WINMARK CORP
Form 4
June 01, 2016

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL

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(Print or Type Responses)

1. Name and Address of Reporting Person *
Zola Steven C

(Last) (First) (Middle)

605 HWY 169 N, SUITE 400

(Street)

MINNEAPOLIS, MN 55441

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
WINMARK CORP [WINA]

3. Date of Earliest Transaction (Month/Day/Year)
06/01/2016

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

__X__ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
President, Winmark Capital

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock								2,003	D	
Common Stock								45,336	I	By Zola Living Trust
Common Stock								500	I	Child 1
Common Stock								500	I	Child 2
Common Stock								500	I	Child 3

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount o Underlying Securities (Instr. 3 and 4)	
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amoun or Numbe of Share
Employee Stock Option (right to buy)	$ 20.32							12/14/2007[(1)](#)	12/14/2016	Common Stock	14,62
Employee Stock Option (right to buy)	$ 20.96							12/13/2008[(1)](#)	12/13/2017	Common Stock	17,68
Employee Stock Option (right to buy)	$ 16.52							08/13/2009[(1)](#)	08/13/2018	Common Stock	8,437
Employee Stock Option (right to buy)	$ 12.75							12/11/2009[(1)](#)	12/11/2018	Common Stock	5,786
Employee Stock Option (right to buy)	$ 13.01							06/01/2010[(1)](#)	06/01/2019	Common Stock	7,306
Employee Stock	$ 22.15							12/10/2010[(1)](#)	12/10/2019	Common Stock	7,500

Option (right to buy)					
Employee Stock Option (right to buy)	$ 31.19	06/01/2011[1]	06/01/2020	Common Stock	7,113
Employee Stock Option (right to buy)	$ 32.92	12/14/2011[1]	12/14/2020	Common Stock	9,250
Employee Stock Option (right to buy)	$ 37.76	06/01/2012[1]	06/01/2021	Common Stock	9,250
Employee Stock Option (right to buy)	$ 53.34	12/08/2012[1]	12/08/2021	Common Stock	9,250
Employee Stock Option (right to buy)	$ 51.17	06/01/2013[1]	06/01/2022	Common Stock	9,250
Employee Stock Option (right to buy)	$ 55.72	12/13/2013[1]	12/13/2022	Common Stock	9,250
Employee Stock Option (right to buy)	$ 59.77	06/01/2014[1]	06/01/2023	Common Stock	9,250
Employee Stock Option (right to buy)	$ 82.72	12/16/2014[1]	12/16/2023	Common Stock	9,250
Employee Stock Option	$ 66.29	06/01/2015[1]	06/01/2024	Common Stock	8,500

(right to buy)									
Employee Stock Option (right to buy)	$ 80.32					12/15/2015 [(1)](#)	12/15/2024	Common Stock	8,500
Employee Stock Option (right to buy)	$ 91.93					06/01/2016 [(1)](#)	06/01/2025	Common Stock	6,800
Employee Stock Option (right to buy)	$ 90.99					12/14/2016 [(1)](#)	12/14/2025	Common Stock	6,800
Employee Stock Option (right to buy)	$ 98.25	06/01/2016		A	5,000	06/01/2017 [(1)](#)	06/01/2026	Common Stock	5,000

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
Zola Steven C 605 HWY 169 N SUITE 400 MINNEAPOLIS, MN 55441	X		President, Winmark Capital	

Signatures

/s/ Steven C. Zola	06/01/2016
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) 25% per year for 4 years

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(1,975,656

)

(1,975,656

)

Comprehensive loss

(1,960,822

)

August 31, 2004 balance:

432,513

433

13,316,135

44,387

36,407,105

14,834

(23,143,260

)

13,323,499

Reimbursement to former CEO

300,000

Explanation of Responses:

1,000

2,414,000

2,415,000

Warrants exercised

29,714

99

(99

Explanation of Responses:

)

Stock options exercised

684,132

2,284

(73,154

)

(554,939

)

1,229,153

676,498

Unrealized losses on marketable securities

(11,381

)

(11,381

)

Net loss

(1,050,881

)

(1,050,881

)

Comprehensive loss

(1,062,262

)

August 31, 2005 balance:

432,513

433

14,329,981

47,770

(73,154

)

(554,939

)

40,050,159

3,453

(24,194,141

)

15,352,735

Gain on extinguishment of related party debt

363,208

363,208

Contingent obligation acquired and extinguishment of debt

242,169

807

2,127,389

Explanation of Responses:

2,128,196

Arkansas River water acquisition

3,000,000

10,000

36,230,000

36,240,000

Warrants exercised

15,520

52

27,884

27,936

Stock options exercised

891,443

2,973

(57,125

)

(454,595

)

1,601,624

1,150,002

Stock based compensation

209,611

209,611

Unrealized losses on marketable securities

(14,107

)

(14,107

)

Net loss

(792,860

)

(792,860

)

Comprehensive loss

(806,967

)

August 31, 2006 balance (restated):

432,513

$

433

18,479,113

$

61,602

(130,279

)

$

(1,009,534

)

$

80,609,875

$

(10,654

)

$

(24,987,001

)

$

54,664,721

See accompanying Notes to Financial Statements

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PURE CYCLE CORPORATION

STATEMENTS OF CASH FLOWS

	For the years ended August 31, 2006	2005	2004
Cash flows from operating activities:			
Net loss	$ (792,860)	$ (1,050,881)	$ (1,975,656)
Adjustments to reconcile net loss to net cash used for operating activities:			
Stock based compensation expense included with general and administrative expenses	209,611		
Interest accrued on long-term debt related parties	7,120	21,360	141,735
Interest accrued on long-term debt	19,258	12,597	32,197
Loss (gain) on sales of marketable securities	(10,414)	15,563	(11,996)
Depreciation	19,229	7,148	4,948
Depletion	853	743	795
Interest added to note receivable Rangeview Metropolitan District	(21,508)	(16,917)	(13,903)
Amortization of warrants			75,600
Extinguishment of contingent obligations and debt	(390,866)		1,126,241
Changes in operating assets and liabilities:			
Export water proceeds to be remitted to escrow agent	174,890	(174,890)	
Trade accounts receivable	(15,361)	179	17,449
Interest receivable and prepaid expenses	(27,250)	(1,862)	(57,152)
Accounts payable and accrued liabilities	19,957	(124,235)	132,102
Deferred revenues	39,754	492,933	
Net cash used for operating activities	(767,587)	(818,262)	(527,640)
Cash flows from investing activities:			
Investments in water and water systems	(2,411,746)	(404,519)	(135,870)
Capitalized acquisition costs	(173,110)		
Purchase of marketable securities	(3,885,238)	(5,424,071)	(8,076,016)
Sales and maturities of marketable securities	4,833,174	5,971,735	4,047,203
Purchase of property and equipment	(2,781)	(5,660)	
Sky Ranch option payments received		60,400	50,000
Net cash (used) provided by investing activities	(1,639,701)	197,885	(4,114,683)
Cash flows from financing activities:			
Proceeds from the sale of common and preferred stock, net	1,177,938	676,498	10,576,743
Construction funding		397,235	
Reimbursement to former CEO		(50,555)	
Payments to contingent liability holders	(174,890)	(3,120)	(50,000)
Payments to purchase contingent liabilities			(2,750,000)
Payments on long-term debt related parties	(195,573)		(2,085,999)
Net cash provided by financing activities	807,475	1,020,058	5,690,744
Net change in cash and cash equivalents	(1,599,813)	399,681	1,048,421
Cash and cash equivalents beginning of year	1,973,882	1,574,201	525,780
Cash and cash equivalents end of year	$ 374,069	$ 1,973,882	$ 1,574,201

See accompanying Notes to Financial Statements

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NOTE 1 ORGANIZATION AND RESTATEMENT

Restatement. Pure Cycle Corporation (the Company) has restated its August 31, 2006 balance sheet and statement of stockholders equity to correct the following errors in the Company s accounting for the Asset Purchase Agreement (the Arkansas River Agreement) between the Company and High Plains A&M, LLC (HP A&M) which were discovered during consultations with the Staff of the Securities and Exchange Commission (the Staff of the Commission).

- The Company initially recorded an approximately $14.6 million liability and contra-equity receivable related to a deemed indirect guarantee of a liability for promissory notes maintained by HP A&M, as described in Note 3 below. During the consultations with the Staff of the Commission, it was determined that the Company s ability to assume these notes, in event of default by HP A&M, was a contingent obligation and not an indirect guarantee of HP A&M s debt. Since the probability of HP A&M defaulting on the notes and the Company losing any of the water rights or properties which serve as collateral for the notes is considered to be remote, this did not require recognition of a liability in accordance with Statement of Financial Accounting Standard (SFAS) No. 5 *Accounting for Contingencies*. Based on this, the Company has removed the liability and contra-equity receivable from its balance sheet and statement of stockholders equity.

- The Company initially recorded the liability captioned *Tap Participation Fees payable to HP A&M* at approximately $66.1 million. This liability was accounted for pursuant to SFAS No. 141 *Business Combinations (as amended)* (SFAS 141). The value of the liability was determined by the residual method, pursuant to which the Company deducted the value of the equity consideration given to HP A&M from the fair value of the assets acquired from HP A&M. During the consultations with the Staff of the Commission, it was determined that the Tap Participation Fees did not constitute contingent consideration per SFAS 141, and therefore valuing the Tap Participation Fees using the residual method was incorrect. Based on this, the Company valued the Tap Participation Fees based on a discounted cash flow model, which resulted in a reduction of the recorded liability and values assigned to the acquired assets of approximately $20.5 million. The Company has reflected the liability account *Tap Participation Fees payable to HP A&M* at its estimated fair value of $45,635,000. The valuation of the Tap Participation Fees is a significant estimate based on available historic market information and estimated future market information. Many factors are necessary to estimate future market conditions, including but not limited to, supply and demand for new homes, population growth along the Front Range, cash flows, tap fee increases at our rate-based districts, and other market forces beyond the Company s control. Actual development may differ substantially from the estimated new home development in our service area, which may have a material effect on the estimated fair value of the Tap Participation Fees payable to HP A&M and such differences may have a material impact on our financial statements. The value of the Tap Participation Fees and the equity issued to HP A&M have been allocated to the acquired assets based on each asset s relative fair values as described in Note 3 below.

Based on these errors, the Company s August 31, 2006 balance sheet, August 31, 2006 statement of stockholders equity, Note 3 Water, Water Systems and Service Agreement and Note 12 Supplemental Disclosure of non-cash activities, have been restated. The impact of the restatement is as follows:

	As Originally Reported	Adjustments	As Restated
Investments in water and water systems	$ 124,923,693	$ (20,467,825)	$ 104,455,868
Tap Participation Fee payable to HP A&M	$ 66,102,825	$ (20,467,825)	$ 45,635,000
Contingent obligations payable upon default by HP A&M	$ 14,597,816	$ (14,597,816)	$
Receivable from HP A&M in event of default (contra-equity)	$ (14,597,816)	$ 14,597,816	$
Stockholders equity	$ 40,066,905	$ 14,597,816	$ 54,664,721

Beginning September 1, 2006, we will impute interest expense on the unpaid balance using an effective interest method. We will assess the value of the Tap Participation Fees each reporting period or whenever events or circumstances indicate a material change in the assumptions utilized to estimate the fair value of the liability.

This restatement has no impact on the Company s originally reported cash flows, net loss or net loss per share. The accompanying balance sheet, statement of stockholders equity and notes to the financial statements reflect the correction of these errors as if the Company had accounted for the Arkansas River Agreement this way initially.

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Description of Business. The Company was incorporated in Delaware in 1976. The Company owns water assets located in the Denver, Colorado metropolitan area, in the Arkansas River valley and on the western slope of Colorado. The Company is currently using its water assets located in the Denver metropolitan area to provide water and wastewater services to customers located in and around its service area. The Company operates water and wastewater systems and provides services which include the design and construction of the systems as well as the operation and maintenance of the systems. The Company s main focus is to provide water and wastewater service to customers within its service area and other areas throughout the Denver metropolitan area and the Front Range of Colorado.

The Company believes that at August 31, 2006, it has sufficient working capital and financing sources to fund its operations for at least the next year. However, there can be no assurances that the Company will be successful in marketing the water from its primary water projects on terms that are acceptable to the Company. The Company s ability to ultimately realize its investment in its primary water projects is dependent on its ability to successfully market the water, or in the event it is unsuccessful, to sell the underlying water assets. In the event increased sales are not achieved, the Company may incur additional short or long-term debt or seek to sell additional shares of the Company s common or preferred stock, as deemed necessary by the Company, to generate sufficient working capital.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Revenue Recognition. The Company generates revenues mainly from three sources; (i) water and wastewater tap fees, (ii) construction fees, and (iii) monthly water usage fees and wastewater service fees. Emerging Issues Task Force Issue No. 00-21 *Revenue Arrangements with Multiple Deliverables* (EITF 00-21), governs how to identify when goods or services, or both, that are separately delivered but included in a single sales arrangement should be accounted for separately. Based on the criteria of EITF 00-21, the Company accounts for each of the items addressed in its service agreements separately.

Proceeds from tap fees and construction fees are deferred upon receipt and recognized in income based on whether or not the Company owns the infrastructure constructed with the proceeds. Tap fees and construction fees derived from agreements in which the customer will own the assets constructed with the fees (for example the assets constructed for use on the Lowry Range Property pursuant to the Company s service agreement with the Rangeview Metropolitan District (the District)) are recognized in accordance with Statement of Position 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, whereby the Company recognizes revenue and costs of construction using the percentage-of-completion method. Tap fees and construction fees derived from agreements for which the Company will own the infrastructure are recognized in accordance with Staff Accounting Bulletin No. 104 *Revenue Recognition (SAB 104),* whereby the up-front fees are recognized ratably over the estimated service life of the facilities constructed, starting at completion of construction.

The Company recognizes water usage revenues upon delivering water to customers. The Company recognizes wastewater processing revenues monthly based on flat fees assessed per single family equivalent (SFE) unit served. An SFE is defined in the Company s Rules and Regulations as the amount of water required each year by a family of four persons living in a single family house on a standard sized lot which is equivalent to the use of approximately 0.4 acre-feet of water per year.

Costs to construct Wholesale Facilities and Special Facilities are capitalized as incurred, including interest. If the costs meet the Company s capitalization criteria, the facilities are depreciated over their estimated useful lives. Costs of delivering water and providing wastewater service to customers are recognized as incurred.

The Company recognized approximately $1,200 of tap fee revenue in fiscal 2006 related to the Agreement for Water Services (the County Agreement) signed with Arapahoe County (the County) in August 2005. The Wholesale Facilities required to provide water service to the new Arapahoe County Fairgrounds (the Fairgrounds) were completed in fiscal 2006 in time for the Fairgrounds opening date on July 21, 2006. In accordance with SAB 104

and Accounting Principles Generally Accepted in the United States of America (GAAP), the Company began recognizing these tap fees ratably over the estimated service period upon completion of the Wholesale Facilities. The tap fees to be recognized over this period are net of the royalty payments to the State of Colorado Board of Land Commissioners (the Land Board) and amounts paid to third parties pursuant to the Comprehensive Amendment Agreement No. 1 (the CAA) as further described in Note 4.

The Company recognized approximately $3,500 of Special Facilities funding as revenue during the year ended August 31, 2006, which is the ratable portion of the Special Facilities funding paid and payable by the County as more fully described in Note 3.

No tap fees or construction revenues were recognized during the years ended August 31, 2005 or 2004.

As of August 31, 2006, the Company has deferred recognition of approximately $1.7 million of tap fee and construction fee revenue which will be recognized as revenue ratably over the estimated life of the assets constructed with the construction proceeds.

Use of Estimates. The preparation of financial statements in conformity with GAAP 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents. Cash and cash equivalents include all highly liquid debt and equity instruments with original maturities of three months or less. The Company s cash equivalents are comprised of money market funds, investments in debt securities and investments in commercial paper. As of August 31, 2006 and 2005, the Company has no investments in equity instruments.

Export Water Proceeds to be Remitted to Escrow Agent. The Export Water Proceeds to be remitted to Escrow Agent account was comprised of the following at August 31, 2005: (i) $159,890 of proceeds received by the Company from the County for Export Water sales (see Notes 3 and 4), that were to be remitted to an escrow agent and paid to external parties as required by the CAA, and (ii) $15,000 of proceeds received by the Company from Sky Ranch (see Notes 3 and 4) that were to be remitted to an escrow agent and paid to external parties as required by the CAA. Both amounts were remitted to the escrow agent and subsequently the CAA holders in September 2005 and therefore these balances are zero at August 31, 2006.

Financial Instruments. Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash equivalents and investments in marketable securities. The Company places its cash equivalents and investments with a high credit-quality financial institution. At various times throughout fiscal 2006, cash deposits have exceeded federally insured limits. The Company invests its excess cash primarily in money market instruments, commercial paper obligations, corporate bonds and US government treasury obligations. To date, the Company has not experienced significant losses on any of these investments.

Cash Flows. During fiscal 2006, 2005 and 2004, respectively, the Company paid $0, $0 and approximately $486,000 of interest. See Notes 6 and 13 regarding extinguishment of debt during fiscal 2006. No cash was paid for income taxes in fiscal 2006, 2005 or 2004.

Marketable Securities. Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations each reporting period. Debt securities are classified as held-to-maturity when the Company has the positive intent and ability to hold the securities to maturity. The Company had no investments classified as held-to-maturity at August 31, 2006 or 2005.

Debt securities for which the Company does not have the positive intent or ability to hold to maturity are classified as available-for-sale, along with any investments in equity securities. Securities classified as available-for-sale are marked-to-market at each reporting period. Changes in value on such securities are recorded as a component of *Accumulated comprehensive income.* The cost of securities sold is based on the specific identification method.

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The following is a summary of marketable securities at August 31, 2006:

	Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Commercial paper	$ 149,156	$	$	$ 149,156
U.S. government debt securities:				
With unrealized losses:				
Less than 12 months	993,129		(3,584)	989,545
Greater than 12 months	299,742		(2,109)	297,633
U.S. corporate debt securities:				
With unrealized gains	295,400	593		295,993
With unrealized losses:				
Less than 12 months	702,503		(4,529)	697,974
Greater than 12 months	249,286		(1,025)	248,261
Total investments	2,689,216	593	(11,247)	2,678,562
Less cash equivalents	(149,156)			(149,156)
Total marketable securities	$ 2,540,060	$ 593	$ (11,247)	$ 2,529,406

The following is a summary of marketable securities at August 31, 2005:

	Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Commercial paper	$ 1,165,487	$	$	$ 1,165,487
U.S. government debt securities:				
With unrealized gains	495,594	2,723		498,317
With unrealized losses:				
Less than 12 months	299,742		(141)	299,601
Greater than 12 months	301,324		(3,832)	297,492
U.S. corporate debt securities:				
With unrealized gains	1,582,780	11,253		1,594,033
With unrealized losses greater than 12 months	798,142		(6,550)	791,592
Total investments	4,643,069	13,976	(10,523)	4,646,522
Less cash equivalents	(1,165,487)			(1,165,487)
Total marketable securities	$ 3,477,582	$ 13,976	$ (10,523)	$ 3,481,035

For the years ended August 31, 2006 and 2004 gross realized gains totaled approximately $10,400 and $12,000, respectively. For the year ended August 31, 2005 gross realized losses totaled approximately $15,600. The investments that are in a net loss position for greater than twelve months are not deemed to be other than temporary losses based on the nature of the corporate bond markets, the significant fluctuations that have occurred in the markets over the past several years and the limited realized losses the Company has experienced. The Company actively monitors the performance of its investments and adopted a new investment policy in fiscal 2005 to more closely align its investment portfolio with its expected capital requirements. Losses incurred during 2005 were the result of the Company shortening its average maturity in its investment portfolio to allow it more flexibility regarding anticipated capital needs in the short-term and to allow it to capitalize on interest rates that have continued to rise since the equity offering in 2004 when the majority of the investments were made.

The Company s marketable securities mature at various dates through December 2007. However, these securities represent the temporary investment of capital and it is not managements intent to hold these securities until maturity.

Accounts receivable. The Company records accounts receivable net of allowances for uncollectible accounts (none as of August 31, 2006 or 2005). Any allowance for uncollectible accounts would be determined based on a review of past due accounts.

Fair value of financial instruments. The carrying value of all financial instruments potentially subject to valuation risk (principally consisting of cash, cash equivalents, accounts receivable, accounts payable, and notes receivable) approximates fair value based upon prevailing interest rates available to the Company.

Long-Lived Assets. The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the eventual use of the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceed the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. The Company believes there are no impairments in the carrying amounts of its long-lived assets at August 31, 2006.

Water and Wastewater Systems. The Company capitalizes design and construction costs related to construction activities and it capitalizes certain legal, engineering and permitting costs relating to the adjudication and improvement of its water assets. For the year ended August 31, 2006, the Company also capitalized legal and engineering costs incurred as a result of the Arkansas River water acquisition.

Depletion and Depreciation of Water Assets. The Company depletes its water assets that are being utilized on the basis of units produced divided by the total volume of water adjudicated in the water decrees. Water systems are depreciated on a straight line basis over their estimated useful lives of 30 years.

Share-based Compensation. Effective September 1, 2005, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options, based on estimated fair values. SFAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) for periods beginning on or after September 1, 2005. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of September 1, 2005, the first day of the Company s fiscal 2006. In accordance with the modified prospective transition method, the Company s financial statements for periods prior to fiscal 2006 have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the year ended August 31, 2006, was approximately $209,600.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as a period expense over the requisite service period in the statement of operations. Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company s statements of operations for the year ended August 31, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of, September 1, 2005, based on the grant date fair value estimated in accordance with the pro forma provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS 123), and compensation expense for the share-based payment awards granted subsequent to September 1, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In accordance with SFAS 123(R) stock-based compensation expense recognized in the statements of operations for the year ended August 31, 2006 is based on awards ultimately expected to vest. The Company does not expect any forfeitures of its prior option grants and therefore the compensation expense has not been reduced for estimated forfeitures. No options were forfeited by option holders during the three years ended August 31, 2006. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company s pro forma information required under SFAS 123

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for the periods prior to fiscal 2006 presented below, the Company accounted for forfeitures as they occurred. The Company attributes the value of stock-based compensation to expense using the straight-line single option method for options granted prior and subsequent to September 1, 2005.

Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123. Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company s statements of operations for the years ended August 31, 2005 and 2004. If the Company had recognized stock-based compensation expense pursuant to SFAS 123 for the years ended August 31, 2005 and 2004 in its statements of operations, the results would have been as follows:

	2005	**2004**
Net loss, as reported	$ (1,050,881)	$ (1,975,656)
Add back stock-based employee compensation expense included in reported net loss		
Deduct: Total stock-based employee compensation expense determined under fair value based method for all options and warrants	(168,000)	(31,000)
Pro forma net loss	$ (1,218,881)	$ (2,006,656)
Weighted average common shares outstanding basic and diluted	13,674,156	8,879,771
Pro forma net loss per share	$ (.09)	$ (.23)

The Company uses the Black-Scholes option-pricing model (Black-Scholes model) for the pro forma information required under SFAS 123 as well as the compensation expense recorded pursuant to SFAS 123(R). The Company s determination of the estimated fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the following variables and assumptions:

- The grant date exercise price which is the closing market price of the Company s common stock on the date of grant;
- Estimated option lives based on historical experience with existing option holders;
- Estimated dividend rates based on historical and anticipated dividends over the life of the option;
- Life of the option pursuant to the 2004 Incentive Plan, all option grants have a 10 year life;
- Risk-free interest rates with maturities that approximate the expected life of the options granted;
- Calculated stock price volatility calculated over the expected life of the options granted, which is calculated based on the weekly closing price of the Company s common stock over a period equal to the expected life of the option; and
- Option exercise behaviors based on actual and projected employee stock option exercises and forfeitures.

In August 2006, the Company granted its new director (see Note 3 regarding Arkansas River water acquisition) an option to purchase 5,000 shares of the Company s common stock pursuant to the 2004 Incentive Plan. The option vests 50% on the first anniversary date of the grant and 50% on the second anniversary date of the grant. The Company calculated the fair value of these options pursuant to SFAS 123(R) at approximately $36,000 using the Black-Scholes model with the following variables: exercise price of $8.27; estimated option life of eight years; estimated dividend rate of 0%; weighted average risk-free interest rate of 4.875%; stock price volatility of 101.6%; and an estimated forfeiture rate of 0%. The $36,000 of stock-based compensation expense calculated pursuant to SFAS 123(R) will be expensed monthly over the vesting period.

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the applicati

Also in August 2006, the Company granted an employee an option to purchase 30,000 shares of the Company s common stock pursuant to the 2004 Incentive Plan. The option vests one-third on each of the next three anniversary

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The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the applicatio

dates of the grant. The Company calculated the fair value of these options pursuant to SFAS 123(R) at approximately $232,000 using the Black-Scholes model with the following variables: exercise price of $8.84; estimated option life of eight years; estimated dividend rate of 0%; weighted average risk-free interest rate of 4.875%; stock price volatility of 101.5%; and an estimated forfeiture rate of 0%. The $232,000 of stock-based compensation expense calculated pursuant to SFAS 123(R) will be expensed monthly over the vesting period.

In April 2006 the Company granted four of its directors options to purchase a combined 10,000 shares of the Company s common stock pursuant to the 2004 Incentive Plan. The options vest one year from the date of grant and expire ten years from the date of grant. The Company calculated the fair value of these options pursuant to SFAS 123(R) at approximately $116,000 using the Black-Scholes model with the following variables: weighted average exercise price of $13.25; estimated option lives of eight years; estimated dividend rate of 0%; weighted average risk-free interest rate of 4.93%; weighted average stock price volatility of 101.8%; and an estimated forfeiture rate of 0%. The $116,000 of stock-based compensation expense calculated pursuant to SFAS 123(R) will be expensed monthly over the vesting period.

On November 10, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 123(R)-3 *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards*. The Company has adopted the alternative transition method provided in the FASB Staff Position for calculating the tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and statements of cash flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R). Because the Company has a full valuation allowance on its deferred tax assets, the granting and exercise of stock options during the year ended August 31, 2006 has no impact on the income tax provision.

Income Taxes. Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryovers. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Accumulated Comprehensive Income (Loss). In addition to net loss, comprehensive income (loss) includes the cumulative unrecognized changes in the fair value of marketable securities that are classified as available-for-sale.

Reverse Stock Split. Effective April 26, 2004, stockholders approved a ten-for-one reverse stock split. Subsequent to the approval, every ten shares of the Company s common stock were replaced with one share of its common stock. Accordingly, all share and per share amounts for all periods presented have been restated to reflect the reverse split.

Loss per Common Share. Loss per common share is computed by dividing net loss by the weighted average number of shares outstanding during each period. Common stock options and warrants aggregating 661,428, 1,523,391 and 2,234,305 common share equivalents as of August 31, 2006, 2005 and 2004, respectively, have been excluded from the calculation of loss per common share as their effect is anti-dilutive.

Reclassifications. Certain amounts in the prior year financial statements have been reclassified to conform with the current year presentation.

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NOTE 3 WATER, WATER SYSTEMS AND SERVICE AGREEMENTS

The Company s water and water systems consist of the following costs and accumulated depreciation and depletion as of August 31:

	2006 (restated)		2005	
	Costs	Accumulated Depreciation and Depletion	Costs	Accumulated Depreciation and Depletion
Assets acquired from HP A&M	$ 82,125,952	$	$	$
Rangeview water supply	13,924,448	(3,768)	13,885,213	(2,913)
Rangeview water system	167,720	(28,862)	167,720	(19,692)
Paradise water supply	5,520,836		5,515,133	
Fairgrounds water and water system	2,653,995	(7,225)	222,500	
Sky Ranch water supply	100,000		100,000	
Water supply other	3,022	(250)	3,360	
Totals	$ 104,495,973	$ (40,105)	$ 19,893,926	$ (22,605)
Net investments in water and water systems	$ 104,455,868		$ 19,871,321	

Depletion and Depreciation. The Company recorded approximately $900, $800 and $800 of depletion related to the Rangeview Water Supply in fiscal 2006, 2005 and 2004, respectively, and approximately $16,700, $5,600 and $4,900 of depreciation related to the Rangeview Water Systems and Fairgrounds water systems in fiscal 2006, 2005 and 2004, respectively. No depletion is taken against the Paradise Water Supply or Sky Ranch Water Supply because these assets have not been placed into service as of August 31, 2006 and no depreciation or depletion was taken against the assets acquired in the Arkansas River Valley because they were acquired on August 31, 2006 and therefore not held by the Company during fiscal 2006.

Acquisition of the Arkansas River Valley Assets. Effective May 10, 2006, the Company entered into the Arkansas River Agreement with HP A&M to acquire the following assets from HP A&M (i) senior water interests in the Arkansas River and its tributaries represented by shares of the Fort Lyon Canal Company (FLCC) (collectively these are referred to as the Water Rights), (ii) certain real property located in Bent, Otero and Prowers counties, Colorado associated with the Water Rights (the Properties) (certain of the Properties are subject to mortgages maintained by HP A&M as further described below), and (iii) certain contract rights, tangible personal property, mineral rights, and other water interests related to the Water Rights and Properties (collectively the Water Rights, Properties, and related assets are referred to as the Acquired Assets). The Company acquired the Water Rights to enhance and better balance its water portfolio by increasing its rights to senior surface water which is being demanded by cities and municipalities granting land use approvals. The Properties and other non-water assets were acquired because the rights to the Arkansas River water the Company seeks to transfer for use in the Denver market are based on the quantity of water historically used to irrigate crops grown on the Properties.

Consideration Paid, Acquired Assets and Purchase Price Allocation

The Company and HP A&M consummated the asset acquisition pursuant to the Arkansas River Agreement on August 31, 2006 after the due diligence period provided for in the Arkansas River Agreement. As consideration for the Acquired Assets, on August 31, 2006, the Company issued HP A&M 3,000,000 shares of Pure Cycle common stock valued at approximately $36.2 million. The Company also granted HP A&M the right to receive ten percent (10%) of the Company s gross proceeds, or the equivalent thereof, from the sale of the next 40,000 water taps (the Tap Participation Fees) (the 40,000 figure was reduced to 39,470 at the August 31, 2006 closing date because HP A&M sold certain assets and properties not related to the FLCC shares which were subject to the Arkansas River Agreement and were available for credits against the Tap Participation Fees), valued at approximately $45.6 million. The Tap Participation Fees will be due and payable once the Company has sold a water tap and received the

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the applicatio

consideration due for such water tap. After five years, under circumstances defined in the Arkansas River Agreement, the Tap Participation Fees can increase to 20% and the number of water taps subject to the Tap Participation Fees would be correspondingly reduced by half. The Tap Participation Fees are subject to acceleration in the event of a merger, reorganization, sale of substantially all assets, or similar transactions and in the event of bankruptcy and insolvency events.

Pursuant to Emerging Issues Task Force Issue No. 99-12 *Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination,* the equity consideration was valued at approximately $36.2 million,.

The $45.6 million estimated fair value of the Tap Participation Fees was determined using a discounted cash flow analysis of the projected payments to HP A&M. The Company determined this value by estimating new home development in the Company s service area over an estimated development period. This was done by utilizing third party historical and projected housing and population growth data for the Denver, Colorado metropolitan area applied to an estimated development pattern supported by historical development patterns of certain master planned communities in the Denver, Colorado metropolitan area. This development pattern was then applied to future water tap fees that were calculated using historical water tap fees. The realizable value of the Tap Participation Fees payable to HP A&M were discounted to August 31, 2006, using a rate that approximates the prevailing rate we believe would be available to similar companies in our industry. Actual development may differ substantially from the estimated new home development in our service area, which may have a material effect on the estimated fair value of the Tap Participation Fees payable to HP A&M and such differences may have a material impact on our financial statements. The valuation of the Tap Participation Fees payable to HP A&M is a significant estimate based on available historic market information and estimated future market information. Many factors are necessary to estimate future market conditions, including but not limited to, supply and demand for new homes, population growth along the Front Range, cash flows, tap fee increases at our rate-based districts, and other market forces beyond the Company s control.

The $81.8 million of consideration paid to HP A&M (comprised of the equity and Tap Participation Fee) was allocated to the Acquired Assets based on estimates of each asset s, or group of asset s, respective fair value. Because the estimated value of the consideration paid was less than the total fair value of the Acquired Assets, the relative values assigned to the Acquired Assets have been ratably reduced (allocated values are detailed in the table below). The relative fair value of the Water Rights of $97.5 million was determined by an independent third party appraisal. The relative fair value of the remaining assets of approximately $4.8 million was determined by internal studies (see detailed purchase price allocation below).

The following table presents the allocation of the acquisition costs, including professional fees and other costs related to the acquisition, to the Acquired Assets based on their relative fair values:

Ratable fair value of consideration assigned to the Acquired Assets:	
Arkansas River water rights	$ 78,000,705
Land	2,667,462
Buildings and water delivery fixtures	1,206,833
Other	250,952
Total fair values allocated to the Acquired Assets	$ 82,125,952
Consideration issued:	
Estimated fair value of Tap Participation Fee	$ 45,635,000
Fair value of equity consideration issued	36,240,000
Cash	250,952
Aggregate fair value of consideration	$ 82,125,952

The amounts recorded to other assets consist of professional fees and other acquisition related costs, of which $77,800 of these fees were accrued in *accrued liabilities* on the accompanying balance sheet as of August 31, 2006, and were paid subsequent to August 31, 2006. The Company has not completed its analysis on the fair value of the non-solicitation agreement but expects it to be immaterial to the financial statements.

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the applicati

The Acquired Assets will be depleted and depreciated consistent with the Company s depletion and depreciation policies.

As noted above, in connection with the Arkansas River Agreement, the Company acquired shares in the FLCC, which represent the amount of water the Company owns in the Fort Lyon Canal. The FLCC is a non-profit mutual ditch company that is responsible for the maintenance and operation of the 110 mile Fort Lyon Canal. The real property is comprised of approximately 80 parcels of real estate encompassing approximately 17,500 acres. Pursuant to the Arkansas River Agreement, HP A&M retained the obligation to manage operating leases on the Properties which permit lessees to farm the Properties and use the Water Rights for irrigation purposes in return for defined lease payments.

The Company assumed title to the farm leases effective August 31, 2006. Pursuant to a property management agreement (described below), HP A&M will manage the leases for a period of five years and will receive all lease payments from the lessees as a management fee. Because the Company does not have the risk of loss associated with the leases (HP A&M s management fee is equal to the lease income for the next five years, and contractually HP A&M has the risk of loss on the leases), in accordance with Emerging Issues Task Force No. 99-19 *Reporting Revenue Gross as Principal versus Net as an Agent*, the lease income and management fees will be reflected on a net revenue basis throughout the term of the management agreement.

The following unaudited pro forma results of operations for the Arkansas River water and related assets have been prepared as if the Company had acquired such assets at September 1, 2004 (all amounts are approximate and do not include historical information of the Company):

	August 31, 2006 (unaudited)	**August 31, 2005 (unaudited)**
Revenues	$	$
Expenses:		
Depreciation expense	(172,000)	(172,000)
Water assessment charges	(265,000)	(265,000)
Imputed interest expense on Tap Participation Fees payable to HP A&M	(5,095,000)	(4,670,000)
Total pro forma expenses	(5,532,000)	(5,107,000)
Net loss as reported	(792,900)	(1,050,900)
Pro forma net loss	$ (6,324,900)	$ (6,157,900)
Pro forma weighted average shares	17,693,585	16,674,156
Pro forma loss per share - basic and diluted	$ (0.36)	$ (0.37)

The pro forma information is presented for informational purposes only and is not necessarily indicative of the results of operations that actually would have been achieved had the asset acquisition been consummated at that time, nor is the information intended to be a projection of future results. The pro forma information includes approximate amounts for depreciation expense based on the fair values recorded by the Company for the buildings and equipment as of the acquisition date. The Company will reflect the revenues and expenses associated with the leases on a net revenue basis in accordance with EITF 99-19 as described above. The Company is obligated to pay FLCC water assessment charges which are the charges assessed to the FLCC shareholders for the upkeep and maintenance of the Fort Lyon Canal. Based on historical information obtained from HP A&M, the Company anticipates paying water assessment charges of approximately $265,000 annually.

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Promissory Notes Payable by HP A&M

Certain of the properties the Company acquired are subject to outstanding promissory notes with principal and accrued interest totaling approximately $14.6 million at August 31, 2006. These promissory notes are secured by deeds of trust on the Properties. The Company did not assume any of these promissory notes and is not responsible for making any of the required payments under these notes. This responsibility remains solely with HP A&M. In the event of default by HP A&M, at the Company s sole discretion, the Company may make payments pursuant to any or all of the notes and cure any or all of the defaults. If the Company does not cure the defaults, it will lose the properties securing the defaulted notes. If HP A&M defaults on the promissory notes, the Company can foreclose on a defined amount of stock issued to HP A&M and reduce the Tap Participation Fee by two times the amount of notes defaulted on by HP A&M. Because HP A&M would lose such a substantial amount of equity and Tap Participation Fees, and based on the financial stability of HP A&M and its owners and affiliated companies, the probability of HP A&M defaulting on the notes is deemed remote.

Because the outstanding notes are collateralized by the Company s Properties and Water Rights, HP A&M is deemed to be a Variable Interest Entity (VIE) as defined by FASB Interpretation No. 46(R) *Consolidation of Variable Interest Entities (as amended)* (FIN 46R). However, because the Company will not absorb any of HP A&M s expected losses or receive any of HP A&M s expected gains, the Company is not deemed the Primary Beneficiary of HP A&M and therefore is not required to consolidate HP A&M. HP A&M became a VIE to the Company on August 31, 2006 when the Company acquired the Arkansas River Water Rights and Properties subject to the outstanding promissory notes. HP A&M is a holding company that acquires water rights and related properties for investment and sale purposes. If HP A&M were to default on the notes, the Company would lose approximately 60 of the 80 real property interests it acquired and the water rights associated with those Properties, unless the Company cured the notes in default.

Additional Agreements and Information

The Arkansas River Agreement permits HP A&M to nominate a designated director to be elected to on the Company s board of directors following the closing. Pursuant to this provision Mark Campbell was appointed to the board of directors on August 31, 2006. In accordance with the Company s 2004 Equity Incentive Plan, the Company issued Mr. Campbell an option to purchase 5,000 shares of the Company s common stock and paid Mr. Campbell his $10,000 board fee.

Upon the closing, the Company and HP A&M also entered into the following agreements, forms of which are included as exhibits to the Arkansas River Agreement (the Arkansas River Agreement and related Exhibits were filed as an attachment to a Form 8-K filed with the Securities and Exchange Commission on May 16, 2006):

- A pledge agreement related to the promissory notes, whereby HP A&M pledged, transferred, assigned and granted to the Company a security interest in and to (a) 1,500,000 shares of Pure Cycle common stock, (b) all shares of Pure Cycle Common Stock hereafter issued to HP A&M by means of any dividend or distribution in respect of the shares pledged hereunder (together with the shares identified in (a), the Pledged Shares), (c) the certificates representing the Pledged Shares, and (d) all rights to money or property which HP A&M now has or hereafter acquires in respect of the Pledged Shares;

- A pledge agreement, whereby the Company pledged to HP A&M: (i) one-half of the shares of FLCC purchased by the Company, (ii) all shares of FLCC hereafter issued to the Company by means of any dividend or distribution in respect of the shares pledged hereunder (together with the shares identified in (i), the Company s Pledged Shares), (iii) the certificates representing the Company s Pledged Shares, (iv) the Properties associated with the water represented by the Company s Pledged Shares, and (v) all rights to money or property which the Company now has or hereafter acquires in respect of the Company s Pledged Shares;

- A five year property management agreement with HP A&M, pursuant to which, HP A&M holds the right to pursue leasing of the Properties and the Water Rights to interested parties. All lease income associated with

leasing the Properties and Water Rights, together with all costs associated with these activities including but not limited to, overhead obligations, real property taxes, and personnel costs, are the sole opportunity and obligation of HP A&M;

- A non-solicitation agreement with each of the owners of HP A&M, pursuant to which each of the named parties agreed, for three years (i) not to solicit the Company s customers or potential customers to provide water in the Company s service areas or potential service areas, (ii) not to solicit employees of the Company, (iii) not to engage in certain activities competitive with the Company and (iv) not to engage in the purchase of water or water rights without first offering such water or water rights to the Company;

- A registration rights agreement, pursuant to which the Company granted HP A&M one demand right to register 750,000 shares of Pure Cycle common stock and piggyback rights to register an additional 750,000 shares of Pure Cycle common stock; and

- A voting agreement, pursuant to which Mr. Mark Harding, the Company s President, agrees to vote shares of Pure Cycle common stock owned by him for HP A&M s designated board member.

The Company assigned no value to the management agreement based on the fact that the Company does not receive any of the lease payments and is not responsible for any of the operating expenses associated with the leases. The leases subject to the property management agreement expire at various dates through 2010, which is earlier than the expiration date of the management agreement.

In order to utilize the Arkansas River water in the Company s service areas, the Company will be required to convert this water to municipal and industrial uses. Change of water use must be done through the Colorado water courts and several conditions must be present prior to the water court granting an application for transfer of a water right. A transfer case would be expected to include the following provisions: (i) a provision of anti-speculation in which the applicant must have contractual obligations to provide water service to customers prior to the water court ruling on the transfer of a water right, (ii) the applicant can only transfer the consumptive use portion of its water rights (the Company expects to face opposition to any consumptive use calculation of the historic agricultural uses of its water), (iii) applicants likely would be required to mitigate the loss of tax base in the basin of origin, (iv) applicants would likely have re-vegetation requirements requiring them to restore irrigated soils to non-irrigated, and (v) applicants would be required to meet water quality measures which would be included in the cost of transferring the water rights. The Company will likely need to construct a pipeline, which would be approximately 150 miles long and cost in excess of $400 million, in order to transport the Arkansas River water to its potential customers along the Front Range. The cost for this pipeline is expected to be funded through tap sales utilizing the Company s existing Denver based assets, but there can be no assurances that the Company will be able to generate the funds necessary to complete this without additional debt or equity offerings.

Rangeview Water Supply and Water System. The Rangeview Water Supply and water system costs represent the costs of assets acquired or facilities constructed to extend water services to customers located on and off the Lowry Range Property. The recorded costs of the Rangeview Water Supply includes payments to the sellers of the Rangeview Water Supply, design and construction costs and certain direct costs relating to improvements to the asset including legal and engineering fees.

The Company acquired the Rangeview Water Supply beginning in 1996 when it (i) entered into the Agreement for Sale of Export Water with the District, a quasi-municipal political subdivision of the State of Colorado; (ii) the District entered into the Amended and Restated Lease Agreement with the State of Colorado Board of Land Commissioners (the Land Board), which owns the Lowry Range Property; and (iii) entered into the Service Agreement with the District for the provision of water service to the Lowry Range Property (collectively these agreements are referred to as the Rangeview Water Agreements).

Pursuant to the Rangeview Water Agreements, the Company will design, construct, operate and maintain the District s water system to provide water service to the District s customers on the Lowry Range Property. The

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Rangeview Water Agreements dedicated 17,620 acre-feet of water per year for use specifically on the Lowry Range Property. Additionally, the Rangeview Water Agreements provide for the Company to use surface reservoir storage capacity in providing water service to customers within the Lowry Range Property. In exchange for providing water service to customers on the Lowry Range Property the Company will receive 95% of all amounts received by the District relating to water services, after the District pays the required royalties to the Land Board totaling 12% of gross revenues received from water sales.

Rates and charges for tap fees and usage or monthly fees are governed by the Company s rates and charges for all water and wastewater services under the terms of the Rangeview Water Agreements. These rates and charges are reviewed annually and are the average of similar rates and charges of three surrounding municipal water and wastewater service providers. These represent gross fees and to the extent that water service is provided using Export Water, the Company is required to pay royalties to the Land Board ranging from 10% of gross revenues to 50% of net revenue after deducting certain costs.

The Company will also design, finance, construct, operate and maintain the District s wastewater system to provide wastewater service to customers within its service area pursuant to the Wastewater Service Agreement between the Company and the District. In exchange for providing wastewater service for the District s customers, the Company will receive 100% of the District s wastewater tap fees and 90% of the District s wastewater usage fees.

Lowry Range Water and Export Water

The Rangeview Water Supply is a combination of tributary surface water and storage rights and nontributary groundwater rights associated with the Lowry Range Property. The Company owns the rights to use 11,650 acre-feet of non-tributary groundwater, which can be exported off the Lowry Range Property to serve area users. The Company has the exclusive rights to use 17,620 acre-feet of nontributary groundwater to serve customers on the Lowry Range Property. The Export Water, together with water that is owned by the Land Board the Company has contracted to utilize under the Rangeview Water Agreements, totals over 29,270 acre-feet of water per year. Additionally, the Company has the option with the Land Board to exchange an aggregate gross volume of 165,000 acre-feet of groundwater for 1,650 acre-feet per year of adjudicated surface water.

Based on independent engineering estimates, the 17,620 acre-feet of water designated for use on the Lowry Range Property is capable of providing water service to approximately 46,500 SFE units, and the 11,650 acre-feet of Export Water owned by the Company can serve approximately 33,600 SFE units throughout the Denver metropolitan region.

On the Lowry Range Property, the Company will operate both the water and the wastewater systems during the contract period and the District will own both systems. After 2081, ownership of the water system servicing customers on the Lowry Range Property will revert to the Land Board, with the District retaining ownership of the wastewater system. The Company owns the Export Water and will use it to provide water and wastewater services to customers off the Lowry Range Property. The Company will also own all the facilities required to extend water and wastewater services off the Lowry Range Property. The Company plans to contract with third parties for the construction of these facilities.

The Company delivered approximately 56.6 million, 52.3 million and 56.3 million gallons of water to customers on the Lowry Range Property in fiscal 2006, 2005 and 2004, respectively.

Arapahoe County Fairgrounds Agreement for Water Service

Effective August 3, 2005, the Company entered into an Agreement for Water Service (the County Agreement) with Arapahoe County (the County) to design and construct a water system for, and provide water services to, the new Arapahoe County Fairgrounds (the Fairgrounds). Pursuant to the County Agreement: (i) the County purchased water taps for 38.5 SFEs for $567,490, or $14,740 per tap; (ii) the Company agreed to design and construct the required Special Facilities, for which the County agreed to provide funding of $1,245,168; and (iii) the Company agreed to acquire rights to approximately 363 acre-feet of groundwater from the County for $293,013. As of August

31, 2006, the water rights deed for 336 acre-feet of water has not been transferred to the Company, and therefore, the cost of this water has not been capitalized on the accompanying balance sheet. The other 27 acre-feet of groundwater, valued at $52,938, has been recorded to the accompanying balance sheet as of August 31, 2006.

Pursuant to the County Agreement, in August 2005 the Company received a net cash payment of $514,552 and the rights to 27 acre-feet of dedicated groundwater valued at $52,938. Since the Company will utilize Export Water to provide water service to the Fairgrounds, the sale of the water taps generated a royalty payment to the Land Board of $34,522. The agreement with the Land Board requires royalty payments on Export Water sales based on net revenues, which are defined as proceeds from the sale of Export Water less direct and indirect costs, including reasonable overhead charges, associated with the withdrawal, treatment and delivery of Export Water. Based on this, in September 2005, the Company made the required $34,522 royalty payment to the Land Board, which is 10% of the net tap fees received from the County.

In addition, tap fees under service agreements in which Export Water will be utilized are subject to the CAA, which is described in more detail in Note 4. Net tap fees subject to the CAA totaled $532,968, which were the tap fees received from the County less the $34,522 Land Board royalty. The $532,968 was distributed by the escrow agent as required by the CAA in September 2005. Based on the 2004 CAA acquisitions made by the Company, the Company received $373,078, or 70%, of the distribution and external parties received $159,890, or 30%. The $159,890 paid to third parties in September 2005, is reflected in the August 31, 2005 balance sheet as *Payable to contingent obligation holders* and is combined with $15,000 payable to the CAA holders as described in Note 2 above.

The tap fees retained by the Company were used to fund construction of the Wholesale Facilities required to extend water service to the Fairgrounds. In July 2006 the Company completed construction of the Wholesale Facilities and in accordance with SAB 104 began recognizing the tap fees in income. For the year ended August 31, 2006, the Company recognized approximately $1,200 of tap fee revenue which equals one month of the approximately $428,000 of tap fee revenues to be recognized over 30 years. The $428,000 is comprised of the tap fees received by the Company of $567,490, decreased by (i) royalties to the Land Board of $34,522; and (ii) 65% of the total payments made to external CAA holders (which is more fully described in Note 4) or $104,136.

Pursuant to the County Agreement, the County is providing funding of approximately $1.245 million for the design and construction of the Special Facilities. In August 2005, the County made an initial payment of approximately $397,000, and will make monthly payments of approximately $9,555 for 10 years (this amount includes interest at 6% per annum and is adjusted from the amount originally reported in the Company s prior year form 10-KSB because the Company has not received the water rights deed for the remaining 336 acre-feet of water from the County and until received, the Company has not deducted the value of this water from the total Special Facilities funding to be provided). In accordance with GAAP, the total construction funding of $1.25 million is deferred and will be recognized as revenue over the expected service period, which is also the estimated useful life of the Special Facilities constructed with the funds. During the year ended August 31, 2006, the Company recognized $3,500 of Special Facilities revenue.

The Company utilized third party contractors to construct the required Wholesale and Special Facilities and remained contractually liable for final construction payments to four contractors totaling approximately $117,300, which was paid subsequent to August 31, 2006.

Sky Ranch Water Supply and Water Service Agreements

On October 31, 2003, and May 14, 2004, the Company entered into two Water Service Agreements (collectively the Sky Ranch Agreements) with the developer of approximately 950 acres of property located 4 miles north of the Lowry Range Property along Interstate 70 known as Sky Ranch. Pursuant to the Sky Ranch Agreements the Company will provide water for all homes and buildings to be constructed at Sky Ranch, which could go as high as 4,850 SFE units. The developer is obligated to purchase a minimum of 400 water taps from the Company before occupancy of the first house in Sky Ranch and a minimum of 310 annually thereafter. This tap purchase schedule is designed to provide the Company with adequate funds with which to construct the Wholesale Facilities required to provide water service. As additional water taps are acquired due to continued development of Sky Ranch, the

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Company will expand the infrastructure to meet demand as necessary. The Company has not received any payments for tap purchases from the developer and the Company continues to discuss the timing of tap purchases and the expected start date of the project with the developer. The developer has informed the Company that it is engineering the final design of the first phase of the project and is marketing lots to several national home builders with operations in the Denver area. Based on these discussions, the Company began the design and engineering of the water facilities but will not initiate construction until the Company receives notice from the developer to proceed together with payment for the initial tap purchases.

As part of the Sky Ranch Agreements, the Company will purchase approximately 537 acre-feet of water through future tap credits totaling $2.6 million on the first 767 taps purchased by the developer. In lieu of the developer receiving these credits the Company will utilize the funds to construct certain Special Facilities required to in order for the Company to provide water service to Sky Ranch. As of August 31, 2006, this water has not been purchased by the Company because Sky Ranch has not yet purchased any water taps.

On October 31, 2003 the Company entered into the Denver Groundwater Purchase Agreement (the DGPA) with the developer of Sky Ranch. The DGPA provides the Company the right to purchase a total of 223 acre-feet of adjudicated decreed water rights owned by the developer for five payments of $50,000 each, totaling $250,000. Under the DGPA, the Company can acquire 44.6 acre-feet of water per year (or 20% of the total 223 acre-feet) for $50,000. On March 26, 2004 and May 26, 2005, the Company exercised its rights and purchased a total of 89.2 acre-feet of Denver aquifer groundwater for payments totaling $100,000. During fiscal 2006 the Company contacted Sky Ranch regarding the next purchase of groundwater pursuant to the DGPA and is in the process of exercising its third payment. The Company anticipates purchasing the remaining 60% of the Sky Ranch groundwater pursuant to the DGPA, by exercising its rights this year and over the next two years for payments totaling $150,000.

The Company plans to initially develop the 760 acre-feet of water beneath the Sky Ranch property purchased from the developer of Sky Ranch under the DGPA and the Sky Ranch Agreements. The purchased water is sufficient to provide water service to approximately 1,500 taps. Any taps purchased by Sky Ranch in excess of 1,500 will be serviced utilizing Export Water and are subject to royalty payments to the Land Board and payments to the CAA holders.

The Sky Ranch Agreements provide the developer options to use a combined 1,200 acre-feet of Export Water per year at Sky Ranch after a defined number of taps have been purchased for use at Sky Ranch unless the developer allows the options to expire. The Sky Ranch Agreements call for two options (i) annual installments of $50,000 over five years (the Sky Ranch Option), and (ii) annual installments of $10,400 over five years (the Hills Option). Option fees received before the options are exercised or allowed to expire will not be refunded and are deferred and recognized into income ratably until the next option payment is due.

In fiscal 2005 and 2004, the developer remitted the first two $50,000 Sky Ranch Option payments which were both distributed in order of priority to the CAA holders. The Company received $35,000 of the fiscal 2005 distribution in September 2005 and outside parties received $15,000. The Company received this distribution because it had repurchased certain CAA interests in fiscal 2004. Of the amounts paid to the outside parties, $5,231 was allocated to the *Participating Interests in Export Water supply* liability and $9,769 reduced the contingency under the CAA. The Company did not retain any of the fiscal 2004 distributions.

In February 2005, the developer remitted the first $10,400 Hills Option payment which was distributed in order of priority to the CAA holders. Of this distribution, the Company received $7,280 and outside parties received $3,120. Of the amounts paid to the outside parties, $1,088 was allocated to the *Participating Interests in Export Water supply* liability and $2,032 reduced the contingency under the CAA.

As of August 31, 2006, both the $50,000 Sky Ranch Option payment and the $10,400 Hills at Sky Ranch Option payment are past due. The Company is in discussions with the developer of Sky Ranch regarding the status of the payments, but as of the date of this filing the Company has not received the payments or any information regarding the expected date of the payments. If the developer of Sky Ranch allows the options to expire, the Company will no longer be obligated to provide Export Water to Sky Ranch and Sky Ranch would likely not be permitted to build the

densities they were approved by the county due to a lack of sufficient water service. Whether Sky Ranch exercises these options or not has no bearing on the DGPA and the Company fully intends to complete its purchase of the remaining water covered by the DGPA.

The Company has dedicated approximately 1,200 acre-feet, or 10%, of the Export Water supply (which is about 4.2% of the Company s overall Rangeview Water Supply) for this project under the Sky Ranch options.

Paradise Water Supply. In 1987, the Company acquired water, water wells, and related assets from Paradise Oil, Water and Land Development, Inc., which constitute the Paradise Water Supply. The recorded costs of the Paradise water supply include the costs to acquire the Paradise water supply, as well as certain direct legal and engineering costs relating to improvements to the asset. The Paradise Water Supply includes 70,000 acre-feet of conditionally decreed tributary Colorado River water, a right-of-way permit from the United States Department of the Interior, Bureau of Land Management, for the construction of a 70,000 acre-foot dam and reservoir across federal lands, and four unrelated water wells.. Due to the strict regulatory requirements for constructing an on-channel reservoir, completing this conditional storage right at its decreed location would be difficult. As a result, there can be no assurance that the Company will ever be able to make use of this asset or sell the water profitably.

Every six years the Paradise Water Supply is subject to a Finding of Reasonable Diligence review by the water court and the State Engineer to determine if the Company is diligently pursuing the development of the water rights. During fiscal 2005, the water court began this review. In fiscal 2006 the Company received objections from two parties to its Paradise Water rights. The objectors have expressed concerns that the Company has not diligently pursued the development of the Paradise water rights and are seeking additional assurances that the Company intends to develop this water in the future. The Company is working with the objectors on specific milestones for development of this water in the future in exchange for the withdrawal of the opposition to the diligence review. At this time, the Company can make no assurances that it will be able to reach a reasonable agreement with the objectors or that the objections will be removed. If the Company does not receive a finding of due diligence from the water court, the Company would lose the water rights, be required to impair the Paradise Water Supply and record an impairment charge of approximately $5.5 million against earnings. The Company intends to continue to vigorously defend its Paradise water rights and look for efficient ways to use this water including agricultural and municipal uses along the western slope of Colorado. Pursuant to agreements entered into prior to the Company s acquisition of the Paradise Water Supply, the Company is required to find uses for this water along the western slope of Colorado.

In accordance with FASB Statement of Financial Accounting Standard No. 144**,** *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144), the Company reviews its long-term assets, including the Paradise water supply, for indicators of impairment. Consistent with SFAS 144, the Company compares the carrying amount of the Paradise Water Supply to the sum of the undiscounted cash flows from the expected eventual use of the asset. Assessment of the recoverability of the carrying value of the Paradise Water Supply assumes revenues from water tap sales and monthly metered water usage fees offset by wholesale development costs, which are based on engineering estimates, over a 35 year development horizon. Based on the latest annual assessment (last test performed as of August 31, 2006), because the fair value exceeds the carrying value of the Paradise water supply no impairment was found to exist.

NOTE 4 PARTICIPATING INTERESTS IN EXPORT WATER

The Company commenced the purchase of its Rangeview Water Supply through a Water Commercialization Agreement (WCA), an agreement with a related investor (the LCH Agreement) and the sale of 432,513 shares of Series B Preferred Stock. The WCA was entered into in 1990 and amended in 1991 and 1992 and again in 1996 by the signing of the CAA. The parties to the WCA and CAA agreements provided the Company approximately $11.1 million of financing to acquire the Rangeview Water Supply. This amount (which has been reduced by the transactions described below) is presented on the accompanying balance sheet as *Participating Interests in Export Water supply*, a liability. In addition to repaying the initial $11.1 million of funding, the CAA provided that the Company would pay the parties to the CAA an additional approximate $20.9 million of proceeds from Export Water sales (of which, $218,500 was to be maintained by the Company). Under the CAA, these funds are to be repaid

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The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the applicatio

strictly with proceeds from the sale of Export Water. Therefore, before the 2004 acquisitions as described below, the first $32.0 million received from the sale of Export Water was required to be paid to external CAA holders.

As the proceeds from the sale of Export Water are received, and the amounts are remitted to the external CAA holders, the Company allocates a ratable percentage of this payment to the principal portion (the Participating Interests liability account) with the balance of the payment being charged to the contingent obligation portion. The amount allocated to the liability is 35% which is the percentage the $11.1 million represented of the total $32.0 million obligation. The remaining portion, or 65%, is allocated to the contingent obligation. The portion allocated to principal will be recorded as a reduction in the Participating Interests liability account while the amounts applied to the contingency are recorded on a net revenue basis when funds are received.

The table below details the transactions impacting the CAA obligations since its signing, which are explained in greater detail below the table:

	Export Water Proceeds Received	**Export Water Proceeds to Pure Cycle**	**Total Potential Obligation**	**Paticipating Interests Liability**	**Contingency**
Original balances	$	$ 218,500	$ 31,807,732	$ 11,090,630	$ 20,717,102
Sky Ranch option payment	50,000		(50,000)	(17,435)	(32,565)
Acquisitions		8,199,333	(8,199,333)	(2,858,920)	(5,340,413)
Balance at August 31, 2004	50,000	8,417,833	23,558,399	8,214,275	15,344,124
Sky Ranch option payment	50,000	(35,000)	(15,000)	(5,231)	(9,769)
Hills at Sky Ranch option payment	10,400	(7,280)	(3,120)	(1,088)	(2,032)
Arapahoe County tap fees *	532,968	(373,078)	(159,890)	(55,754)	(104,136)
Balance at August 31, 2005	643,368	8,002,475	23,380,389	8,152,202	15,228,187
Acquisition		4,698,001	(4,698,001)	(1,638,086)	(3,059,915)
Balance at August 31, 2006	$ 643,368	$ 12,700,476	$ 18,682,388	$ 6,514,116	$ 12,168,272

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* The Arapahoe County tap fees are less the $34,522 royalty payment to the Land Board.

In August 2006, the Company acquired the rights to approximately $4.7 million of CAA interests, and retired approximately $896,000 of debt (which included approximately $471,500 of accrued interest) in exchange for the issuance of 242,169 shares of restricted common stock valued at approximately $2.1 million. The Company agreed to register these shares no later than December 14, 2006. As a result of this agreement, the Company now has the right to retain an additional $4.7 million of the initial $32.0 million of proceeds from the sale of Export Water. This brings the Company s total to be retained per the CAA as of August 31, 2006 to $12.7 million (including the fiscal 2004 acquisitions described below and net of the payments made pursuant to the CAA in fiscal 2005 and 2004). Based on the original accounting treatment of the CAA, which is consistent with the fiscal 2004 acquisitions described below, the Company recorded a gain on the extinguishment of debt and acquisition of the CAA of $390,900 during the fiscal year ended August 31, 2006.

During fiscal 2004, the Company acquired the rights to approximately $8.2 million of CAA obligations in exchange for cash payments of $2.75 million and the issuance of 40,512 shares of restricted common stock. As a result of these transactions, the Company, rather than external CAA holders, has the right to retain an additional $8.4 million of the initial $32.0 million of proceeds from the sale of Export Water. Based on the original accounting treatment for the CAA, the Company recorded an extinguishment charge of approximately $217,000 related to this transaction during the fiscal year ended August 31, 2004.

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the applicati

The acquisition of these CAA obligations and debt reduction, reduces the long term impact of the CAA and provides the Company with additional cash flows to fund operations and pursue other business opportunities that may arise.

The CAA includes contractually established priorities, and the rights the Company acquired in fiscal 2006 and 2004 includes $5.6 million in the highest priority level, $1.45 million in the third priority level, and the remaining $5.75 million at various other priority levels.

The CAA obligation is non-interest bearing, and if the Export Water is not sold, the parties to the CAA have no recourse against the Company. If the Company does not sell the Export Water, the holders of the Series B Preferred Stock are not entitled to payment of any dividend and have no contractual recourse against the Company.

The LCH Agreement and Preferred Stock. Pursuant to the LCH Agreement, the Company agreed to pay the next $4.0 million of proceeds from Export Water sales to LCH, Inc. a party related to the Company s former CEO, Thomas Clark. Further, the next $433,000 of proceeds from Export Water sales were required to be paid to the holders of the Series B Preferred Stock. Accordingly, the Company would only be entitled to retain 100% of the proceeds from Export Water sales after paying $36.5 million under the CAA and LCH agreements and to the holders of the Series B Preferred Stock.

On August 31, 2004 the Company entered into the Settlement Agreement with LCH, whereby LCH released the Company from its obligations under the LCH Agreement in consideration of the Company s former CEO surrendering 306,279 shares of common stock (which were pledged as collateral against notes payable to LCH), and the Company repaying the $950,000 of notes payable to LCH. The 306,279 shares were designated to repay approximately $1,557,100 of accrued interest payable to LCH and to acquire the $4.0 million of contingent obligations, which represents the Company s obligations under the LCH Agreement extending the $32.0 million of obligations under the CAA to $36.0 million. In January 2005, the Company paid Mr. Clark $50,555 in cash and issued him 300,000 shares of restricted common stock, which totaled $2,465,555. Based on the original accounting treatment for this contingent obligation, the Company recorded an extinguishment charge of approximately $909,000 related to this transaction in the year ended August 31, 2004.

NOTE 5 ACCRUED LIABILITIES

At August 31, 2006, the Company had accrued liabilities of approximately $289,600, of which $143,400 is for professional fees (of which $77,800 is related to the Arkansas River Agreement as described in Note 3), $117,300 relates to construction invoices for the County Agreement, and the remainder is for operating payables. At August 31, 2005, the Company had accrued liabilities of $31,500 of which $23,000 were for professional fees, approximately $4,000 relates to construction invoices for the County Agreement and the remainder were for operating payables.

NOTE 6 - LONG-TERM DEBT

Long-term debt, including accrued interest, at August 31, is comprised of the following:

	2006	2005
Note payable to former CEO s estate, due October 2007, non-interest bearing, unsecured	$ 26,542	$ 26,542
Notes payable, extinguished in August 2006.		876,718
Notes payable to former CEO s estate extinguished in December 2005.		551,661
Total long-term debt	$ 26,542	$ 1,454,921

The Participating Interest in Export Water supply and the Tap Participation Fees payable to HP A&M are obligations of the Company that have no scheduled maturity dates. Therefore, these liabilities are not included in the table above. As of August 31, 2006, the only debt the Company has with a contractual maturity date is the note payable to the estate of our former CEO, which is due in October 2007 and is therefore classified entirely as long-term.

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the applicatio

As further described in Note 4 above, in August 2006 the Company issued 242,169 shares of restricted common stock as consideration for the extinguishment of approximately $896,000 of debt and accrued interest and $4.7 million of CAA interests. The net gain on this transaction was approximately $390,900 which is reflected in the Company s statement of operations.

As further described in Note 13 below, in December 2005, the Company and the estate of its former CEO agreed to terms whereby the Company paid the estate approximately $195,600 in full consideration of notes payable and accrued interest totaling approximately $558,800.

NOTE 7 - STOCKHOLDERS EQUITY

Preferred and Common Stock. The Company s non-voting Series B Preferred Stock have a preference in liquidation of $1.00 per share less any dividends previously paid. Additionally, the Series B Preferred Stock are redeemable at the discretion of the Company for $1.00 per share less any dividends previously paid. In the event that the Company s proceeds from sale or disposition of Export Water rights exceeds $36,026,232, the Series B Preferred Stock holders will receive the next $433,000 of proceeds in the form of a dividend.

Stock Options. The Company maintains two stock option plans, the 2004 Incentive Plan which was approved by stockholders in April 2004, and the Equity Incentive Plan which was approved by stockholders in June 1992, (collectively the Option Plans) for executives, eligible employees and non-employee directors. Under the Option Plans, options to purchase shares of stock can be granted with exercise prices and vesting periods determined by the Compensation Committee of the Board and are exercisable over periods of up to ten years. The Company has 1.6 million and 1.2 million shares of common stock reserved for issuance under the 2004 Incentive Plan and the Equity Incentive Plan, respectively. Of these amounts, 1,477,500 options can still be granted under the 2004 Incentive Plan. The Equity Incentive Plan expired in 2002 and no additional options can be granted under this plan.

The following table summarizes the stock option activity for the Company s option plans for fiscal 2006:

	Number of Options	Weighted-Average Exercise Price
Outstanding at beginning of year	1,507,779	$ 1.94
Granted	45,000	9.76
Exercised	(891,443)	1.80
Forfeited or expired		
Outstanding at end of year	661,336	$ 3.08
Options exercisable at year end	601,336	$ 2.46

The following table summarizes the activity and value of non-vested options during fiscal 2006:

	Number of Options	Weighted-Average Grant Date Fair Value
Non-vested options outstanding at beginning of year	45,000	$ 6.78
Granted	45,000	8.55
Vested	(30,000)	6.80
Forfeited		
Non-vested options outstanding at end of year	60,000	$ 8.10

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the applicatio

The following table summarizes information regarding options granted and vested during the years ended August 31:

	2006	2005	2004
Number of options granted	45,000	12,500	65,000
Weighted average grant date fair value	$ 8.55	$ 6.22	$ 7.00
Number of options exercised	891,443	684,132	485,589
Aggregate intrinsic value of options exercised	$ 534,900	$ 410,500	$ 291,400
Number of options vested	30,000	20,000	
Total fair value of options vested	$ 209,600	$ 142,400	$

The following table summarizes information about stock options that are fully vested and exercisable as of August 31, 2006:

Range of Exercise Prices	Number	Weighted-average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Aggregate Value
$1.80	538,836	1.0	$ 1.80	$ 323,300
$7.00-$9.00	62,500	8.0	8.10	431,600
$12.00-$14.00				
$1.80 to $14.00	601,336	1.7	$ 2.46	$ 754,900

At August 31, 2006, the Company has unrecognized SFAS 123(R) expenses relating to non-vested options that are expected to vest totaling $508,900. The weighted-average period over which these options are expected to vest is 2 years. The Company has not recorded any excess tax benefits to additional paid in capital.

In August 2006, the Company granted its new director an option to purchase 5,000 shares of the Company s common stock pursuant to the 2004 Incentive Plan. The option vests 50% on the first anniversary date of the grant and 50% on the second anniversary date of the grant. Also in August in 2006, the Company granted an employee options to purchase 30,000 shares of the Company s common stock pursuant to the 2004 Incentive Plan. The shares vest one third on each of the next three anniversary dates of the grant.

In April of 2005, options to purchase 10,000 shares of the Company s common stock were granted to non-employee directors under the 2004 Incentive Plan, which vest in one year.

During the fiscal year ended August 31, 2006, the Company received approximately $1,150,000 from the exercise of stock options. Option holders can either exercise their options by paying the Company their exercise price in cash or, upon approval by the compensation committee of the board of directors, by the option holder exchanging shares of common stock held by the option holder for more than six months, with a market value at the date of exercise equal to the exercise price of options being exercised , for the shares to be issued pursuant to the option exercise. If option holders use mature shares to exercise their options, the Company records the mature shares utilized as treasury stock. Since the option holders determine which method they will utilize to pay the exercise price of the options, the Company can not estimate the number of treasury shares that may be received in the coming year.

The exercise price for 391,443 of the options exercised in fiscal 2006 was paid for by the option holders utilizing 57,125 shares of common stock held by the applicable option holders more than six months with a market value at the dates of exercise totaling approximately $454,600, which is shown as Treasury Stock on the accompanying balance sheet.

The exercise price for 308,299 of the options exercised in fiscal 2005 was paid for by the option holders utilizing 73,154 shares of common stock held by the applicable option holders more than six months with a market value at the dates of exercise totaling approximately $554,900, which is shown as Treasury Stock on the accompanying balance sheet.

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the applicati

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the applicatio

Warrants. As of August 31, 2006, the Company has outstanding warrants to purchase 92 shares of common stock at an exercise price of $1.80 per share. During fiscal 2006, the Company issued 15,520 shares of common stock upon the exercise of 15,520 warrants. The warrant holder paid the exercise price of $27,936 in cash. These warrants expire six months from the earlier of (i) the date all of the Export Water is sold or otherwise disposed of, (ii) the date the CAA is terminated with respect to the original holder of the warrant, or (iii) the date on which the Company makes the final payment pursuant to Section 2.1(r) of the CAA.

Gain on extinguishment of related party debt. See Note 13 *Related Party Transactions* regarding gain on extinguishment of related party debt recorded as additional paid in capital.

NOTE 8 - SIGNIFICANT CUSTOMERS

The Company had accounts receivable from two customers totaling approximately $60,600 and $47,900 as of August 31, 2006 and 2005, respectively. The same customers accounted for approximately 96%, 98% and 96% respectively, of the Company s revenues during the years ended August 31, 2006, 2005 and 2004.

NOTE 9 - INCOME TAXES

There is no provision for income taxes because the Company has incurred operating losses. Deferred income taxes reflect the tax effects of net operating loss carryforwards and temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company s deferred tax assets as of August 31 are as follows:

	2006	**2005**	**2004**
Deferred tax assets:			
Net operating loss carryovers	$ 3,366,200	$ 3,472,500	$ 2,406,100
Depreciation and depletion of water and water systems	479,200	77,900	712,700
Water tap revenues	159,500		
Valuation allowance	(4,003,300)	(3,548,900)	(3,118,800)
Net deferred tax asset	1,600	1,500	
Deferred tax liabilities:			
Depreciation on property and equipment	(1,600)	(1,500)	
Net deferred assets	$	$	$

The Company has recorded a valuation allowance equal to the excess of the deferred tax assets over the deferred tax liability as the Company is unable to reasonably determine if it is more likely than not that deferred tax assets will ultimately be realized.

Income taxes computed using the federal statutory income tax rate differs from our effective tax rate primarily due to the following for the years ended August 31:

	2006	**2005**	**2004**
Expected benefit from federal income taxes at statutory rate of 34%	$ (269,600)	$ (357,300)	$ (667,300)
State taxes, net of federal benefit	(26,200)	(34,700)	(64,800)
Expiration of net operating losses	160,500	176,900	365,800
Permanent differences	(319,100)	(215,000)	200
Change in valuation allowance	454,400	430,100	366,100
Total income tax expense	$	$	$

At August 31, 2006, the Company has approximately $9,025,000 of net operating loss carryovers available for income tax purposes which expire between fiscal 2007 and 2026. Utilization of these net operating loss carryforwards may be subject to substantial annual ownership change limitations provided by the Internal Revenue Code. Such an annual limitation could result in the expiration of the net operating loss carryforwards before utilization.

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the applicati

Net operating loss carryforwards of approximately $430,000, $474,000 and $981,000 expired during the years ended August 31, 2006, 2005 and 2004, respectively.

NOTE 10 INFORMATION CONCERNING BUSINESS SEGMENTS

The operating segments reported below are the segments of the Company for which separate discrete financial information is available and for which results are evaluated by the Company s President in deciding how to allocate resources and in assessing performance. The Company evaluates the performance of its segments based on gross margins of the respective business units before corporate and unallocated shared expenses if any. The accounting policies of the segments are the same as those of the Company as described in Note 2.

The Company principally has two lines of business: (i) the design and construction of water and wastewater systems, and (ii) the provision of water and wastewater services, which includes the operations and maintenance of systems the Company constructed, to customers within the Company s service area.

The Company had one construction project occur in fiscal 2006 and none in fiscal 2005 or 2004 because development has not begun on either the Lowry Range Property or Sky Ranch, and therefore, the Company has not recognized any construction revenues or expenses during the years ended August 31, 2005 or 2004.

Beginning in August 2005 and concluding in fiscal 2006, the Company constructed a water system to provide water services to the Fairgrounds. The construction project included the design and construction of a 500,000 gallon water tank, a new deep water well and pipelines. The Company designed the system and hired third party contractors to build the required infrastructure, which was supervised by the Company s engineer. The construction costs totaled $2.6 million, which is capitalized with the Company s investments in water and water systems. As of August 31, 2006, these assets were fully operational and transferred to the service provider segments balance sheet and therefore there are no construction related assets on the Company s accompanying balance sheet.

The results of operations for the year ended August 31, 2006 relate to the service provider segment with the exception of (i) the $1,200 of tap fees recognized as revenues which relates to tap fees received by the Company which were used for the construction of the required wholesale facilities, (ii) the $3,500 of Special facility funding recognized during fiscal 2006 which is the ratable portion of the construction funding being provided by the County related entirely to the construction of the Special Facilities, and (iii) an estimated $90,000 of salaries and related costs incurred by the Company for the work performed by Company employees on the construction project.

NOTE 11 401(k) PLAN

Effective July 25, 2006, the Company adopted the Pure Cycle Corporation 401(k) Profit Sharing Plan (the Plan), a defined contribution retirement plan for the benefit of its employees. The Plan is currently a salary deferral only plan and at this time the Company does not match employee contributions. The Company pays the annual administrative fees of the Plan, which are estimated to be approximately $2,500 per year, and the Plan participants pay the investment fees. The Plan is open to all employees, age 21 or older, who have been employees of the Company for at least six months. During the year ended August 31, 2006, because the Plan was not open for the entire year, the Company paid fees of less than $1,000 for the administration of the Plan.

NOTE 12 SUPPLEMENTAL DISCLOSURE OF NON-CASH ACTIVITIES

	Years Ended August 31, 2006		2005		2004	
Tap Participation Fee issued to HP A&M pursuant to Arkansas River Agreement (restated)	$	45,635,000	$		$	
Common stock issued to HP A&M pursuant to the Arkansas River Agreement	$	36,240,000	$		$	
Common stock issued to acquire contingent obligations, and extinguish debt	$	2,128,196	$		$	326,122
Construction proceeds receivable included in deferred revenue	$	864,955	$		$	
Gain on extinguishment of related party debt accounted for as contributed capital	$	363,208	$		$	
Treasury stock accepted upon exercise of stock options with mature shares used as consideration	$	454,595	$	554,939	$	
Investments in water and water systems included with accrued liabilities	$	117,287	$		$	
Capitalized legal and engineering fees incurred in connection with Arkansas River water acquisition included with accrued liabilities	$	77,842	$		$	
Water rights acquired with deferred tap fee credits	$	52,938	$		$	
Estimated common stock registration costs included with accrued liabilities	$	15,000	$		$	
Restricted common stock issued to former CEO in satisfaction of reimbursement obligation	$		$	2,415,000	$	
Preferred stock converted to common stock	$		$		$	10,055

NOTE 13 RELATED PARTY TRANSACTIONS

On December 29, 2005, the Company and the estate of its former CEO agreed to terms whereby the Company paid the estate $195,573 in full consideration of notes payable and accrued interest totaling $558,781. Because the estate of our former CEO is deemed a related party, the Company recorded the $363,208 gain as a contribution of capital.

The Company leases office space from the son of its former CEO, who is also the sole manager of TPC Ventures, LLC which is a greater than 5% holder of the Company s common stock. The Company leases the office space on a month-to-month basis for $1,000 per month.

In 1995, the Company extended a loan to the District, a related party. The loan provided for borrowings of up to $250,000 is unsecured, bears interest based on the prevailing prime rate plus 2% (10.25% at August 31, 2006) and matures on December 31, 2006. The $452,230 balance of the note receivable at August 31, 2006 includes

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borrowings of $229,310 and accrued interest of $222,920. The Company extended the due date to December 31, 2007 and accordingly the note has been classified as non-current.

NOTE 14 SUPPLEMENTAL DATA: SELECTED QUARTERLY FINANCIAL INFORMATION (unaudited)

In thousands, except per share amounts

Fiscal 2006 quarters ended:	**August 31**	**May 31**	**February 28**	**November 30**
Total revenues	$ 83.5	$ 67.7	$ 55.0	$ 65.6
Gross margin	$ 55.3	$ 54.8	$ 40.9	$ 46.8
Net loss	$ (79.1)	$ (201.9)	$ (306.8)	$ (205.1)
Earnings per share - basic and diluted	$ (0.01)	$ (0.01)	$ (0.02)	$ (0.01)
Market price of common stock				
High	$ 11.23	$ 14.48	$ 11.88	$ 8.00
Low	$ 7.67	$ 9.57	$ 6.61	$ 5.56

Fiscal 2005 quarters ended:	**August 31**	**May 31**	**February 28**	**November 30**
Total revenues	$ 71.5	$ 68.4	$ 40.8	$ 54.0
Gross margin	$ 57.6	$ 54.5	$ 28.5	$ 30.9
Net loss	$ (330.9)	$ (216.3)	$ (297.7)	$ (206.0)
Earnings per share - basic and diluted	$ (0.02)	$ (0.02)	$ (0.02)	$ (0.02)
Market price of common stock				
High	$ 8.90	$ 7.85	$ 9.50	$ 9.40
Low	$ 6.57	$ 3.06	$ 6.30	$ 7.05

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Item 9. **Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None.

Item 9A. **Controls and Procedures.**

(a) *Evaluation of Disclosure Controls and Procedures*

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined in the Exchange Act Rule 13a 15(f). Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

The President and Chief Financial Officer assessed the effectiveness of internal control over financial reporting as of August 31, 2006 based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon this evaluation, the President and Chief Financial Officer has concluded that the Company s disclosure controls and procedures were not effective as of August 31, 2006 due to the material weakness in internal control over financial reporting described below (Item 9A(b)).

(b) *Management s Report on Internal Control Over Financial Reporting*

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The Securities and Exchange Act of 1934 defines internal control over financial reporting in Rule 13a-15(f) as a process designed by, or under the supervision of, the Company s principal executive and principal financial officers and effected by the Company s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company;

- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and

- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company s management assessed the effectiveness of the Company s internal control over financial reporting as of August 31, 2006. In making this assessment, the Company s management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*.

Based upon its assessment, management concluded that, as of August 31, 2006, the Company has inadequate controls over the process for the identification and implementation of the proper accounting for certain transactions which resulted in material audit adjustments.

A material weakness represents a significant deficiency (as defined in the Public Company Accounting Oversight Board s Auditing Standard No. 2), or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis.

As a result of this deficiency, there were misstatements in the Company s financial statements that were not corrected prior to the original issuance of the fiscal 2006 financial statements, which required a restatement of the fiscal 2006 financial statements.

As a result of the aforementioned material weakness, management has concluded that the Company did not maintain effective internal control over financial reporting as of August 31, 2006.

Anton Collins Mitchell LLP, the Company s independent registered public accounting firm, who has audited the Company s financial statements included herein, has issued an attestation report on management s assessment of the effectiveness of the Company s internal control over financial reporting at August 31, 2006 which report is included herein.

(c) Changes in Internal Controls

There have been no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation referred to above.

(d) Remediation Efforts to Address Material Weaknesses in Internal Control Over Financial Reporting

The Company is developing a formal remediation plan and intends to make progress on remediation during fiscal 2007 and to complete the remediation of this weakness by August 31, 2007. Remediation includes the verification through management testing that the revised control procedures are operating effectively, which may extend the remediation timeline if these tests indicate that the control deficiency remains.

(e) Report of Independent Registered Public Accounting Firm

The report of the Company s independent registered public accounting firm is included in *Item 8. Financial Statements and Supplementary Data*.

Item 9B. <u>Other Information.</u>

None

PART III

Information concerning Items 10 through Items 14 are contained in our definitive Proxy Statement pursuant to Regulation 14A promulgated under the Securities Exchange Act of 1934 for the 2007 Annual Meeting of Stockholders and is incorporated herein by reference, which is expected to be filed on or about December 15, 2006.

PART IV

Item 15. <u>Exhibits, Financial Statement Schedules</u>

(a) Exhibits

3.1 Amended and Restated Certificate of Incorporation - Incorporated by reference from Exhibit 3.1 to Amendment No. 2 to Registration Statement on Form SB-2, filed June 10, 2004, Registration No. 333-114568

3.2 Amended and Restated Bylaws of Registrant - Incorporated by reference from Exhibit 3.2 to Amendment No. 2 to Registration Statement on Form SB-2, filed June 10, 2004, Registration No. 333-114568-.

4.1 Specimen Stock Certificate - Incorporated by reference to Registration Statement No. 2-62483.

10.1

Letter Agreement dated August 31, 1987 between Pure Cycle Corporation and Paradise Oil, Water & Land Development, Inc. Incorporated by reference from Current Report on Form 8-K filed with the SEC on August 5, 1988.

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10.2 Right of First Refusal Agreement dated August 12, 1992 between INCO Securities Corporation and Richard F. Myers, Mark W. Harding, Thomas P. Clark, Thomas Lamm and Rowena Rogers. Incorporated by Reference from Registration Statement on Form SB-2, filed April 19, 2004, Registration No. 333-114568.

10.3 Equity Incentive Plan. Incorporated by reference from Proxy Statement for Annual Meeting held April 2, 1993.

10.4 2004 Equity Incentive Plan. Incorporated by reference from Proxy Statement for Annual Meeting held April 12, 2004

10.5 Service Agreement, dated April 11, 1996, by and between Pure Cycle Corporation and the Rangeview Metropolitan District. Incorporated by reference from Quarterly Report on Form 10-QSB for the period ended May 31, 1996.

10.6 Wastewater Service Agreement, dated January 22, 1997, by and between Pure Cycle Corporation and the Rangeview Metropolitan District. Incorporated by reference from the Annual Report on Form 10-KSB for the fiscal year ended August 31, 1998.

10.7 Comprehensive Amendment Agreement No. 1, dated April 11, 1996, by and among ISC, the Company, the Bondholders, Gregory M. Morey, Newell Augur, Jr., Bill Peterson, Stuart Sundlun, Alan C. Stormo, Beverlee A. Beardslee, Bradley Kent Beardslee, Robert Douglas Beardslee, Asra Corporation, International Properties, Inc., and the Land Board. Incorporated by reference from Quarterly Report on Form 10-QSB for the period ended May 31, 1996.

10.8 Settlement Agreement and Mutual Release dated April 11, 1996 by and among the Land Board and the District, Pure Cycle Corporation, INCO Securities Corporation, Apex Investment Fund II, L.P., Landmark Water Partners, L.P., Landmark Water Partners II, L.P., Environmental Venture Fund, L.P., Environmental Private Equity Fund II, L.P., The Productivity Fund II, L.P., Proactive Partners, L.P., Warwick Partners, L.P., Auginco, Anders C. Brag, Amy Leeds, and D.W. Pettyjohn, and OAR, Incorporated, Willard G. Owens and H.F. Riebesell, Jr. Incorporated by reference from Quarterly Report on Form 10-QSB for the fiscal quarter ended May 31, 1996).

10.9 Agreement for Sale of Export Water dated April 11, 1996 by and among the Company and the District. Incorporated by reference from Quarterly Report on Form 10-QSB for the fiscal quarter ended May 31, 1996).

10.10 Water Service Agreement for the Sky Ranch PUD dated October 31, 2003 by and between Airpark Metropolitan District, Icon Investors I, LLC, the Company and the District. Incorporated by reference from Registration Statement on Form SB-2, filed April 19, 2004, Registration No. 333-114568.

10.11 Non-Statutory Stock Option Agreement dated April 19, 2001 between the Company and Mark W. Harding. Incorporated by reference from Registration Statement on Form SB-2, filed April 19, 2004, Registration No. 333-114568.

10.12 Amendment to Water Service Agreement for the Sky Ranch PUD dated January 6, 2004. Incorporated by Reference from Amendment No. 1 to Registration Statement on Form SB-2, filed June 7, 2004, Registration No. 333-114568.

10.13 Amendment to Water Service Agreement for the Sky Ranch PUD dated January 30, 2004. Incorporated by Reference from Amendment No. 1 to Registration Statement on Form SB-2, filed June 7, 2004, Registration No. 333-114568.

10.14 Amendment to Water Service Agreement for the Sky Ranch PUD dated January 30, 2004 pertaining to amendment of the Option Agreement for Export Water. Incorporated by Reference from Amendment No. 1 to Registration Statement on Form SB-2, filed June 7, 2004, Registration No. 333-114568.

10.15 Corrected Amendment to Water Service Agreement for the Sky Ranch PUD dated March 5, 2004. Incorporated by Reference from original Annual Report on Form 10-K for the fiscal year ended August 31, 2006, filed November 21, 2006.

10.16 Amended and Restated Lease Agreement between the Land Board and the District dated April 4, 1996. Incorporated by Reference from Amendment No. 1 to Registration Statement on Form SB-2, filed June 7, 2004, Registration No. 333-114568.

10.17 Bargain and Sale Deed among the Land Board, the District and the Company dated April 11, 1996. Incorporated by Reference from Amendment No. 1 to Registration Statement on Form SB-2, filed June 7, 2004, Registration No. 333-114568.

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NOTE 13 RELATED PARTY TRANSACTIONS

10.18	Mortgage Deed, Security Agreement, and Financing Statement between the Land Board and the Company dated April 11, 1996. Incorporated by Reference from Amendment No. 1 to Registration Statement on Form SB-2, filed June 7, 2004, Registration No. 333-114568.
10.19	Water Service Agreement for the Hills at Sky Ranch Water dated May 14, 2004 among Icon Land II, LLC, a Colorado limited liability company, the Company, and the District. Incorporated by reference from the Current Report on Form 8-K filed with the SEC on May 21, 2004.
10.20	Purchase and Sale Agreement dated as of August 31, 2004 between Pure Cycle Corporation and Proactive Partners, L.P. incorporated by reference from Form 8-K filed on November 12, 2004.
10.21	Settlement Agreement dated as of August 31, 2004 among Pure Cycle Corporation, Thomas P. Clark and LCH, Inc. incorporated by reference from Form 8-K filed on November 12, 2004.
10.22	Purchase and Sale Agreement dated as of August 31, 2004 among Pure Cycle Corporation, OAR Incorporated and Willard G. Owens incorporated by reference from Form 8-K filed on November 12, 2004.
10.23	Form of Amendment to Warrant incorporated by reference from Form 8-K filed on November 12, 2004.
10.24	Agreement for Water Service dated August 3, 2005 among Pure Cycle Corporation, Rangeview Metropolitan District and Arapahoe County incorporated by reference from Form 8-K filed on August 4, 2005.
10.25	Arkansas River Agreement dated May 10, 2006 among Pure Cycle Corporation and High Plains A&M, LLC incorporated by reference from Form 8-K filed on May 16, 2006.
14	Code of Ethics Adopted February 13, 2004 incorporated by reference from our Proxy Statement for the Annual Meeting held April 12, 2004.
16.1	Letter from KPMG to the Securities and Exchange Commission, dated December 17, 2004, incorporated by reference from form 8-K filed on December 17, 2005.
23.1	Consent of Anton Collins Mitchell LLP *
23.2	Consent of KPMG, LLP *
31.1	Certification under Section 302 of the Sarbanes-Oxley Act of 2002. *
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. *

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* Filed herewith

(b) Financial Statement Schedules

None

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Signature

In accordance with Section 13 or 15(d) of the Securities Exchange Act, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PURE CYCLE CORPORATION

By: /s/ Mark W. Harding
Mark W. Harding, President and Chief Financial Officer
April 16, 2007

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