HMN FINANCIAL INC
Form 10-Q
May 04, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2012

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) FOR THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission File Number 0-24100

HMN FINANCIAL, INC.

(Exact name of Registrant as specified in its Charter)

Delaware	**41-1777397**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
1016 Civic Center Drive N.W., Rochester, MN	**55901**
(Address of principal executive offices)	**(ZIP Code)**

Registrant s telephone number, including area code: (507) 535-1200

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 ¨

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	x

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of the latest practicable date.

Class	Outstanding at April 20, 2012
Common stock, $0.01 par value	4,423,589

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PART I FINANCIAL INFORMATION

Item 1 : Financial Statements

HMN FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(Dollars in thousands)	March 31, 2012 (unaudited)	December 31, 2011
Assets		
Cash and cash equivalents	$ 45,977	67,840
Securities available for sale:		
Mortgage-backed and related securities (amortized cost $16,609 and $19,586)	17,597	20,645
Other marketable securities (amortized cost $70,699 and $105,700)	70,358	105,469
	87,955	126,114
Loans held for sale	3,279	3,709
Loans receivable, net	538,069	555,908
Accrued interest receivable	2,262	2,449
Real estate, net	13,595	16,616
Federal Home Loan Bank stock, at cost	4,172	4,222
Mortgage servicing rights, net	1,497	1,485
Premises and equipment, net	7,704	7,967
Prepaid expenses and other assets	1,899	2,262
Assets held for sale	0	1,583
Deferred tax asset, net	0	0
Total assets	$ 706,409	790,155
Liabilities and Stockholders Equity		
Deposits	$ 568,237	620,128
Deposits held for sale	0	36,048
Federal Home Loan Bank advances	70,000	70,000
Accrued interest payable	562	780
Customer escrows	1,623	933
Accrued expenses and other liabilities	6,522	5,205
Total liabilities	646,944	733,094
Commitments and contingencies		
Stockholders equity:		
Serial preferred stock ($.01 par value):		
Authorized 500,000 shares; issued shares 26,000	24,915	24,780
Common stock ($.01 par value):		
Authorized 11,000,000; issued shares 9,128,662	91	91
Additional paid-in capital	52,193	53,462
Retained earnings, subject to certain restrictions	45,462	42,983
Accumulated other comprehensive income, net of tax	292	471
Unearned employee stock ownership plan shares	(3,142)	(3,191)
Treasury stock, at cost 4,705,073 and 4,740,711 shares	(60,346)	(61,535)

Total stockholders equity	59,465	57,061
Total liabilities and stockholders equity	$ 706,409	790,155

See accompanying notes to consolidated financial statements.

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HMN FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Loss)

(unaudited)

(Dollars in thousands)	Three Months Ended March 31, 2012	2011
Interest income:		
Loans receivable	$ 7,796	9,903
Securities available for sale:		
Mortgage-backed and related	193	324
Other marketable	249	417
Cash equivalents	27	1
Other	10	69
Total interest income	8,275	10,714
Interest expense:		
Deposits	1,217	1,940
Federal Home Loan Bank advances and Federal Reserve borrowings	845	1,329
Total interest expense	2,062	3,269
Net interest income	6,213	7,445
Provision for loan losses	(128)	1,946
Net interest income after provision for loan losses	6,341	5,499
Non-interest income:		
Fees and service charges	829	924
Loan servicing fees	232	250
Gain on sales of loans	909	495
Gain on sale of branch office	552	0
Other	184	117
Total non-interest income	2,706	1,786
Non-interest expense:		
Compensation and benefits	3,413	3,560
(Gain) loss on real estate owned	(77)	47
Occupancy	882	940
Deposit insurance	270	404
Data processing	337	253
Other	1,418	1,588
Total non-interest expense	6,243	6,792
Income before income tax expense	2,804	493
Income tax expense	0	76

Net income	2,804	417
Preferred stock dividends and discount	(461)	(449)
Net income (loss) available to common shareholders	2,343	(32)
Basic earnings (loss) per common share	$ 0.60	(0.01)
Diluted earnings (loss) per common share	$ 0.58	(0.01)
Other comprehensive loss, net of tax:		
Unrealized holding losses arising during the period	$ (179)	(114)
Other comprehensive loss, net of tax	(179)	(114)
Comprehensive income (loss) attributable to common shareholders	$ 2,164	(146)

See accompanying notes to consolidated financial statements.

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HMN FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Statement of Stockholders Equity

For the Three Month Period Ended March 31, 2012

(unaudited)

(Dollars in thousands)	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Unearned Employee Stock Ownership Plan Shares	Treasury Stock	Total Stock-Holders Equity
Balance, December 31, 2011	$ 24,780	91	53,462	42,983	471	(3,191)	(61,535)	57,061
Net income				2,804				2,804
Other comprehensive loss					(179)			(179)
Preferred stock discount amortization	135		(135)					0
Stock compensation tax benefits			2					2
Unearned compensation restricted stock awards			(1,199)				1,199	0
Restricted stock awards forfeited			10				(10)	0
Amortization of restricted stock awards			76					76
Preferred stock dividends accrued				(325)				(325)
Earned employee stock ownership plan shares			(23)			49		26
Balance, March 31, 2012	$ 24,915	91	52,193	45,462	292	(3,142)	(60,346)	59,465

See accompanying notes to consolidated financial statements.

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HMN FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(unaudited)

(Dollars in thousands)	Three Months Ended March 31, 2012	2011
Cash flows from operating activities:		
Net income	$ 2,804	417
Adjustments to reconcile net income to cash provided by operating activities:		
Provision for loan losses	(128)	1,946
Depreciation	291	327
Amortization of premiums, net	37	69
Amortization of deferred loan fees	(64)	(236)
Amortization of mortgage servicing rights, net	175	98
Capitalized mortgage servicing rights	(187)	(87)
Deferred income tax expense	0	76
(Gain) loss on sales of real estate	(77)	47
Gain on sales of loans	(909)	(495)
Proceeds from sale of loans held for sale	27,605	14,266
Disbursements on loans held for sale	(22,672)	(9,812)
Amortization of restricted stock awards	76	79
Amortization of unearned ESOP shares	49	48
Earned employee stock ownership shares priced below original cost	(23)	(19)
Stock option compensation	2	8
Decrease in accrued interest receivable	187	90
Decrease in accrued interest payable	(218)	(175)
Decrease in other assets	377	153
Decrease in other liabilities	(745)	(61)
Other, net	74	41
Net cash provided by operating activities	6,654	6,780
Cash flows from investing activities:		
Principal collected on securities available for sale	2,979	3,756
Proceeds collected on maturities of securities available for sale	35,000	30,000
Purchases of securities available for sale	0	(40,032)
Redemption of Federal Home Loan Bank stock	50	333
Proceeds from sales of real estate	3,508	1,055
Net decrease in loans receivable	14,063	19,212
Gain on sale of branch office	(552)	0
Payment on sale of branch office	(36,981)	0
Purchases of premises and equipment	(25)	0
Net cash provided by investing activities	18,042	14,324
Cash flows from financing activities:		
(Decrease) increase in deposits	(47,250)	4,787
Repayment of borrowings	0	(7,500)
Increase in customer escrows	691	604
Net cash used by financing activities	(46,559)	(2,109)

(Decrease) increase in cash and cash equivalents	(21,863)	18,995
Cash and cash equivalents, beginning of period	67,840	20,981
Cash and cash equivalents, end of period	$ 45,977	39,976
Supplemental cash flow disclosures:		
Cash paid for interest	$ 2,280	3,443
Cash paid for income taxes	5	0
Supplemental noncash flow disclosures:		
Transfer of loans to real estate	478	6,231
Loans transferred to loans held for sale	3,818	2,806

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(unaudited)

March 31, 2012 and 2011

(1) ***HMN Financial, Inc.***

HMN Financial, Inc. (HMN or the Company) is a stock savings bank holding company that owns 100 percent of Home Federal Savings Bank (the Bank). The Bank has a community banking philosophy and operates retail banking and loan production offices in Minnesota and Iowa. The Bank has one wholly owned subsidiary, Osterud Insurance Agency, Inc. (OIA), which offers financial planning products and services. HMN has another wholly owned subsidiary, Security Finance Corporation (SFC), which is currently not actively engaged in any activities.

The consolidated financial statements included herein are for HMN, SFC, the Bank and OIA. All significant intercompany accounts and transactions have been eliminated in consolidation.

(2) ***Basis of Preparation***

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and therefore, do not include all disclosures necessary for a complete presentation of the consolidated balance sheets, consolidated statements of comprehensive income (loss), consolidated statement of stockholders equity and consolidated statements of cash flows in conformity with U.S. generally accepted accounting principles. However, all normal recurring adjustments which are, in the opinion of management, necessary for the fair presentation of the interim financial statements have been included. The results of operations for the three-month period ended March 31, 2012 is not necessarily indicative of the results which may be expected for the entire year.

(3) ***New Accounting Standards***

In April 2011, the FASB issued ASU 2011-03, *Transfers and Servicing (Topic 860), Reconsideration of Effective Control for Repurchase Agreements.* This ASU prescribes when an entity may or may not recognize a sale upon the transfer of financial assets subject to repurchase agreements. That determination is based, in part, on whether the entity has maintained effective control over the transferred assets. The amendments in this ASU removed from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion. Other criteria applicable to the assessment of effective control are not changed by the amendments in this ASU. This ASU is effective for the first interim or annual period beginning on or after December 15, 2011 and should be applied prospectively to transactions or modification of existing transactions that occur on or after the effective date. The adoption of this ASU in the first quarter of 2012 did not have a material impact on the Company s consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04, *Fair Value Measurement (Topic 820), Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.* The amendments in this ASU change the wording used to describe the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements in order to improve consistency in wording between U.S. GAAP and IFRS. Also, the amendments in the ASU require that for each class of assets and liabilities not measured at fair value on the balance sheet but for which the fair value is disclosed, the Company shall disclose the fair value hierarchy for each asset and liability class. This ASU is effective for interim or annual period beginning on or after December 15, 2011. The adoption of this ASU in the first quarter of 2012 did not have a material impact on the Company s consolidated financial statements other than to change the disclosures relating to fair value measurements.

In June 2011, the FASB issued ASU 2011-05, *Comprehensive Income (Topic 220), Presentation of Comprehensive Income.* Prior to this ASU, U.S. GAAP allowed reporting entities three alternatives for presenting other comprehensive income and its components in financial statements. The first two options were to present this information in a single continuous statement of comprehensive income or in two separate but consecutive statements.

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The third option, which was used by the Company, was to present the components of other comprehensive income as part of the statement of changes in stockholders equity. This ASU eliminates the third option and therefore the Company selected to present this information in a single continuous statement of comprehensive income. This ASU is effective for fiscal years, and interim periods beginning after December 15, 2011. The adoption of this ASU in the first quarter of 2012 did not have a material impact on the Company s consolidated financial statements other than to change the presentation of other comprehensive income as discussed above.

In December 2011, the FASB issued ASU 2011-11, *Balance Sheet (Topic 210).* The objective of this ASU is to provide enhanced disclosures that will enable users of its financial statements to evaluate the effect or potential effect of rights of setoff associated with an entity s financial position. This includes the effect or potential effect of rights of setoff associated with an entity s recognized assets and recognized liabilities within the scope of this ASU. The amendments require enhanced disclosures by requiring improved information about financial instruments and derivative instruments that are either (1) offset in accordance with either Section 210-20-45 or Section 815-10-45 or (2) subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with either Section 210-20-45 or Section 815-10-45. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods with those annual periods. The adoption of this ASU in the first quarter of 2013 is not anticipated to have any impact on the Company s consolidated financial statements as it currently has no outstanding rights of setoff.

In December 2011, the FASB issued ASU 2011-12, *Comprehensive Income (Topic 220).* The amendments in this ASU supersede certain pending paragraphs in ASU 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income,* to effectively defer only those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments out of accumulated other comprehensive income. All other requirements in ASU 2011-05 are not affected by this ASU, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. The amendments in this ASU will be temporary to allow the FASB time to redeliberate the presentation requirements for reclassifications out of accumulated other comprehensive income for annual and interim financial statements for public, private, and non-profit entities. The adoption of this ASU in the first quarter of 2012 did not have a material impact on the Company s consolidated financial statements other than to change the presentation of other comprehensive income as discussed above.

(4) ***Derivative Instruments and Hedging Activities***

The Company had commitments outstanding to extend credit to future borrowers that had not closed prior to the end of the quarter. The Company intends to sell these commitments, which are referred to as its mortgage pipeline. As commitments to originate or purchase loans enter the mortgage pipeline, the Company generally enters into commitments to sell the mortgage pipeline into the secondary market on a firm commitment or best efforts basis. The commitments to originate, purchase or sell loans on a firm commitment basis are derivatives and are recorded at fair market value. As a result of marking these derivatives to market for the period ended March 31, 2012, the Company recorded an increase in other assets of $14,000, an increase in other liabilities of $11,000 and a gain included in the gain on sales of loans of $3,000.

The current commitments to sell loans held for sale are derivatives that do not qualify for hedge accounting. As a result, these derivatives are marked to market and the related loans held for sale are recorded at the lower-of-cost-or-market. The Company recorded a decrease in other liabilities of $56,000 and a gain included in the gain on sales of loans of $56,000.

(5) ***Fair Value Measurements***

ASC 820, *Fair Value Measurements* establishes a framework for measuring the fair value of assets and liabilities using a hierarchy system consisting of three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

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Level 1 Valuation is based upon quoted prices for identical instruments traded in active markets that the Company has the ability to access.

Level 2 Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which significant assumptions are observable in the market.

Level 3 Valuation is generated from model-based techniques that use significant assumptions not observable in the market and are used only to the extent that observable inputs are not available. These unobservable assumptions reflect our own estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

The following table summarizes the assets of the Company for which fair values are determined on a recurring basis as of March 31, 2012 and December 31, 2011.

	Carrying value at March 31, 2012			
(Dollars in thousands)	Total	Level 1	Level 2	Level 3
Securities available for sale	$ 87,955	360	87,595	0
Mortgage loan commitments	43	0	43	0
Total	$ 87,998	360	87,638	0

	Carrying value at December 31, 2011			
(Dollars in thousands)	Total	Level 1	Level 2	Level 3
Securities available for sale	$ 126,114	613	125,501	0
Mortgage loan commitments	(94)	0	(94)	0
Total	$ 126,020	613	125,407	0

There were no transfers between Levels 1, 2, or 3 during the three months ended March 31, 2012.

The Company may also be required, from time to time, to measure certain other financial assets at fair value on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from the application of the lower-of-cost-or-market accounting or write-downs of individual assets. For assets measured at fair value on a nonrecurring basis that were still held at March 31, 2012 and December 31, 2011, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related individual assets or portfolios at March 31, 2012 and December 31, 2011.

	Carrying value at March 31, 2012				Three months ended March 31, 2012
(Dollars in thousands)	Total	Level 1	Level 2	Level 3	Total Gains (Losses)
Loans held for sale	$ 3,279	0	3,279	0	16
Mortgage servicing rights	1,497	0	1,497	0	0
Loans [(1)]	47,999	0	47,999	0	(1,101)
Real estate, net [(2)]	13,595	0	13,595	0	(143)
Total	$ 66,370	0	66,370	0	(1,228)

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(Dollars in thousands)	Carrying value at December 31, 2011 Total	Level 1	Level 2	Level 3	Year ended December 31, 2011 Total Gains (Losses)
Loans held for sale	$ 3,709	0	3,709	0	129
Mortgage servicing rights	1,485	0	1,485	0	0
Loans [1]	38,162	0	38,162	0	(4,167)
Real estate, net [2]	16,616	0	16,616	0	(2,690)
Assets held for sale	1,583	0	1,583	0	0
Deposits held for sale	36,048	0	36,048	0	0
Total	$ 97,603	0	97,603	0	(6,728)

(1) Represents carrying value and related write-downs of loans for which adjustments are based on the appraised value of the collateral. The carrying value of loans fully charged-off is zero.

(2) Represents the fair value and related losses of foreclosed real estate and other collateral owned that were measured at fair value subsequent to their initial classification as foreclosed assets.

(6) *Fair Value of Financial Instruments*

Generally accepted accounting principles require interim reporting period disclosure about the fair value of financial instruments, including assets, liabilities and off-balance sheet items for which it is practicable to estimate fair value. The fair value hierarchy level for each asset and liability, as defined in note 5, have been included in the following table as of March 31, 2012 as required by the adoption of ASU 2011-04 in the first quarter of 2012. The fair value estimates are made based upon relevant market information, if available, and upon the characteristics of the financial instruments themselves. Because no market exists for a significant portion of the Company s financial instruments, fair value estimates are based upon judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. The estimated fair value of the Company s financial instruments as of March 31, 2012 and December 31, 2011 are shown below.

	March 31, 2012						December 31, 2011		
			Fair value hierarchy						
(Dollars in thousands)	Carrying amount	Estimated fair value	Level 1	Level 2	Level 3	Contract amount	Carrying amount	Estimated fair value	Contract Amount
Financial assets:									
Cash and cash equivalents	$ 45,977	45,977	45,977				67,840	67,840	
Securities available for sale	87,955	87,955	360	87,595			126,114	126,114	
Loans held for sale	3,279	3,279		3,279			3,709	3,709	
Loans receivable, net	538,069	546,984		546,984			555,908	566,266	
Federal Home Loan Bank stock	4,172	4,172		4,172			4,222	4,222	
Accrued interest receivable	2,262	2,262		2,262			2,449	2,449	
Assets held for sale	0	0					1,583	1,605	
Financial liabilities:									
Deposits	568,237	568,237		568,237			620,128	620,128	
Deposits held for sale	0	0					36,048	36,048	
Federal Home Loan Bank advances	70,000	73,840		73,840			70,000	74,433	
Accrued interest payable	562	562		562			780	780	
Off-balance sheet financial instruments:									
Commitments to extend credit	16	16		16		97,662	29	29	91,113
Commitments to sell loans	(49)	(49)		(49)		7,932	(94)	(94)	7,263

Cash and Cash Equivalents

The carrying amount of cash and cash equivalents approximates their fair value.

Securities Available for Sale

The fair values of securities were based upon quoted market prices for identical or similar instruments in active markets.

Loans Held for Sale

The fair values of loans held for sale were based upon quoted market prices for loans with similar interest rates and terms to maturity.

Loans Receivable

The fair values of loans receivable were estimated for groups of loans with similar characteristics. The fair value of the loan portfolio, with the exception of the adjustable rate portfolio, was calculated by discounting the scheduled cash flows through the estimated maturity using anticipated prepayment speeds and using discount rates that reflect the credit and interest rate risk inherent in each loan portfolio. The fair value of the adjustable loan portfolio was estimated by grouping the loans with similar characteristics and comparing the characteristics of each group to the prices quoted for similar types of loans in the secondary market. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC 820, Fair Value Measurements and Disclosures.

Federal Home Loan Bank Stock

The carrying amount of FHLB stock approximates its fair value.

Accrued Interest Receivable

The carrying amount of accrued interest receivable approximates its fair value since it is short-term in nature and does not present unanticipated credit concerns.

Deposits

The fair value of demand deposits, savings accounts and certain money market account deposits is the amount payable on demand at the reporting date. The fair value of fixed maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities. If the fair value of the fixed maturity certificates of deposit is calculated at less than the carrying amount, the carrying value of these deposits is reported as the fair value.

The fair value estimate for deposits does not include the benefit that results from the low cost funding provided by the Company s existing deposits and long-term customer relationships compared to the cost of obtaining different sources of funding. This benefit is commonly referred to as the core deposit intangible.

Federal Home Loan Bank Advances

The fair values of advances with fixed maturities are estimated based on discounted cash flow analysis using as discount rates the interest rates charged by the FHLB for borrowings of similar remaining maturities.

Accrued Interest Payable

The carrying amount of accrued interest payable approximates its fair value since it is short-term in nature.

Commitments to Extend Credit

The fair values of commitments to extend credit are estimated using the fees normally charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counter parties.

Commitments to Sell Loans

The fair values of commitments to sell loans are estimated using the quoted market prices for loans with similar interest rates and terms to maturity.

(7) *Other Comprehensive Loss*

Other comprehensive loss is defined as the change in equity during a period from transactions and other events from nonowner sources. Comprehensive income (loss) is the total of net income and other comprehensive loss, which for the Company is comprised of unrealized losses on securities available for sale. The components of other comprehensive loss and the related tax effects were as follows:

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	For the period ended March 31,					
		2012			2011	
(Dollars in thousands)	Before tax	Tax effect	Net of tax	Before tax	Tax effect	Net of tax
Securities available for sale:						
Net unrealized losses arising during the period	$ (179)	0	(179)	(190)	(76)	(114)
Other comprehensive loss	$ (179)	0	(179)	(190)	(76)	(114)

(8) ***Securities Available For Sale***

The following table shows the gross unrealized losses and fair value for the securities available for sale portfolio, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2012 and December 31, 2011.

	March 31, 2012							
	Less than twelve months			Twelve months or more			Total	
(Dollars in thousands)	# of Investments	Fair Value	Unrealized Losses	# of Investments	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Other marketable securities:								
Corporate preferred stock	0	$ 0	0	0	$ 175	(525)	$ 175	(525)
Total temporarily impaired securities	0	$ 0	0	0	$ 175	(525)	$ 175	(525)

	December 31, 2011							
	Less than twelve months			Twelve months or more			Total	
(Dollars in thousands)	# of Investments	Fair Value	Unrealized Losses	# of Investments	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Other marketable securities:								
Corporate preferred stock	0	$ 0	0	1	$ 175	(525)	$ 175	(525)
Total temporarily impaired securities	0	$ 0	0	1	$ 175	(525)	$ 175	(525)

We review our investment portfolio on a quarterly basis for indications of impairment. This review includes analyzing the length of time and the extent to which the fair value has been lower than the cost, the market liquidity for the investment, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer, and our intent and ability to hold the investment for a period of time sufficient to recover the temporary loss.

The unrealized losses reported for corporate preferred stock at March 31, 2012 and December 31, 2011 related to a single trust preferred security that was issued by the holding company of a small community bank. Typical of most trust preferred issuances, the issuer has the ability to defer interest payments for up to five years with interest payable on the deferred balance. In October 2009, the issuer elected to defer its scheduled interest payments as allowed by the terms of the security agreement. The issuer s subsidiary bank has incurred operating losses due to increased provisions for loan losses but still meets the regulatory requirements to be considered adequately capitalized based on its most recent regulatory filing. Based on a review of the issuer, it was determined that the trust preferred security was not other-than-temporarily impaired at March 31, 2012. The Company does not intend to sell the preferred stock and has the intent and ability to hold it for a period of time sufficient to recover the temporary loss. Management believes that the Company will receive all principal and interest payments contractually due on the security and that the decrease in the market value is primarily due to a lack of liquidity in the market for trust preferred securities and the deferral of interest by the issuer. Management will continue to monitor the credit risk of the issuer and may be required to recognize other-than-temporary impairment charges on this security in future periods.

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A summary of securities available for sale at March 31, 2012 and December 31, 2011 is as follows:

(Dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
March 31, 2012:				
Mortgage-backed securities:				
FHLMC	$ 9,612	528	0	10,140
FNMA	6,641	456	0	7,097
Collateralized mortgage obligations:				
FHLMC	167	2	0	169
FNMA	189	2	0	191
	16,609	988	0	17,597
Other marketable securities:				
U.S. Government agency obligations	69,999	184	0	70,183
Corporate preferred stock	700	0	(525)	175
	70,699	184	(525)	70,358
	$ 87,308	1,172	(525)	87,955

(Dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
December 31, 2011:				
Mortgage-backed securities:				
FHLMC	$ 11,310	553	0	11,863
FNMA	7,670	499	0	8,169
Collateralized mortgage obligations:				
FHLMC	335	4	0	339
FNMA	271	3	0	274
	19,586	1,059	0	20,645
Other marketable securities:				
U.S. Government agency obligations	105,000	294	0	105,294
Corporate preferred stock	700	0	(525)	175
	105,700	294	(525)	105,469
	$ 125,286	1,353	(525)	126,114

The following table indicates amortized cost and estimated fair value of securities available for sale at March 31, 2012 based upon contractual maturity adjusted for scheduled repayments of principal and projected prepayments of principal based upon current economic conditions and interest rates.

(Dollars in thousands)	Amortized Cost	Fair Value
Due less than one year	$ 33,528	34,071

Due after one year through five years	52,679	53,283
Due after five years through ten years	401	426
Due after 10 years	700	175
Total	$ 87,308	87,955

The allocation of mortgage-backed securities and collateralized mortgage obligations in the table above is based upon the anticipated future cash flow of the securities using estimated mortgage prepayment speeds. The allocation of other marketable securities that have call features is based on the anticipated cash flows to the call date if it is anticipated that the security will be called, or to the maturity date if it is not anticipated to be called.

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(9) ***Loans Receivable, Net***

A summary of loans receivable at March 31, 2012 and December 31, 2011 is as follows:

(Dollars in thousands)	March 31, 2012	December 31, 2011
1-4 family	$ 117,645	119,066
Commercial real estate:		
Residential developments	53,929	52,746
Alternative fuels	15,884	18,882
Other	210,493	218,286
	280,306	289,914
Consumer	59,187	62,161
Commercial business:		
Construction/development	4,661	4,786
Banking	4,899	4,899
Other	93,293	99,574
	102,853	109,259
Total loans	559,991	580,400
Less:		
Unamortized discounts	79	93
Net deferred loan fees	419	511
Allowance for loan losses	21,424	23,888
Total loans receivable, net	$ 538,069	555,908

(10) ***Allowance for Loan Losses and Credit Quality Information***

The allowance for loan losses is summarized as follows:

(Dollars in thousands)	1-4 Family	Commercial Real Estate	Consumer	Commercial Business	Total
Balance, December 31, 2011	$ 3,718	13,622	1,159	5,389	23,888
Provision for losses	30	(184)	219	(193)	(128)
Charge-offs	0	(2,630)	(265)	(8)	(2,903)
Recoveries	0	241	9	317	567
Balance, March 31, 2012	$ 3,748	11,049	1,122	5,505	21,424
Allocated to:					
Specific reserves	$ 1,000	3,882	429	2,200	7,511
General reserves	2,748	7,167	693	3,305	13,913
Balance, March 31, 2012	$ 3,748	11,049	1,122	5,505	21,424
Allocated to:					
Specific reserves	$ 1,086	3,559	367	1,621	6,633
General reserves	2,632	10,063	792	3,768	17,255

Balance, December 31, 2011	$ 3,718	13,622	1,159	5,389	23,888
Loans receivable at December 31, 2011:					
Individually reviewed for impairment	$ 6,241	30,495	1,205	6,855	44,796
Collectively reviewed for impairment	112,825	259,419	60,956	102,404	535,604
Ending balance	$ 119,066	289,914	62,161	109,259	580,400
Loans receivable at March 31, 2012:					
Individually reviewed for impairment	$ 8,714	38,064	1,377	7,355	55,510
Collectively reviewed for impairment	108,931	242,242	57,810	95,498	504,481
Ending balance	$ 117,645	280,306	59,187	102,853	559,991

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(Dollars in thousands)	1-4 Family	Commercial Real Estate	Consumer	Commercial Business	Total
Balance, December 31, 2010	$ 2,145	24,590	924	15,169	42,828
Provision for losses	756	539	147	504	1,946
Charge-offs	(403)	(7,576)	(52)	(2,308)	(10,339)
Recoveries	0	5	4	509	518
Balance, March 31, 2011	$ 2,498	17,558	1,023	13,874	34,953
Allocated to:					
Specific reserves	$ 1,578	7,501	133	9,636	18,848
General reserves	920	10,057	890	4,238	16,105
Balance, March 31, 2011	$ 2,498	17,558	1,023	13,874	34,953
Loans receivable at December 31, 2010:					
Individually reviewed for impairment	$ 6,729	45,077	299	26,855	78,960
Collectively reviewed for impairment	121,806	311,314	70,304	126,184	629,608
Ending balance	$ 128,535	356,391	70,603	153,039	708,568
Loans receivable at March 31, 2011:					
Individually reviewed for impairment	$ 6,113	30,371	293	24,495	61,272
Collectively reviewed for impairment	121,509	296,735	67,655	123,452	609,351
Ending balance	$ 127,622	327,106	67,948	147,947	670,623

The following table summarizes the amount of classified and unclassified loans at March 31, 2012 and December 31, 2011:

	March 31, 2012						
		Classified				Unclassified	
(Dollars in thousands)	Special Mention	Substandard	Doubtful	Loss	Total	Total	Total Loans
1-4 family	$ 2,344	19,320	809	0	22,473	95,172	117,645
Commercial real estate:							
Residential developments	689	37,628	309	0	87,200		

Restricted shares issued for bonuses	0	234,500
Vested restricted shares issued as share-based compensation	0	60,719
Fair value of vested options issued for officers' and directors' compensation	0	795,087
Cashless exercise of options	0	0
Cashless exercise of warrants	0	0
Net loss	(1,119,400)	(1,119,400)
BALANCE, DECEMBER 31, 2011	(145,632,499)	(14,202,019)
Shares issued for convertible debt conversion	0	1,692,871
Shares issued for services	0	458,979
Shares issued for legal settlements	0	269,325
Shares issued for directors' compensation	0	586,920

Shares issued for compensation and accrued salaries	0	396,300
Fair value of vested restricted shares issued for compensation	0	58,979
Fair value of vested restricted shares previously issued as performance-based compensation	0	342,370
Common and restricted shares rescinded and exchanged for fully-vested options	0	0
Fair value of vested options issued as share-based compensation	0	598,439
Net loss	(3,362,853)	(3,362,853)
BALANCE, DECEMBER 31, 2012	$(148,995,352)	$(13,160,689)

See accompanying notes to consolidated financial statements

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WORLD SURVEILLANCE GROUP INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31,

	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$(3,362,853)	$(1,119,400)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	183,000	123,450
Fair value of share-based compensation	1,879,813	1,109,580
Change in fair value of derivative liabilities	(125,057)	(1,204,069)
Net gain on release of restricted assets and derecognition of liabilities of discontinued operations	(544,201)	0
Gain on derecognition of legacy payables	(1,787,324)	0
Loss on conversion of convertible debt	1,304,712	0
Loan interest capitalized to debt	420,078	419,792
Amortization of deferred financing costs	18,952	0
Gain on extinguishment of liabilities to joint venture partner	0	(2,474,753)
Change in operating assets and liabilities:		
Accounts receivables	(8,977)	(8,411)
Accounts receivable from related party	(27,334)	0
Inventories	4,500	15,125
Prepaid expenses	56,015	36,563
Deposits	(50,000)	0
Accounts payable	535,051	521,829
Accrued liabilities	804,622	639,416
Deferred revenues	(197,160)	204,660
NET CASH USED IN OPERATING ACTIVITIES	(896,163)	(1,736,218)
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisition, net of cash acquired	0	(336,032)
Property and equipment	0	(3,683)
Deposits	0	350
NET CASH USED IN INVESTING ACTIVITIES	0	(339,365)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from sale of common stock	0	2,051,624
Proceeds from convertible debt, net of deferred financing costs	354,974	0
Proceeds from purchases under the Equity Investment Agreement	585,000	0
NET CASH PROVIDED BY FINANCING ACTIVITIES	939,974	2,051,624
NET CHANGE IN CASH	43,811	(23,959)
CASH – BEGINNING OF YEAR	5,532	29,491
CASH – END OF YEAR	$49,343	$5,532

SUPPLEMENTAL DISCLOSURES

Cash paid during the period for:		
Interest	$0	$38,519
NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Common stock issued for acquisition	0	2,250,000
Common stock issued in exchange for convertible debt	1,692,871	0
Common stock issued as payments for accounts payable	458,979	496,486
Common stock issued for accrued settlements	269,325	0
Common stock issued as payments for accrued salaries and directors' fees	103,200	178,691
Stock options for accrued bonus and expenses	0	193,926
Acquisition payable due seller	0	250,000

See accompanying notes to consolidated financial statements

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WORLD SURVEILLANCE GROUP INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2012 AND 2011

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING PRINCIPLES

DESCRIPTION OF BUSINESS

World Surveillance Group Inc. ("WSGI" or the "Company") designs, develops, markets, and sells, autonomous lighter-than-air (LTA) aerostats and unmanned aerial systems (UAS) capable of carrying payloads that provide semi-persistent intelligence, surveillance and reconnaissance (ISR), security and/or wireless communications from air to ground solutions at low and mid altitudes. The Company's primary business focus is the design and development of innovative aerostats and UAS that provide situational awareness and other communications capabilities via the integration of wireless capabilities and customer payloads. The Company's aerostats and airships when integrated with cameras, electronics systems and other high technology payloads, are designed for use by government-related and commercial entities that require real-time ISR or communications support for military, homeland defense, border control, drug interdiction, natural disaster relief, maritime and environmental missions. The Company believes a very large market opportunity exists for aerostats and UAS that can provide situational awareness for mobile missions and/or fly on station for periods of time performing continuous remote sensing and communications relay missions in an affordable manner. Existing solutions such as communications satellites, manned aircraft, non-mobile tethered aerostats or balloons, and heavier-than-air fixed wing unmanned aircraft address some of this emerging demand, but either are imperfect in their capabilities and/or operate at relatively high financial and resource costs.

Through the Company's wholly owned subsidiary Global Telesat Corp. (GTC), we provide mobile voice and data communications services globally via satellite to the U.S. government, defense industry and commercial users. GTC specializes in services related to the Globalstar satellite constellation, including satellite telecommunications voice airtime, tracking devices and services, and ground station construction. GTC has an e-commerce mobile satellite solutions portal and is an authorized reseller of satellite telecommunications equipment and services offered by other leading satellite network providers such as Inmarsat, Iridium, Globalstar and Thuraya. During 2012, GTC launched a new subscription based online tracking portal called GTCTrack, designed to attract new satellite and GSM tracking customers by offering an easy-to-use interface and compatibility with a wide range of devices. GTC's equipment is installed in various ground stations across Africa, Asia, Australia, Europe and South America.

PRINCIPLES OF CONSOLIDATION AND BASIS OF PRESENTATION

The accompanying consolidated financial statements of World Surveillance Group Inc. and its subsidiaries were prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP") and include the assets, liabilities, revenues and expenses of all majority-owned subsidiaries over which the Company exercises control and, where applicable entities for which the Company has a controlling financial interest or is the primary beneficiary.

All material intercompany accounts and transactions are eliminated in consolidation.

The preparation of financial statements in accordance with U.S. GAAP requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. The Company's consolidated financial statements include amounts that are based on management's best estimates and judgments. Actual results could differ from those estimates.

GOING CONCERN

The accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. However, as reflected in the accompanying consolidated financial statements, the Company incurred a loss from operations of $4,541,587 and negative cash flows from operations of $896,163 for the year ended December 31, 2012. The Company had a working capital deficit of $15,369,729 and total stockholders' deficit of $13,160,689 at December 31, 2012. The Company had an accumulated deficit of $148,995,352 at December 31, 2012. These factors raise substantial doubt about the Company's ability to continue as a going concern. The Company's ability to continue as a going concern is dependent upon its ability to raise additional funds either through investments or by generating revenue from the sale of the Company's products to continue its business operations and implement its strategic plan, which includes, among other things, continued development of its aerostats and UAS, the pursuit or continued development of strategic relationships and expansion of the Company's subsidiary GTC's business. The Company's business plan, which if successfully implemented, will allow it to sell aerostats, UAS and other products for a profit, which in turn will reduce the Company's dependence on raising additional funds from outside sources. The consolidated financial statements do not include any adjustments that might be necessary if the Company is unable to continue as a going concern. The Company anticipates a net loss to continue for at least the next several quarters if not for all of the year 2013.

Additional cash will be needed to support our ongoing operations until such time that operations provide sufficient cash flow to cover expenditures. We are currently pursuing both short and long-term financing options from private investors as well as through institutional investors. We are also working to commercialize our aerostats, Argus One airship, and GTC products to begin generating revenues from customers. We anticipate generating revenues from the sale of our airships in 2013 and are already generating revenue from our aerostats and GTC products. The costs associated with our strategic plan are variable and contingent on our ability to raise capital or begin generating revenue from customer contracts, but we expect to need funding of approximately $3 million over the next 12 months. We have an agreement with La Jolla Cove Investors for $5 million of funding, however, such funding has been and may continue to be negatively impacted by our stock price. We continue to have discussions with various entities relating to funding, but there can be no assurance that such funding will be received in the amounts required, on a timely basis, or at all. While we believe we will be able to continue to raise capital from various funding sources in such amounts sufficient to sustain operations at our current levels through at least December 31, 2013, if we are not able to do so and if we are not able to generate revenue through the sale of our products, we would likely need to modify our strategy or cut back or terminate some of our operations. If we are able to raise additional funds through the issuance of equity securities, substantial dilution to existing shareholders may result. However, if our plans are not achieved and/or if significant unanticipated events occur or if we are unable to obtain the necessary additional funding on favorable terms or at all, we will likely have to modify our business plan and reduce, delay or discontinue some or all of our operations to continue as a going concern or seek a buyer for all or a portion of our assets. As of the date hereof, we continue to raise capital to sustain our current operations.

REVENUE RECOGNITION

The Company recognizes revenue when all four of the following criteria are met: 1) persuasive evidence of an arrangement exists; 2) delivery has occurred and title has transferred or services have been rendered; 3) our price to the buyer is fixed or determinable; and 4) collectability is reasonably assured. The Company records unearned contract revenues and subscription fees as deferred revenues and their associated costs of sales as prepaid expenses. Deferred revenue from contracts and their related costs are recognized upon completion and fulfillment of the contractual obligation using the completed contract method. During 2012, the Company recognized $200,000 in contract revenue, previous recorded as deferred revenue. The Company fulfilled its contractual obligation to Space Florida by providing performance parameters of the Argus One airship payload and flight tests completed in Nevada during May. Deferred revenues from subscription fees and their related costs are amortized over the subscription term.

INCOME TAXES

The Company accounts for income taxes using the asset and liability approach. Under this approach, deferred income taxes are recognized based on the tax effects of temporary differences between the financial statement and tax bases of assets and liabilities, as measured by current enacted tax rates. Valuation allowances are recorded to reduce the deferred tax assets to an amount that will more likely than not be realized.

U.S. GAAP requires that, in applying the liability method, the financial statement effects of an uncertain tax position be recognized based on the outcome that is more likely than not to occur. Under this criterion the most likely resolution of an uncertain tax position should be analyzed based on technical merits and on the outcome that will likely be sustained under examination. There were no adjustments related to uncertain tax positions recognized during the years ended December 31, 2012 and 2011, respectively.

FAIR VALUE MEASUREMENTS

U.S. GAAP includes a framework for measuring fair value, which also addresses disclosure requirements for fair value measurements. Fair value is the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date and in the principal or most advantageous market for that asset or liability. The fair value, in this context, should be calculated based on assumptions that market participants would use in pricing the asset or liability, not on assumptions specific to the entity. In addition, the fair value of liabilities should include consideration of non-performance risk, including the Company's own credit risk.

Under the measurement framework, a fair valuation hierarchy for disclosure of the inputs to valuation used to measure fair value has been established. This hierarchy prioritizes the inputs into three broad levels that reflect the degree of subjectivity necessary to determine fair value measurements, as follows. Level 1 inputs are based on unadjusted quoted prices in active markets for identical assets or liabilities. Level 2 inputs are based on quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly, through market corroboration, for substantially the full term of the asset or liability. Level 3 inputs are unobservable inputs and reflect the Company's estimates of assumptions that market participants would use to measure assets and liabilities at fair value. The fair values are therefore determined using model-based techniques that include option pricing models and discounted cash flow models. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company's financial instruments include cash, accounts payable, notes payable and derivative instruments. The carrying values for the current financial assets and liabilities approximate fair value due to their short maturity. The fair values of the Company's derivative instruments are recorded in the consolidated balance sheets.

BASIC AND DILUTED NET INCOME (LOSS) PER COMMON SHARE

Basic and diluted net income (loss) per common share has been computed by dividing the net income (loss) by the weighted average number of shares of common stock outstanding during each period. Whenever net losses are reported, the weighted average number of common shares outstanding excludes common stock equivalents because their inclusion would be anti-dilutive, thus resulting in a diluted loss per share less than the basic loss per share. If all outstanding options, warrants and convertible shares were converted or exercised as of December 31, 2012, the shares outstanding would be 652,225,475.

PROPERTY AND EQUIPMENT

Property and equipment are carried at historical cost less accumulated depreciation. Depreciation is based on the estimated service lives of the depreciable assets and is calculated using the straight-line method. Expenditures that increase the value or productive capacity of assets are capitalized. Fully depreciated assets are retained in the property and equipment, and accumulated depreciation accounts until they are removed from service. When property and equipment are retired, sold or otherwise disposed of, the asset's carrying amount and related accumulated depreciation are removed from the accounts and any gain or loss is included in operations. Repairs and maintenance are expensed as incurred.

The estimated useful lives of property and equipment are generally as follows:

Appliqués and ground stations	15 – 25 years
Machinery and equipment	3 – 12 years
Office furniture and fixtures	3 – 10 years
Computer hardware and software	3 – 7 years
Transportation vehicles	3 – 6 years

The Company follows the authoritative guidance for impairment testing of property and equipment, which requires that a triggering event occur before impairment testing an asset or group of assets is appropriate. Triggering events include but are not limited to a significant disposal of a portion of such assets, an adverse change in the market involving the business employing the related asset, a significant decrease in the benefits realized from an acquired business, difficulties or delays in integrating the acquired business, and a significant change in the operations of an acquired business. Once a triggering event has occurred, the Company performs the impairment test based on its intention to hold or sell the asset or asset group. If the Company intends to hold the asset or group of assets for continued use, the Company compares the asset or asset group's carrying value to the sum of their estimated undiscounted future cash flows. If the carrying value of the asset or asset group exceeds the sum of their estimated undiscounted future cash flows, the asset or asset group is deemed impaired and the Company recognizes an impairment loss for the difference. If the Company intends to sell the asset or asset group and certain other criteria are met (i.e., the asset can be disposed of currently, appropriate levels of authority have approved the sale, and there is an actively pursuing buyer), the Company compares the asset's or asset group's carrying value to its fair value less costs to sell. The Company generally determines fair value by using the discounted cash flow method. If the carrying value of the asset or group of assets is greater than the fair value less costs to sell, the asset or asset group is deemed impaired and the Company recognizes an impairment loss for the difference. Generally, the Company performs its testing of the asset or asset group at the lowest level for which identifiable cash flows are available. Assets held for sale are separately presented on the balance sheet and are no longer depreciated.

DERIVATIVE FINANCIAL INSTRUMENTS

Derivative liabilities primarily relate to warrants to purchase common stock of the Company issued in conjunction with certain debt and equity financings. Each reporting period the Company determines the fair value of the stock warrants using the Black-Scholes option pricing model at the balance sheet date. Changes in the fair value of the stock warrants are recognized each period in current earnings.

SHARE-BASED COMPENSATION

The Company offers share-based compensation programs to its officers, directors and employees that consist of employee stock options, common stock and restricted stock awards. Common stock and restricted stock awards are issued at the closing price of the Company's common stock on the date of grant. The Company recognizes compensation expense ratably over the vesting periods for restricted stock awards using the grant date fair value of the stock awarded. The Black-Scholes option pricing model is used to value stock options, and compensation expense is recognized ratably over the requisite service vesting period. Stock options typically have contractual terms of three to seven years. Share-based compensation for employees and non-employees is reflected in the appropriate functional expense category, primarily general and administrative, and research and development. Share-based compensation incurred during the years ended December 31, 2012 and 2011 was $1,983,008 and $1,109,580, respectively.

NOTE 2. DISCONTINUED OPERATIONS

During 2007, the Company discontinued operations of its telecom and wireless segments and reported the effects as discontinued operations. The assets and liabilities from its discontinued operations are carried at fair value in the consolidated balance sheets at December 31, 2011 as follows:

	Telecom	GlobeTel Wireless	Total
Cash	$6,406	$—	$6,406
ASSETS FROM DISCONTINUED OPERATIONS	$6,406	$—	$6,406
Accounts payable	$140,116	$1,216,208	$1,356,324
Accrued liabilities	9,605	—	9,605
LIABILITIES FROM DISCONTINUED OPERATIONS	149,721	1,216,208	1,365,929
Net liabilities of discontinued operations	$143,315	$1,216,208	$1,359,523

During the quarter ended June 30, 2012, the Company conducted a detailed analysis of certain of its accounts payable and accrued liabilities including (i) liabilities from discontinued operations of $1,365,929, and (ii) legacy payables and accrued liabilities of $1,787,324. Accounts payable includes an amount for legal judgments that were excluded from the potential write-off. The remaining analyzed liabilities from discontinued operations and legacy payables and accrued liabilities are no longer enforceable debts of the Company due to the passage of the applicable statutes of limitation and were written-off the books of the Company. These liabilities along with the assets of discontinued operations of $6,406 have resulted in an aggregate gain of $2,331,525, comprised of the gain on the release of restricted assets and derecognition of liabilities of discontinued operations of $544,201 and the gain on the derecognition of legacy payables of $1,787,324.

NOTE 3. ACQUISITIONS

On May 25, 2011, World Surveillance Group Inc. (the “Company”) entered into a Stock Purchase Agreement (the “Agreement”) by and among the Company, Global Telesat Corp. (“GTC”), Growth Enterprise Fund, S.A. (the “Shareholder”) and David Phipps (“Phipps”) pursuant to which the Company acquired 100% of the outstanding shares of capital stock of GTC, such that GTC is now a wholly-owned subsidiary of the Company.

The purchase price paid by the Company for GTC consisted of cash and shares of the Company’s common stock, and an earn-out equal to 5% of the gross revenues related to the construction by GTC of certain potential satellite ground

stations. Pursuant to the Agreement and an Escrow Agreement, 5,500,000 shares of common stock out of the 30,000,000 shares issued by the Company were placed in escrow for one year to satisfy possible indemnification claims of the Company, but have since been released. David Phipps, the President of GTC, has entered into an employment agreement to continue in his role as President of GTC. The Shareholder has the right to nominate two members of the Company's Board of Directors, both of whom are required to be "independent" under the rules and regulations of the Securities and Exchange Commission. The Agreement also includes restrictions on the sale of the Company's securities issued as the purchase price by the Shareholder for a two-year period following the Closing.

In connection with the Closing, GTC, the Shareholder and the Company also entered into an Option Agreement pursuant to which the Shareholder was granted an exclusive option to purchase certain GTC assets on the occurrence of a bankruptcy event of WSGI occurring within 18 months from the Closing, which option has since terminated.

The common stock of the Company issued to pay the purchase price pursuant to the Agreement was issued as restricted securities under an exemption provided by Section 4(2) of the Securities Act of 1933, as amended. The Agreement provides the Shareholder with certain piggyback registration rights. However, these rights have been waived in connection with the registration statement the Company filed pursuant to certain Registration Rights Agreements and in connection with the registration statement the Company filed relating to its February 2012 financing.

The 2012 operating results for GTC are included in the Company's Consolidated Statements of Operations for the year ended December 31, 2012. The 2011 operating results for GTC are included in the Company's Consolidated Statements of Operations for the year ended December 31, 2011 since the acquisition date of May 25, 2011. The Company's Condensed Consolidated Balance Sheets at December 31, 2012 and 2011 reflect the accounts of GTC, effective since the acquisition date of May 25, 2011.

The following table summarizes the original and revised allocation of the GTC acquisition purchase price, which has been accounted at the fair values of the assets acquired and liabilities assumed under the acquisition method of accounting:

	Original Allocation	Allocation Adjustment	Revised Allocation
Current assets	$203,780	(19,000)	$ 184,780
Property and equipment	2,736,732	19,000	2,755,732
Current liabilities assumed	(90,512)	—	(90,512)
Total Purchase Price	$2,850,000		$ 2,850,000

The acquired property and equipment primarily consists of eight satellite network infrastructure devices, known as appliqués, which provide the signal receipt and processing technology that enables and powers Globalstar's satellite data service. GTC's appliqués are located at a number of Globalstar satellite ground stations and provide service across Europe, Russia and parts of Australia, Asia, the Middle East and South America. Long-term contracts with Globalstar allow GTC access to their satellite network for the purposes of offering tracking services for commercial applications over the useful life of the appliqués through 2025. GTC has developed various simplex satellite tracking devices that are capable of transmitting locational and other information from any location within the Globalstar satellite network. Although GTC can sell to U.S. government customers without the need for any form of certification, GTC cannot sell such tracking devices commercially without certification from Globalstar and the Federal Communications Commission for use in the U.S., and from comparable entities globally, like CE Mark. GTC has begun the process to apply for certification to sell these devices both in the U.S. and globally. Although, GTC believes the likelihood of obtaining these certifications is high due to its experience in producing these tracking devices for government customers combined with its knowledge and experience of the Globalstar network and their certification requirements, there is no guarantee that GTC will be able to certify its tracking devices. GTC is currently obtaining certification of their proprietary tracking devices for commercial applications and expects to begin selling the tracking devices and service plans in 2013.

NOTE 4. RELATED PARTY TRANSACTIONS

The accounts receivable from related party at December 31, 2012 and 2011, includes trade receivables from Global Telesat Communications, Ltd. ("GTCL") of $48,220 and $20,886, respectively. GTCL is a related party based in the United Kingdom and controlled by a current officer of GTC. Total sales to GTCL for the years ended December 31, 2012 and 2011 were $632,992 and $184,789, respectively, and account for 71% and 91% of GTC's total sales for the respective periods. GTC began charging a 10% handling fee on all orders from GTCL in 2012.

NOTE 5. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following:

	December 31, 2012	December 31, 2011
Appliqués and ground stations	$ 2,755,732	$ 2,755,732
Office furniture and fixtures	6,904	6,904
	2,762,636	2,762,636
Less: accumulated depreciation	(309,670)	(126,670)
	$ 2,452,966	$ 2,635,966

NOTE 6. OTHER ACCRUED LIABILITIES

Accrued liabilities consisted of the following:

	December 31, 2012	December 31, 2011
Payroll liabilities	$1,494,883	$ 1,304,303
Professional fees	10,000	15,000
Accrued legal claims payable	334,540	424,201
Accrued cash true-up from conversion	176,831	0
Accrued interest on debenture	18,243	0
Due to officer	0	50,000
GTC acquisition payable	75,000	125,000
Other	22,588	40,287
OTHER ACCRUED LIABILITIES	$2,132,085	$ 1,958,791

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NOTE 7. NOTES PAYABLE

Notes payable is comprised of the following:

	December 31, 2012	December 31, 2011
Unsecured promissory notes	$5,997,030	$ 5,997,030
Accrued interest	2,654,350	2,234,272
NOTES PAYABLE	$8,651,380	$ 8,231,302

Notes payable consists of two unsecured promissory notes aggregating $5,997,030 with no stated interest rate or repayment terms. The Company has accrued interest at 7% per annum on both notes since their inception and includes the notes in current liabilities.

NOTE 8. IMPAIRMENT OF INTANGIBLE ASSETS AND EXTINGUISHMENT OF DEBT

By agreement the Company, TAO Technologies Gmbh (“TAO”) and Professor Bernd Kroeplin (“Kroeplin”) formed a 50/50 U.S. based joint venture company owned by the Company and TAO to be called Sanswire-TAO Corp. to place, among other things, the license rights to certain TAO intellectual property for the exclusive use in the U.S., Canada and Mexico. The intellectual property included, but was not limited to, an existing patent in Germany as well as any updates to that patent. This integration of the Company and Stuttgart, Germany-based TAO was intended to create various strategic advantages for both companies.

During the first quarter of 2011, the Company entered into an agreement by and among the Company, TAO, Kroeplin and Global Telesat Corp., providing for, among other things, the termination of all existing agreements between the parties (the “Old Agreements”); the retention by TAO and Kroeplin of all cash and shares of the Company’s common stock previously paid to them; the return of the old STS 111 (SD34) airship by the Company to TAO; the discharge in full of $2,474,753 in debt owed by the Company under the Old Agreements; and the winding down and dissolution of the joint venture, Sanswire-TAO Corp. The Company recorded a $2,474,753 gain on the extinguishment of the debt during the first quarter ended March 31, 2011. The Sanswire-TAO Corp. was dissolved on June 20, 2011.

NOTE 9. DERIVATIVE LIABILITIES

The Company's derivative instruments are stock warrants that contained anti-dilution provisions that were issued with certain debt and equity financings. The Company accounts for derivative instruments at fair value using the Black-Scholes option pricing model. Gains and losses from changes in the fair value of derivatives are recognized in Other Income (Expense).

Warrants

In the past, the Company obtained financing from the issuance of convertible promissory notes and stock purchase agreements, which included Class A and Class B warrants. Both Class A and Class B warrants contained anti-dilution rights and are considered to be derivative liabilities under U.S. GAAP. During 2010, the Company adopted two new stock purchase agreements and has issued an aggregate of 9,890,167 warrants under the new stock purchase agreements. The warrants issued under these new stock purchase agreements have no anti-dilution rights and are not derivative liabilities. All warrants have 3-year terms and are exercisable for a purchase price of $0.21 per share or, in the case of Class B warrants, $0.315 per share.

The following table summarizes certain information about the Company's warrants to purchase common stock.

	Derivative Liabilities		Other	Weighted Average
	Warrants	Warrants	Purchase Rights and	Exercise
	Class A	Class B	Warrants	Price
Outstanding at December 31, 2011	19,631,826	18,988,965	8,293,834	$ 0.253
Warrants issued	0	0	1,596,333	0.210
Warrants expired	(11,304,364)	(10,661,503)	0	0.261
Purchase rights issued			10,142,854	0.210
Outstanding at December 31, 2012	8,327,462	8,327,462	20,033,021	$ 0.234

The following tables provide the assets and liabilities carried at fair value as determined under the U.S. GAAP measurement framework:

		Fair Value Measurements at December 31, 2012 using:		
	Total	(Level 1)	(Level 2)	(Level 3)
Derivative liabilities	363	0	0	363
Totals	$363	$ 0	$ 0	$ 363

		Fair Value Measurements at December 31, 2011 using:		
	Total	(Level 1)	(Level 2)	(Level 3)
Derivative liabilities	125,420	0	0	125,420
Totals	$125,420	$ 0	$ 0	$ 125,420

The derivative liabilities are measured at fair value using quoted market prices and estimated volatility factors, and are classified within Level 3 of the valuation hierarchy, due to use of estimated volatility factors. There were no changes in the valuation techniques during the years ended December 31, 2012 and 2011.

The following table provides a summary of the changes in the fair value of the derivative liability measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the years ended December 31, 2012 and 2011:

Fair Value Measurements Using Level 3 Inputs

Warrants:	Derivative liability
Balance as of December 31, 2010	$1,329,489
Fair value of warrants issued	0
Fair value of warrants expired	0
Total fair value adjustment	(1,204,069)
Balance as of December 31, 2011	125,420
Fair value of warrants issued	0
Fair value of warrants expired	0
Total fair value adjustment	(125,057)
Balance as of December 31, 2012	$363

During the years ended December 31, 2012 and 2011, the Company recognized gains as a result of decreases in the fair value of derivative liabilities of $125,057 and $1,204,069, respectively.

The fair value of the Class A and Class B warrants, which are derivative liabilities was determined using the Black-Scholes option pricing model with the following assumptions:

	December 31, 2012	December 31, 2011
Warrants:		
Risk-free interest rate	0.16%	0.06% - 0.25%
Expected volatility	124% - 130%	29% - 146%
Expected life (in years)	0.50 - 0.75	0.33 - 1.75
Expected dividend yield	- -	-
Aggregate fair value of warrants outstanding	$ 363	$ 125,420

The warrants outstanding and exercisable at December 31, 2012 and 2011 had no intrinsic value. All warrants were fully exercisable and there was no unamortized cost to be recognized in future periods.

NOTE 10. CONVERTIBLE NOTE PAYABLE

	December 31, 2012	December 31, 2011
Secured Convertible Note Payable, principal due 2/1/15, interest payable monthly at 4.75%	$ 287,000	$ 0
CONVERTIBLE NOTE PAYABLE	$ 287,000	$ 0

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On February 2, 2012, the Company closed on a Securities Purchase Agreement with a California-based institutional investor (the "Investor") for an aggregate of $5.5 million. The $500,000 initial tranche was funded at the closing in connection with a Convertible Debenture due in February 2015 and an Equity Investment Agreement (the "EIA"). The Debenture is convertible by the Investor into shares of common stock beginning on the earlier to occur of (i) the effectiveness of the Registration Statement, but in no event prior to ninety-one (91) days following the Closing Date, or (ii) one hundred eighty one (181) days following the Closing Date subject to the terms and conditions of the conversion feature contained in the Debenture agreement.

The Debenture is secured by a personal guaranty of Michael K. Clark, then Chairman of the Board, and is backed by a mortgage on certain real property owned by Mr. Clark. The guaranty terminates on the earlier of January 29, 2013, or the conversion of the entire principal amount of the Debenture by the Investor.

The Debenture grants the Investor with a right of first refusal on future financings of the Company, subject to certain terms and conditions, and contains acceleration provisions requiring 120% of the principal amount, accrued and unpaid interest, to become immediately due and payable on certain events of default described therein. The Debenture contains provisions for a cash true-up in the event the conversion price is less than the floor price of $.075, in which the Company will pay to the holder an amount equal to the difference in the value of the actual common stock issued using the floor price as the conversion price, and the value of the common stock that would have been delivered had the conversion been done without regard to the floor price.

Pursuant to the EIA, the Investor agreed to invest an additional $5.0 million in monthly tranches beginning on the effectiveness of a registration statement the Company filed with the Securities and Exchange Commission, but not prior to 91 days following the closing. The Investor also has the right to purchase an additional $5.0 million of the Company's common stock at an exercise price of $0.21 per share for a period of three years.

The Company incurred customary closing costs including attorney's fees, commissions and closing costs of $62,027, which are recorded as deferred financing costs to be amortized as additional interest expense on a straight-line basis over the 3-year term of the related Debenture and EIA. During the year ended December 31 2012, we received net proceeds of $437,973 ($500,000 less financing cost of $62,027) from a 4 ¾% Secured Convertible Debenture and $840,000 in additional net proceeds from a total $5.5 million financing agreement with the Investor. The Debenture agreement contains provisions for an optional cash true-up adjustment in the event the conversion price is less than a floor price of $0.075 per share. When this occurs, we have the option to pay to the Investor an amount equal to the difference in the value of the actual common stock issued using the floor price as the conversion price, and the value of the common stock that would have been delivered had the conversion been done without regard to the floor price. At December 31, 2012, our accrued cash true-up balance was $176,831, and we have recognized an aggregate loss of $816,703 on the conversions completed during the period. The accrued cash true-up balance can be credited against the $5.0 million investment at the discretion of the Investor. Pursuant to the terms of a related Equity Investment Agreement (the "EIA"), on each successive thirty (30) day anniversary of the initial investment date, the Company is to receive minimum monthly tranches of $250,000, which can be increased to $500,000 if certain stock price

performance criteria set forth in the EIA are met.

NOTE 11. COMMON STOCK TRANSACTIONS

In July 2011, the authorized shares of the Company's common stock were increased from 500 million to 750 million.

During the year ended December 31, 2012, the Company issued the following shares of common stock:

SHARES	CONSIDERATION	VALUATION
81,785,908	Shares issued for convertible debt conversion	$ 1,692,871
13,140,325	Shares issued for services	458,979
16,715,543	Shares issued for legal settlements	269,325
12,700,000	Shares issued for directors' compensation	586,920
12,978,261	Shares issued for compensation and accrued salaries	396,300
5,000,000	Fair value of vested restricted shares issued for compensation	58,979
0	Fair value of vested restricted shares previously issued as performance-based compensation	342,370
(22,316,667)	Common and restricted shares rescinded and exchanged for fully-vested options	0
120,003,370		

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During the year ended December 31, 2011, the Company issued the following shares of common stock:

SHARES	CONSIDERATION	VALUATION
27,354,998	Shares issued for cash (net of offering costs)	$ 2,051,625
17,562,200	Shares issued for settlement of debts	352,911
30,000,000	Shares issued for acquisition	2,250,000
2,448,331	Shares issued for services	182,266
1,300,000	Shares issued for directors fees	87,200
3,666,667	Shares issued for compensation and accrued salaries	266,000
20,250,000	Restricted shares issued for bonuses	234,500
1,763,405	Cashless exercises - warrants and options	0
104,345,601		

The valuation for the common stock issued is based upon the fair value of the stock at the date of issue. Unvested restricted stock will be recorded according to its vesting schedule on future date(s). No values are recorded on the date of the cashless exercise for warrants and options as their valuations were recorded on the date of grant or issuance.

NOTE 12. SHARE-BASED COMPENSATION

The Company makes share-based compensation awards to its directors, officers, employees and consultants that consist of common stock, restricted stock and stock options. All common stock and restricted stock awards are subject to the securities law restrictions of Rule 144 as promulgated under the Securities Act of 1933, as amended.

Common Stock

The Company recognizes the cost of the common stock issued to directors, officers, and employees as compensation expense at the closing market price on the grant date. All common stock awards are fully vested on the date of grant, therefore no unrecognized compensation expense is associated with these awards. During 2012, the Company awarded 12,700,000 common shares totaling $586,920 for director fees of which 5.0 million shares totaling $180,000 were issued to the new Chairman of the Board of Directors and 6.0 million shares totaling $310,000 were issued to the former Chairman. During 2012, the Company also issued 9.5 million common shares totaling $316,300 as compensation expense and 3.478 million shares totaling $80,000 for accrued salaries. The director fees and compensation are included in general and administrative expense.

Restricted Stock

Awards of restricted stock are independent of stock option grants and are generally subject to forfeiture if employment terminates prior to vesting. Prior to vesting, ownership of the restricted stock cannot be transferred. The restricted stock has the same voting rights as the common stock. The Company recognizes fair value of restricted stock awards based upon the stock's closing market price on the grant date as compensation according to the terms of award's vesting schedule; i.e. ratably over the vesting period or upon attainment of specific performance-based goals and objectives. During 2012, the Company awarded 5.0 million shares of restricted stock as employee compensation, of which approximately 3.95 million shares or $58,979 was immediately vested; the balance will vest ratably over the following year. Vested restricted stock previously issued as performance-based compensation and research and development totaled $272,020 and $70,350, respectively. Share-based compensation is included in general and administration expense. At December 31, 2012, there remains approximately $130,571 in unrecognized compensation and consulting fees relating to performance-based restricted stock awards.

Stock Options

The Company has issued stock options at exercise prices equal to the Company's common stock market price on the date of grant with contractual terms of three to seven years. Historically, the stock options were fully vested and expensed as compensation on the grant date. During 2010, the Company began issuing stock options with vesting schedules and such stock options are generally subject to forfeiture if employment terminates prior to vesting. During 2012, certain officers and employees rescinded approximately 22.3 million shares of previously awarded common and restricted shares for fully-vested stock options on a one-for-one basis. Also during 2012, the Company issued 14 million stock options in retention bonuses and performance-based awards, totaling $208,534 and modified certain existing agreements by extended 2-year terms, totaling $190,401. Total share-based compensation attributable to vested option agreements of $545,639 is included in general and administrative and $52,800 is included in research and development. At December 31, 2012, there was approximately $78,845 in unrecognized compensation expense.

The Company uses the Black-Scholes option pricing model to estimate the fair value of stock options. The principal assumptions utilized in valuing stock options include the expected stock price volatility (based on the most recent historical period equal to the expected life of the option); the expected option life (an estimate based on historical experience); the expected dividend yield; and the risk-free interest rate (an estimate based upon on the yields of Treasury constant maturities equal to the expected life of the option).

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The fair values for the 7-year options granted during the year ended December 31, 2012 were determined using the following assumptions:

	7-Year Options	
Expected stock volatility	271.68%- 277.36	%
Expected option life	7 years	
Expected dividend yield	0.0	%
Risk-free interest rate	1.020%- 1.030	%

During the year ended December 31, 2012, the Company issued the following options to acquire common stock:

Date Issued	Shares	Consideration	Valuation	Relationship
03/31/2012	8,861,111	Modified/Extended 2 Years	$190,401	Management
10/02/2012	14,000,000	Compensation	208,534	Management
11/13/2012	22,316,667	Rescinded Stock/Exchange	0	Management
	45,177,778		$398,935	

During the year ended December 31, 2011, the Company issued the following options to acquire common stock:

Date Issued	Shares	Consideration	Valuation	Relationship
02/08/2011	1,500,000	Compensation	$77,570	Corporate Officer
03/02/2011	3,500,000	2010 Bonus Awards	193,926	Board Member & Mgmt Team
03/30/2011	13,750,000	Performance Based Award	907,058	Board, Mgmt, and Consultant
	18,750,000		$1,178,554	

The following table summarizes the stock option activity for the years ended December 31,

	2012		2011	
	Shares	Weighted average exercise price	Shares	Weighted average exercise price
Outstanding at beginning of year	40,916,667	$ .067	26,583,334	$ .078

Granted	14,000,000	.015	18,750,000	.068
Exchanged for rescinded stock	22,316,667	.023	0	.000
Exercised	0	.000	(3,861,111	.074
Forfeited / expired / cancelled	(8,583,334)	.073	(555,556)	.090
Outstanding at end of year	68,650,000	$ .046	40,916,667	$ .067
Options exercisable at end of year	63,358,333	$ .048	35,009,904	$ .068
Weighted average remaining contractual term	4.55 years		1.80 years	

The following table summarizes information about stock options outstanding and exercisable at December 31, 2012:

	Options Outstanding and Exercisable		
Exercise prices	Number outstanding	Weighted average remaining contractual terms (years)	Weighted Average Exercise price
$ .015	8,708,333	6.75	$ .015
$ .023	22,316,667	6.87	.023
$ .045	4,444,444	1.34	.045
$ .066	9,750,000	5.25	.066
$ .070	1,500,000	1.11	.070
$ .075	2,500,000	1.16	.075
$ .080	1,500,000	1.27	.080
$ .090	11,338,889	1.05	.090
$ .094	1,300,000	0.76	.094
	63,358,333	4.55	$ .048

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The aggregate intrinsic value of the 63,358,333 options outstanding and exercisable at December 31, 2012 was $0. The aggregate intrinsic value for the options is calculated as the difference between the prices of the underlying awards and quoted price of the Company's common stock for the options that were in-the-money at December 31, 2012.

NOTE 13. INCOME TAXES

The Company has federal and state net operating loss (NOL) carryforwards, which can be used to offset future earnings. Accordingly, no provision for income taxes is recorded in these consolidated financial statements. A deferred tax asset for the future benefits of net operating losses and other differences is offset by a 100% valuation allowance due to the uncertainty of the Company's ability to realize future tax benefits from the losses. These net operating losses will expire in the years 2021 through 2031.

Certain income and expenses are recognized in different periods for tax and financial reporting purposes. The items that give rise to these temporary differences at the Company consist of its NOL carryforwards and the related valuation allowances. The resulting deferred tax assets and liabilities consist of the tax effects (computed at 15%) of the temporary differences and are listed below:

	2012	Current Period Changes	2011
Deferred tax assets:			
Net operating loss carry-forwards	$17,749,701	$504,428	$17,245,273
Valuation allowance	(17,749,701)	(504,428)	(17,245,273)
Net deferred tax asset	$—	$—	$—

A reconciliation of income benefit provided at the federal statutory rate of 15% to income tax benefit is as follows:

	2012	2011
Income tax benefit computed at federal statutory rate	$(504,428)	$(167,910)
Deferred income taxes	504,428	167,910

$—	$—

At the end of 2012, the Company also had net operating loss carry-forwards of its predecessor, related to its reincorporation and reorganization under the Internal Revenue Code, available to offset future taxable income. These NOL carryforwards total approximately $81,429,083 and expire at various dates through 2021.

The Company operated in multiple tax jurisdictions within the United States of America. Although management does not believe that the Company is currently under examination in any major tax jurisdiction in which it operates other than for the issues with the IRS as described in Note 15, the Company remains subject to examination in all of those tax jurisdictions until the applicable statute of limitations expire. As of December 31, 2012, 2007 and subsequent tax years remain subject to examination by the Internal Revenue Service ("IRS") and in the Company's major state tax jurisdictions. The Company does not expect to have a material change to unrecognized tax positions within the next twelve months.

NOTE 14. PER SHARE INFORMATION:

The computation of basic and diluted earnings per share of common stock is below. There were no common stock equivalents in-the-money at December 31, 2012. Common stock equivalents totaling 4,444,444 shares were excluded from the computation of Diluted EPS for 2011, as their effect on the computation of Diluted EPS would have been anti-dilutive.

	Years Ended December 31,	
	2012	2011
Numerator:		
Net loss	$(3,362,853)	$(1,119,400)
Denominator:		
Weighted-average common shares outstanding	420,841,556	374,043,495
Net loss per share:		
Basic and diluted	$(0.01)	$(0.00)

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NOTE 15. COMMITMENTS

Agreements

The Company has entered into several agreements and memorandums of understanding during 2012 and 2011 and through the date of this Annual Report on Form 10-K, none of which require the recording of any assets, liabilities, revenues or expenses.

Lease Commitments

The Company's headquarters are located at the Kennedy Space Center, FL on State Road 405, Building M6-306A, Room 1400. In December 2012, the Company renewed its annual lease agreement for $1,607 per month plus state sales tax. In April 2012, the Company renewed an annual lease agreement for GTC office space at $3,000 per month. The Company is also obligated under other monthly rental agreements for additional facilities and office furniture.

Rent expense for 2012 and 2011 was $120,727 and $81,505, respectively.

The estimated future minimum rental payments on non-cancelable operating leases at December 31, 2012 consist of $30,780 due during the year ended December 31, 2013.

NOTE 16. LITIGATION AND CONTINGENCIES

In the ordinary conduct of business, the Company is subject to periodic lawsuits, investigations and litigation claims, which the Company accrues for where appropriate and can be reasonably estimated. The Company cannot predict with certainty the ultimate resolution of such lawsuits, investigations and claims asserted against it. At December 31, 2012, the Company had the following material contingencies:

Brio Capital

Brio Capital, the holder of a warrant, filed an action against us on February 25, 2011 in the New York Supreme Court, County of New York, for the issuance of approximately 6.2 million shares of common stock upon the exercise of certain warrants. The Court granted a non-final Summary Judgment Order on a portion of the action in favor of Brio in December 2011 requiring the Company, among other things, to issue 6.2 million shares of common stock. The Company has issued the shares required by the Court order. We have also entered into a settlement agreement to pay $57,661 in legal fees as required by the Court order, the unpaid balance of $9,610 is included in accounts payable.

Tsunami Communications v. GlobeTel

On March 3, 2006, Civil Action File No. 06A-02368-5 was filed in Superior Court for Gwinnett County, Georgia by Tsunami Communications and several of its former shareholders. We asserted affirmative defenses and a trial was held in November 2009. By Order of the Court entered on September 2, 2010, an Order was entered against GlobeTel and several other co-defendants for the breach by Sanswire Technologies, Inc. (“ST”) (a then unrelated party) of its asset purchase agreement with the plaintiff Tsunami based on a deemed de facto merger resulting from a subsequent asset purchase agreement between ST and GlobeTel. As damages, we were ordered to issue 530,015 shares of common stock to former shareholders of Tsunami and pay $229,180 to a former Tsunami shareholder with respect to two outstanding promissory notes. Subsequent to the Order, the plaintiffs filed a Motion for Reconsideration asking the Court to both reconsider its decision to deny several of the plaintiffs’ claims and to substantially increase the award of damages and a Claim for Attorney’s Fees, which has been denied by the Court. We have issued the share portion of the Order. We reached a settlement with the plaintiffs resolving the cash portion of the Order. Under the terms of the settlement, we issued 3.75 million shares of common stock and are required to pay them $60,000 over a twelve-month period, the unpaid balance of $40,000 is included in accounts payable.

The DeCarlo Group

A lawsuit was filed by the DeCarlo Group on November 24, 2010 in Miami-Dade County Courthouse for over $400,000 claimed in connection with CFO and accounting services allegedly rendered to the Company. It is our position that the Company was overcharged in connection with the services rendered and that no amounts are due. DeCarlo has once again found a new attorney to represent him in this matter. We have filed a motion for sanctions and to dismiss and strike on the pleadings and intend to otherwise defend ourselves vigorously in this matter, but the outcome of the action cannot be predicted. Accordingly, the Company has not recorded an accrual.

Siegel

A lawsuit was filed by Frances Siegel, the mother of a former officer and director of the Company, on January 20, 2011 in Miami-Dade County Courthouse for $300,000 plus interest claimed in connection with an alleged investment in the Company back in 2003. We reached a settlement with the plaintiff resolving this lawsuit, without admitting or

denying the allegations. Under the terms of the settlement, we were required to issue them 4.0 million shares of common stock.

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Siefert

A lawsuit was filed by Thomas Seifert, a former officer and director of the Company, on April 9, 2012 in the Circuit Court of the 17th Judicial Circuit in Broward County for $548,000 and 7.0 million shares of common stock for alleged unpaid compensation. The Company has recorded an accrual of $50,000 in accounts payable and $100,000 in accrued liabilities.

Dohan

The Company filed a lawsuit on November 3, 2008, in the Florida Circuit Court for the Eleventh Circuit in Miami-Dade County, FL against our former auditors, Dohan Brown Salum + Ferro CPA PA n/k/a Dohan Salum + Company CPA PA and the individual auditors who performed work for us. The claim asserts that but for the professional negligence of the audit firm in failing to observe GAAP and other accounting and auditing standards, we would not have incurred the substantial fees and professional expenses necessary to restate our financials and defend allegations of wrongdoing asserted by the SEC against us. The Company filed an amended complaint to add claims. Dohan and Company, P.A., C.P.A.'s filed a related lawsuit against us on July 29, 2011 in the same court alleging unpaid professional accounting fees of $126,820, which case has now been combined with our lawsuit. The Company has recorded an accrual of $11,000 in accounts payable.

IRS

During 2010 and 2009, we, under our former name Sanswire Corp., incurred and reported to the Internal Revenue Service ("IRS") payroll tax liabilities (and deposited the appropriate withholding amounts) during the normal course of business at each payroll cycle. The Company has reported its payroll tax liabilities for all the tax periods in 2007 and 2008, however, it failed to deposit the appropriate withholding amounts for those periods We recognized this issue and, accordingly, contacted the IRS to make arrangements to pay any taxes due. One such matter has been resolved with the IRS, and we currently estimate the amount involved in the second matter to be approximately $200,000. We may be subject to additional penalties and interest from the IRS in connection with these payroll tax matters. We are engaged in discussions with the IRS to settle this matter and filed an Offer in Compromise with the IRS, which was not accepted. We are continuing to cooperate with the IRS to resolve this matter.

The Company provides indemnification, to the extent permitted by law, to its officers, directors, employees and agents for liabilities arising from certain events or occurrences while the officer, director, employee, or agent is or was serving at our request in such capacity.

NOTE 17. SUBSEQUENT EVENTS

The Company has evaluated subsequent events from the balance sheet date. The following material subsequent events were as follows:

On January 17, 2013, Global Telesat Corp. (“GTC”) was awarded a $605,000 contract from the United States Department of Defense for a set of Blimp in a Box (“BiB”) aerostat systems. The contract award includes on-location support for technical fact gathering, installation and training for the BiB systems. Delivery, installation and on-site training of the initial BiB systems, spares and payloads are scheduled to be completed by the end of April 2013.