the adoption of SFAS 141R will have an impact on its consolidated financial statements unless the Company enters into business acquisitions in the future.

In December 2007, the FASB issued SFAS No. 160, Non-controlling Interests in Consolidated Financial Statements ("SFAS 160"). SFAS 160 establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a non-controlling interest in a subsidiary (minority interest) is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements and separate from the parent company's equity. Among other requirements, this statement requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the non-controlling interest. It also requires disclosure, on the face of the consolidated statement of operations, of the amounts of consolidated net income attributable to the parent and to

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the non-controlling interest. This statement is effective for the Company on July 1, 2009. The Company is currently evaluating the effect the adoption of this statement may have on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133 ("SFAS 161"). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities by requiring that the objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation. The statement is effective for the Company on January 1, 2009. The Company does not expect that the adoption of SFAS 161 will have an impact on its consolidated financial statements.

THREE MONTHS ENDED DECEMBER 31, 2008 COMPARED TO THE THREE MONTHS ENDED DECEMBER 31, 2007

### General and Administrative

Total general and administrative expenses increased slightly from \$155,000 to \$159,000 for the three months ended December 31, 2007 and 2008, respectively.

General and administrative expenses, excluding stock-based compensation charges/(credits) of \$(314,000) and \$107,000 for the three months ended December 31, 2008 and 2007, respectively, were \$473,000 versus \$48,000 for the three months ended December 31, 2008 and 2007, respectively. The primary reason for the increase in general and administrative expenses excluding stock-based compensation during the three months ended December 31, 2008 is due to the shift in the Company's focus from research and development to pre-commercial and commercial business activities related to its next generation technology applications, therefore costs of various employees and consultants (and their activities) that were previously incurred as research and development expense are now allocated to general and administrative expense. Salary and payroll related taxes were \$146,000 and \$44,000 for the three

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months ended December 31, 2008 and 2007, respectively, and the increase is due to the expensing of previous research and development employees to general and administrative expense. Consulting expense increased from \$7,000 to \$124,000 for the three months ended December 31, 2007 and 2008, respectively due to the Company's shift from research and development to general and administrative described above and additional lobbying and public relations consulting during the three months ended December 31, 2008. Legal costs were \$24,000 and \$(126,000) for the three months ended December 31, 2008 and 2007, respectively, and the increase was due to the absence of the insurance reimbursement for fiscal year 2008 legal fees associated with the Centerpoint litigation. Accounting and tax costs decreased from \$39,000 for the three months ended December 31, 2007 to \$8,000 during the same period in fiscal year 2009, due to lower quarterly review costs and tax related expenses. The Company also incurred lower rent expense, \$15,000 and \$25,000 for the three months ended December 31, 2008 and 2007, respectively, due to additional sub-tenant month to month rentals during the three months ended December 31, 2008.

General and administrative stock-based compensation for the three years ended December 31, 2008 and 2007 consist of the following:

| Three months ended | Three months ended |
|--------------------|--------------------|
|--------------------|--------------------|

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|   | December 31,<br>2008 | December 31,<br>2007 |
|---|----------------------|----------------------|
|   | -----                | -----                |
| Fair value remeasurement of convertible notes - affiliates  | \$ -                 | \$ (43,000)          |
| Fair value remeasurement of options with service conditions | (390,000)            | -                    |
| Fair value of stock options expensed under SFAS 123(R)      | 76,000               | 150,000              |
|   | -----                | -----                |
| Total   | \$(314,000)          | \$ 107,000           |
|   | =====                | =====                |

Stock-based compensation charges/(credits) decreased to \$(314,000) for the three months ended December 31, 2008 from \$107,000 for the three months ended December 31, 2007. The change in stock-based compensation fair value adjusted expense relating to the President's convertible deferred compensation of \$(43,000) is primarily due to the fact his note was converted in December 2007, therefore no remeasurement was required for the three months ended December 31, 2008. For the three months ended December 31, 2008 the Company recognized expense relating to the fair value of stock options for general and administrative employees of \$76,000, compared to \$150,000. The Company also recognized as general and administrative expenses \$(390,000) for the remeasurement of options with service conditions due to the reallocation of research and development related costs and the decrease in the fair value of the options from approximately \$2.10 per share to approximately \$0.97 per share during the three months ended December 31, 2008.

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Research and development

Total research and development expenses have decreased \$474,000 from \$545,000 to \$71,000 for the three months ended December 31, 2007 and 2008, respectively.

Research and development expenses, excluding stock-based compensation charges of \$8,000 and \$55,000 for the three months ended December 31, 2008 and 2007, respectively, were \$63,000 and \$490,000 for the three months ended December 31, 2008 and 2007, respectively. The primary reason for the decrease in research and development expenses during the three months ended December 31, 2008 is due to the shift in the Company's focus from research and development to pre-commercial and commercial activities related to its next generation technology applications, therefore costs of various employees and consultants (and their related activities) that were previously incurred as research and development expense are now allocated to general and administrative expense. Salary and payroll related taxes were \$45,000 and \$176,000 for the three months ended December 31, 2008 and 2007, respectively, and the decrease is due to the expensing of previous research and development employees to general and administrative. Consulting expenses also decreased significantly, from \$234,000 to \$3,000 for the three months ended December 31, 2007 and 2008, respectively, due to the shift from research and development to general and administrative.

Research and development stock-based compensation for the three months ended December 31, 2008 and 2007 consist of the following:

| Three months<br>ended | Three months<br>ended |
|-----------------------|-----------------------|
|-----------------------|-----------------------|

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|   | December 31,<br>2008 | December 31,<br>2007 |
|---|----------------------|----------------------|
|   | -----                | -----                |
| Fair value remeasurement of convertible notes - affiliates  | \$ -                 | \$ (96,000)          |
| Fair value remeasurement of options with service conditions | -                    | 81,000               |
| Fair value of stock options expensed under SFAS 123 (R)     | 8,000                | 70,000               |
|   | -----                | -----                |
| Total   | \$ 8,000             | \$ 55,000            |
|   | =====                | =====                |

Stock-based compensation charges decreased from \$55,000 for the three months ended December 31, 2007 to \$8,000 for the same period in fiscal year 2009. Stock-based compensation fair value adjusted credits of \$(96,000) for the three months ended December 31, 2007, were recorded to re-measure the fair value of Brightcap's convertible deferred compensation. There was no similar charge for the three months ended December 31, 2008 as the note was converted at May 31, 2008. The Company recorded stock-based compensation expense of \$8,000 and \$70,000 under the provisions of SFAS 123(R) for the three months ended December 31, 2008 and 2007, respectively for options vested to research and development employees. The decrease is due to expensing options issued to employees who in the prior year were deemed to be

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research and development and in the fiscal year 2009 were primarily allocated to general and administrative. The Company also recognized as research and development expenses \$81,000 for the remeasurement of options with service conditions for the three months ended December 31, 2007 while no expense was recognized for the three months ended December 31, 2008 due to the allocation of such expenses to general and administrative expenses.

Loss from Operations

As a result of the factors described above, the loss from operations was \$229,000 and \$699,000 for the three months ended December 31, 2008 and 2007, respectively.

Other expense and (income)

Other expense and (income) was \$(1,023,000) and \$94,000 for the three months ended December 31, 2008 and 2007, respectively. Interest expense decreased \$35,000 from \$51,000 for the three months ended December 31, 2007 to \$16,000 for the three months ended December 31, 2008. Interest expense decreased due to the lower debt balances on the 2006 and 2007 Series A Notes for the three months ended December 31, 2008. For the three months ended December 31, 2008, the Company recognized other income of \$1,034,000 due to the forfeiture of deferred compensation relating the cancellation of Mr. Zizza's Notes of \$959,000 and a \$75,000 settlement with the Company's directors and officers liability insurance providers. For the three months ended December 31, 2007, the Company received reimbursements for legal fees relating to the Centerpoint litigation which resulted in a positive net equity position for the Company's majority held subsidiary, Centerpoint, which resulted in the recording of the \$53,000 minority interest expense of Centerpoint for the three months ended December 31, 2007 while for the three months ended December 31, 2008 the amount was \$(4,000).

Net income (loss)

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As a result of the factors described above, the net income (loss) was 794,000 and \$(794,000) for the three months ended December 31, 2008 and 2007, respectively, representing a \$0.18 increase in the net earnings per basic and net earnings per diluted common share, respectively, for the three months ended December 31, 2008 and 2007, respectively.

SIX MONTHS ENDED DECEMBER 31, 2008 COMPARED TO THE SIX MONTHS ENDED DECEMBER 31, 2007

### General and Administrative

Total general and administrative expenses increased from \$309,000 to \$788,000 for the six months ended December 31, 2007 and 2008, respectively.

General and administrative expenses, excluding stock-based compensation credits of \$161,000 and \$9,000 for the six months ended December 31, 2008 and 2007, respectively, were \$949,000 versus \$318,000 for the six months ended December 31, 2008 and 2007, respectively. The primary reason for the increase in general and administrative expenses excluding stock-based compensation during the six months ended December 31, 2008 is due to the

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shift in the Company's focus from research and development to pre-commercial and commercial business activities related to its next generation technology applications, therefore costs of various employees and consultants (and their activities) that were previously incurred as research and development expense are now allocated to general and administrative expense. Salary and payroll related taxes were \$280,000 and \$90,000 for the six months ended December 31, 2008 and 2007, respectively, and the increase is due to the expensing of previous research and development employees to general and administrative expense. Consulting expense increased from \$33,000 to \$268,000 for the six months ended December 31, 2007 and 2008, respectively due to the Company's shift from research and development to general and administrative described above and additional lobbying and public relations consulting during the six months ended December 31, 2008. Legal costs increased \$71,000 for the six months ended December 31, 2008 due to the fact during the six months ended December 31, 2007 insurance reimbursements for the Centerpoint litigation of \$133,000 were received. The Company also incurred lower rent expense, \$31,000 and \$56,000 for the six months ended December 31, 2008 and 2007, respectively, due to additional sub-tenant month to month rentals during the six months ended December 31, 2008.

General and administrative stock-based compensation for the six years ended December 31, 2008 and 2007 consist of the following:

|   | Six months<br>ended<br>December 31,<br>2008 | Six months<br>ended<br>December 31,<br>2007 |
|---|---|---|
|   | -----                                       | -----                                       |
| Fair value remeasurement of convertible notes - affiliates  | \$ -  | \$(237,000)                                 |
| Fair value remeasurement of options with service conditions | (275,000)                                   | -   |
| Fair value of stock options expensed under SFAS 123(R)      | 114,000                                     | 228,000                                     |
|   | -----                                       | -----                                       |
| Total   | \$(161,000)                                 | \$ (9,000)                                  |
|   | =====                                       | =====                                       |

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Stock-based compensation credits decreased to \$161,000 for the six months ended December 31, 2008 from \$9,000 for the six months ended December 31, 2007. The change in stock-based compensation fair value adjusted expense relating to the President's convertible deferred compensation of \$(237,000) is primarily due to the fact his note was converted in December 2007, therefore no remeasurement was required for the six months ended December 31, 2008. For the six ended December 31, 2008 the Company recognized expense relating to the fair value of stock options for general and administrative employees of \$114,000, compared to \$228,000 for the six months ended December 31, 2007. The Company also recognized as general and administrative expenses \$(275,000) for the remeasurement of options with service conditions due to the reallocation of research and development related costs and the decrease in the fair value of the options from approximately \$2.06 per share to approximately \$0.97 per share during the six months ended December 31, 2008.

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### Research and development

Total research and development expenses have decreased \$325,000 from \$672,000 to \$347,000 for the six months ended December 31, 2007 and 2008, respectively.

Research and development expenses, excluding stock-based compensation charges/(credits) of \$98,000 and \$(295,000) for the three six months ended December 31, 2008 and 2007, respectively, were \$249,000 and \$967,000 for the three months ended December 31, 2008 and 2007, respectively. The primary reason for the decrease in research and development expenses during the six months ended December 31, 2008 is due to the shift in the Company's focus from research and development to pre-commercial and commercial activities related to its next generation technology applications, therefore costs of various employees and consultants (and their related activities) that were previously incurred as research and development expense are now allocated to general and administrative expense. Salary and payroll related taxes were \$147,000 and \$357,000 for the six months ended December 31, 2008 and 2007, respectively, and the decrease is due to the expensing of previous research and development employees to general and administrative. Consulting expenses also decreased significantly, from \$300,000 to \$16,000 for the six months ended December 30, 2007 and 2008, respectively, due to the shift from research and development to general and administrative.

Research and development stock-based compensation for the six months ended December 31, 2008 and 2007 consist of the following:

|   | Six months<br>ended<br>December 31,<br>2008 | Six months<br>ended<br>December 31,<br>2007 |
|---|---|---|
|   | -----                                       | -----                                       |
| Fair value remeasurement of convertible notes - affiliates  | \$ -  | \$ (362,000)                                |
| Fair value remeasurement of options with service conditions | 65,000                                      | (70,000)                                    |
| Fair value of stock options expensed under SFAS 123 (R)     | 33,000                                      | 137,000                                     |
|   | -----                                       | -----                                       |
| Total   | \$ 98,000                                   | \$ (295,000)                                |
|   | =====                                       | =====                                       |



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Stock-based compensation charges/(credits) increased from \$(295,000) for the six months ended December 31, 2007 to \$98,000 for the same period in fiscal year 2009. Stock-based compensation fair value adjusted credits of \$(362,000) for the six months ended December 31, 2007, were recorded to re-measure the fair value of Brightcap's convertible deferred compensation. There was no similar charge for the six months ended December 31, 2008 as the note was converted at May 31, 2008. The Company recorded stock-based compensation expense of \$33,000 and \$137,000 under the provisions of SFAS 123(R) for the six months ended December 31, 2008 and 2007, respectively for options vested to research and development employees. The decrease is due to

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expensing options issued to employees who in the prior year were deemed to be research and development and in the fiscal year 2009 were primarily allocated to general and administrative. The Company also recognized as research and development expenses \$(70,000) for the remeasurement of options with service conditions for the six months ended December 31, 2007 while \$65,000 was recognized for the six months ended December 31, 2008 due to the allocation of such expenses to general and administrative expenses.

### Loss from Operations

As a result of the factors described above, the loss from operations was \$1,135,000 and \$980,000 for the six months ended December 31, 2008 and 2007, respectively.

### Other expense and (income)

Other expense and (income) was \$(999,012) and \$(1,044,000) for the six months ended December 31, 2008 and 2007, respectively. Interest expense decreased \$76,000 from \$104,000 for the six months ended December 31, 2007 to \$28,000 for the six months ended December 31, 2008. Interest expense decreased due to the lower debt balances on the 2006 and 2007 Series A Notes for the six months ended December 31, 2008. For the six months ended December 31, 2008, the Company recognized other income of \$1,034,000 due to the forfeiture of deferred compensation relating the cancellation of Mr. Zizza's Notes of \$959,000 and a \$75,000 settlement with the Company's director's and officer's liability insurance providers. For the six months ended December 31, 2007, the Company recognized other income of \$1,258,000 due to the receipts of \$828,000 from litigation settlements and \$430,000 from release of previously escrowed funds owed to Centerpoint. The receipts of the litigation settlement proceeds and the escrowed funds resulted in a positive net equity position for the Company's majority held subsidiary, Centerpoint, which resulted in the recording of the \$127,000 minority interest expense of Centerpoint for the six months ended December 31, 2007 while for the six months ended December 31, 2008 the amount was \$10,000.

### Net (loss) income

As a result of the factors described above, the net (loss) income was \$(136,000) and \$63,000 for the six months ended December 31, 2008 and 2007, respectively, representing a \$0.02 decrease in the net earnings per basic and net earnings per diluted common share, respectively, for the six months ended December 31, 2008 and 2007, respectively.

### LIQUIDITY AND CAPITAL RESOURCES

As of December 31, 2008, the Company had cash and cash equivalents equal to \$37,000. During the six months ended December 31, 2008, net cash used in operating activities was \$754,000, primarily consisting of cash operating

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expenses. As previously noted, the Company is currently not generating revenue and accordingly has not generated cash flows from operations. The Company does not anticipate generating sufficient revenues to offset operating and capital costs for a minimum of two to five years. While there are no assurances that the Company will be successful in its efforts to

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develop and construct its Projects and market its Systems, it is certain that the Company will require significant funding from external sources. Given the unsettled state of the current credit and capital markets, there is no assurance the Company will be able to raise the funds it needs on reasonable terms.

### Investing Activities

During the six months ended December 31, 2008 the Company provided \$42,000 of cash due to the release of restricted cash related to the New York office operating lease.

### Financing Activities

During the six months ended December 31, 2008, \$165,000 of cash was provided by financing activities from short-term promissory notes - affiliates and \$105,000 of cash was provided from the sale of the Company's restricted common stock.

As of December 31, 2008 the Company has significant debt obligations consisting primarily of deferred compensation of \$241,000 and promissory notes - affiliates of \$167,000. The Company has entered into an 88-month operating lease for office space in New York City, with an average monthly lease expense of \$15,820.

### Plan of Operations and Outlook

As of December 31, 2008 the Company had cash and cash equivalents of approximately \$37,000. Based on our operating plan, management believes that existing cash on hand will not be sufficient to fund the Company's basic overhead through the end of the 2009 fiscal year.

The Company currently faces a severe working capital shortage and it is not currently generating any revenues. The Company will need to obtain additional capital to fund its operations and technology development, to satisfy existing creditors and to develop Projects. The Company anticipates that it will seek to raise from \$3,000,000 to \$50,000,000 (debt and equity) during the next twelve months. There is no assurance, especially in the extremely unsettled capital markets that presently exist, that the Company will be able to obtain the funds that it needs to stay in business, complete its technology development or to successfully develop its business.

There can be no assurance that funds required during the next twelve months or thereafter will be generated from operations or that those funds will be available from external sources such as debt or equity financings or other potential sources. The lack of additional capital resulting from the inability to generate cash flow from operations or to raise capital from external sources would force the Company to substantially curtail or cease operations and would, therefore, have a material adverse effect on its business. Further, there can be no assurance that any such required funds, if available, will be available on attractive terms or that they will not have a significantly dilutive effect on the Company's existing shareholders. All of these factors have been exacerbated by the extremely unsettled credit and

capital markets presently existing.

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Currently, Bion is focused on using applications of its patented waste management technology to pursue two main business opportunities: 1) to develop Integrated Projects which will include large CAFOs, such as large dairies, beef cattle feed lots and hog farms, with Bion waste treatment System modules processing the aggregate CAFO waste stream from the equivalent of 40,000 or more beef and/or dairy cows (or the waste stream equivalent of other species) while producing solids to be utilized for renewable energy production (and potentially to be marketed as feed and/or fertilizer), integrated with an ethanol plant capable of producing 40 (or more) million gallons of ethanol per year and/or integrated with CAFO end product processors, and 2) environmental retrofit and remediation of the waste streams of existing CAFOs in selected markets.

Bion is currently working with local, state and federal officials and with potential industry participants to evaluate sites in multiple states and anticipates selecting a site for its initial Project during the 2009 calendar year. At present it is possible, but not certain, that the initial Integrated Project will be located in upstate New York (although locations in other states are also under review). In addition, Bion intends to choose sites for additional Projects during the remainder of calendar years 2009-2010 to create a pipeline of Projects. Management has a 5-year development target (through calendar year 2014) of approximately 12-25 Integrated Projects. At the end of the 5-year period, Bion projects that 8 or more of these Integrated Projects will be in full operation in 3-8 states, and the balance would be in various stages ranging from partial operation to early permitting stage. No Integrated Project has been developed to date.

The Company has also commenced actively pursuing the opportunity presented by environmental retrofit and remediation of the waste streams of existing CAFOs in selected markets. The first commercial activity in this area is the recently announced agreement with Kreider Farms in Pennsylvania.

#### CONTRACTUAL OBLIGATIONS

We have the following material contractual obligations (in addition to employment and consulting agreements with management and employees):

1) The Company executed a non-cancelable operating lease for office space in New York City effective August 1, 2006 and extending to November 30, 2013. The average monthly rent expense under the lease is \$15,820. The Company has provided the lessor with a letter of credit in the amount of \$85,973 in connection with the lease as of December 31, 2008. The Company's obligations under the lease are partially guaranteed by Salvatore Zizza, Chairman of Bion Dairy. The Company has entered into sub-leases with non-affiliated parties for approximately 32% of the obligations under the lease. Effective January 1, 2009, Mr. Zizza has entered into a Master Sublease with the Company whereby Mr. Zizza will become a sublessee and will, for a one year initial period, make all payments pursuant to the lease and manage the lease premises. Rental payments from existing sub-tenants will be deposited into a Company bank account such that Mr. Zizza will have use of those funds towards the monthly lease payment. Mr. Zizza will have the option on or before November 15, 2009 to continue the Master Sublease for the entire

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period of the lease. If Mr. Zizza fulfills his obligations under the Master Sublease during the one year initial period, he shall receive the funds from the next release from the Company's letter of credit approximating \$28,000. If Mr. Zizza exercises the option to continue the Master Sublease for the entire term of the lease, Mr. Zizza will be entitled to the balance of funds held under the letter of credit.

2) On September 27, 2008, the Company executed an agreement with Kreider Farms (and its affiliated entities) (collectively "Kreider") to design, construct and operate, through its wholly-owned subsidiary, Bion Services Group, Inc. ("Bion Services"), a Bion system to treat the waste of the dairy cows (milkers, dry cows and heifers) at the Kreider Dairy, located in Mannheim, Pennsylvania. In addition, the agreement provides for an integrated renewable energy facility that will provide energy for Bion's waste treatment facility through the combustion of the cellulose captured in the Bion process. The system will be owned and operated by Bion through a new entity to be formed and initially 100% owned by Bion Services, in which Kreider will have the option to purchase a minority interest. Upon completion of final design work and resolution of all building, zoning and other related pre-construction matters, it will be necessary to raise substantial capital (equity and/or debt) to construct and operate the Kreider system, which may be difficult to do on reasonable terms due to the current unsettled condition of the capital markets. Upon successful construction and operation of the system, the Company anticipates that it will receive revenue from the sale of nutrient (and other) environmental credits related to the Kreider system and through sales of renewable energy generated at the Kreider system. On January 27, 2009 the Board of the Pennsylvania Infrastructure Investment Authority (PENNVEST) approved a \$7.8 million loan to Bion for "the construction of a livestock waste treatment facility at Kreider Farms..." for the dairy portion of the Kreider Farms project. Definitive agreements regarding this loan have not yet been negotiated or executed.

### OFF-BALANCE SHEET ARRANGEMENTS

We do not have any off-balance sheet arrangements (as that term is defined in Item 303 of Regulation S-K) that are reasonably likely to have a current or future material effect on our financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Not Applicable.

### ITEM 4. CONTROLS AND PROCEDURES.

#### (a) Evaluation of Disclosure Controls and Procedures.

The term "disclosure controls and procedures" is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). This term refers to the controls and procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files under the Exchange Act is recorded, processed, summarized, and reported within the required time periods. Our

Chief Executive Officer and Principal Financial Officer has evaluated the effectiveness of the design and operations of our disclosure controls and procedures as of the end of the period covered by this quarterly report, and has concluded that, as of that date, our disclosure controls and procedures

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were not effective at ensuring that required information will be disclosed on a timely basis in our reports filed under the Exchange Act, as a result of the material weakness in internal control over financial reporting discussed in Item 8A(T) of our Form 10-KSB for the year ended June 30, 2008.

(b) Changes in Internal Control over Financial Reporting.

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the period covered by this report 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.

There have been no material developments in the legal proceedings described in our Form 10-KSB since filing.

ITEM 1A. RISK FACTORS.

Not Applicable.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

During the quarter ended December 31, 2008 the Company sold 140,000 shares of restricted common stock for \$105,000. The proceeds were used for working capital purposes.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

Not Applicable.

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

Not applicable.

ITEM 5. OTHER INFORMATION.

Not Applicable

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ITEM 6. EXHIBITS.

| Exhibit No. | Description  |
|-------------|--|
| 10.1        | Agreement between Jeff Kapell and Bion dated November 1, 2008 - Incorporated by reference to Exhibit 10.1 to Form 8-K dated October 30, 2008 |

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- 10.2 Agreement Between David Mager and Bion dated November 1, 2008 - Incorporated by reference to Exhibit 10.2 to Form 8-K dated October 30, 2008
- 10.3 Promissory Note between Anthony Orphanos and Bion dated October 30, 2008, Guaranteed by Dominic Bassani - Incorporated by reference to Exhibit 10.3 to Form 8-K dated October 30, 2008
- 10.4 Addendum to Settlement Agreement and Release Stipulation from Bion, Bion Dairy and Mark Smith dated October 31, 2008 - Incorporated by reference to Exhibit 10.4 to Form 8-K dated October 30, 2008
- 10.5 Agreement between Salvatore Zizza and Bion effective December 31, 2008 - Incorporated by reference to Exhibit 10.1 to Form 8-K dated December 31, 2008
- 10.6 Amendment #3 to 2006 Consolidated Incentive Plan - Incorporated by reference to Exhibit 10.2 to Form 8-K dated December 31, 2008
- 10.7 Agreement Between David Mager and Bion dated November 1, 2008 - Incorporated by reference to Exhibit 10.2 to the Registrant's Form 8-K dated October 30, 2008
- 10.8 Promissory Note between Anthony Orphanos and Bion dated October 30, 2008, Guaranteed by Dominic Bassani - Incorporated by reference to Exhibit 10.3 to the Registrant's Form 8-K dated October 30, 2008
- 10.9 Addendum to Settlement Agreement and Release Stipulation from Bion, Bion Dairy and Mark Smith dated October 31, 2008 - Incorporated by reference to Exhibit 10.4 to the Registrant's Form 8-K dated October 30, 2008
- 31.1 Certification of CEO and Principal Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) - Filed herewith electronically
- 32.1 Certification of CEO and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 - Filed herewith electronically

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### SIGNATURES

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

BION ENVIRONMENTAL TECHNOLOGIES, INC.

Date: February 12, 2009

By: /s/ Mark A. Smith  
Mark A. Smith, President (Chief  
Executive Officer) and Interim Chief

Financial Officer (Principal Financial  
and Accounting Officer)