

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

YEARS ENDED JUNE 30, 2006 AND 2005

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors
Bion Environmental Technologies, Inc.

We have audited the accompanying consolidated balance sheet of Bion Environmental Technologies, Inc. and subsidiaries as of June 30, 2006, and the related consolidated statements of operations, stockholders' equity deficit and cash flows for each of the two years in the period ended June 30, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Bion Environmental Technologies, Inc. and its subsidiaries as of June 30, 2006, and the results of their operations and cash flows for each of the two years in the period ended June 30, 2006, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the consolidated financial statements, the Company has suffered recurring losses from operations and has a stockholders' deficit at June 30, 2006 that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

GHP Horwath, P.C.

September 18, 2006

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

JUNE 30, 2006

ASSETS

Current assets:

Cash and cash equivalents	\$ 1,152,199
Prepaid services	103,513
Other assets	6,107
Total current assets	<u>1,261,819</u>

Property and equipment, net	<u>7,473</u>
Total assets	<u>\$ 1,269,292</u>

LIABILITIES AND STOCKHOLDERS' EQUITY DEFICIT

Current liabilities:

Accounts payable and accrued expenses	\$ 454,193
Accrued payable - affiliate	41,647
Convertible debt	30,437
Subscribed promissory notes	155,000
Deferred compensation	581,344
Total current liabilities	<u>1,262,621</u>

Deferred compensation	412,500
Convertible notes – affiliates	<u>2,871,698</u>
Total liabilities	<u>4,546,819</u>

Stockholders' equity deficit:

Preferred stock, \$.01 par value, 10,000 shares authorized, no shares issued and outstanding	-
Common stock, no par value, 100,000,000 shares authorized, 8,625,996 shares issued, 7,932,197 outstanding	-
Additional paid-in capital	66,736,874
Accumulated deficit	<u>(70,014,401)</u>
Total stockholders' equity deficit	<u>(3,277,527)</u>
Total liabilities and stockholders' deficit	<u>\$ 1,269,292</u>

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
YEARS ENDED JUNE 30, 2006 AND 2005

	Year Ended June 30,	
	2006	2005
Revenue	\$ -	\$ -
Operating expenses:		
General and administrative	1,343,431	640,965
Research and development	3,809,716	1,212,531
	5,153,147	1,853,496
Loss from operations	(5,153,147)	(1,853,496)
Other (income) and expense:		
Interest expense	134,540	289,948
Interest income	(21,514)	(531)
Other, net	(92,879)	(27,581)
	20,147	261,836
Net loss	\$ (5,173,294)	\$ (2,115,332)
Net loss per common share, basic and diluted	\$ (0.70)	\$ (0.50)
Weighted-average number of common shares outstanding, basic and diluted	7,353,914	4,231,126

See notes to consolidated financial statements.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY DEFICIT
YEARS ENDED JUNE 30, 2006 AND 2005

	Common Stock		Additional paid-in capital	Accumulated deficit	Total stockholders' equity deficit
	Shares	Amount			
Balances, July 1, 2004	4,206,194	\$ -	\$ 59,768,602	\$ (62,638,722)	\$ (2,870,120)
Conversion of deferred compensation to common stock	50,000	-	55,000	-	55,000
Issuance of warrants in exchange for deferred compensation	-	-	132,500	-	132,500
Sale of warrants	-	-	13,000	-	13,000
Vesting of options for services	-	-	20,860	-	20,860
Net loss	-	-	-	(2,115,332)	(2,115,332)
	-	-	-	-	-
Balances, June 30, 2005	4,256,194	-	59,989,962	(64,754,054)	(4,764,092)
Conversion of debt to equity	4,077,642	-	4,651,207	-	4,651,207
Retirement of common stock	(83,340)	-	-	(87,053)	(87,053)
Conversion of deferred compensation to common stock	30,000	-	60,000	-	60,000
Sale of common stock	295,500	-	1,136,500	-	1,136,500
Issuance of common stock for services	50,000	-	100,000	-	100,000
Sale of warrants	-	-	32,500	-	32,500
Issuance of warrants for services	-	-	5,000	-	5,000
Issuance of options for services	-	-	34,918	-	34,918
Vesting of options for services	-	-	726,787	-	726,787
Net loss	-	-	-	(5,173,294)	(5,173,294)
	-	-	-	-	-
Balances, June 30, 2006	8,625,996	\$ -	\$ 66,736,874	\$ (70,014,401)	\$ (3,277,527)

See notes to consolidated financial statements.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

YEARS ENDED JUNE 30, 2006 AND 2005

	Year ended June 30,	
	<u>2006</u>	<u>2005</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	\$ (5,173,294)	\$ (2,115,332)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation expense	77,971	142,269
Stock-based compensation	866,705	20,860
Increase in intrinsic value of convertible notes	1,974,292	-
(Increase) decrease prepaid services	(4,508)	46,677
(Increase) decrease other assets	(6,107)	14,841
Increase (decrease) accounts payable and accrued expenses	(465,037)	271,008
Deferred compensation and accrued interest	689,270	338,685
Net cash used in operating activities	<u>(2,040,708)</u>	<u>(1,280,992)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(9,166)	-
Net cash used in investing activities	<u>(9,166)</u>	<u>-</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Net proceeds from sale of convertible debt	1,870,821	419,516
Net proceeds from sale of common stock	1,136,500	-
Increase in subscribed promissory notes	155,000	-
Proceeds from sale of warrants	32,500	13,000
Net cash provided by financing activities	<u>3,194,821</u>	<u>432,516</u>
Net increase (decrease) in cash and cash equivalents	1,144,947	(848,476)
Cash and cash equivalents at beginning of year	7,252	855,728
Cash and cash equivalents at end of year	<u>\$ 1,152,199</u>	<u>\$ 7,252</u>
Supplemental disclosure of cash flow information:		
Cash paid for interest and income taxes	\$ -	\$ -
Non-cash investing and financing transactions:		
Conversion of debt to equity	\$ 4,610,832	\$ -
Conversion of deferred compensation to warrants	-	132,500
Conversion of deferred compensation to common stock	60,000	55,000
Conversion of accounts payable into convertible debt	-	30,437

See notes to consolidated financial statements.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEARS ENDED JUNE 30, 2006 AND 2005

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

Organization and business:

Bion Environmental Technologies, Inc. ("Bion" or the "Company") was incorporated in 1987 in the State of Colorado.

Bion's patented and proprietary technology provides solutions for environmentally sound clean-up of the waste streams of large-scale animal farming operations ("confined animal feeding operations" or "CAFO's") (dairy, cattle feedlot, hogs and poultry) and creates economic opportunities for integration of alternative, renewable energy production, ethanol production, sustainable animal husbandry and organic soil/fertilizer and feed production. Bion's technology also potentially allows direct integration with dairy end-users (bottling operations, cheese and ice cream plants, etc.) that can potentially increase the profitability and quality control of each participant while mitigating the environmental impact of the entire integrated complex. The Company is in the process of finalizing engineering, design and economic modeling for applications and integrated projects based on its second-generation technology.

Bion is currently evaluating sites in multiple states and anticipates selecting a site for its initial integrated project during its 2007 fiscal year. Bion is presently establishing its implementation management team with the intention of commencing development and construction of the initial project during fiscal 2007. In addition, Bion intends to site additional projects during 2007 and 2008 to create a pipeline of projects that will insure significant market share and profitability within 3-5 years (both regionally and nationally). Each project is to include: a) Bion waste treatment system, b) processing the CAFO waste stream from the equivalent of approximately 20-40,000 dairy cows, c) while producing renewable energy for on-site use, d) solids to be marketed as feed and/or fertilizer e) which is integrated with a 20-40+M gallon/year ethanol plant (though some smaller projects may be undertaken in appropriate situations). At the end of the 5-year period, Bion hopes to have numerous projects in various stages of development ranging from full operation to early construction stage.

Through 2001 the Company was primarily an environmental service company focused on the needs of CAFOs. Thereafter, Bion elected to cease sales of its first generation systems and focused its activities on development of its second-generation technology.

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 \$5,173,000 and \$2,115,000 during the years ended June 30, 2006 and 2005, respectively. At June 30, 2006, the Company has a working capital deficiency and a stockholders' deficit of approximately \$1,000 and \$3,278,000, 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 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.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
YEARS ENDED JUNE 30, 2006 AND 2005

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

Going concern and management's plans (continued):

Bion suffered from severe financial difficulties from late 2002 through the closing of its operating subsidiary Bion Dairy Corporation's ("Dairy") Series C Note offering on September 30, 2005. These financial difficulties resulted in the resignation of nearly all of the Company's officers and directors during February and March of 2003, and the termination of most Company employees. New management was able to retain core technical staff, but the Company drastically curtailed business activities to include only those activities that were directly needed to complete development and testing of the second-generation technology. On September 30, 2005, the Company, through Dairy, completed a placement of convertible debt, raising net proceeds of \$1,871,000, all of which has been converted to common stock as of June 30, 2006 (Note 10).

The Company completed a private placement of restricted common stock in December 2005, raising net proceeds of \$1,136,500 (Note 10). During September 2006, the Company completed a convertible note offering, raising \$700,000 (Note 6). The Company continues to explore sources of additional financing to satisfy its current operating requirements.

While the Company currently does not face a severe working capital shortage, it is not currently generating any revenues. The Company will need to obtain additional capital to fund its operations and technology development, and to satisfy existing creditors. There is no assurance 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 sufficient funds required during the next twelve months or thereafter will be generated from operations or 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.

2. SIGNIFICANT ACCOUNTING POLICIES:

Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Bion Technologies, Inc., BionSoil, Inc. and Bion Dairy Corporation and its 57.7% owned subsidiary, Centerpoint Corporation ("Centerpoint"). All significant intercompany accounts and transactions have been eliminated in consolidation.

Property and equipment:

Property and equipment are stated at cost and are depreciated using the straight-line method over the estimated useful lives of the related assets, generally three to ten years. The Company reviews its property and equipment for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
YEARS ENDED JUNE 30, 2006 AND 2005

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

Income taxes:

The Company recognizes deferred tax assets and liabilities for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their tax bases, as well as net operating losses.

Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets or liabilities of a change in tax rates is recognized in the period in which the tax change occurs. A valuation allowance is provided to reduce the deferred tax assets to a level, that more likely than not, will be realized.

Cash and cash equivalents:

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Loss per share:

Basic 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. During each of the years ended June 30, 2006 and 2005, the effect of outstanding options and warrants would have been anti-dilutive.

Fair value of financial instruments:

The fair values of cash and cash equivalents, convertible debt, subscribed promissory notes and accounts payable approximate their carrying amounts due to their short-term maturities. It is not practicable to estimate the fair value of the accounts payable-affiliate, convertible notes-affiliates and deferred compensation liability due to the related party nature of the underlying transactions.

Use of estimates:

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Concentrations of credit risk:

The Company's financial instruments that are exposed to concentrations of credit risk consist of cash and cash equivalents. The Company's cash and cash equivalents are in demand deposit accounts placed with federally insured financial institutions and selected brokerage accounts. Such deposit accounts at times may exceed federally insured limits. The Company has not experienced any losses on such accounts.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
YEARS ENDED JUNE 30, 2006 AND 2005

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

Stock-based compensation:

SFAS No. 123, *Accounting for Stock-Based Compensation* (“SFAS No. 123”), establishes financial accounting and reporting standards for stock-based employee compensation plans. SFAS No. 123 encourages entities to adopt a fair-value-based method of accounting for stock compensation plans. However, SFAS No. 123 also permits entities to continue to measure compensation cost under Accounting Principles Board Opinion No. 25 (“APB 25”) with the requirement that pro forma disclosures of net income (loss) and earnings (loss) per share be included in the notes to the financial statements. The Company has elected to measure compensation cost under APB 25; accordingly, the Company uses the intrinsic value method to account for its stock-based employee compensation plans. Had compensation cost for these plans been determined consistent with the fair value method prescribed by SFAS No. 123, the Company’s pro forma net loss and loss per share would have been as follows:

	<u>June 30, 2006</u>	<u>June 30, 2005</u>
Net loss:		
As reported	\$ (5,173,000)	\$ (2,115,000)
Less: Stock-based compensation expense determined under fair value method	<u>(464,000)</u>	<u>(184,000)</u>
Pro forma	<u>\$ (5,637,000)</u>	<u>\$ (2,299,000)</u>
 Basic and diluted net loss per share:		
As reported	<u>(\$0.70)</u>	<u>(\$0.50)</u>
Pro forma	<u>(\$0.77)</u>	<u>(\$0.54)</u>

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions for the grants in each of the following years:

<u>Options granted year ended</u>	<u>Expected dividend</u>	<u>Expected volatility</u>	<u>Risk-Free interest rate</u>	<u>Expected term</u>
June 30, 2004	nil	177	2.87%	4 years
June 30, 2005	nil	196	3.90%	5 years
June 30, 2006	nil	195	4.75%	3.5 years

Comprehensive income (loss):

SFAS No. 130, *Reporting Comprehensive Income* establishes standards for reporting and display of comprehensive income (loss), its components, and accumulated balances. For the years ended June 30, 2006 and 2005, there was no difference between net loss and comprehensive loss.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
YEARS ENDED JUNE 30, 2006 AND 2005

2. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED):

Revenue recognition:

While the Company has not reported any revenues for the years ended June 30, 2006 and 2005, the Company anticipates that future revenues will be generated from product sales and technology license fees. 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 integrated system. 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.

Recent accounting pronouncements:

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123(R) *Share Based Payment*, which addresses the accounting for share-based payment transactions. SFAS No. 123(R) eliminates the ability to account for share-based compensation transactions using APB No. 25, and generally requires instead that such transactions be accounted and recognized in the statement of income based on their fair values. SFAS No. 123(R) will be effective for the Company beginning on July 1, 2006. Depending upon the number and terms of options that may be granted in future periods, management believes that the implementation of this standard could have a material impact on the Company's financial statements. As of June 30, 2006, the estimated fair value of non-vested employee stock options was approximately \$130,000.

3. MINORITY INTEREST OF CENTERPOINT CORPORATION:

In January 2002, Bion purchased a 57.7% majority interest in Centerpoint from a third party. For the years ended June 30, 2006 and 2005, the losses applicable to the minority interest in Centerpoint exceeded the minority interest in the equity capital of Centerpoint, therefore the losses attributable to the minority interest have been charged against the Company's earnings as there is no obligation of the minority interest to make good on such losses. If Centerpoint has future earnings, the Company shall be credited to the extent of the minority interest losses previously absorbed.

4. PREPAID SERVICES:

The Company has issued options to purchase shares of the Company's common stock in exchange for services. As of June 30, 2006, non-employee options represented 630,833 of the 1,410,833 options outstanding under the Company's 2006 Consolidated Incentive Plan (Note 10). Of the 630,833 non-employee options outstanding, 260,833 were fully vested and contained no service conditions as of June 30, 2006. These non-employee options were valued using the Black-Scholes option-pricing model. Prepaid services of approximately \$43,000 at June 30, 2006 in connection with the fully vested options are being amortized on the straight-line method through June 30, 2007. The Company also issued shares of common stock to a consultant in exchange for services to be performed through June 30, 2007, of which \$60,000 is deferred as of June 30, 2006.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
YEARS ENDED JUNE 30, 2006 AND 2005

4. PREPAID SERVICES (CONTINUED):

The remaining 370,000 non-employee options outstanding include service conditions and have graded vesting schedules through May 1, 2009. As of June 30, 2006, 97,500 of these options 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. Any subsequent changes in fair value is recorded on the measurement date. Compensation cost in connection with options that are not fully vested as of June 30, 2006 is being recognized on a straight-line basis over the requisite service period for the entire award. Compensation expense of \$726,787 and \$20,860 was recorded during the years ended June 30, 2006 and 2005, respectively.

5. PROPERTY AND EQUIPMENT:

Property and equipment consists of the following as of June 30, 2006:

Research and development equipment	\$ 305,266
Computers and office equipment	<u>13,189</u>
	318,455
Less accumulated depreciation	<u>(310,982)</u>
	<u>\$ 7,473</u>

Depreciation expense was \$77,971 and \$142,269 for the years ended June 30, 2006 and 2005, respectively.

6. SUBSCRIBED PROMISSORY NOTES:

In June 2006, the Company commenced an offering of its 2006 Series A Convertible Promissory Notes (the “Notes”), with a minimum of \$500,000 and maximum of \$3,000,000 in Notes to be issued. The holders of the Notes are to earn interest on the unpaid principal balance of the Notes at 6%, payable on May 31, 2008, the maturity date of the Notes. All of the principal and accrued interest under the Notes shall be converted into common shares of the Company at the conversion rate of one share for each \$6.00 that is owed under the terms of the Notes if the following conditions are met:

- A) The closing market price of the Company’s shares has been at or above \$7.20 per share for 10 consecutive trading days, and
- B) The earliest of the following events:
 - 1) An effective registration allowing public resale of the shares to be received by the Note holders upon conversion, or
 - 2) One year after the initial closing date of the offering, and
 - 3) No conversion without an effective registration statement shall take place until the Company has become a “reporting company” with the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934, as amended.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
YEARS ENDED JUNE 30, 2006 AND 2005

6. SUBSCRIBED PROMISSORY NOTES (CONTINUED):

The Notes may also be convertible, in whole or in part, into the Company's common shares at any time at the election of the Note holders at a conversion rate of \$6.00 per share. As of June 30, 2006, the Company had received signed subscription agreements and proceeds totaling \$155,000, and through September 13, 2006, the date the offering closed, \$700,000 was received.

7. CONVERTIBLE DEBT:

In June 2005, the Company and a vendor signed an agreement whereby \$30,437 of unpaid consulting fees due to the vendor are to be convertible into common stock of the Company at a conversion price of \$2.50 per share at the vendor's option until May 1, 2007. If the vendor does not elect to convert the debt prior to May 1, 2007, the debt will be paid by the Company.

8. CONVERTIBLE NOTES – AFFILIATES:

On April 4, 2006 convertible deferred compensation due to the Company's president, Mark A. Smith, pursuant to an April 2003 deferred compensation agreement, was exchanged for a promissory note and conversion agreement. The promissory note and conversion agreement have the same terms and conversion features as the April 2003 deferred compensation agreement. Under the agreements, the president earns compensation of \$150,000 annually, all of which has been deferred to date. Sums accrued through March 31, 2006, accrue interest at 6% per annum, and are convertible into the Company's common stock at the lower of the current market value at the time of conversion, or \$2.00 per share. Through July 1, 2007, conversions may occur by mutual agreement between the Company and Mr. Smith. The Company may convert the deferred compensation, in whole or in part, at any date after July 1, 2007 and the convertible deferred compensation owed the president is mandatorily converted to common stock of the Company on July 1, 2009. The Company is accounting for this employee stock-based agreement under APB 25. At June 30, 2006, the note balance (principal and accrued interest) due to Mr. Smith was \$378,981, and the market price of the Company's common stock was \$6.40 per share. Therefore the Company has recorded the intrinsic value of the deferred compensation agreement at \$1,212,739 as of June 30, 2006. Had the Company been accounting for this employee stock-based agreement under SFAS 123, the fair value of the deferred compensation agreement as of June 30, 2006 would approximate the intrinsic value. Sums accrued after April 1, 2006, (\$37,500 through June 30, 2006), are non-interest bearing and are non-convertible.

On December 31, 2005, convertible deferred compensation payable to Bright Capital, Ltd. ("Brightcap") for services provided to the Company by Dominic Bassani, the general manager of Dairy, between April 1, 2003 and September 30, 2005 was exchanged for a promissory note and conversion agreement with the same terms and features as the deferred compensation agreement. Effective March 31, 2005, Brightcap entered into an agreement to continue to provide Mr. Bassani's services to the Company through March 31, 2009 and Brightcap earns compensation of \$300,000 annually with payment deferred. Sums accrued through September 30, 2005, accrue interest at 6% per annum and are convertible into the Company's common stock at the lower of the current market value at the time of conversion or \$2.00 per share. Through January 1, 2007 conversions may occur by mutual agreement between the Company and Brightcap. The Company may convert the deferred compensation, in whole or in part, at any date after January 1, 2007 and, on July 1, 2009, the Company's obligation owed Brightcap is mandatorily convertible to common stock of the Company. The Company is accounting for this employee stock-based agreement under APB 25. At June 30, 2006, compensation due to Brightcap was \$518,425 and the market price of the Company's common stock was \$6.40 per share.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
YEARS ENDED JUNE 30, 2006 AND 2005

8. CONVERTIBLE NOTES – AFFILIATES (CONTINUED):

Therefore the Company has recorded the intrinsic value of the deferred compensation agreement at \$1,658,959 as of June 30, 2006. Had the Company been accounting for this employee stock-based agreement under SFAS 123, the fair value of the deferred compensation agreement as of June 30, 2006 would approximate the intrinsic value. Sums accrued after October 1, 2005, (\$225,000 through June 30, 2006), are non-interest bearing and are non-convertible.

9. DEFERRED COMPENSATION:

Prior to March 31, 2003, the Company incurred management fees under various management agreements with the D2 LLC Deferred Compensation Trust (“Trust”) for management and consulting services. These fees totaled \$581,344 including interest at 6%, as of June 30, 2006. The services were provided in part by Dominic Bassani, who beneficially owns 50% of the Trust. In March 2003, the Trust agreed to accept payment on March 31, 2007, by conversion of the deferred compensation into common stock of the Company at the higher of the average price of the Company’s common stock during the ten trading days ending March 27, 2007, or \$4.00 per share.

The Company has also recorded deferred compensation liabilities of \$412,500 for three officers of the Company consisting of \$37,500 to Mark A. Smith (Note 8), \$225,000 to Brightcap Capital Ltd. (Note 8), and \$150,000 to Salvatore Zizza, a former officer and director of the Company, who assumed the position of Chairman and director of Dairy with an annual salary of \$300,000. This deferred compensation does not accrue interest and is non-convertible. Payment is to be made at the earliest date that the Company has in excess of \$2,000,000 in cash and cash equivalents or as decided by the Board of Directors or December 31, 2007.

10. 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.

On December 31, 2004, the president of the Company converted \$55,000 of deferred compensation into 50,000 shares of common stock.

In May 2005, Brightcap converted deferred compensation of \$60,000 into 600,000 warrants and Salvatore Zizza was issued 600,000 warrants valued at \$60,000 in lieu of payment for services rendered to the Company. Also in May 2005, Mark Smith was granted a \$12,500 bonus and purchased 125,000 warrants of the Company for \$12,500.

In June 2005, Mark Smith and Jeff Kapell purchased 30,000 and 100,000 warrants of the Company at \$.10 per warrant for \$3,000 and \$10,000, respectively.

On September 30, 2005, the Company completed a \$1,917,500 (net proceeds \$1,870,821) placement of Series C notes of Dairy, which triggered the conversion of the Dairy’s Series A, B and C notes (\$5,239,489 in aggregate) into 3,847,217 shares of the Company’s common stock, including 693,799 shares issued to Centerpoint and 83,340 shares issued to Bion.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
YEARS ENDED JUNE 30, 2006 AND 2005

10. STOCKHOLDERS' EQUITY (CONTINUED):

Common stock (continued):

In conjunction with the conversion, the Company retired the 83,340 shares of common stock issued to the Company. The shares issued to Bion and Centerpoint were recorded at \$87,053 and \$807,045, being the carrying value of the debt that was converted.

As a result of dividends declared in July 2004, Centerpoint holds the shares for the benefit of its shareholders without any beneficial interest. The Company is accounting for the shares issued to Centerpoint as treasury stock. The Company issued 20,428 shares of common stock as commissions in connection with the placement of the C Notes of Dairy.

On December 31, 2005, the president of the Company converted promissory notes of the Company, totaling \$265,440 in principal and interest for 209,997 shares of common stock and converted \$60,000 of deferred compensation into 30,000 shares of common stock.

In December 2005, the Company completed a private financing of 291,750 shares of common stock priced at \$4.00 per share. Net proceeds to the Company were \$1,136,500 and the Company also issued 3,750 shares of common stock as commissions in connection with the financing.

During the year ended June 30, 2006, the Company issued 50,000 shares of common stock to a consultant for services valued at \$100,000.

Warrants:

As of June 30, 2006 the Company had the following common stock warrants outstanding:

	<u>Number of Shares</u>	<u>Exercise Price</u>	<u>Expiration Date</u>
Class J/SLAV	10,573	\$ 6.00	August 31, 2006
Class SVDB 1-6	800,000	\$ 3.00	July 31, 2013
Class SVDM-1	387,343	\$ 5.00	July 31, 2008
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	May 31, 2009
Class SVMAS-1A	40,000	\$ 3.50	October 11, 2009
Class SVMAS-2	32,500	\$ 2.50	September 30, 2009
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	41,667	\$ 1.50	June 30, 2009
Class C, D, E	725,000	\$ 2.50	April 30, 2015
Class O	<u>100,000</u>	\$ 3.00	December 31, 2008
	<u>3,694,583</u>		

The weighted average exercise for the outstanding warrants is \$2.73 and the weighted average life as of June 30, 2006 is 7 years.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
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10. STOCKHOLDERS' EQUITY (CONTINUED):

Warrants (continued):

During the year ended June 30, 2006, the president of the Company purchased 80,000 warrants in two separate transactions of 40,000 warrants each at \$.25 per warrant, totaling \$20,000. The president also purchased 125,000 warrants at \$.10 per warrant for \$12,500.

The Company issued 25,000 warrants priced at \$.20 per warrant to a consultant during the year ended June 30, 2006 for services valued at \$5,000.

Stock options:

Prior to June 2006, the Company had various incentive plans (the "Plans") that provided for incentive stock options to be granted to selected employees and directors of the Company, and selected non-employee advisors to the Company. Effective June 2006, the Company approved the 2006 Consolidated Incentive Plan (the "2006 Plan"), which consolidated previously reserved incentive stock options under the Plans into the 2006 Plan. The Company has reserved 3,200,000 shares, the maximum number of shares of the common stock of the Company issuable pursuant to the 2006 Plan. 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 option may be exercisable for more than ten years.

During the year ended June 30, 2006, the Company granted options to purchase 17,000 shares of common stock at \$3.00 to \$6.00 per share to non-employees. The fair value of the options, using the Black-Scholes option pricing model, is \$34,918, of which options totaling \$32,738 vested immediately and were recognized as non-cash stock compensation expense. The remaining \$2,180 of options vest over a year and \$1,163 was amortized on a straight line basis in the year ended June 30, 2006 as non-cash stock compensation.

The Company granted options to purchase 77,500 shares of common stock to employees and directors for the year ended June 30, 2006. The options have an exercise price of \$4.25 to \$5.50 per share and are fully vested. The Company applies APB Opinion 25 and related interpretations in accounting for equity instruments issued to employees. Accordingly, no compensation cost has been recognized for its employee stock options as all options had an exercise price equal to or greater than the market value of the Company's common stock at the date of grant.

As of June 30, 2006, options outstanding under the 2006 Plan are summarized as follows:

	Outstanding Options	
	Number of Shares	Weighted Average Exercise Price
Balance, July 1, 2004	651,333	\$ 3.14
Options granted	665,000	\$ 2.50
Options exercised	-	-
Options cancelled	-	-
Balance, June 30, 2005	1,316,333	\$ 2.82
Options granted	94,500	\$ 4.69
Options exercised	-	-
Options cancelled	-	-
Balance, June 30, 2006	1,410,833	\$ 3.15

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
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10. STOCKHOLDERS' EQUITY (CONTINUED):

Stock Options (continued):

There were 956,667 options exercisable as of June 30, 2006.

The following table presents information relating to stock options outstanding and exercisable as of June 30, 2006:

<u>Range of Exercise Prices</u>	<u>Outstanding Shares</u>	<u>Weighted- Average Remaining Contractual Life-</u>	<u>Weighted- Average Outstanding Exercise Price-</u>	<u>Exercisable Shares</u>	<u>Weighted- Average Exercise Price</u>
\$2.00 - \$2.50	812,500	7.7	\$ 2.41	363,334	\$ 2.30
\$3.00 - \$3.50	420,333	2.1	\$ 3.00	415,333	\$ 3.00
\$4.00 - \$4.75	40,000	4.4	\$ 4.28	40,000	\$ 4.28
<u>\$5.00 - \$7.50</u>	<u>138,000</u>	<u>2.7</u>	<u>\$ 5.53</u>	<u>138,000</u>	<u>\$ 5.53</u>
	<u>1,410,833</u>	5.5	<u>\$ 2.94</u>	<u>956,667</u>	<u>\$ 3.15</u>

The Company, after giving consideration for the contingent deferred stock bonuses (Note 12) and employee stock bonuses in 2002 and previously exercised options of 75,440 shares, had 1,023,727 shares reserved for future issuance under the 2006 Plan as of June 30, 2006.

11. INCOME TAXES:

The Company has net operating loss carry-forwards ("NOLs") for tax purposes of approximately \$36,100,000 as of June 30, 2006. These NOLs expire on various dates from 2009 to 2027.

The utilization of the NOLs may be limited under Section 382 of the Internal Revenue Code.

The Company's deferred tax assets as of June 30, 2006, are estimated as follows:

NOLs	\$ 13,700,000
Deferred compensation	<u>1,500,000</u>
	15,200,000
Valuation allowance	<u>(15,200,000)</u>
Net deferred tax assets	<u>\$ -</u>

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

The Company has provided a valuation allowance of 100% of its net deferred tax asset due to the uncertainty of generating future profits that would allow for the realization of such deferred tax assets.

The expected tax benefit for each of the years ended June 30, 2006 and 2005, based on a federal tax rate of 34%, is approximately \$1,759,000 and \$719,000, respectively. The difference between the expected tax benefit and non-recognition of a tax benefit during 2006 and 2005 is primarily the result of a valuation allowance applied to the deferred tax assets.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
YEARS ENDED JUNE 30, 2006 AND 2005

12. COMMITMENTS AND CONTINGENCIES:

Employment and consulting agreements:

The Company has an employment agreement with its president, Mark A. Smith, through March 31, 2007 providing \$150,000 per year compensation.

Effective March 31, 2005, an agreement with Brightcap, through which the services of the general manager of Dairy, 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.

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 (Note 8).

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 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.

During February and March of 2003, four members of the Company's core technical staff who had previously been terminated, returned to the Company to work for reduced compensation. While the Company does not have a legal obligation to pay the difference between the original compensation and the reduced compensation, if and when the Company has sufficient financial resources, it is the Company's intention to provide bonuses, over a one to two-year period, to compensate for the reduced wages. As of June 30, 2006, the amount of reduced compensation amounted to approximately \$130,000.

Joint venture agreement:

In June 2006, the Company entered into a joint venture agreement with Fair Oaks Dairy Farm ("FODF") to construct a long term Bion research facility at FODF ("Stage I System"). The Stage I System will initially be used to complete testing necessary for the development of design criteria for permitting and construction of the integrated, full-scale Stage II installation at FODF. The estimated cost of Stage I, including system construction and testing operations in support of Stage II permitting, is \$750,000 which the Company and FODF have agreed to split equally net of any grants. Bion has also agreed that FODF funding shall be convertible into the Company's common shares under the same terms as the 2006 Series A Convertible Promissory Notes. Dr. Michael McCloskey and Mr. Timothy den Dulk, co-owners of FODR, are both consultants to Dairy and have each received 175,000 options with service conditions and graded vesting schedules through May 1, 2009. The Company is accounting for its investment in the joint venture using the equity method. Through June 30, 2006, neither the Company nor FODF have contributed any amounts to the joint venture.

BION ENVIRONMENTAL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
YEARS ENDED JUNE 30, 2006 AND 2005

12. COMMITMENTS AND CONTINGENCIES (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 2002. 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.

The Company, together with the former controlling persons of Centerpoint, and the Company's president are defendants in a class action derivative action lawsuit in Delaware Chancery Court (TCMP#3 Partners, LLP, et al v. Trident Rowan Group, Inc. et al, Civil Action No. 170-N). The claims against the Company primarily relate to a January 2002 financing transaction with Centerpoint, in which it is claimed the Company breached its fiduciary duties to Centerpoint and its shareholders and/or aided and abetted others in breaching their duties. Litigation is in the early stages of discovery and motion practice. Settlement discussions are under way, and the parties have participated in voluntary, non-binding mediation to attempt to resolve the disputed matters, which has led to a contingent settlement agreement. This agreement is contingent on settlement of a complaint to be filed by the Company against the former controlling shareholders of Centerpoint. Management believes the claims against the Company are without merit and intends to defend the claims if a settlement is not reached.

13. RELATED PARTY TRANSACTIONS:

The Company has an accrued payable of \$41,647 to a company controlled by Salvatore Zizza for rental of office space in 2003.

14. SUBSEQUENT EVENTS:

Effective August 28, 2006, pursuant to terms agreed upon on December 15, 2005, the Company entered into a four year employment agreement with Jeremy Rowland. As of September 18, 2006, Mr. Rowland will assume the position of Chief Operating Officer of Dairy with an annual salary of \$150,000. In addition, 150,000 options were issued which are exercisable at \$4.00 per share through December 2015 and vest 25% at the start date of his employment, and 25% at each of the next 3 anniversaries of his start date.

The Company signed a non-cancellable operating lease commitment for office space, in New York, effective August 1, 2006 and expiring November 30, 2013. The average monthly rental under the terms of the lease is \$15,820. The Company is currently negotiating sublease agreements to unrelated third parties.