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CLEAN DIESEL TECHNOLOGIES INC  
Form 10-K/A  
May 07, 2004

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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A-2

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]

FOR THE FISCAL YEAR ENDED: DECEMBER 31, 2003

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]

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

COMMISSION FILE NO. 0-27432

CLEAN DIESEL TECHNOLOGIES, INC.  
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(Exact name of registrant as specified in its charter)

Delaware  
-----

(State or other jurisdiction of incorporation of organization)

06-1393453  
-----

(I.R.S. Employer Identification Number)

SUITE 702, 300 ATLANTIC STREET  
STAMFORD, CT 06901  
(203) 327-7050  
-----

(Address and telephone number of principal executive offices)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT: NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

COMMON STOCK \$0.05 PAR VALUE PER SHARE  
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(Title of Class)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No  
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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any

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amendment to this Form 10-K. X  
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Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes No X  
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Aggregate market value of the voting stock held by non-affiliates of the registrant based on the average bid and asked prices as of June 30, 2003: \$2.65 and as of March 19, 2004: \$3.02

Indicate number of shares outstanding of each of the registered classes of Common Stock at March 25, 2004: 15,679,337 shares Common Stock, \$0.05 par value. Certain portions of the Proxy Statement for the annual meeting of stockholders to be held in 2003 are incorporated by reference into parts II, III and IV hereof.

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EXPLANATORY NOTE

This is an amendment of the Clean Diesel Technologies, Inc. Annual Report to the Commission on Form 10-K for the period ended December 31, 2003 which was previously filed on March 24, 2004 (the "10-K") and later amended on March 29, 2004. The purpose of this second amendment is to conform the certificates attached as Exhibits 31.1, 31.2 and 32 to the current requirements of Regulation SK and also to eliminate the legend "Draft Subject to Revision" inadvertently left on the Auditors Report in Item 8 of the electronic transmission of the 10-K.

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TABLE OF DEFINED TERMS

TERM ----	TERM DEFINITIONS -----
ARIS(R) 2000	Clean Diesel Technologies' Advanced Reagent Injection System for Ure
AIM	Alternative Investment Market of the London Stock Exchange
Bhp hour	Break horsepower per hour
BUWAL	Bundesamt fur Umwelt, Wald und Landschaft (German Federal Office for Environment, Forest and Landscape)
CARB	California Air Resources Board
CDT	Clean Diesel Technologies, Inc.
CNG	Compressed Natural Gas

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CO	Carbon Monoxide
CO(2)	Carbon dioxide
CWMF	Catalyzed Wire Mesh Filter
DOCs	Diesel Oxidizing Catalysts
DPFs	Diesel Particulate Filters
EGR	Exhaust Gas Recirculation
FBC	Fuel Borne Catalyst
Fuel Tech	Fuel-Tech N. V., a substantial shareholder of Clean Diesel Technologies
HC	Hydrocarbons
LOE-NOx(TM)	Clean Diesel Technologies' diesel fuel water emulsion technology
NESCAUM	North East States for Coordinated Air Use Management
NOx	Nitrogen Oxide
PFCs	Platinum Fuel Catalysts
Platinum Plus(R)	Clean Diesel Technologies' Platinum & Cerium fuel additive
PM	Particulate Matter
SCR	Selective Catalytic Reduction
US EPA	United States Environmental Protection Agency
Usg	US gallons
VERT	Program in Germany and Switzerland to develop, test and certify diesel particulate filter systems

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### PART I

#### FORWARD-LOOKING STATEMENTS

Statements in this Form 10-K that are not historical facts, so-called "forward-looking statements," are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Investors are cautioned that all forward-looking statements involve risks and uncertainties, including those detailed in Clean Diesel Technologies' filings with the Securities and Exchange Commission. See "Risk Factors of the Business" in Item 1, "Business," and also Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

#### ITEM 1. BUSINESS

##### GENERAL

Clean Diesel Technologies, Inc. "Clean Diesel Technologies", a Delaware

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corporation with a principal place of business at 300 Atlantic Street, Stamford CT 06901, was formed in 1994 as a wholly owned subsidiary of Fuel Tech to develop technologies for cleaning up harmful emissions from diesel engines while reducing fuel consumption. Clean Diesel Technologies was spun-off from Fuel Tech in December 1995 by way of a rights issue. Over the past eight years, CDT has developed its technologies and is now commercializing Platinum Plus(R) fuel borne catalyst, and the ARIS(R) 2000 NOx reduction system.

Management has worked together for over 15 years in the chemical, power, fuel and emission control fields and has brought Clean Diesel Technologies to the commercialization stage on a cost effective basis by co-operative funding for development and demonstration programs with industry partners. Clean Diesel Technologies has a strong patent position with 26 US patents issued and 8 US patent applications pending as well as 70 other international patents issued and 76 international patent applications pending.

Combustion engine development is influenced by concern over global warming caused by CO2 emissions from fossil fuels and toxic exhaust emissions. Since CO2 is the result of combustion of fossil fuels, the primary way to reduce CO2 emissions is to reduce fuel consumption. The diesel engine is as much as 40% more fuel-efficient than gasoline engines. Thus, increased use of diesel engines relative to gasoline engines is one way to reduce overall fuel consumption and thereby significantly reduce CO2 emissions. Diesel engines, however, emit higher levels of two toxic pollutants, namely particulates and NOx, than gasoline engines fitted with auto catalysts. Each of these pollutants affects human health and the environment.

### TECHNOLOGIES AND PRODUCTS

Clean Diesel Technologies' products, combined with other devices, can reduce particulate emissions and NOx from diesel engines to or below the emission levels of natural gas engines, while also reducing fuel consumption. This results in a reduction in fuel costs and greenhouse gas emissions, primarily CO2, as well as in emissions of particulates, NOx, CO and un-burnt hydrocarbons.

### PLATINUM PLUS (R)

Platinum Plus is a patented, fuel soluble, fuel borne catalyst, which contains minute amounts of platinum and cerium catalysts. Platinum Plus takes the catalytic action into engine cylinders where it improves combustion thereby reducing particulates, un-burnt hydrocarbons and CO emissions as well as improving fuel economy. Recent fleet tests using Platinum Plus have shown improvement in fuel economy of between 3% and 12%. Platinum Plus can be used on its own with either regular or ultra low sulphur diesel fuel to reduce particulate emissions by 10% to 25% while also improving the performance of diesel oxidation catalysts and particulate filters (which trap up to 95% of particulates but in doing so clog up with soot) by burning off the soot particles and further reducing toxic emission components of CO and un-burnt hydrocarbons.

From 1996 to 1999, Clean Diesel Technologies defined and managed several research and development programs on platinum fuel catalysts which were conducted by Delft Technical University (Netherlands), Ricardo Consulting Engineers (UK), Cummins Engine Company (USA) and Southwest Research Institute (USA). Through its strategy of using independent test houses, Clean Diesel Technologies' small technical team has been able to run several programs on a cost effective basis while bringing in a wide range of expertise. Most importantly, the results have been independently derived.

Development of Platinum Plus was completed in 1999. In December of that year, Clean Diesel Technologies received its US EPA registration of Platinum

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Plus for use in bulk fuel by refiners, distributors and fleets. In 2000, CDT completed the European VERT certification protocol for particulate filters and additives for use with particulate filters and in 2001 BUWAL approved Platinum Plus for use as a fuel borne catalyst with particulate filters. In 2002, the Mining, Safety and Health Administration (MSHA) accepted the Platinum Plus FBC for use in mines. In 2003 CDT received EPA verification for its FBC and a diesel oxidation catalyst (Purifier system). CDT has completed a second verification program for the FBC and a catalyzed wire mesh filter (CWMF) from

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Mitsui & Co. of Japan and is awaiting final verification results from the EPA. CDT is applying to CARB for verification of both the FBC/DOC and FBC/CWMF systems. Verification is needed for the end user of Platinum Plus to get emission reduction credit from the EPA's voluntary retrofit program or CARB's mandatory retrofit program.

Over the past three years, eleven large fleet demonstration trials have been carried out in the US in a range of industries including the beverage delivery, waste hauling, grocery and fuel delivery. The improvement in fuel economy from using Platinum Plus ranged from 3% to 12% with an average 7% improvement. The best results were generally attributable to short haul "stop and go" driving where Platinum Plus has the greatest opportunity to improve the combustion process. The field testing programs have confirmed the 3% to 8% improvement measured in lab engine test beds at both Cummins Engine Company and the Southwest Research Institute.

In several tests above, it was shown that Platinum Plus based systems do not increase emissions of NO<sub>2</sub> which is the much more toxic component of NO<sub>x</sub>. This is in contrast to many of the systems currently on the market which are heavily catalyzed with platinum.

Platinum Plus is effective with normal sulfur diesel, ultra low sulfur diesel, arctic diesel (kerosene) and biodiesel. When used with biodiesel and No1D, Platinum Plus FBC prevents the normal increase in NO<sub>x</sub> associated with biodiesel.

ARIS(R) 2000

The ARIS 2000 (Advanced Reagent Injection System) is a patented injection system for the reduction of NO<sub>x</sub> emissions from diesel engines. The system comprises a single fluid computer-controlled injector that provides precise injection of non-toxic urea-based reagents into the exhaust of a stationary or mobile engine where it converts NO<sub>x</sub> across a catalyst to nitrogen and water vapor. The system has shown NO<sub>x</sub> reductions of up to 90% or more on a steady state operation and of up to 85% in transient operations. This process, known as selective catalytic reduction (SCR), has been in use for many years in power stations and is considered by management to be well proven. ARIS 2000 is a miniature version of the SCR injection system. The principle advantage of the patented ARIS system is that it does not require compressed air to operate. The system is designed for volume production and is very compact with very few components, making it inherently cheaper than the compressed air systems which were first to be developed for heavy duty vehicles. The ARIS system is applicable to both stationary diesel engines for power generation and mobile diesels used in trucks, buses, trains and boats.

THE MARKET AND THE REGULATORY ENVIRONMENT

Clean Diesel Technologies estimates that worldwide annual consumption of diesel fuel amounts to approximately 200 billion gallons (US), including 50 billion in the United States, 60 billion in Europe and 50 billion in Asia.

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### NEW DIESEL ENGINES

While engine manufacturers have, to date, met emissions regulations by engine design changes (which tend to increase fuel consumption), management believes that further reductions can only be achieved by using combinations of cleaner burning fuels and after treatment systems such as diesel particulate filters and catalytic systems for NOx reduction.

There is an immediate market for NOx reduction systems for stationary diesel engines, many of which are used in power generation. Some 9,000 new high horse power engines are sold each year in the US. An SCR system comprising an ARIS 2000 injection system and a suitable catalyst is being sold into the US market by the RJM Corporation (a licensee of the ARIS 2000 technology). Mitsui & Co. Ltd has also licensed both the ARIS stationary and mobile technology for Japan. Combustion Component Associates (CCA) of Monroe Connecticut licensed the ARIS mobile technology for the US market in 2003.

In the last several years, emissions regulations for new mobile diesel engines in the major world markets have continued to tighten. Emission levels which came into effect in 1999 for new vehicles were some 40% to 90% less than levels of the mid 1980s. Regulations for introduction over the next seven years in Europe, the United States and Japan should reduce emission levels by 85% to 99% below the mid 1980s levels. The market for mobile NOx reduction systems is expected by management to develop between 2005 and 2010. European engine manufacturers have decided to use urea SCR in 2006, at least on heavy duty vehicles and very likely on medium and light trucks in later years. There is a clear preference to use a single fluid system for the medium and light-duty trucks which have no compressed air system. It also seems probable that European manufacturers will adopt particulate filters to meet 2010 regulations which are being formulated

In the opinion of management, the US market for diesel engines is expected to grow significantly in the next few years based on fuel economy considerations, if NOx and particulate emissions can be controlled. Engine manufacturers have indicated that they will use diesel particulate filters to meet regulations for 2007. US regulations for 2010 are fixed and require a further 50% reduction

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in NOx over 2007. Urea SCR is a candidate technology for 2010. However, the US EPA has a preference to adopt alternative technology named "NOx Traps" or "Lean NOx Catalysis". The advantage of these systems is that they do not require an infrastructure to supply urea but so far these technologies have not demonstrated durable performance at the required levels.

### EXISTING DIESEL ENGINES AND THE RETROFIT MARKET

While much of the regulatory pressure and the response from engine manufacturers has been focused on new engine emissions, there is increasing concern over pollution from existing diesel engines which have a life of 20 to 30 years and hence there is a growing interest in the potential for retrofitting diesel engines with emission reduction systems. These include stationary diesels, construction equipment and public transportation vehicles such as buses as well as truck fleets.

In 1998, CARB declared diesel particulates to be toxic and in 2000 it proposed reductions in particulate emissions from over one million existing engines in California as well as more stringent controls for new engines. In March 2000, the US EPA announced a program to provide emissions credits for

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reduction in emissions from existing heavy-duty diesel engines. The US EPA has stated its objective for retrofitting vehicles with particulate controls and has developed the Clean School Bus USA program to reduce emissions on school buses and the Smartway Transport Program to reduce both diesel emissions and fuel consumption on over-the-road trucks.

Japan has announced a retrofit program, which would require all diesel vehicles residing or passing through Tokyo to install particulate matter traps phasing in between April 2004 and April 2007.

### MARKET OPPORTUNITY

Continuing tightening of clean air standards, emission control regulations, pressure for fuel efficiency and growing international awareness of the greenhouse effect provide Clean Diesel Technologies with a substantial opportunity in world markets.

Without compromising the fuel economy benefits of diesel, a significant reduction of particulate and NOx emissions can only be achieved by using combinations of improved engine design, cleaner burning fuels and after treatment systems such as diesel particulate filters and catalytic systems. Clean Diesel Technologies' Platinum Plus (which improves combustion catalytically) and the ARIS 2000 technology (which allows engines to be tuned for best fuel economy while reducing NOx emissions) can form key components of both these after treatment systems.

The convergence of requirements for emission compliance and the high cost of fuel, make the use of CDT's products economical. With diesel fuel selling at about \$1.75 per USG in the United States, the fuel economy improvement alone pays for the use of Platinum Plus. A fuel saving of 3% will provide a payback to US fleet operators. Platinum Plus in controlled fleet tests showed an average of 7% fuel economy improvement. In Europe, where in some countries diesel fuel retails for as much as \$4.00 per gallon, because of the high tax component, fuel economy benefits are even more pronounced.

Accordingly, there are two basic market drivers for CDT's products, namely reduction in emissions and reduction in fuel consumption. Platinum Plus is an "enabling technology" which enables reductions from the engine itself and enhances performance of the exhaust treatment system whilst improving fuel economy.

### MARKETING STRATEGY AND COMMERCIALIZATION

Clean Diesel Technologies' plan is to supply finished fuel additive products direct in certain North American markets and to license its ARIS 2000 NOx reduction technology and Platinum Plus products for international markets and in some sectors of the North American market. Large chemical and additive companies will be supplied platinum concentrate by Clean Diesel Technologies and they will blend and market Platinum Plus. CDT believes its strategy of licensing represents the most efficient way to gain widespread distribution quickly and exploit worldwide demand for its technologies.

Clean Diesel Technologies has licensed the RJM Corporation on a non-exclusive basis to market the ARIS 2000 technology for stationary, marine and railroad diesels in the Americas. The market in the US alone is estimated at over 9,000 new engines per year with an installed base of over 150,000 engines. Clean Diesel received \$1.1 million in initial license revenue from the RJM Corporation and is receiving a \$1,500 to \$2,500 royalty on each stationary ARIS unit sold. Clean Diesel Technologies has also exclusively licensed Mitsui & Co., Ltd. ("Mitsui") to market the ARIS 2000 technology for stationary engines in Japan. CDT received \$495,000 in non-refundable up front license fees and will earn a \$1,500 to \$2,500 royalty on each ARIS unit sold.

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Mitsui also exclusively licensed the ARIS technology for mobile applications in Japan. Mitsui paid \$250,000 in mobile license fees and invested an additional \$200,000 in the development and testing of mobile ARIS systems. CDT also receives a per unit royalty on each mobile ARIS system sold. CDT has licensed Combustion Component Associates for the ARIS mobile

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technology for the US market. CDT received an upfront license fee and an ongoing per unit royalty. CDT is in discussions with several companies to license the mobile ARIS technology for retrofit and OEM opportunities in the United States and Europe.

Clean Diesel Technologies has also entered into a number of marketing distribution agreements with chemical additive companies, fuel delivery companies ("wet hosers") and fuel marketers. CDT has licensed Baker Petrolite Corporation (a division of Baker Hughes) for the non-exclusive distribution of Platinum Plus to refiners and terminals in the United States and the Global Companies, LLC to supply Platinum Plus treated fuels to fleets in New England. CDT is also working with Texas Night Fueling and Taylor Oil to supply Platinum Plus treated fuel directly to fleets.

### HEALTH EFFECTS AND REGISTRATION OF ADDITIVES

Metallic additives have come under scrutiny for their possible effects on health. Clean Diesel Technologies registered its platinum additive in 1997 in both the US and United Kingdom. The platinum - cerium bimetallic additive required further registration in the US and that process involved a 1,000-hour engine test and extensive emission measurements and analysis. The registration was completed in 1999 and issued in December 1999.

Germany, Austria and Switzerland have set up a protocol (VERT) for approving diesel particulate filters and additive systems used with them. Clean Diesel Technologies completed the required tests under the VERT protocol in 2000 and in January 2001, the Swiss authority BUWAL approved the Platinum Plus fuel additive for use with a filter.

Engine tests, in US and Switzerland, show that 95 to 99% of the catalyst metal introduced to the fuel by the FBC is retained within the engine and exhaust and that the amount of platinum emitted from the use of Platinum Plus is roughly equivalent to platinum attrition from automotive catalytic converters.

In December 1996, the United Kingdom Ministry of Health's Committee on Toxicity reviewed the product and all the data submitted by Clean Diesel Technologies and in its response stated "The Committee is satisfied that the platinum emission from vehicles would not be in an allergenic form and that the concentrations are well below those known to cause human toxicity." In 1997, Radian Associates reviewed Clean Diesel Technologies' data and the literature on platinum health effects and concluded, "the use of Clean Diesel Technologies Platinum containing diesel fuel additive is not expected to have a adverse health effect on the population under the condition reviewed." Radian also concluded that emissions of platinum from the additive had a margin of safety ranging from 2,000 to 2,000,000 times below workplace standards.

In 2002 the Mining Safety and Health Administration (MSHA) accepted the use of Platinum Plus with particulate filters and also allowed its use in all fuel used in underground mining even without filters.

In October 2003, the EPA verified the Platinum Plus Purifier System, which is the first time the EPA has verified a metal catalyst additive based system.



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### SOURCES OF SUPPLY

Clean Diesel Technologies has outsourcing arrangements with two companies in the precious metal refining industry and may make arrangements with others. Clean Diesel Technologies has made the product itself in the past but considers outsourcing to a precious metal refinery to be more cost effective. Clean Diesel Technologies has established several sources of cerium to use in its bimetallic diesel additive.

### RESEARCH AND DEVELOPMENT

During 2003, Clean Diesel Technologies employed 3 individuals, including one executive officer, in engineering and product development. During the years ended December 31, 2003, 2002, and 2001, Clean Diesel Technologies' research and development expenses exclusive of patent costs totaled approximately \$855,000, \$693,000, and \$365,000, respectively. The recent increase can be attributed to EPA and CARB verification programs and testing. Clean Diesel Technologies expenses all research and development costs as incurred.

### PROTECTION OF PROPRIETARY INFORMATION

Clean Diesel Technologies holds the rights to a number of patents and patent applications pending. There can be no assurance that pending patent applications will be approved or that the issued patents or pending applications will not be challenged or circumvented by competitors. Certain critical technology incorporated in Clean Diesel Technologies' products is protected by trademark and trade secret laws and confidentiality and licensing agreements. There can be no assurance that such protection will prove adequate or that Clean Diesel Technologies will have adequate remedies for disclosure of its trade secrets or violations of its intellectual property rights.

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### INSURANCE

Clean Diesel Technologies maintains coverage for the customary risks inherent in its operations. Although Clean Diesel Technologies believes its insurance policies to be adequate in the amount and coverage for its current operations, no assurance can be given that this coverage will, in fact, be or continue to be available in adequate amounts or at a reasonable cost or that such insurance will be adequate to cover any future claims against Clean Diesel Technologies.

### EMPLOYEES

Clean Diesel Technologies has ten full-time employees. In addition, one executive officer of Fuel Tech provides management and legal services for Clean Diesel Technologies pursuant to a Management and Services Agreement between Fuel Tech and Clean Diesel Technologies on an as needed basis. Clean Diesel Technologies also retains several outside technical consultants and marketing agents for specific projects related to platinum, engines and NOx reduction and fuel additive selling.

Clean Diesel Technologies enjoys good relations with its employees and is not a party to any labor management agreements.

### RISK FACTORS OF THE BUSINESS

Investors in Clean Diesel Technologies should be mindful of the following risk factors relative to Clean Diesel Technologies business:

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### LIQUIDITY & CONTINUING OPERATING LOSSES

Prior to 2000, Clean Diesel Technologies was a development stage business and has incurred losses since inception totaling \$25,272,000 (excluding the effect of non-cash preferred stock dividends). At the date of this report, Clean Diesel Technologies has cash resources estimated to be sufficient for its needs through the year 2005. See the text below under the captions "Liquidity and Sources of Capital" in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," elsewhere herein.

Clean Diesel Technologies has had minimal revenues through December 31, 2003. CDT expects to continue to incur operating losses at least through 2004. There can be no assurance that Clean Diesel Technologies will achieve or sustain significant revenues or profitability in the future. See Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," elsewhere herein.

### COMPETITION

Competition in the diesel fuel additive market is from other additive suppliers such as Lubrizol, Octel and O2 Diesel (AAE Technologies International), supplying other additives and other emission reduction companies such as Johnson Matthey, Engelhard, Environmental Solutions Worldwide and Engine Control Systems (ECS), supplying other emission reduction systems. CDT competes on the basis of effectiveness, price, proprietary technology, and emission reduction performance.

Competition in the NOx control market is from other suppliers of reagent-based post-combustion NOx control systems such as KleenAir Systems, Miratech Corporation and Siemens inc. as well as the engine manufacturing companies. CDT has proprietary technology.

### NEED FOR REGISTRATION

Clean Diesel Technologies needs to comply with registration requirements for each territory in which it sells its products. CDT received its registration from USEPA under Tier 1 of 211(b) registration for its platinum - cerium additive in December 1999. It can sell the product with its current registration status, which provides for pass through rights for other additive companies to use the product without further registration. However, there are provisions in the Act under which EPA could require further testing. The EPA has not exercised these provisions yet for any additive. Registration will be required in other countries as markets are expanded and further testing in support of these registrations is likely to be necessary.

Clean Diesel Technologies' business is impacted by air quality regulations and regulations governing vehicle emissions as well as emissions from stationary engines. If such regulations were to be abandoned or held invalid, CDT's prospects would be adversely affected.

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### NEED FOR PRODUCT VERIFICATION

In the USA verification of the system or products performance over time is required to be demonstrated against newly established protocols. There are separate verification protocols for the EPA and CARB. Verification is required for systems to be sold into the mandated or state funded programs. CDT has achieved verification with the EPA for its first system as listed on the EPA website (<http://www.epa.gov/otaq/retrofit/retroverifiedlist.htm>). Verification

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for a second system is pending with the EPA. Applications are being made to CARB and further applications to extend the verification to additional engine categories and models will be necessary as new CARB and EPA programs become effective or as marketing is expanded. Failure to achieve verifications for a specific category would effectively prevent sales developing in that area. CARB also requires a multimedia assessment for all verified fuel or fuel additive technologies.

### NO ASSURANCES OF ADDITIONAL FUNDING

Clean Diesel Technologies may seek additional funding in the form of a private offering of additional shares of equity securities. Any offering of such securities would result in dilution to the stockholders of Clean Diesel Technologies. The ability of CDT to consummate financing will depend on the status of CDT's marketing programs and commercialization progress, as well as conditions then prevailing in the relevant capital markets. There can be no assurance that such funding will be available if needed, or on acceptable terms. In the event that Clean Diesel Technologies needs additional funds and is unable to raise such funds, CDT may be required to delay, scale back, or severely curtail its operations or otherwise impede its ongoing commercialization, which could have a material adverse effect on the business, operating results, financial condition and long-term prospects. See the text below under the captions "Liquidity and Sources of Capital" in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," elsewhere herein.

### UNCERTAINTY OF MARKET ACCEPTANCE

The commercial success of CDT's products will depend upon acceptance by the fuel additive, oil, and engine industries, and acceptance by governmental regulatory bodies. This market acceptance will in turn depend upon competitive developments and CDT's ability to demonstrate the efficiency, cost effectiveness, safety, and ease of use of the PFCs and NOx control products of Clean Diesel Technologies. The failure to receive market acceptance for the PFCs and NOx control products would have an adverse effect on the business, operating results and financial condition. See "Products and Markets" in Item 1, "Business."

### NO ASSURANCE OF PROTECTION OF PATENTS AND PROPRIETARY RIGHTS

Clean Diesel Technologies holds licenses to a number of patents, holds certain patents, and has patent applications pending. There can be no assurance that pending patent applications will be approved or that the issued patents or pending applications will not be challenged or circumvented by competitors. Certain critical technology incorporated in Clean Diesel Technologies' products is protected by trademark and trade secret laws and confidentiality and licensing agreements. There can be no assurance that such protection will prove adequate or that CDT will have adequate remedies for disclosure of its trade secrets or violations of its intellectual property rights. See "Protection of Proprietary Information" in Item 1, "Business."

### PLATINUM PRICE

The cost of platinum may have a direct impact on the future pricing and profitability of the Platinum Plus FBCs. Although Clean Diesel Technologies intends to minimize this risk through various purchasing and hedging strategies, there can be no assurance that CDT will be able to do so. A significant prolonged increase in the price of platinum could have a material adverse effect on the business, operating results and financial condition.

### DEPENDENCE ON ATTRACTING AND RETAINING PERSONNEL

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The success of Clean Diesel Technologies will depend, in large part, on its ability to retain current key personnel, attract and retain additional qualified management, scientific, and manufacturing personnel; and develop and maintain relationships with research institutions and other outside consultants. The loss of key personnel or the inability of Clean Diesel Technologies to hire or retain qualified personnel, or the failure to assimilate effectively such personnel could have a material adverse effect on the business, operating results and financial condition. See "Employees" in Item 1, "Business."

### ITEM 2. PROPERTIES

#### FACILITIES

Clean Diesel Technologies has a month to month lease of 2,900 square feet of office space for administrative purposes at 300 Atlantic Street, Stamford, Connecticut. CDT has signed a lease in the same building for 3,925 square feet

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of administrative space beginning in May 2004. The 5 year lease will have annual cost of \$115,875, including rent, utilities and parking.

#### PATENTS AND TECHNOLOGY ASSIGNMENTS

CDT's technology is comprised of patents, patent applications, trade or service marks, data, and know-how. This technology was acquired by assignment from Fuel Tech or developed internally. This assignment agreement provides for running royalties of 2.5% of gross revenues derived from the sale of the Platinum Plus FBC, commencing in 1998 and terminating in 2008. Clean Diesel Technologies may at any time terminate this royalty obligation by payment to Fuel Tech of amounts in 2004 of \$5.5 million and declining annually to \$1.1 million in 2008. CDT, as owner, maintains the technology at its expense.

During 2003, Clean Diesel Technologies filed 4 additional US patent applications and 9 international patent applications. Clean Diesel Technologies now has a total of 26 US patents granted and 70 international patents. There are currently 8 US patent applications pending and 76 international applications pending. These patents and patent applications cover the means of controlling the four principal emissions from diesel engines (NOx, particulates, CO, and HC).

### ITEM 3. LEGAL PROCEEDINGS

Clean Diesel Technologies is not involved in any legal proceedings.

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

There were no submissions of matter to a vote of security holders in the fourth quarter of 2003.

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

#### COMMON STOCK

Clean Diesel Technologies' Common Stock is traded in the US on the over-the-counter (OTC) market and on the London Stock Exchange through the Alternative Investment Market (AIM). Reports of transactions of Clean Diesel

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Technologies' shares are available on the OTC Electronic Bulletin Board (Symbol CDTI) and on the AIM (Symbol CDT and CDTS). At March 3, 2004, there are 192 registered holders and approximately 700 beneficial holders of Common Stock.

No dividends have been paid on CDT's Common Stock and Clean Diesel Technologies does not intend to pay dividends on these shares in the foreseeable future.

STOCK PRICE DATE: -----	OTC BULLETIN BOARD		LONDON STOCK EXCHANGE AIM	
	(IN US\$)		(IN GBP)	
	HIGH	LOW	HIGH	LOW
-----	----	----	----	----
1st Quarter 2002 . . . . .	3.50	2.10	2.55	1.56
2nd Quarter 2002 . . . . .	4.00	2.60	2.35	1.40
3rd Quarter 2002 . . . . .	2.60	1.30	1.60	0.97
4th Quarter 2002 . . . . .	1.90	1.25	1.40	1.10
1st Quarter 2003 . . . . .	3.00	1.40	1.54	1.10
2nd Quarter 2003 . . . . .	2.40	1.41	1.48	1.25
3rd Quarter 2003 . . . . .	2.00	1.50	1.35	1.05
4th Quarter 2003 . . . . .	4.70	1.85	2.55	0.95

### SALES AND USES OF UNREGISTERED SECURITIES DURING THE PERIOD

Pursuant to a Regulation S exemption with respect to an offshore placement, Clean Diesel Technologies sold, effective December 1, 2003, 1,282,600 shares of its Common Stock. The price of the Common Stock was 1.70 GBP per share (approximately \$2.92 per share). The proceeds of the Common Stock issuance, \$3.583 million, net of \$170,000 in expenses, will be used for the general corporate purposes of Clean Diesel Technologies.

Pursuant to a Regulation S exemption with respect to an offshore placement, Clean Diesel Technologies sold, effective September 26, 2003, 2,395,597 shares of its Common Stock. The price of the Common Stock was \$1.63 per

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share. The proceeds of the Common Stock issuance, \$3.866 million, net of \$39,000 in expenses, will be used for the general corporate purposes of Clean Diesel Technologies.

### ITEM 6. SELECTED FINANCIAL DATA

Clean Diesel Technologies was incorporated on January 19, 1994, as a wholly owned subsidiary of Fuel Tech. Effective December 12, 1995, Fuel Tech completed a Rights Offering of CDT's Common Stock, with Fuel Tech retaining a 27.6% ownership interest in Clean Diesel Technologies. In 2003 and 2002, CDT obtained \$7.449 million and \$1.356 million of proceeds, respectively, through private placement sales of shares of its Common Stock. As a result of the additional stock transactions, Fuel Tech's 1,825,119 shares of CDT's Common Stock represent approximately a 11.6% interest in Clean Diesel Technologies at December 31, 2003.

As discussed elsewhere herein, prior to 2000, Clean Diesel Technologies was a development stage business. The following selected data are derived from the financial statements of CDT. The data should be read in conjunction with the

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financial statements, related notes and other financial information herein.

	FOR THE YEARS ENDED DECEMBER 31,				
	2003	2002	2001	2000	1999
STATEMENTS OF OPERATIONS DATA <span style="float: right;">(in thousands, except per share data)</span>					
Product Revenue	\$ 373	\$ 142	\$ 176	\$ 199	\$ 142
License and Royalty Revenue	194	299	1,424	383	--
Total Revenues	567	441	1,600	582	142
Costs and expenses:					
Cost of product sales	219	86	117	133	81
General and administrative	2,695	2,291	1,858	1,799	1,585
Research and development	855	693	365	534	827
Patent filing and maintenance	58	43	196	152	134
Loss from operations	(3,260)	(2,672)	(936)	(2,036)	(2,485)
Interest income/(expense), net	15	30	(170)	35	44
Loss before preferred stock dividend	(3,245)	(2,642)	(1,106)	(2,001)	(2,441)
Preferred Stock Dividend (non-cash)	--	--	(621)	(712)	(393)
One-time Preferred Stock conversion premium	--	--	(1,276)	--	--
One-time imputed non-cash preferred dividend	--	--	--	--	(1,750)
Net loss attributable to common stockholders	\$ (3,245)	\$ (2,642)	\$ (3,003)	\$ (2,713)	\$ (4,584)
Basic and diluted loss per common share	\$ (0.26)	\$ (0.23)	\$ (1.08)	\$ (1.03)	\$ (1.77)
Weighted-average shares outstanding	12,721	11,419	2,777	2,631	2,594
Cash dividends paid	\$ 0.00	\$ 0.00	\$ 0.00	\$ 0.00	\$ 0.00

	DECEMBER 31,				
	2003	2002	2001	2000	1999
BALANCE SHEET DATA <span style="float: right;">(in thousands)</span>					
Current assets	\$7,023	\$2,757	\$4,612	\$ 965	\$1,311
Total assets	7,441	2,979	4,658	1,057	1,346
Current liabilities	8,687	223	808	400	494
Long-term liabilities	0	418	368	808	196
Working capital	6,155	2,534	3,804	565	817

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Stockholders' equity (deficit)	6,573	2,338	3,482	(151)	656
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### ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Prior to 2000, Clean Diesel Technologies was a development stage enterprise and its efforts were devoted to the research and development of platinum fuel catalysts and nitrogen oxide reduction technologies to reduce emissions from diesel engines. During December 1999, CDT received its EPA registration for its platinum-cerium product and in early

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2000 completed its first commercial sales; accordingly, in the opinion of management, Clean Diesel Technologies was no longer a development stage enterprise. Although the Company has been unable to generate positive cash flows, it has made significant progress in commercializing its technologies.

#### RESULTS OF OPERATIONS

##### 2003 VERSUS 2002

Revenues and cost of product sales were \$567,000 and \$219,000, respectively, in 2003 versus \$441,000 and \$86,000, respectively, in 2002. The 2003 revenues consist of Platinum Plus sales, ARIS 2000 system sales, ARIS license revenue and royalties, and miscellaneous equipment sales.

CDT received EPA verification of its purifier system (FBC and DOC) in October 2003, and has completed a second verification program with the EPA for the FBC and Mitsui CWMF and is waiting for final verification results from the EPA to be posted. Clean Diesel Technologies has applied for verification for emission reduction by CARB as well. The Platinum Plus FBC is registered with the EPA. In 2003, sales of the platinum-cerium additive totaled \$192,000. Based on initial trial results and licensing agreements, ongoing revenues from sales of its Platinum Plus additives are expected from distributors, refiners, additive marketing companies and fleets.

Clean Diesel Technologies identified a market opportunity for urea selective catalytic reduction (SCR) systems for use with stationary diesel engines primarily for power generation. The ARIS 2000 is a single-fluid injection and metering system complete with an electronic control unit that can be integrated with engine electronic and diagnostic systems. CDT has licensed the ARIS 2000 system for stationary diesel engines in North, South and Central America to the RJM Corporation on a non-exclusive basis and completed a stationary license agreement with Mitsui for Japan on an exclusive basis. In December of 2002 Clean Diesel Technologies completed an additional exclusive license agreement with Mitsui Ltd for the mobile ARIS technology in Japan. In 2003 CDT completed an ARIS mobile license with Combustion Components Associates for the US market. Total sales of systems and license/royalties of the ARIS 2000 in 2003 were \$111,000 and \$194,000, respectively, versus \$102,000 and \$298,000 in 2002, respectively. CDT and its licensees have sold and installed over 175 systems. CDT believes that the ARIS 2000 NOx reduction system has applications for both stationary engines and mobile engines. While the ARIS system for stationary use is being sold commercially, the ARIS system for mobile applications needs further development from the present prototype stage. CDT believes that the ARIS 2000 system can most effectively be commercialized through licensing several companies with a related business in these markets. Clean Diesel Technologies is actively seeking to license the mobile ARIS technology in the US and Europe and the stationary technology in the US, Europe

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and Asia.

General and administrative expenses increased to \$2,695,000 in 2003 from \$2,291,000 in 2002. The increase is the result of an increase in staff expense and marketing and travel relating to the increased sales effort in marketing CDT's technologies. The increase is also related to higher professional fees including the effects of exchange rates, associated with being listed on AIM. Research and development expenses increased to \$855,000 in 2003 from \$693,000 in 2002. The increase in research and development in 2003 is due to the development of new applications for CDT's technologies and for verification testing relating to CARB and EPA certification.

Patent filing and maintenance expenses increased to \$58,000 in 2003 versus \$43,000 in 2002. The increase is attributable to the canceling of some patents in non-viable countries and the resultant charge to income of the related asset amounts which had been accrued. Clean Diesel Technologies capitalizes the expenses related to filing and maintaining each patent and then amortizes the expense over the remaining life of the patent. Interest income decreased to \$15,000 in 2003 from \$39,000 in 2002 due to the decrease in funds used for operations. Interest expense decreased to \$0 in 2003 from \$9,000 in 2002 as a result of using equity to fund operations.

### 2002 VERSUS 2001

Revenues and cost of product sales were \$441,000 and \$86,000, respectively, in 2002 versus \$1,600,000 and \$117,000, respectively, in 2001. The 2002 revenues consist of Platinum Plus sales, ARIS 2000 system sales and ARIS license revenue and royalties.

Clean Diesel Technologies received its EPA registration of the platinum-cerium additive. Field trials of the platinum-cerium additive for fuel economy started in 2000 and continued in 2002. In 2002, CDT initiated field trials of platinum-cerium for emission reduction as well. Clean Diesel Technologies applied for the platinum-cerium product to be verified for emission reduction by both the EPA and CARB. In 2002, sales of the platinum-cerium additive totaled \$40,000. Based on initial trial results and licensing agreements, ongoing revenues from sales of its Platinum Plus additive is expected from distributors, refiners, additive marketing companies and fleets.

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Clean Diesel Technologies identified a market opportunity for urea selective catalytic reduction (SCR) systems for use with stationary diesel engines primarily for power generation. The ARIS 2000 is a single-fluid injection and metering system complete with an electronic control unit that can be integrated with engine electronic and diagnostic systems. CDT has licensed the ARIS 2000 system for stationary diesel engines in North, South and Central America to the RJM Corporation and completed a stationary license agreement with Mitsui for Japan. In December of 2002 Clean Diesel Technologies completed an additional license agreement with Mitsui Ltd for the mobile ARIS technology in Japan. Total sales of systems and license/royalties of the ARIS 2000 in 2002 were \$102,000 and \$298,000, respectively, versus \$62,000 and \$1,424,000 in 2001, respectively. CDT and its licensees have sold and installed over 150 systems. CDT believes that the ARIS 2000 NOx reduction system has applications for both stationary engines and mobile engines. While the ARIS system for stationary use is being sold commercially, the ARIS system for mobile applications needs further development from the present prototype stage. CDT believes that the ARIS 2000 system can most effectively be commercialized through licensing several companies with a related business in these markets. Clean Diesel Technologies is actively seeking to license the mobile ARIS technology in the US and Europe and the stationary technology in Europe and Asia.



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General and administrative expenses increased to \$2,291,000 in 2002 from \$1,858,000 in 2001. The increase is the result of higher professional fees associated with listing on AIM. There were also increases in marketing and travel relating to the increased effort in marketing CDT's technologies. Research and development expenses increased to \$693,000 in 2002 from \$365,000 in 2001. The increase in research and development in 2002 is due to the development of new applications for CDT's technologies and for verification testing relating to CARB and EPA certification.

Patent filing and maintenance expenses decreased to \$43,000 in 2002 versus \$196,000 in 2001. The decrease relates to a change in accounting policy. Clean Diesel Technologies now capitalizes the expenses related to filing and maintaining each patent and then amortizes the expense over the remaining life of the patent. Interest income increased to \$39,000 in 2002 from \$11,000 in 2001 due to funds raised from the issuance of CDT's Common Stock. Interest expense decreased to \$9,000 in 2002 from \$181,000 in 2001 due to the retirement of the term loan financing arrangement in January 2002.

In 2002, Clean Diesel Technologies recorded no in-kind preferred stock dividends on its Series A Preferred Stock due to the conversion of the preferred stock into common stock in December 2001, for which no dividends are paid. In 2001, CDT recorded \$1,897,000 of in-kind preferred stock dividends on its Series A Preferred Stock.

### LIQUIDITY AND SOURCES OF CAPITAL

Prior to 2000, Clean Diesel Technologies was primarily engaged in research and development and has incurred losses since inception aggregating \$25,272,000 (excluding the effect of the preferred stock dividends). CDT expects to incur losses through the foreseeable future as it further pursues its commercialization efforts. Although CDT has begun selling limited quantities of Platinum Plus additive and generating ARIS licensing and royalties, revenue to date has been insufficient to cover operating expenses, and Clean Diesel Technologies continues to be dependent upon sources other than operations to finance its working capital requirements.

For the years ended 2003, 2002 and 2001, Clean Diesel Technologies used cash of \$2,744,000, \$2,836,000 and \$725,000, respectively, in operating activities.

At December 31, 2003, and December 31, 2002, Clean Diesel Technologies had cash and cash equivalents of \$6,515,000 and \$2,083,000, respectively. The increase in cash and cash equivalents in 2003 from 2002 was due to the fund raising completed in the second half of 2003. Working capital increased to \$6,155,000 at December 31, 2003, from \$2,534,000 at December 31, 2002. CDT anticipates incurring additional losses through at least 2004 as it further pursues its commercialization efforts.

In April 2003, Clean Diesel Technologies completed a non-exclusive license agreement with Combustion Component Associates Inc. (CCA) of Monroe, Connecticut, for the mobile ARIS technology in the US. Under terms of the agreement CCA agreed to pay CDT a \$150,000 license fee and committed to spend an additional \$100,000 in developing, testing and demonstrating ARIS mobile prototypes. CDT recognized the \$150,000 license revenue in the second quarter of 2003, as there are no significant ongoing services required to be performed by CDT.

In December 2002, Clean Diesel Technologies completed an additional exclusive license agreement with Mitsui for the mobile ARIS technology for Japan. Under terms of the agreement Mitsui agreed to pay CDT a \$250,000 license fee and Mitsui committed to spend an additional \$200,000 in developing, testing

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and demonstrating ARIS mobile prototypes. CDT recognized the \$250,000 of license revenue in the fourth quarter of 2002.

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In August 2001, Clean Diesel Technologies completed a license agreement with Mitsui for CDT's ARIS 2000 NOx control system for all stationary diesel power generators in Japan. Under the agreement, CDT received nonrefundable up-front license payments of \$495,000 and will receive ongoing standard royalties on each system sold by Mitsui. Mitsui also has an option to license the ARIS technology for mobile applications in Japan for an additional license fee.

In November 2000, Clean Diesel Technologies secured a \$1,000,000 privately financed term loan facility. In December 2000, CDT drew down \$500,000 of the term loan facility and in March 2001 the remaining \$500,000 of the term loan was drawn down. As part of the private placement stock transaction in December 2001, \$750,000 of the outstanding term loan plus accrued interest was converted to Common Stock. In January 2002, the remaining \$250,000 and accrued interest for the term loan was repaid.

In December 2001, Clean Diesel Technologies received \$3.721 million (net of expenses) through a private placement of 2,580,664 shares of its common stock. In conjunction with the private placement, CDT converted all of its Series A Preferred Stock to Common Stock. All of CDT's Common Stock shares were registered to trade on the AIM of the London Stock Exchange.

In October 2002, Clean Diesel Technologies received \$1.356 million (net of \$69,000 in expenses) through a private placement of 704,349 shares of its Common Stock on AIM.

In September 2003, Clean Diesel Technologies received \$3.866 million (net of \$39,000 in expenses) through a private placement of 2,395,597 shares of its Common Stock on AIM.

In December 2003, Clean Diesel Technologies received \$3.583 million (net of \$170,000 in expenses) through a private placement of 1,282,600 shares of its Common Stock on AIM.

### CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results can differ from those estimates. The Company believes that of its significant accounting policies (see Note 1 to the Financial Statements), the following may involve a higher degree of judgment and complexity.

### REVENUE RECOGNITION

Clean Diesel Technologies recognizes revenue from sales of Platinum Plus fuel borne catalyst and ARIS systems upon shipment. CDT sells to end user fleets, resellers, and additive distribution companies primarily in the US. CDT recognizes license revenue at the time of the license agreement when there are no significant ongoing services to be performed by CDT.

### RESEARCH AND DEVELOPMENT COSTS

Costs relating to the research, development and testing of products are charged to operations as they are incurred. These costs include test programs,

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salary and benefits, consultancy fees, materials and certain testing equipment.

### PATENT EXPENSE

Effective January 1, 2002, all patent costs are capitalized and amortized over the remaining life of each patent. Patents are reviewed regularly and any patents deemed not commercial or cost effective are dropped and the cumulative accrued expense is written off. Prior to this all patent related costs were expensed as incurred.

### ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

In the opinion of management, with the exception of exposure to fluctuations in the cost of platinum, it is not subject to any significant market risk exposure. See "Risk Factors of the Business - Platinum Price" in Item 1, "Business."

Clean Diesel Technologies generally receives all income in United States dollars. CDT typically makes several small payments monthly in various foreign currencies for patent expenses, product tests and registration, local marketing and promotion and consultants.

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### ITEM 8. FINANCIAL STATEMENTS

#### REPORT OF INDEPENDENT AUDITORS

DRAFT - SUBJECT TO REVISION

BOARD OF DIRECTORS AND STOCKHOLDERS  
Clean Diesel Technologies, Inc.  
Stamford, Connecticut

We have audited the accompanying balance sheet of Clean Diesel Technologies, Inc. as of December 31, 2003 and the related statements of operations, changes in stockholders' equity (deficit) and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. 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 audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Clean Diesel Technologies, Inc. as of December 31, 2003 and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

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Eisner, LLP  
New York, New York  
March 24, 2004

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REPORT OF INDEPENDENT AUDITORS - 2002

The Board of Directors and Stockholders  
Clean Diesel Technologies, Inc.

We have audited the accompanying balance sheet of Clean Diesel Technologies, Inc. as of December 31, 2002, and the related statements of operations, stockholders' equity (deficit), and cash flows for each the two years in the period ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the 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 financial statements referred to above present fairly, in all material respects, the financial position of Clean Diesel Technologies, Inc. at December 31, 2002, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States.

/s/ Ernst & Young LLP

Stamford, Connecticut  
January 24, 2003

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CLEAN DIESEL TECHNOLOGIES, INC.  
BALANCE SHEETS

(IN THOUSANDS EXCEPT SHARE DATA)

DECEMBER 31,	
2003	2002
-----	-----
-----	-----

ASSETS

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CURRENT ASSETS:		
Cash and cash equivalents	\$ 6,515	\$ 2,083
Accounts receivable, net of allowance of \$3 and \$0 in 2003 and 2002, respectively	115	284
Inventories	320	314
Other current assets	73	76
	-----	-----
TOTAL CURRENT ASSETS	7,023	2,757
Patents, net	274	114
Fixed assets, net of accumulated depreciation of \$123 in 2003 and \$74 in 2002, respectively	126	90
Other assets	18	18
	-----	-----
TOTAL ASSETS	\$ 7,441	\$ 2,979
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Deferred compensation and pension benefits	\$ 441	\$ --
Accounts payable and accrued expenses	427	223
	-----	-----
TOTAL CURRENT LIABILITIES	868	223
Deferred compensation and pension benefits	--	418
	-----	-----
TOTAL LONG-TERM LIABILITIES	--	418
STOCKHOLDERS' EQUITY:		
Preferred Stock, par value \$0.05 per share, authorized 80,000 , no shares issued and outstanding	--	--
Series A Convertible Preferred Stock, par value \$0.05 per share, \$500 per share liquidation preference, authorized 20,000 shares, no shares issued and outstanding	--	--
Common Stock, par value \$0.05 per share, authorized 30,000,000 shares, issued and outstanding 15,679,337 and 11,986,387 shares	784	598
Additional paid-in capital	35,813	28,519
Accumulated deficit	(30,024)	(26,779)
	-----	-----
TOTAL STOCKHOLDERS' EQUITY	6,573	2,338
	-----	-----
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 7,441	\$ 2,979
	=====	=====

See accompanying notes.

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	2003	2002	2001
	-----	-----	-----
Product revenue	\$ 373	\$ 142	\$ 176
License and royalty revenue	194	299	1,424
	-----	-----	-----
Total revenue	567	441	1,600
Costs and expenses:			
Cost of revenue	219	86	117
General and administrative	2,695	2,291	1,858
Research and development	855	693	365
Patent amortization and other expense	58	43	196
	-----	-----	-----
Loss from operations before interest, expense and preferred dividends	(3,260)	(2,672)	(936)
Interest income	15	39	11
Interest expense	--	(9)	(181)
	-----	-----	-----
Net loss before preferred stock dividends	(3,245)	(2,642)	(1,106)
Preferred Stock dividends	--	--	(621)
Preferred Stock conversion premium	--	--	(1,276)
	-----	-----	-----
Net loss attributable to common stockholders	\$ (3,245)	\$ (2,642)	\$ (3,003)
	=====	=====	=====
BASIC AND DILUTED LOSS PER COMMON SHARE ATTRIBUTABLE TO COMMON STOCKHOLDERS	\$ (0.26)	\$ (0.23)	\$ (1.08)
	=====	=====	=====
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING	12,721	11,419	2,777
	=====	=====	=====

See accompanying notes.

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CLEAN DIESEL TECHNOLOGIES, INC.  
STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIT)

(IN THOUSANDS)

	Series A Convertible Preferred Stock		Common Stock		Additional Paid-In Capital	Accumulated Deficit	Total Stockholders' Equity (Deficit)
	Shares	Amount	Shares	Amount			
	-----	-----	-----	-----	-----	-----	-----
Balance at December 31, 2000	14.6	\$ 1	2,660	\$ 133	\$ 20,849	\$ (21,134)	\$ 9,847
Net loss for year	--	--	--	--	--	(1,106)	--
Issuance of common stock warrants	--	--	--	--	157	--	--
Payment of directors' fees in common stock	--	--	26	1	40	--	--
Stock options exercised	--	--	13	1	2	--	--

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Declared but not issued preferred dividend	1.2	--	--	--	621	(621)	
Conversion of Preferred Shares to common stock	(15.8)	(1)	5,299	265	(264)	--	
Premium (12%) paid to preferred shareholders for conversion to common stock	--	--	636	32	1,244	(1,276)	
Issuance of common stock	--	--	2,175	109	3,612	--	
Term loan and related interest conversion to common stock	--	--	405	20	797	--	
	-----	-----	-----	-----	-----	-----	-----
Balance at December 31, 2001	--	\$ --	11,214	\$ 561	\$ 27,058	\$ (24,137)	\$ --
Net loss for year	--	--	--	--	--	(2,642)	--
Issuance of common stock warrants	--	--	--	--	95	--	--
Payment of directors' fees in common stock	--	--	23	1	46	--	--
Exercise of warrants	--	--	27	1	(1)	--	--
Issuance of common stock	--	--	654	33	1,224	--	--
Issuance of common stock	--	--	50	2	97	--	--
	-----	-----	-----	-----	-----	-----	-----
BALANCE AT DECEMBER 31, 2002	--	\$ --	11,968	\$ 598	\$ 28,519	\$ ( 26,779)	\$ --
NET LOSS FOR YEAR	--	--	--	--	--	(3,245)	--
EXERCISE OF WARRANTS	--	--	17	1	(1)	--	--
ISSUANCE OF COMMON STOCK	--	--	2,396	120	3,746	--	--
PAYMENT OF DIRECTORS' FEES IN COMMON STOCK	--	--	13	1	26	--	--
ISSUANCE OF COMMON STOCK	--	--	1,283	64	3,519	--	--
EXERCISE OF WARRANTS	--	--	2	--	4	--	--
	-----	-----	-----	-----	-----	-----	-----
BALANCE AT DECEMBER 31, 2003	--	\$ --	15,679	\$ 784	\$ 35,813	\$ ( 30,024)	\$ --
	=====	=====	=====	=====	=====	=====	=====

See accompanying notes.

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CLEAN DIESEL TECHNOLOGIES, INC.  
STATEMENTS OF CASH FLOWS

(IN THOUSANDS)  
FOR THE YEARS ENDED DEC

	2003	2002	
OPERATING ACTIVITIES			
Net loss	\$ (3,245)	\$ (2,642)	\$ --
Adjustments to reconcile net loss to cash used in operating activities:			
Depreciation and amortization	81	26	
Amortization of deferred financing costs	--	8	
Interest expense from term loans converted to common shares	--	--	
Compensatory stock warrant	--	95	
Changes in operating assets and liabilities:			
Accounts receivable	169	(87)	
Inventories	(6)	(18)	

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Other current assets	3	20	
Accounts payable and accrued expenses	254	(238)	
	-----	-----	-----
Net cash used in operating activities	(2,744)	(2,836)	
	-----	-----	-----
INVESTING ACTIVITIES			
Patent activities	(192)	(122)	
Purchase of fixed assets	(85)	(88)	
	-----	-----	-----
Net cash used in investing activities	(277)	(210)	
	-----	-----	-----
FINANCING ACTIVITIES			
Proceeds from exercise of stock options and warrants	4	--	
Proceeds from (repayment of) term loans	--	(250)	
Proceeds from issuance of common stock, net	7,449	1,356	
	-----	-----	-----
Net cash provided by financing activities	7,453	1,106	
	-----	-----	-----
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS			
CASH EQUIVALENTS	4,432	(1,940)	
Cash and cash equivalents at beginning of the year	2,083	4,023	
	-----	-----	-----
CASH AND CASH EQUIVALENTS AT END OF THE YEAR	\$ 6,515	\$ 2,083	\$
	=====	=====	=====
NON-CASH INVESTING AND FINANCING ACTIVITIES			
Preferred Stock dividend	\$ --	\$ --	\$
Preferred Stock conversion premium (non-cash)	--	--	
Conversion of term loans and related interest into	--	--	
Stock to be issued to Directors in lieu of cash fee	\$ 57	\$ 28	\$

See accompanying notes.

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CLEAN DIESEL TECHNOLOGIES, INC.  
NOTES TO FINANCIAL STATEMENTS

1. BUSINESS

Clean Diesel Technologies, Inc. ("CDT") located in Stamford CT, was incorporated in the State of Delaware on January 19, 1994, as a wholly owned subsidiary of Fuel-Tech N.V. ("Fuel Tech"). Effective December 12, 1995, Fuel Tech completed a Rights Offering of CDT's Common Stock, and reduced its ownership in CDT's Common Stock to 27.6%. As a result of additional equity offerings in subsequent years, Fuel Tech currently holds a 11.6% interest in CDT as of December 31, 2003.



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Clean Diesel Technologies is a specialty chemical and energy technology company supplying fuel additives and proprietary systems to reduce harmful emissions from internal combustion engines while improving fuel economy. Over the past several years the Company has filed patents, developed its technologies and is now commercializing Platinum Plus, a fuel borne catalyst (FBC), the Purifier System which includes the FBC combined with a traditional diesel oxidation catalyst, the FBC/catalyzed wire mesh (CWMF) system and the ARIS 2000 NOx reduction system through a direct sales and licensing distribution strategy. CDT is developing a network of licensed distributors to sell and market its patented Platinum Plus FBC, recently verified Purifier System and the FBC/CWMF system (verification pending). CDT continues to market and sell the FBC, Purifier and CWMF systems to key corporate fleets to generate demand for its technologies. CDT's strategy for the ARIS 2000 NOx reduction system is to continue licensing the patented technology to engineering and automotive companies for an upfront license fee and an on-going royalty. The success of CDT's technologies will depend upon the commercialization opportunities of the technologies, governmental regulations, and corresponding foreign and state agencies. CDT's raw materials are maintained off site and the majority of its blending and manufacturing is performed by third parties.

### 2. SIGNIFICANT ACCOUNTING POLICIES

#### USE OF ESTIMATES

The preparation of the financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

#### CASH AND CASH EQUIVALENTS AND FINANCIAL INSTRUMENTS

Clean Diesel Technologies considers all highly liquid investments with maturity of three months or less when purchased to be cash equivalents. At December 31, 2003, substantially all of CDT's cash and cash equivalents were on deposit with one financial institution. All financial instruments are reflected in the accompanying balance sheets at amounts that approximate fair market value.

#### RECLASSIFICATION

Certain prior year balances have been reclassified in order to conform to the current year's presentation.

#### INVENTORIES

Inventories are stated at the lower of cost or market and consist primarily of finished product (\$73,000) platinum (metal) concentrate (\$171,000) and ARIS injectors and parts (\$56,000). Cost is determined using the first-in, first-out (FIFO) method.

#### REVENUE RECOGNITION

Clean Diesel Technologies recognizes revenue from sales of Platinum Plus fuel borne catalyst, Purifier and ARIS systems upon shipment. CDT sells to end user fleets, resellers, and additive distribution companies primarily in the US. One customer represents 65% of CDT's accounts receivable at December 31, 2003 and 26% of revenue for 2003.

In August 2001, Clean Diesel Technologies completed an exclusive license

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agreement with Mitsui Ltd for CDT's ARIS 2000 NOx control system for all stationary diesel power generators in Japan for the remaining life of the patents. Under the agreement, CDT received a nonrefundable up-front license payment of \$495,000, and will receive ongoing standard royalties on each system sold by Mitsui. CDT recognized the license payment as revenue in 2001, as there are no significant ongoing services to be performed by CDT.

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### CLEAN DIESEL TECHNOLOGIES, INC. NOTES TO FINANCIAL STATEMENTS (CONTINUED)

In December 2002, Clean Diesel Technologies completed an additional exclusive license agreement with Mitsui for the mobile ARIS technology for Japan for the remaining life of the patents. Under terms of the agreement Mitsui agreed to pay CDT a \$250,000 license fee and Mitsui committed to spend an additional \$200,000 in developing, testing and demonstrating ARIS mobile prototypes. CDT recognized the \$250,000 license revenue in the fourth quarter of 2002.

In April 2003, Clean Diesel Technologies completed a non-exclusive license agreement with Combustion Component Associates Inc. (CCA) of Monroe, Connecticut, for the mobile ARIS technology in the US for the remaining life of the patents. Under terms of the agreement CCA agreed to pay CDT a \$150,000 license fee and the licensee committed to spend an additional \$100,000 in developing, testing and demonstrating ARIS mobile prototypes. CDT will also receive ongoing royalty payments on a per unit basis. CDT recognized the \$150,000 license revenue in the second quarter of 2003, as there are no significant ongoing services required to be performed by CDT.

Royalty fees are recognized by Clean Diesel Technologies when earned and royalty revenue for 2003 was \$44,000.

### RESEARCH AND DEVELOPMENT COSTS

Costs relating to the research, development and testing of products are charged to operations as they are incurred. These costs include test programs, salary and benefits, consultancy fees, materials and certain testing equipment.

### PATENT EXPENSE

Effective January 1, 2002, CDT commenced capitalizing all direct incremental costs associated with initial patent filing costs and amortized the cost over the estimated remaining life of such patent. Patents are reviewed regularly and any patents deemed not commercial or cost effective are dropped and the cumulative accrued expense is written off. Prior to this all patent related costs were expensed as incurred. The expiration of CDT's patents range from 2008 to 2021.

### STOCK-BASED COMPENSATION

Clean Diesel Technologies accounts for employee/director stock option grants in accordance with Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees." Under CDT's current plan, options may be granted at not less than the fair market value on the date of grant and therefore no compensation expense is recognized for the stock options granted to employees. In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value-based method of accounting for stock-based employee compensation. In addition, the Statement

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amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company adopted the disclosure requirements of this Statement as of December 31, 2002.

If compensation expense for CDT's plan had been determined based on the fair value at the grant dates for awards under its plan, consistent with the method described in SFAS No. 123, CDT's net loss and basic and diluted loss per common share would have been increased to the pro forma amounts indicated below:

	2003	2002	2001
Net loss attributable to common stockholders as reported	\$ (3,245)	\$ (2,642)	\$ (3,000)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(1,176)	(591)	(420)
Pro forma net loss attributable to common stockholders	\$ (4,421)	\$ (3,233)	\$ (3,420)
Net loss per share attributable to common stockholders:			
Basic and diluted net loss per common share-as reported	\$ (0.26)	\$ (0.23)	\$ (1.00)
Basic and diluted per common share-pro forma	\$ (0.35)	\$ (0.28)	\$ (1.20)

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CLEAN DIESEL TECHNOLOGIES, INC.  
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

In accordance with the provisions of SFAS No. 123, for purposes of the pro forma disclosures the estimated fair value of the options is amortized over the option vesting period. The application of the pro forma disclosures presented above are not representative of the effects SFAS No. 123 may have on operating results and earnings (loss) per share in future years due to the timing of stock option grants and considering that options vest over a period of three years.

The fair value of each option grant, for pro forma disclosure purposes, was estimated on the date of grant using the modified Black-Scholes option-pricing model with the following weighted-average assumptions:

	2003	2002	2001
Expected dividend yield	0.0%	0.0%	0.0%
Risk-free interest rate	4.1%	4.85%	4.66%
Expected volatility	99.4%	94.2%	94.2%
Expected life of option	4 YEARS	4 years	4 years

The 2003 weighted average fair value per option granted was \$2.10.

BASIC AND DILUTED LOSS PER COMMON SHARE

Basic and diluted loss per share is calculated in accordance with SFAS No.

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128, Earnings Per Share. Basic loss per share is computed by dividing net earnings by the weighted-average shares outstanding during the reporting period. Diluted loss per share is computed similar to basic earnings per share except that the weighted-average shares outstanding are increased to include additional shares from the assumed exercise of stock options and warrants, if dilutive. CDT's computation of diluted net loss per share for 2003 does not include the common shares associated with 1,020,000 in the money options as of December 31, 2003, as this would be anti-dilutive.

### 3. INCOME TAXES

The Company follows the liability method of accounting for income taxes. Such method requires recognition of deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax liabilities and assets are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse.

At December 31, 2003 and 2002, Clean Diesel Technologies had tax losses available for offset against future years' earnings of approximately \$23.0 million and \$19.8 million, respectively. Temporary differences were insignificant as of such dates. CDT has provided a full valuation allowance to reduce the related deferred tax asset to zero.

Approximately \$0.9 million, \$2.0 million, \$3.2 million, \$3.4 million, \$3.0 million, \$1.9 million, \$1.9 million, \$0.9 million, \$2.6 million and \$3.2 million of the tax loss carryforwards expire in 2009, 2010, 2011, 2012, 2018, 2019, 2020, 2021, 2022 and 2023, respectively. CDT has not recognized any benefit from the aforementioned tax loss carryforwards. The Taxpayer Relief Act of 1997 modified the net operating loss provisions so that losses arising for tax years beginning after the effective date of the Act (August 5, 1997) would be eligible for carryforward for 20 years. Existing losses would still be subject to a 15-year carryforward period.

Under the provisions of the United States Tax Reform Act of 1986, utilization of CDT's US federal tax loss carry forwards for the period prior to December 12, 1995 may be limited as a result of the ownership change in excess of 50% related to the 1995 Fuel Tech Rights Offering. Losses subsequent to the aforementioned date may be limited due to cumulative ownership changes in any three-year period.

### 4. STOCKHOLDERS' EQUITY

During 2003, Clean Diesel Technologies received proceeds of \$7.5 million (net of expenses) through two private placements totaling approximately 3.7 million shares of its Common Stock on the AIM of the London Stock Exchange. In 2002, Clean Diesel Technologies received proceeds of \$1.356 million (net of expenses) through a private placement of approximately 0.7 million shares of its Common Stock on the AIM of the London Stock Exchange. In 2001, CDT

CLEAN DIESEL TECHNOLOGIES, INC.  
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

received proceeds of \$3.721 million (net of \$0.644 million in expenses and \$0.817 million in term loan repayment) through a private placement of approximately 2.6 million shares of its Common Stock.

During 2001, \$1.9 million of dividends were declared for Series A Preferred

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Stock and converted into CDT's Common Stock. On December 28, 2001, CDT converted all outstanding Series A Preferred Stock (15,897 shares) including accrued stock dividends, into Common Stock (approximately 5.9 million shares).

In October 2003 and May 2002, CDT issued 13,276 and 22,658 shares, respectively, of Common Stock to its Board of Directors in lieu of approximately \$27,500 and \$46,800 of Director's fees pertaining to their services for the years ended December 31, 2002 and 2001. The share price used represented the average of CDT's quarter-end high and low trading prices. Such Director's fees had been accrued and charged to expense during 2002 and 2001.

### 5. STOCK OPTIONS AND WARRANTS

Clean Diesel Technologies maintains a stock award plan, the 1994 Incentive Plan (the "Plan"). Under the Plan, awards may be granted to participants in the form of incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock, performance awards, bonuses, or other forms of share-based or non-share-based awards, or combinations thereof. CDT grants awards at fair market value on the date of grant with expiration dates typically 10 years. Participants in the Plan may include CDT's directors, officers, employees, consultants and advisers (except consultants or advisers in capital-raising transactions) as the Directors determine are key to the success of the business. The percentage of outstanding Common Shares of CDT used to determine the maximum number of awards to participants is 17.5%. In general, the policy of the Board was to grant stock options vesting in three equal portions on the first through third anniversaries of the grant date for grants prior to 1997, and in equal portions on the grant date and the first and second anniversaries of the grant date for grants awarded after 1997.

The following table presents a summary of CDT's stock option activity and related information for the years ended December 31:

	2003		2002	
	OPTIONS (000'S)	WEIGHTED-AVERAGE EXERCISE PRICE	OPTIONS (000'S)	WEIGHTED-AVERAGE EXERCISE PRICE
Outstanding, beginning of year	1,567	\$ 2.60	1,139	\$ 2.48
Granted	681	2.12	470	2.94
Exercised	--	--	--	--
Forfeited	--	--	(42)	2.97
Outstanding, end of year	2,248	\$ 2.45	1,567	\$ 2.60
Exercisable, end of year	1,711	\$ 2.49	1,220	\$ 2.56
Weighted-average fair value of options granted during the year		\$ 2.10		\$ 2.01

The following table summarizes information about stock options outstanding at December 31, 2003:

OPTIONS OUTSTANDING	OPTIONS EXERCISABLE
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RANGE OF EXERCISE PRICES	NUMBER OF OPTIONS	WEIGHTED-AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED-AVERAGE EXERCISE PRICE	NUMBER OF OPTIONS	WEIGHTED-AVERAGE EXERCISE PRICE
\$ .20 - \$2.49	1,142,500	7.58	\$ 1.63	852,500	\$ 1.9
2.50 - 4.63	1,046,000	7.35	3.11	798,665	3.14
5.63 - 6.82	59,450	2.05	6.72	59,450	6.72
\$ .20 - \$6.82	2,247,950	7.33	\$ 2.45	1,710,615	\$ 2.49

In November 2000, CDT granted the lenders a total of 100,000 warrants in conjunction with a \$1,000,000 term loan agreement. Fifty thousand of the warrants were awarded in November 2000, 25,000 of the warrants were awarded in December 2000 when \$500,000 of the term loan was borrowed and the remaining 25,000 warrants were awarded when the remaining \$500,000 was borrowed in March 2001. The warrants were priced at \$2.00 per share. The value of the

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CLEAN DIESEL TECHNOLOGIES, INC.  
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

warrants issued was \$60,750 and has been capitalized as a deferred financing cost and will be amortized over the life of the loan. The value of the 25,000 warrants issued in March 2001 was \$37,250 and has also been capitalized as a deferred financing cost. In December 2001, CDT converted \$750,000 of the outstanding \$1,000,000 loan into Common Stock and expensed \$16,100 of the remaining capitalized warrant expense.

In February 2001, in consideration of their performing investor relations on behalf of Clean Diesel Technologies in the UK, CDT granted Equity Development Limited two 50,000 blocks of warrants at \$1.50 per share. The first 50,000 block of warrants has a one year term and vests when CDT's stock price remains above \$2.50 for seven consecutive days. The second 50,000 block of warrants has a term of two years and vests when CDT's stock price remains above \$3.00 for seven consecutive days. The value of such warrants was \$119,500 and charged to earnings in 2001. In 2002, as a result of the warrants becoming vested, CDT charged to earnings an additional \$95,000 for the 100,000 warrants.

In conjunction with CDT's December 2001 AIM listing and private placement of Common Stock, Clean Diesel Technologies granted its financial advisor, Nabarro Wells Limited, 51,613 warrants at \$2.00 per share on December 28, 2001, which was considered cost of capital.

In conjunction with the September 2003 stock offering CDT granted the private placement investors 230,240 warrants (approximately one warrant for each 10 shares of common stock purchased) at the same \$1.63 price as the common stock issued.

CDT Warrants

2003		2002		2001	
Warrants (000'S)	EXERCISE PRICE PER SHARE	Warrants (000'S)	EXERCISE PRICE PER SHARE	Warrants (000'S)	EXERCISE PRICE PER SHARE

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Outstanding, beginning of year	379		N/A	429		N/A	302	
Granted	230	\$	1.63	-		-	177	\$ 1.
Exercised	19	\$	1.50 - 2.00	50	\$	1.50 - 2.00	-	
Forfeited	33		-	-		-	(50)	\$
-----								
Outstanding, end of year	557	\$	1.50 - 10.00	379	\$	1.50 - 10.00	429	\$ 1.5
=====								

WARRANTS OUTSTANDING				WARRANTS EXERCISABLE	
RANGE OF EXERCISE PRICES	NUMBER OF WARRANTS	WEIGHTED-AVERAGE REMAINING (YEARS) EXERCISE LIFE	WEIGHTED-AVERAGE EXERCISE PRICE	WEIGHTED-AVERAGE EXERCISABLE	PRICE
\$1.50 - \$2.00	466,908	6.55	\$ 1.73	466,908	\$ 1.73
2.25 - 3.00	64,825	4.41	2.54	64,825	2.54
10.00	25,000	0.33	10.00	25,000	10.00
-----					
\$1.50 - \$10.00	556,733	6.02	\$ 2.19	556,733	\$ 2.19

6. COMMITMENTS

Clean Diesel Technologies is obligated under a sublease agreement for its principal office, through the end of 2003. CDT has agreed to move to a larger space within the same building and has signed a new 5 year lease directly with Equity Office beginning May 1, 2004. Annual rent will be \$115,875 and the company will remain in its current location until the new space is available. For the years ended December 31, 2003, 2002 and 2001, rental expense approximated \$110,500, \$112,100 and \$81,500, respectively.

Effective October 28, 1994, Fuel Tech granted two licenses to Clean Diesel Technologies for all patents and rights associated with its platinum fuel catalyst technology. Effective November 24, 1997, the licenses were canceled and Fuel Tech assigned to CDT all such patents and rights on terms substantially similar to the licenses. In exchange for the assignment, CDT will pay Fuel Tech a royalty of 2.5% of its annual gross revenue from sales of the platinum fuel catalysts commencing in 1998. The royalty obligation expires in 2008. CDT may terminate the royalty obligation to Fuel Tech by payment of \$5,454,546 in 2004 and declining annually to \$1,090,910 in 2008. CDT as assignee and owner will maintain the technology at its own expense. Minimum royalties were paid to Fuel Tech in 2002 and royalties payable to Fuel Tech at December 31, 2003 were \$4,800.

CLEAN DIESEL TECHNOLOGIES, INC.  
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

7. RELATED PARTY TRANSACTIONS

In November 2000, Clean Diesel Technologies secured a \$1,000,000 term loan facility at a 10% interest rate from several preferred shareholders, including Fuel Tech Inc., which pledged \$250,000. In 2000 and 2001 CDT drew down the

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entire \$1,000,000 term loan. As part of the December 2001 private placement of Common Stock discussed in Note 4, \$750,000 of the term loan plus accrued interest was repaid in common stock. In January 2002, the remaining \$250,000 plus accrued interest of the term loan was repaid.

Clean Diesel Technologies has a Management and Services Agreement with Fuel Tech. The agreement requires CDT to reimburse Fuel Tech for management, services and administrative expenses incurred on behalf of CDT. CDT agreed to pay Fuel Tech a fee equal to an additional 3-10% of the costs paid on CDT's behalf, dependent upon the nature of the costs incurred. One Fuel Tech officer/director serves as an officer/director of Clean Diesel Technologies. The financial statements include charges from Fuel Tech of certain management and administrative costs, which approximate \$69,000, \$69,000 and \$70,000 for the years ended December 31, 2003, 2002 and 2001, respectively.

Clean Diesel Technologies had a deferred salary plan with its Chief Executive Officer in which he deferred \$62,500 of his annual salary until CDT reaches \$5 million in revenue. This agreement was terminated in March 2001 and the executive's salary was returned to full pay. No additional expense has been accrued. At December 31, 2003 and 2002, total obligations were \$135,400 in both years pertaining to this plan.

Clean Diesel Technologies makes annual pension payments or accruals pursuant to a deferred compensation plan on behalf of its Chief Executive Officer. The CEO has also agreed to defer payment of the deferred compensation plan until the Company reaches \$5 million in revenue or he retires. In June 2003 the CEO elected to discontinue his deferred compensation plan. For the three years ended December 31, 2003, \$22,900, \$50,000 and \$50,000 of expense was recognized each year in connection with the plan. At December 31, 2003 and 2002, total obligations were \$305,600 and \$282,700, respectively, pertaining to this plan.

### 8. MARKETING AND JOINT DEVELOPMENT AGREEMENTS

Clean Diesel Technologies and AMBAC International reached an agreement in December 1997 under which the parties will jointly share in the cost of development of the ARIS injector for urea SCR (Selective Catalytic Reduction). CDT holds the exclusive marketing rights to the injector for a period of five years subject to certain minimum purchases of injectors from AMBAC. CDT has agreed to purchase injectors exclusively from AMBAC until November 3, 2002 or to pay AMBAC for 50% of AMBAC's development cost and a royalty on injectors made elsewhere for CDT. Clean Diesel Technologies has assigned its rights with AMBAC to the RJM Corporation as part of its License Agreement. No rights or licenses have been granted by either party to the other on patents or inventions conceived prior to the agreement. However, the parties have filed a joint patent on the specific ARIS injector. CDT has retained all rights to its underlying patents including the fundamental return-flow injection concept on which the US patent office has issued a "notice of allowance."

### 9. RECENT ACCOUNTING PRONOUNCEMENTS

#### Impairment or Disposal of Long-Lived Assets

In August 2001, the FASB issued SFAS No. 144. This standard supersedes SFAS No. 121 and the provisions of APB Opinion No. 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions" with regard to reporting the effects of a disposal of a segment of a business. SFAS No. 144 establishes a single accounting model for assets to be disposed of by sale and addresses several SFAS No. 121 implementation issues. Clean Diesel Technologies is required to adopt SFAS No. 144 effective January 1, 2002 and does not expect the impact of the adoption of SFAS No. 144 to have a material



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effect on CDT's results of operations or financial position.

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CLEAN DIESEL TECHNOLOGIES, INC.  
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

10. QUARTERLY FINANCIAL DATA (UNAUDITED)  
(IN THOUSANDS EXCEPT PER SHARE DATA)

	1st Quarter Ended 3/31/03 Unaudited	2nd Quarter Ended 6/30/03 Unaudited	3rd Quarter Ended 9/30/03 Unaudited	4th Quarter Ended 12/31/03 Unaudited
TOTAL REVENUE	\$ 96	\$ 283	\$ 99	\$ 89
GROSS PROFIT *	39	219	52	38
NET LOSS ATTRIBUTABLE TO COMMON STOCKHOLDERS	(907)	(585)	(664)	(1,089)
BASIC NET LOSS PER COMMON SHARE	(0.08)	(0.05)	(0.05)	(0.08)
DILUTED NET LOSS PER COMMON SHARE	(0.08)	(0.05)	(0.05)	(0.08)

	1st Quarter Ended 3/31/02 Unaudited	2nd Quarter Ended 6/30/02 Unaudited	3rd Quarter Ended 9/30/02 Unaudited	4th Quarter Ended 12/31/02 Unaudited
Total revenue	\$ 71	\$ 19	\$ 51	\$ 300
Gross profit *	27	7	34	287
Net loss attributable to common stockholders	(662)	(860)	(717)	(403)
Basic net loss per common share	(0.06)	(0.08)	(0.06)	(0.03)
Diluted net loss per common share	(0.06)	(0.08)	(0.06)	(0.03)