



**ANNUAL REPORT  
2007**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders  
ZBB Energy Corporation  
Milwaukee, Wisconsin

We have audited the accompanying consolidated balance sheet of ZBB Energy Corporation and subsidiaries as of June 30, 2007 and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the years ended June 30, 2007 and 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ZBB Energy Corporation and subsidiaries at June 30, 2007 and the results of their operations and their cash flows for the years ended June 30, 2007 and 2006 in conformity with accounting principles generally accepted in the United States of America.

/s/ PKF  
Certified Public Accountants  
A Professional Corporation  
New York, New York  
October 9, 2007

**ZBB Energy Corporation**  
**Consolidated Balance Sheet**

**June 30, 2007**

<b>Assets</b>	
Current assets:	
Cash and cash equivalents	\$ 17,823,022
Accounts receivable	192,768
Other receivables	36,602
Inventories	1,272,568
Prepays and other current assets	319,790
<b>Total current assets</b>	<b>19,644,750</b>
Long-term assets:	
Property, plant and equipment, net	3,570,386
Investment in joint venture	213,025
Goodwill	803,079
<b>Total assets</b>	<b>\$ 24,231,240</b>
<b>Liabilities and Shareholders' Equity</b>	
Current liabilities:	
Bank loans	1,890,379
Accounts payable	836,183
Accrued loss on contracts	357,250
Deferred revenues	336,305
Accrued compensation and benefits	84,148
Notes payable	4,523,060
<b>Total current liabilities</b>	<b>8,027,325</b>
Long-term liabilities:	
Bank loans	285,712
<b>Total liabilities</b>	<b>\$ 8,313,037</b>
Shareholders' equity	
Common stock ( <i>\$0.01 par value</i> ); <i>150,000,000 authorized</i> <i>10,087,090 shares issued and outstanding</i>	100,871
Additional paid-in capital	44,994,333
Note receivable from shareholders	(808,333)
Accumulated other comprehensive (loss)	(1,546,537)
Accumulated (deficit)	(26,822,131)
<b>Total shareholders' equity</b>	<b>\$ 15,918,203</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 24,231,240</b>

*See accompanying notes to consolidated financial statements*

**ZBB Energy Corporation**  
Consolidated Statements of Operations

	<i>Years Ended June 30,</i>	
	<b>2007</b>	<b>2006</b>
<b>Revenues</b>		
Contracts	\$ 583,819	\$ 526,807
Other operating revenues	-	13,592
<b>Total Revenues</b>	<b>583,819</b>	<b>540,399</b>
<b>Cost and Expenses</b>		
Cost of contracts	548,356	524,320
Other operating costs	-	2,661
Selling, General, and Administrative	2,783,033	1,341,578
Research and Development	1,249,053	676,948
Depreciation and Amortization	259,668	150,362
Accrued loss on contract	-	357,250
<b>Total Costs and Expenses</b>	<b>4,840,110</b>	<b>3,053,119</b>
<b>Loss from Operations</b>	(4,256,291)	(2,512,720)
<b>Other Income (Expense)</b>		
Interest income	57,822	4,287
Interest expense	(910,096)	(148,534)
Income from lease termination agreement	-	160,000
Deferred finance fees	(583,258)	(41,313)
Finance charges	(3,133,665)	(408,925)
Debt extinguishment expenses	(864,712)	-
Other income (expense)	60,468	12,813
<b>Total Other Income (Expense)</b>	<b>(5,373,441)</b>	<b>(421,672)</b>
Loss before provision for Income Taxes	(9,629,732)	(2,934,392)
Provision for Income Taxes	-	-
<b>Net Loss</b>	<b>\$ (9,629,732)</b>	<b>\$ (2,934,392)</b>
<b>Net Loss per share-</b>		
Basic and diluted	<b>\$ (1.80)</b>	<b>\$ (0.60)</b>
<b>Weighted average shares-basic and diluted:</b>		
Basic	5,361,010	4,858,213
Diluted	5,361,010	4,858,213

*See accompanying notes to consolidated financial statements.*

**ZBB Energy Corporation**  
**Consolidated Statements of Changes in Shareholders' Equity**  
**June 30, 2007**

	Number of Shares	Common Stock	Add'l Paid-in Capital	Note Receivable from Shareholders	Accumulated Other Comprehensive (Loss)	Accumulated Deficit	<b>TOTAL</b> <b>Shareholders'</b> <b>Equity</b>	Comprehensive (Loss)
<b>Balance: June 30, 2005</b>	<b>4,821,449</b>	<b>\$ 48,214</b>	<b>\$ 18,889,500</b>	-	<b>\$ (1,612,815)</b>	<b>\$ (14,258,007)</b>	<b>\$ 3,066,892</b>	
Stock Options Exercised	73,529	735	229,587				230,322	
Issuance of common stock pursuant to notes payable conversions	23,640	236	49,764				50,000	
Convertible Notes-embedded equity feature			700,000				700,000	
Issuance of warrants with notes payable - Bushido loan			243,225				243,225	
Net Loss						(2,934,392)	(2,934,392)	\$ (2,934,392)
Net Translation Adjustment					(25,094)		(25,094)	(25,094)
<b>Balance: June 30, 2006</b>	<b>4,918,618</b>	<b>\$ 49,186</b>	<b>\$20,112,076</b>	-	<b>(\$1,637,909)</b>	<b>(\$17,192,399)</b>	<b>\$1,330,954</b>	<b>\$ (2,959,486)</b>
Issuance of common stock 41 Broadway Assoc.	294,118	2,941	997,059	(1,000,000)				
Issuance of common stock pursuant to conversions	36,888	369	59,631				60,000	
Convertible debt accrued interest add'l embedded conversion feature			25,808				25,808	
Convertible notes issued embedded conversion feature benefits			1,130,000				1,130,000	
Reduction of note receivable from stockholder				191,667			191,667	
Stock Options Exercised	9,882	99	41,901				42,000	
Options issued			171,013				171,013	
Issuance of common stock public offering - net of underwriters' cost	3,333,333	33,333	18,376,667				18,410,000	
Issuance of common stock pursuant to convertible note conversions	836,395	8,364	2,498,941				2,507,305	
Issuance of common stock warrant grants and exercise - Bushido loan	657,856	6,579	2,312,357				2,318,936	
Warrants issued-public offering/underwriters			265,935				265,935	
Public offering costs			(1,408,390)				(1,408,390)	
Montgomery debt redemption warrants issued in lieu of conversion			411,335				411,335	
Net Loss						(9,629,732)	(9,629,732)	\$ (9,629,732)
Net Translation Adjustment					91,372		91,372	91,372
<b>Balance: June 30, 2007</b>	<b>10,087,090</b>	<b>\$ 100,871</b>	<b>\$ 44,994,333</b>	<b>\$ (808,333)</b>	<b>\$ (1,546,537)</b>	<b>\$ (26,822,131)</b>	<b>\$ 15,918,203</b>	<b>\$ (9,538,360)</b>

*See accompanying notes to consolidated financial statements.*

**ZBB Energy Corporation**

Year Ended June 30,

## Consolidated Statements of Cash Flows

**2007****2006****Cash flows from operating activities:**Net loss \$ (9,629,732) \$ (2,934,392)

## Adjustments to reconcile net loss to net cash used in operating activities:

Depreciation and amortization	259,668	150,362
Accrued interest-converted to equity on conversions	234,805	-
Accrued interest on notes payable	369,109	49,785
Options issued	171,013	-
Payments applied to note receivable for consulting fees	191,667	-
Finance charges	3,133,665	400,000
Amortization of deferred finance fees	534,775	112,790
Debt extinguishment expenses	864,712	-

## (Increase) decrease in operating assets:

Accounts receivable	(28,670)	(121,317)
Inventory	155,845	(469,069)
Prepays and other current assets	106,192	(204,161)

## Increase (decrease) in operating liabilities:

Accounts payable	546,041	131,140
Accrued expenses	26,061	(3,448)
Accrued loss on contracts	-	357,250
Deferred revenues	(336,768)	(274,159)

<b>Net cash used in operating activities</b>	<b>(3,401,618)</b>	<b>(2,805,220)</b>
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**Cash flows from investing activities**

Capital expenditures	(201,667)	(2,290,472)
Increase in other assets	-	8,975

<b>Net cash (used) in investing activities</b>	<b>(201,667)</b>	<b>(2,281,497)</b>
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**Cash flows from financing activities**

Bank loans and other borrowings	117,223	1,895,976
Proceeds from exercise of stock warrants	1,113,333	-
Proceeds from exercise of stock options	42,000	230,322
Proceeds from issue of notes payable	2,260,000	3,670,000
Proceeds from public offering - net of underwriter fees	18,410,000	-
Public offering costs	(1,142,635)	-
Deferred finance fees	(106,250)	(563,190)

<b>Net cash provided by financing activities</b>	<b>20,693,671</b>	<b>5,233,108</b>
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Effect of exchange rate changes on cash	(61,972)	(25,097)
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<b>Net increase in cash and cash equivalents</b>	<b>17,028,416</b>	<b>121,295</b>
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Cash and cash equivalents - beginning of year	794,606	673,311
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<b>Cash and cash equivalents - end of year</b>	<b>\$ 17,823,022</b>	<b>\$ 794,606</b>
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Cash paid for interest	\$ 326,964	\$ 98,749
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## Supplemental schedule of non-cash investing and financing activities:

Issuance of common stock pursuant to conversion of convertible notes	2,567,305	50,000
Increase in paid-in capital pursuant to warrants issued - Bushido loan	1,205,603	-
Beneficial conversion features on convertible debt issued	1,155,808	400,000
Options issued - directors and officers	171,013	-
Warrants issued - public offering/underwriters	265,935	-

*See accompanying notes to consolidated financial statements.*

**ZBB Energy Corporation**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2007**

**NOTE 1 – NATURE OF ORGANIZATION**

ZBB Energy Corporation (“ZBB” or the “Company”) develops and manufactures distributed energy storage solutions based upon the Company’s proprietary zinc-bromine rechargeable electrical energy storage technology. ZBB was incorporated under the laws of Wisconsin in 1998.

The Company develops, manufactures, and markets energy storage systems, with electric utility applications as its initial market. This scaleable, mobile system is ideally suited for a number of market applications, including:

--- Load management for generation, transmission and distribution utilities, energy service companies, and large industrial customers, allowing peak shaving and deferral of capital expenditures that otherwise would be required to alleviate utility system constraints

--- Uninterruptible power supply (“UPS”) providing power and quality protection for voltage, current, or frequency deviations

--- Storage of renewable wind and solar energy production in both grid connected and grid independent environments

The consolidated financial statements include the accounts of the Company and those of its wholly owned subsidiaries, ZBB Technologies, Inc. (ZBBT, Inc.) manufacturing facility in the U.S., and ZBB Technologies, Ltd., the Perth, Australia based research and development facility. ZBB China Pty Ltd, a joint venture company, was formed in March 2006, to assist in the development of Asian markets.

**NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation**

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries and have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). All significant intercompany accounts and transactions have been eliminated upon consolidation. The Company accounts for its 49% investment in ZBB China Pty Ltd, a joint venture company, under the “equity” method of accounting.

**Stock Split**

The Company completed a 1-for-17 reverse stock split immediately prior to the Company completing its public offering on June 20, 2007. All share and per share information included in these financial statements has been restated for this reverse stock split.

**Foreign Currency**

The Company uses the United States dollar as its reporting currency, while the Australian dollar is the functional currency of two of its operating units. Assets and liabilities of the Company’s international operations are translated into United States dollars at exchange rates that are in effect as at the balance sheet date while equity accounts are translated at historical exchange rates. Income and expense items are translated at average exchange rates which were applicable during the reporting period. Translation adjustments are accumulated in Accumulated Other Comprehensive Income (Loss) as a separate component of Shareholders’ Equity in the consolidated balance sheet. No gain or loss on translation is included in the net loss.

**ZBB Energy Corporation**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**June 30, 2007**

**Use of Estimates**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and revenues and expenses during the period reported on. Actual results could differ from those estimates. Estimates are used in accounting for among other things, recognition of revenue, allowances for uncollectible receivables, impairment of assets, depreciation, and valuations of equity and debt instruments. Estimates and assumptions are reviewed periodically and the effects of any revisions are reflected in the consolidated financial statements in the period they are determined to be necessary.

**Income Tax**

Provisions for income taxes are based on taxes payable or refundable for the current year and deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled as prescribed in FASB Statement No. 109, "Accounting for Income Taxes". As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Deferred tax assets, if any, are recorded at the likely realizable amounts as at the balance sheet dates.

**Property, Plant and Equipment**

Land, building, equipment, computers and furniture and fixtures are recorded at cost. Maintenance, repairs and betterments are charged to expense.

Finished goods normally held for sale to customers may sometimes be used in demonstration and testing by customers. During these periods that the units are transferred from Inventory to Plant and Equipment they are depreciated over the period in use. Since the intent is for these units to be eventually sold they are returned to Inventory upon the completion of customer demonstration and testing at their written down value.

**Depreciation**

Depreciation is provided for all Property, Plant and Equipment (excluding land) on a straight line basis over estimated useful lives of the assets.

The depreciation rate used for each class of depreciable assets is:

	<u>Depreciation Rate</u>
Manufacturing Equipment	3 – 15 years
Office Equipment	3 – 8 years
Building	40 years

**Impairment of Long-Lived Assets**

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal Of Long-Lived Assets," the Company assesses potential impairments to its long-lived assets including property, plant and equipment when there is evidence that events or changes in circumstances indicate that the carrying value may not be recoverable.

If such an indication exists, the recoverable amount of the asset, being the higher of the asset's fair value less costs to sell and value in use, is compared to the asset's carrying value. Any excess of the asset's carrying value over its recoverable amount is expensed to the statement of operations. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate.

**ZBB Energy Corporation**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**June 30, 2007**

**Goodwill**

Goodwill represents the cost of acquisition of a group of assets in excess of the net fair value of the identifiable assets.

Following initial recognition, goodwill is measured at cost less any accumulated impairment losses. Goodwill is not amortized but reviewed for impairment annually or more frequently if events or changes in circumstances indicate that its carrying value may be impaired.

**Cash and Cash Equivalents**

The Company considers all highly liquid investments with original maturities of 90 days or less to be cash equivalents.

The Company maintains its cash deposits with a few high credit quality financial institutions predominately in the United States. At times such balances may exceed federally insurable limits. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant risk.

**Inventories**

Inventories are stated at the lower of cost (first-in, first-out method) or market and consist of raw materials, work in progress and finished goods held for resale.

Costs incurred in bringing each product to its present location and conditions are accounted for as follows:

- Raw materials – purchased cost of direct material
- Finished goods and work-in-progress – purchase cost of direct material plus direct labor plus a proportion of manufacturing overheads.

**Revenue Recognition**

The Company contracts with its customers to develop, manufacture, and install its energy storage systems under long-term contracts. The Company recognizes revenue under the percentage-of-completion method. Revenue is recognized proportionally as costs are incurred and compared to the estimated total costs for each contract. The amount of revenue deferred as of June 30, 2007 is \$336,305 based on the \$1,882,042 billed under the terms of the current contracts, less \$1,545,736 recognized as revenue to date. Included in the deferred revenue was \$160,000 received from ZBB China Pty Ltd, a 49% owned joint venture company (see Note 14 – Related Party Transactions).

As the Company's energy storage systems are in their later stages of development, actual costs incurred could differ materially from those previously estimated. Once the Company has established that its costs can be reasonably estimated, costs to complete an individual contract in excess of revenue will be accrued upon identification. As of June 30, 2007 provisions of \$357,250 have been identified and accrued on existing contracts.

For the years ended June 30, 2007 and 2006, substantially all of the Company's revenue was from a multi-year contract with one customer.

**ZBB Energy Corporation**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**June 30, 2007**

**Loss per Share**

The Company adopted Statement of Financial Accounting Standards No. 128 which requires the reporting of both basic and diluted earnings (loss) per share. Basic earnings (loss) per share is computed by dividing net income (loss) available to common stockholders by the weighted average number of common shares outstanding for the period.

Diluted earnings (Net loss) per share reflects the potential dilution that could occur if securities or other contracts to issue Common stock were exercised or converted into common stock. In accordance with FASB 128, any anti-dilutive effects on net income (loss) per share are excluded.

Net losses per share for fiscal 2007 and 2006 are not adjusted for anti-dilutive shares, as the Company incurred net losses for these years. Shares of common stock issuable upon the exercise of stock options and warrants, 100,588 and 117,647 at June 30, 2007 and 2006 respectively, have been excluded from the computation of net loss per share as their effect would have been anti-dilutive. Any shares which may result from the conversion of convertible debt, but have not been converted as of June 30, 2007 have also been excluded from the computation of net loss per share as their effect would have been anti-dilutive.

**Convertible Notes**

The Company accounts for conversion options embedded in convertible notes in accordance with SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133") and Emerging Issues Task Force ("EITF") 00-19, "Accounting for Derivative Financial Instruments Indexed to and potentially settled in a Company's Own Stock" ("EITF 00-19"). SFAS 133 generally requires companies to bifurcate conversion options embedded in convertible notes from their host instruments and to account for them as free standing derivative financial instruments in accordance with EITF 00-19. SFAS 133 provides for an exception to this rule when convertible notes, as host instruments, are deemed to be conventional as that term is described in the implementation guidance under Appendix A to SFAS 133 and further clarified in EITF 05-2 the Meaning of "Conventional Convertible Debt Instrument" in Issue No. 00-19.

The Company accounts for convertible notes deemed conventional and conversion options embedded in non-convertible notes which qualify as equity under EITF 00-19, in accordance with the provisions of Emerging Issues Task Force Issue ("EITF") 98-5 "Accounting for Convertible Securities with Beneficial Conversion Features," and EITF 00-27 "Application of EITF 98-5 to Certain Convertible Instruments," Accordingly, the Company records, as a discount to convertible notes, the intrinsic value of such conversion options based upon the differences between the fair value of the underlying common stock at the commitment date of the note transaction and the effective conversion price embedded in the note. Debt discounts under these arrangements are amortized over the term of the related debt to their earliest date of redemption.

**Stock-Based Compensation**

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)"), which is a revision of SFAS No. 123. SFAS 123(R) supersedes APB 25 and amends SFAS No. 95, "Statement of Cash Flows." Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. The provisions of this statement are effective for the Company as of July 1, 2006.

**Research and Development**

The Company expenses research and development costs as incurred. These costs consist primarily of labor, overhead, materials to build prototype units, materials for testing, consulting fees and other costs. Intellectual property, including internally generated patents and know-how is carried at no value.

**ZBB Energy Corporation**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**June 30, 2007**

**Comprehensive income (loss)**

The Company reports its comprehensive income (loss) in accordance with SFAS 130, Reporting Comprehensive Income, which requires presentation of the components of comprehensive earnings. Comprehensive income (loss) consists of net income (loss) for the period plus or minus any net translation adjustments applicable for the years ended June 30, 2007 and 2006.

**Recent accounting pronouncements**

SFAS 157 Fair Value Measurements (September 2006)

This standard defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosure about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. Early adoption is encouraged.

SFAS 159 The Fair Value Option for Financial Assets and Financial Liabilities (February 2007)

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115" ("SFAS 159"). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. This provides entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without being required to apply complex hedge accounting provisions. SFAS 159 is effective for fiscal years beginning after November 15, 2007.

FIN No. 48 Accounting for Uncertainty in Income Taxes (July 2006)

Also known as Interpretation No. 48, this interpretation requires recognition and measurement of uncertain income tax positions using a "more-likely-than-not" approach. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of adoption of this interpretation.

SAB No. 108 Prior Year Misstatements (September 2006)

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin 108, "Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"). SAB 108 provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment, and is effective for fiscal years ending after November 15, 2006. The adoption of SAB 108 had no impact on the Company's financial statements in 2007.

The Company does not expect the adoption of any recently issued accounting pronouncements to have a significant effect on its balance sheet or statement of operations.

**NOTE 3 - INVENTORIES**

Inventory balances are comprised of the following amounts as of June 30, 2007:

Raw materials	\$	443,893
Work in progress		346,389
Finished goods		482,286
<b>TOTAL</b>	<b>\$</b>	<b>1,272,568</b>

**ZBB Energy Corporation**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**June 30, 2007**

**NOTE 4- PROPERTY, PLANT & EQUIPMENT**

Office equipment	\$	102,426
Manufacturing equipment		1,917,880
Test units		983,874
Building		1,996,134
Land		217,000
		<b>5,217,314</b>
Less, accumulated depreciation		(1,646,928)
Net Property, Plant & Equipment	<b>\$</b>	<b>3,570,386</b>

**NOTE 5 – INVESTMENT IN JOINT VENTURE**

In March 2005, the Company acquired a 49% interest in ZBB China Pty Ltd. The joint venture company is licensed to distribute ZBB energy storage systems into the Chinese market.

During the years ended June 30, 2007 and 2006 there was no significant activity in the joint venture company.

**NOTE 6 – GOODWILL**

The Company through a series of transactions in March 1996 acquired ZBBT, Inc., a wholly-owned subsidiary.

Goodwill is the excess of the purchase price paid over the fair value of the identifiable net assets acquired in purchase business combinations. The Company accounts for goodwill in accordance with Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (“Statement 142”). Under Statement 142, goodwill and other intangible assets deemed to have indefinite lives are not amortized, but are subject to annual impairment tests. Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. The implied fair value of goodwill is the amount determined by deducting the estimated fair value of all tangible and identifiable intangible net assets of the reporting unit to which goodwill has been allocated from the estimated fair value of the reporting unit. If the recorded value of goodwill exceeds its implied value, an impairment charge is recorded for the excess.

The goodwill amount of \$1.134 million, the difference between the price paid for ZBBT, Inc. and the net assets of the acquisition, amortized through fiscal 2002, results in the net goodwill amount of \$803,079 as of June 30, 2007.

**NOTE 7 – NOTE RECEIVABLE-SHAREHOLDER**

In July 2006, the Company agreed to a stock sale agreement with 41 Broadway Associates, LLC. Under the terms of the agreement the Company sold to 41 Broadway Associates a total of 294,118 shares in consideration for a \$1,000,000 promissory note from 41 Broadway Associates, bearing interest at 4% per annum and payable in installments over 5 years. None of the members of 41 Broadway Associates are affiliated with each other or were or are officers, directors or otherwise affiliated with the company. Neither 41 Broadway Associates nor any of its members owns individually or in the aggregate of record or beneficially 5% or more of the Company’s shares.

As of June 30, 2007 the Company is owed \$808,333 on the note, which is reflected as a reduction to Shareholders’ equity (deficit), and \$36,602 in accrued interest.

**ZBB Energy Corporation**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**June 30, 2007**

**NOTE 8 – INCOME TAXES**

The Company did not record a provision for federal, state or foreign income taxes for the years ended June 30, 2007 and 2006. The Company has not recorded a benefit for deferred tax assets as its realizability is uncertain.

The Company's combined effective income tax rate differed from the U.S federal statutory income tax rate as set forth below:

	<u>2007</u>	<u>2006</u>
Income tax benefit computed at the federal statutory rate	-34%	-34%
Foreign rate differential	4%	4%
Change in valuation allowance	30%	30%
Total	<u>0%</u>	<u>0%</u>

Significant components of the Company's net deferred tax assets as of June 30, 2007 and 2006 were as follows:

	<u>2007</u>	<u>2006</u>
Net operating loss carryforwards	\$ 6,781,267	\$ 4,538,607
Foreign loss carryforwards	826,494	690,080
Deferred tax asset valuation allowance	(7,607,761)	(5,228,686)
Total deferred tax assets	<u>\$ -</u>	<u>\$ -</u>

As of June 30, 2007, the Company had U.S net operating loss carryforwards of approximately \$19,900,000 which begins to expire in 2014 for federal tax purposes. The Company also has gross foreign tax loss carryforwards of approximately \$2,755,000 that are available to offset future liabilities for foreign income taxes. Substantially all of the foreign tax losses are carried forward indefinitely, subject to certain limitations.

A valuation allowance has been established for certain future income tax benefits related to income tax loss carryforwards and temporary tax adjustments based on an assessment that it is more likely than not that these benefits will not be realized. During 2007, the valuation allowance increased by \$2,379,075.

**NOTE 9 – NOTES PAYABLE AND CONVERTIBLE DEBT**

***\$1,000,000 Montgomery Capital Partners LP Convertible Debt Facility***

On February 28, 2006 the Company borrowed \$1,000,000 from Montgomery Capital Partners L.P., and entered into a convertible loan and warrant agreement (the "Montgomery Notes"). Interest on this facility accrued at 10% per annum compounded monthly with a default rate of 13% and becomes payable in full on the earliest to occur of the consummation by the Company of any major financing, a default, or February 28, 2008. In July 2007, as per the Montgomery Note agreement and subsequent to the closing of the June 2007 public offering, the Company repaid all of the debt outstanding (\$1,192,918 as of June 30, 2007).

During the year ended June 30, 2007, Montgomery Capital received 36,888 shares from converting loan principal of \$60,000. All outstanding debt discounts and deferred finance charges were amortized and expensed in full as of June 30, 2007 to reflect the complete fulfillment of all debt obligations which occurred in July 2007.

**ZBB Energy Corporation**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**June 30, 2007**

***\$2,226,666 Bushido Loan***

On June 22, 2006 the Company entered into a Note Purchase Agreement with Bushido Capital Master Fund, L.P.; ABS SOS-Plus Partners, Ltd; and Pierce Diversified Strategy Master Fund, (the "Bushido Lenders") pursuant to which the Company issued an aggregate of \$2,226,667 face amount of secured promissory notes at a 25% original issue discount and warrants to purchase the Company's common stock (the "Bushido Warrants"). Interest on the Bushido Loan accrues at 8%, payable quarterly on 75% of the face amount of the notes. The Bushido loan is due in full on the earliest to occur of a default under the Bushido loan or July 14, 2008. The Bushido loan is secured by a mortgage on the Company's Wisconsin Property, a lien on all of its assets and a pledge of all of the shares of the Company's subsidiaries, and of all of the Company's shares of ZBB China Pty Ltd. Subsequent to the June public offering, the Company agreed to the early redemption of the loan which was fully redeemed in August 2007. All outstanding debt discounts and deferred finance charges were amortized and expensed in full as of June 30, 2007 to reflect the agreed upon redemption of all debt obligations which were repaid in August 2007.

***Convertible Promissory Notes ("Empire Notes")***

Between April and June of 2006 the Company issued \$1,000,000 of convertible promissory notes (the "Empire Notes") to 24 accredited investors in a private placement transaction for which Empire Financial Group acted as placement agent. The Empire Notes accrue interest at 15% per annum and are due on June 30, 2007. Each lender has the right to receive payment in full along with a warrant to purchase such number of shares of common stock equal to 50% of the principal amount of the Note at an exercise price equal to 120% of the offering price in the Company's forthcoming IPO. Alternatively, each lender can choose to convert the principal and interest owed into the Company's common stock at a conversion price equal to 50% of the offering price in the Company's forthcoming IPO. On issuance of the convertible notes, there was deemed to be an embedded conversion benefit feature available to the note holders to convert the notes into shares at a discount to market value. This "embedded conversion benefit discount" resulted in additional paid-in capital recorded at the time the notes were issued of \$500,000 amortized over the term of the notes.

Between July 2006 and May 2007 the Company issued a further \$2,260,000 of convertible promissory notes to an additional three funds, under the same terms as above. On issuance of the convertible notes, there was deemed to be an embedded conversion benefit feature available to the note holders to convert the notes into shares at a discount to market value. This "embedded conversion benefit discount" resulted in additional paid-in capital recorded at the time the notes were issued of \$1,130,000 amortized over the term of the notes.

During the year ended June 30, 2007, \$2,507,305 of principal and accrued interest was converted into 836,395 of the Company's shares at \$3.00 per share. All outstanding debt discounts and deferred finance charges were amortized and expensed in full as of June 30, 2007 to reflect the activity subsequent to June 30, 2007 and prior to the issuance of the financial statements which resulted in either the redemption or conversion of all principal and interest outstanding during July and August 2007.

As of June 30, 2007, \$987,500 of principal, and \$87,772 of accrued interest is outstanding. Subsequent to June 30, 2007 all principal and interest outstanding on the notes were either repaid (\$597,504 in principal and interest) or converted into common shares (\$477,768 in principal and interest converted into 159,256 shares) of the Company.

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**June 30, 2007**

**NOTE 10 – BANK LOANS AND NOTES PAYABLE**

At June 30, 2007 the Company's debt consisted of the following:

Notes payable, includes accrued interest of \$418,894 (see Note 9)	\$ 4,523,060
Bank loans	1,890,379
<b>Short-term debt</b>	<b><u>\$ 6,413,439</u></b>
Bank loans	285,712
<b>Long-term debt</b>	<b><u>\$ 285,712</u></b>

Subsequent to the year ended June 30, 2007 the Company came to terms with all the note and convertible debt holders to retire all principal and interest outstanding.

Interest on the bank loans is calculated at prime rate, secured by the property and equipment, with a balance at June 30, 2007 of \$2,176,091. The Company is currently in negotiations with its lenders to convert their outstanding bank loan balances to long-term.

Maximum aggregate annual principal payments for the 12 month periods subsequent to June 30, 2007 are as follows:

2008	\$ 6,413,439
2009	100,036
2010	108,608
2011	77,068
	<b><u>\$ 6,699,151</u></b>

**NOTE 11- EMPLOYEE/DIRECTOR OPTION PLANS**

In 1998 the Company entered into a Key Employees Stock Option Plan (KESOP) whereby a stock option committee comprising three Directors was given the discretion to grant up to 282,353 options to key employees of the Company. At June 30, 2007 all KESOP options had been granted. During the year ended June 30, 2007 no KESOP options were exercised. At June 30, 2007 there remains 4,412 KESOP options with an exercise price of \$8.50 and exercise date of March 15, 2008 outstanding.

In 1998 the Company entered into an Outside (Non-Executive) Directors Stock Option Plan (ODSOP) whereby 70,588 options were issued to Non-Executive Directors over a five year period commencing on January 2, 1999. At June 30, 2003 all ODSOP options had been granted. During the period ended June 30, 2007, 9,882 ODSOP options were exercised. At June 30, 2007 there are 8,470 ODSOP options with an exercise price of \$4.25 with an exercise date of January 2, 2008 outstanding.

In 2002 the Company established the Company's 2002 Stock Option Plan ("SOP") whereby a stock option committee comprising all Directors was given the discretion to grant up to 617,647 options to key employees of the Company at exercise prices to be determined (but in any case not less than \$5.67 per share) and exercise dates at times to be determined by the Company. During the year ended June 30, 2007 no 2002 SOP options were exercised. At June 30, 2007 there remains 197,728 options with exercise prices of not less than US\$5.61 and exercise dates up to March 30, 2010 outstanding. A further 193,213 options are available to be issued under the SOP. No options were exercised under this plan in 2006 and 2007.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**June 30, 2007**

During the 2005 financial year the Company established an Employee Option Scheme whereby at the discretion of the Board of Directors of the Company, options could be granted to employees and Directors of the Company or any company related to it. The maximum number of options that could be granted in aggregate at any time under this option scheme is equivalent to 5% of the total number of shares on issue in the Company (as if all options issued under any employee or executive option scheme had been exercised, excluding this plan). The options will not be listed nor are they transferable. As of June 30, 2007 there are 274,546 options available for future grant. Any options issued under this scheme expire 5 years after they are vested in the holder. The exercise price for options issued under this scheme is an amount determined by Directors provided that in no event the exercise price shall be a price less than 10% higher than the weighted average market price for shares on the AMEX over the last 20 days on which sales in shares were recorded on the AMEX immediately preceding the date of grant of the option. During the year ended June 30, 2007 250,000 options were granted leaving a balance of 274,546 options available for future grant.

Information with respect to activity under the employee and director plans is as follows:

<u>Stock Option Activity</u>	<u>Number of Options</u>	<u>Weighted-Average Exercise Price Per Share</u>
<b>Balance at June 30, 2005</b>	<b>271,875</b>	<b>\$ 5.78</b>
Options granted	-	-
Options expired	(14,118)	4.25
Options exercised	-	-
<b>Balance at June 30, 2006</b>	<b>257,757</b>	<b>\$ 5.86</b>
Options granted	250,000	3.82
Options expired	(37,264)	5.61
Options exercised	(9,882)	4.25
<b>Balance at June 30, 2007</b>	<b>460,611</b>	<b>\$ 4.81</b>

At June 30, 2007 the Company had 467,759 options available for future grant.

The following table summarizes information relating to the stock options outstanding at June 30, 2007:

	<u>Outstanding</u>			<u>Exercisable</u>	
	<u>Number of Options Outstanding</u>	<u>Weighted- Average Remaining Contractual Life (in years)</u>	<u>Weighted- Average Exercise Price</u>	<u>Number of Options</u>	<u>Weighted- Average Exercise Price</u>
<u>Range of Exercise Prices</u>					
\$3.06-3.82	250,000	5.0	\$ 3.82	250,000	\$ 3.82
\$4.25-5.61	118,292	0.8	\$ 5.51	118,292	\$ 5.51
\$6.51-8.50	92,319	2.7	\$ 6.61	92,319	\$ 6.61
<b>Balance at June 30, 2007</b>	<b>460,611</b>	<b>3.4</b>	<b>\$ 4.81</b>	<b>460,611</b>	<b>\$ 4.81</b>

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**June 30, 2007**

**NOTE 12 - NON RELATED PARTY OPTIONS**

At June 30, 2007 there are 286,765 options (issued one option per four shares acquired through the Australian IPO, March 2005) with an expiration date of December 2007 and an exercise price of \$6.46 issued and outstanding.

At June 30, 2007 there are 314,176 options (per Australian IPO brokerage agreement) with an expiration date of December 2007 and an exercise price of \$6.46 issued and outstanding.

At June 30, 2007 there are 117,647 options (per Montgomery Capital Partners LP Convertible Debt Facility) with an expiration date of April 2008 and an exercise price of \$2.21 issued and outstanding.

At June 30, 2007 there are 120,023 options (per Empire brokerage agreement) with an expiration date of September 2011 and an exercise price of \$3.23 issued and outstanding.

At June 30, 2007 there are 50,000 options (per Empire brokerage agreement) with an expiration date of June 2012 and an exercise price of \$7.20 issued and outstanding.

At June 30, 2007 there are 195,800 options (Strategic Growth International) with an expiration date between March 2011 and June 2012 and an exercise price of between \$3.75 and \$7.20 issued and outstanding.

The table below summarizes non-related party option balances:

<b>Stock Options Non-related party activity</b>	<b>Number of Options</b>	<b>Weighted-Average Exercise Price Per Share</b>
<b>Balance at June 30, 2005</b>	<b>916,347</b>	<b>\$ 5.39</b>
Options granted	641,569	5.44
Options expired	(241,877)	3.23
Options exercised	(73,529)	3.23
<b>Balance at June 30, 2006</b>	<b>1,242,510</b>	<b>\$ 5.96</b>
Options granted	715,103	3.40
Options expired	(152,811)	6.00
Options exercised	(720,391)	4.33
<b>Balance at June 30, 2007</b>	<b>1,084,411</b>	<b>\$ 5.41</b>

**NOTE 13 – COMMITMENTS**

In July 2006, the Company entered into a business development agreement with 41 Broadway Associates, whereby 41Broadway Associates is to provide consulting services including business planning, facilitation of introductions to strategic relationships and customers, corporate financiers and investment bankers at a fee of \$200,000 per year payable quarterly until September 2010. During the year ended June 30, 2007 fees of \$191,667 were incurred by the Company.

**ZBB Energy Corporation**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**June 30, 2007**

**NOTE 14 - RELATED PARTY TRANSACTIONS**

The Company leases its Australian office facility from an entity affiliated with three of the Company's officers. The current rental is \$49,875 per annum (A\$66,500) and is subject to an annual CPI adjustment. During the period, ZBB Technologies, Ltd exercised its option of renewal to release this facility for an additional 5 years.

Rent expense was \$49,875 and \$41,791 for the years ended June 30, 2007 and 2006.

The future payments required under the terms of the lease are as follows:

<u>For the years ending June 30,</u>	
2008	\$49,875
2009	\$49,875
2010	\$49,875
2011	\$49,875
2012	<u>\$16,625</u>
<b>TOTAL:</b>	<b><u>\$216,125</u></b>

The Company has received a purchase order from ZBB China Pty Ltd; a 49% owned joint venture company, for delivery of an energy storage system in 2007. The Company has received a deposit of \$160,000 on the order which it has recorded as deferred revenue at June 30, 2007. See additional discussion in Note 2, "Revenue Recognition".

**NOTE 15 - RETIREMENT PLANS**

All Australian based employees are entitled to varying degrees of benefits on retirement, disability, or death. The Company contributes to an accumulation fund on behalf of the employees under an award which is legally enforceable. For US employees, the Company has a 401(k) plan. All active participants are 100% vested immediately.

Expenses under these plans were \$30,765 and \$57,392 in the years ended June 30, 2007 and 2006.

**NOTE 16 - EMPLOYMENT CONTRACTS**

The Company has entered into an employment agreement with its Chief Executive Officer for a period expiring on June 30, 2009 on normal commercial terms and conditions and is paid a remuneration package totaling \$187,620 per annum exclusive of any options granted to him.

The Company has entered into an employment agreement with its Chief Financial Officer for a period expiring on June 30, 2009 on normal commercial terms and conditions and is paid a remuneration package totaling \$160,000 per annum exclusive of any options granted to him.

**NOTE 17 - STOCK-BASED COMPENSATION**

On July 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123R, "Share-Based Payment". Consequently, for the year ended June 30, 2007, the Company's results of operations reflect compensation expense for new stock options granted and vested under its stock incentive plans. The amount recognized in the financial statements related to stock-based compensation was \$171,013 for the year ended June 30, 2007.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS - continued**  
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The fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing method. The Company uses historical data to estimate the expected price volatility, the expected option life and the expected forfeiture rate. The Company has not made any dividend payments nor does it have plans to pay dividends in the foreseeable future. The following assumptions were used to estimate the fair value of options granted during the year ended June 30, 2007 using the Black-Scholes option-pricing model:

	<u><b>2007</b></u>
Expected life (years)	5
Interest rate	4.1%
Volatility	22%
Dividend yield	0%

**NOTE 18 – SUBSEQUENT EVENTS**

In July 2007, ZBB Technologies Ltd, the Company’s subsidiary based in Western Australia, commenced work on the Advanced Electricity Storage Technologies project (“AEST”) as per the recently signed agreement with the Commonwealth of Australia. This agreement provides for a three year project under which the Commonwealth of Australia will provide \$2.6 million (A\$3.1 million, “A\$” refers to Australian dollars) in project funding over several periods, totaling \$1.35 million in year one, \$1.01 million in year two and \$0.24 million in year three, as certain development progress “milestones” are met. A \$250,000 deposit for initial funding of contract activities was received by the Company in July 2007.

During July and August 2007 the entire balances of principal and interest due on all notes payable and convertible debt were either redeemed or converted into 159,265 shares of common stock of the Company. The only outstanding debt remaining at October 2, 2007 are balances on the building and equipment loans. See Note 9 for additional details on the redemption and conversion subsequent activity.

During July and August 2007 the Company issued 159,265 shares to convertible debt holders on the conversion of outstanding debt and also issued 265,937 shares to debt holders on the exercise of warrants. Upon issuance of these shares of common stock the Company had 10,512,283 shares issued and outstanding as of October 2, 2007.

Effective as of August 9, 2007, the Company de-listed its CUFS from the Australian Stock Exchange and all common stock previously trading as CUFS became tradeable in the United States as shares of common stock.

On August 14, 2007 the Company filed a registration statement with the U.S Securities and Exchange Commission to register for resale 702,537 shares of common stock, all of which are currently outstanding (436,600 shares are owned by ABS SOS-Plus Partners, Ltd. and 265,937 shares are owned by Montgomery Capital Partners, L.P.). These shares were issued in June 2007 pursuant to the terms of separate lending transactions originally entered into with Montgomery Capital Partners L.P. in February 2006 and with ABS SOS-Plus Partners, Ltd. in June of 2006. The sale of these shares may have an adverse effect on the price of the Company’s common stock. If the registration statement is not declared effective by the SEC by October 31, 2007, then ABS-SOS will have the right to elect one of the following two options:

(i) to require the Company to purchase, for \$1,113,300, a total of 185,555 shares of the 436,600 shares owned by ABS SOS, leaving them with 251,045 shares; or

(ii) to retain its 436,600 ZBB shares, in which event the Company shall be obligated to pay to ABS-SOS a penalty equal to the sum of \$1,500 per day from November 1, 2007 that the selling shareholders’ registration statement is not declared effective by the SEC; such that the aggregate amount of such per diem penalty shall not exceed \$50,000.