

**NAPIER ENVIRONMENTAL  
TECHNOLOGIES INC.**

**CONSOLIDATED  
INTERIM FINANCIAL STATEMENTS**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**JUNE 30, 2003**

**(UNAUDITED – Prepared by Management)**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS SECOND QUARTER FISCAL 2003**

Napier Environmental Technologies Inc. manufactures a broad range of environmentally advantaged chemical formulations to remove surface coatings as well as refurbish and protect wood. Napier products are distributed worldwide in a variety of industrial sectors as well as consumer markets in Canada and the US. The products employ patented technology which work extremely well and are safe to use as well as cost effective. The global market opportunity for the products is considerable and management expects increased penetration of those markets will significantly increase shareholder value into the foreseeable future.

This Management Discussion and Analysis (MD&A) for this second fiscal quarter of 2003 should be read in conjunction with the interim consolidated financial statements for the three month period ended June 31, 2003. The MD&A has been prepared to give shareholders an assessment of not only what management has accomplished in the past fiscal period but also of what specific initiatives are being taken to increase shareholder value for the future.

### **Results of Operations**

As experienced in the first quarter, revenues were less than planned as a consequence of a continued wet and lingering spring, exacerbated by a continued weak economy in the US and accompanied by a weakening of the US dollar. Quarter revenues of \$2,566,779 were 21% below last year's revenues of \$3,259,352. Gross profit of approximately 46% held steady despite decreased sales volume. Having said that, as weather conditions improved sales in June were \$1,041,240 a 16% increase over last year and a company record for the month. Consumer product sales in Canada remained steady despite adverse weather conditions. US consumer sales showed signs of recovering in the latter half of the quarter and are expected to exceed last year's levels as the buying season is extended with improved weather conditions. In the industrial sector the lagging US economy continues to limit demand for our products. Governments at all levels are in budget deficits and projects are being cancelled or deferred for lack of funding. As a consequence sales to ICI of "Hydrostrip", a private label industrial stripper, are very slow and not expected to recover until product currently in their US inventory is fully consumed. Finally, the sudden and unexpected rise of the Canadian dollar in relation to US currency continued to negatively impact sales. In spite of management efforts to mitigate the effects of a declining US dollar the impact on sales is approximately \$210,000 year to date. During the fall buying season we will have an opportunity to address this issue and implement effective pricing strategies for next year.

To meet the unexpected challenges this year management continued to carefully control and reduce costs in the second quarter. General and Administrative costs were reduced 14% and Selling and Marketing costs by 12% from a year ago. Our emphasis on strict cost control has resulted in a 9% overall reduction in expenses for the year to date.

During the quarter we signed several marketing and distribution agreements with major paint and coatings manufacturers. Their confidence in our products and Company speaks well for our future. These agreements are intended to support growth in both our industrial and consumer product lines and reflect our ongoing commitment to both markets. In addition these agreements embrace our intention to market consumer oriented products overseas.

The first of a number of “private label” products was shipped to stores in Canada in the quarter. This program will be extended to other products in North America throughout the remainder of 2003 and include a number of products which are non-seasonal in nature. In addition our marketing and distribution agreement with Akzo Nobel will renew our commitment to growth in the worldwide aviation sector. After several demonstrations involving stripping Airbus and Boeing aircraft, both in the US and Europe, Akzo training begins in Europe this month and orders for product have begun and will grow steadily over the remainder of the year and beyond. This program involves labelling our products in 17 different languages for distribution within the European Economic Community. To ensure our future growth and ongoing success in this and other markets we are devoting considerable Research and Development resources to maximize the efficacy of our current products and are developing the next generation of superior stripping products utilizing our unique technologies.

In the second quarter select products were accepted into MAB Paints, a large paint dealer in the Eastern US. In addition we are now an accepted vendor in Lowe’s in the US, albeit with a limited product offering and are engaged in ongoing and active discussions with a number of other dealers both in the US and overseas. During the quarter we shipped a small opening order of wood restoration products to our new dealer in Japan all of which were labelled in Japanese. In addition we have a new dealer in Scandanavia selling and distributing our products in four Nordic languages. With our new and established dealers we are working hard to increase the number of products each currently sells. To this end we are nearing completion of a renewed program specifically designed to appeal to the US consumer market but also applicable overseas. Included are products utilizing SARA technology that can be applied with a brush for ease of consumer use. We are currently test marketing the program in anticipation of a 3<sup>rd</sup> quarter launch.

### **Liquidity and Capital Resources**

Despite less than anticipated sales year to date, the company had a positive operating income of \$55,132 in the second quarter and generated positive net income of \$10,650. Of equal importance during periods of economic challenge was our ability to generate cash from operating activities of \$51,086 during the quarter versus using \$297,594 for operating activities during the same period last year. The fully subscribed closing of a \$500,000 convertible debenture in the quarter and our ongoing participation in a commercial bank program to monetize receivables provides sufficient cash to meet our immediate needs. As of June 30,2003, the Company’s working capital was approximately \$1,504,000, including cash and cash equivalents of \$33,000.

Management expects improvements in sales over 2002 levels throughout the remainder of fiscal 2003. The buying season for our products primarily in wood restoration products should be extended this year due to the unusually hot and dry conditions forecast. Marketing and distribution agreements signed in the second quarter, including private labelling and the aviation sector are, in large measure, not seasonal in nature. This should result in stronger sales in our 3<sup>rd</sup> and 4<sup>th</sup> quarters.

## **Forward Looking Statements**

This MD&A contains forward looking statements that are subject to a number of known and unknown risks, uncertainties and other factors that may cause actual results to differ materially from those anticipated in our forward looking statements. Factors that could cause actual results to differ materially include: rapid technological and/or market changes in the industry; the ability to maintain and grow successful third party and customer relationships, to improve current products and develop new products, to adequately protect the Company's proprietary rights and other factors described in the Company's regulatory filings. Although we believe the expectations reflected in our forward looking statements are reasonable, individual results may vary, and we cannot guarantee future results, levels of activity, performance or achievements.

ON BEHALF OF THE BOARD OF DIRECTORS

“signed”

Frank Dixon  
President and CEO

August 15, 2003

**NAPIER ENVIRONMENTAL TECHNOLOGIES INC.**

**INTERIM CONSOLIDATED BALANCE SHEETS**  
**(UNAUDITED - Prepared by Management)**

	June 30 2003	December 31 2002
<b>ASSETS</b>		
Current		
Cash and cash equivalents	\$ 32,989	\$ 285,097
Accounts receivable (Note 3)	1,533,186	617,166
Inventory (Note 4)	1,765,432	1,574,303
Prepaid expenses	150,833	185,079
	<u>3,482,440</u>	<u>2,661,645</u>
Investments (Note 5)	107,585	161,585
Capital assets (Note 6)	703,600	754,517
	<u>\$ 4,293,625</u>	<u>\$ 3,577,747</u>
<b>LIABILITIES</b>		
Current		
Accounts payable	\$ 1,910,173	\$ 936,999
Bank indebtedness (Note 7)	-	353,000
Current portion of long term debt	67,619	80,033
	<u>1,977,792</u>	<u>1,370,032</u>
Long term debt (Note 8)	82,156	114,313
Convertible debenture (Note 9)	326,300	-
	<u>2,386,248</u>	<u>1,484,345</u>
<b>SHAREHOLDERS' EQUITY</b>		
Capital stock (Note 10)	23,343,041	23,335,041
Equity component of convertible debenture (Note 9)	173,700	-
Contributed surplus	39,890	39,890
Deficit	(21,649,254)	(21,281,529)
	<u>1,907,377</u>	<u>2,093,402</u>
	<u>\$ 4,293,625</u>	<u>\$ 3,577,747</u>

Approved by the Board of Directors

signed: "B. Frank Dixon"

signed: "Lionel G. Dodd"

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS  
AND DEFICIT (UNAUDITED - Prepared by Management)

	Three month period ended June 30		Six month period ended June 30	
	2003	2002	2003	2002
Sales	\$ 2,566,779	\$ 3,259,352	\$ 4,093,740	\$ 5,210,313
Cost of sales	1,385,872	1,746,889	2,249,711	2,869,786
Gross profit	1,180,907	1,512,463	1,844,029	2,340,527
Expenses				
Selling and marketing (Schedule)	681,414	773,897	1,260,466	1,392,870
General and administrative (Schedule)	385,078	448,863	743,325	825,664
Research and product development	59,283	54,705	110,780	99,626
	1,125,775	1,277,465	2,114,571	2,318,160
Operating income (loss)	55,132	234,998	(270,542)	22,367
Other non-operating items				
Equity income (loss)	(27,000)	63,418	(54,000)	(59,993)
Foreign exchange loss	(17,616)	(42,231)	(44,056)	(42,231)
Interest and other income	134	22,707	823	27,144
Gain (loss) on disposal of assets	-	(1,912)	50	(1,912)
	(44,482)	41,982	(97,183)	(76,992)
Net income (loss) for the period	10,650	276,980	(367,725)	(54,625)
Deficit at beginning of the period	(21,659,904)	(20,382,100)	(21,281,529)	(20,050,495)
Deficit at end of the period	\$ (21,649,254)	\$ (20,105,120)	\$ (21,649,254)	\$ (20,105,120)
Weighted average shares outstanding	47,634,635	47,450,020	47,631,357	47,350,141
Earnings (loss) per share, basic and fully diluted	\$ 0.00	\$ 0.01	\$ (0.01)	\$ (0.00)

**NAPIER ENVIRONMENTAL TECHNOLOGIES INC.**

**INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED - Prepared by Management)**

	Thee month period ended June 30		Six month period ended June 30	
	2003	2002	2003	2002
<b>Operating activities</b>				
Net income (loss) for the period	\$ 10,650	\$ 276,980	\$ (367,725)	\$ (54,625)
Items not involving cash				
Amortization	42,227	40,938	84,271	82,158
Equity (income) loss	27,000	(63,418)	54,000	59,993
(Gain) loss on disposal of assets	-	1,912	(50)	1,912
	<b>79,877</b>	<b>256,412</b>	<b>(229,504)</b>	<b>89,438</b>
<b>Change in non-cash operating working capital</b>				
Accounts receivable	(493,508)	(845,255)	(916,020)	(1,405,533)
Inventory	118,366	(192,048)	(191,129)	(320,388)
Prepaid expenses	38,569	63,562	42,246	54,376
Accounts payable	307,782	419,745	973,174	618,922
Working capital requirements	<b>(28,791)</b>	<b>(553,996)</b>	<b>(91,729)</b>	<b>(1,052,623)</b>
	<b>51,086</b>	<b>(297,584)</b>	<b>(321,233)</b>	<b>(963,185)</b>
<b>Financing activities</b>				
Bank indebtedness	(497,773)	425,000	(353,000)	695,000
Shares issued for cash	-	30,600	-	47,600
Convertible debenture issued	500,000	-	500,000	-
Repayment of long-term debt	(25,592)	(20,784)	(44,571)	(39,363)
	<b>(23,365)</b>	<b>434,816</b>	<b>102,429</b>	<b>703,237</b>
<b>Investing activities</b>				
Purchase of capital assets	(561)	(10,165)	(33,354)	(14,180)
Proceeds of disposal of capital assets	-	2,000	50	4,800
	<b>(561)</b>	<b>(8,165)</b>	<b>(33,304)</b>	<b>(9,380)</b>
Change in cash during the period	<b>27,160</b>	<b>129,067</b>	<b>(252,108)</b>	<b>(269,328)</b>
Cash and cash equivalents				
at beginning of the period	<b>5,829</b>	<b>583,403</b>	<b>285,097</b>	<b>981,798</b>
Cash and cash equivalents				
at end of the period	\$ <b>32,989</b>	\$ <b>712,470</b>	\$ <b>32,989</b>	\$ <b>712,470</b>
<b>Supplemental information</b>				
Interest paid	\$ <b>16,004</b>	\$ <b>18,255</b>	\$ <b>32,117</b>	\$ <b>32,980</b>

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**INTERIM CONSOLIDATED FINANCIAL STATEMENTS**  
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**1. CONTINUING OPERATIONS**

The company is incorporated under the Company Act of British Columbia and is primarily involved in the manufacture and distribution of a wide range of products created through environmentally advanced technology. The product lines include coating removal and wood restoration products.

The company has incurred significant losses over the past fiscal periods and has been reliant on sources of cash from other than operations. Such sources have included bank financing and issuances of equity. The ability of the company to continue as a going concern is dependent upon either achieving cash flow from operations or obtaining an injection of capital.

These interim consolidated financial statements have been prepared on the basis of accounting principles applicable to a going concern, which assume that the company will continue to operate in the foreseeable future and will be able to realize its assets and discharge its liabilities in the normal course of business. If the going concern assumption was not appropriate, then certain adjustments would be necessary to the carrying values of assets and liabilities, the reported costs and expenses and balance sheet classifications used.

Management believes that the actions already taken or planned will mitigate the conditions and events that raise doubts about the validity of the going concern assumption used in preparing these financial statements.

**2. BASIS OF PRESENTATION**

These interim consolidated financial statements should be read in conjunction with the financial statements for the company's most recently completed fiscal year ended December 31, 2002. They do not include all disclosures required in annual financial statements but rather are prepared in accordance with recommendations for interim financial statements in conformity with Canadian generally accepted accounting principles. They have been prepared using the same accounting policies and methods as those used in the December 31, 2002 annual accounts. Certain of the comparative figures have been reclassified to conform with the current period's presentation.

The preparation of interim financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the revenues and expenses during the reporting period. Actual results could differ from those estimates.

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**2. BASIS OF PRESENTATION (continued)**

The company's business has historically been seasonal, with the lowest volumes of business experienced in the first and fourth quarters and the highest volumes in the second and third quarters.

**3. SALE OF ACCOUNTS RECEIVABLE**

During the quarter the company entered into a revolving arrangement to sell eligible receivables to a major financial institution. Under the terms of the arrangement, the company has the option to sell 90% of insured foreign receivable for a flat fee of 1.5% to 2.0% plus interest at prime plus 1.5% until receivables are collected. The sale of receivables is without recourse except for unanticipated product returns.

**4. INVENTORY**

	<b>June 30</b>	December 31
	<b>2003</b>	2002
Raw materials	<b>\$ 597,008</b>	\$ 786,639
Finished goods	<b>1,168,424</b>	787,664
	<b><u>\$ 1,765,432</u></b>	<u>\$ 1,574,303</u>

**5. INVESTMENT**

	<b>June 30</b>	December 31
	<b>2003</b>	2002
Investment in Ecoprogress, beginning of period	<b>\$ 111,585</b>	\$ 225,545
Equity share of losses	<b>(54,000)</b>	(150,110)
Gain on dilution of equity interest	-	36,150
Investment in Ecoprogress, end of period	<b><u>57,585</u></b>	<u>111,585</u>
Investment in Radical Elastomers Inc., at written down cost	<b>50,000</b>	50,000
Total investments at end of the period	<b><u>\$ 107,585</u></b>	<u>\$ 161,585</u>

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**6. CAPITAL ASSETS**

	<b>June 30 2003</b>		December 31 2002	
	<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Net Book Value</b>	Net Book Value
Machinery and equipment	\$ 918,449	\$ 564,475	\$ 353,974	\$ 378,365
Furniture and fixtures	210,693	68,445	142,248	153,496
Leasehold improvements	277,544	70,166	207,378	222,656
	<b>\$ 1,406,686</b>	<b>\$ 703,086</b>	<b>\$ 703,600</b>	<b>\$ 754,517</b>

**7. BANK INDEBTEDNESS**

During the quarter the company's operating loan facility was repaid and replaced by a revolving accounts receivable sale arrangement (see Note 3).

**8. LONG TERM DEBT**

	<b>June 30 2003</b>	December 31 2002
Capital lease obligations repayable in aggregate monthly instalments of \$7,117 including interest averaging 11.19% per annum due until January, 2005.	\$ 149,775	\$ 194,346
Less current portion	<b>67,619</b>	80,033
	<b>\$ 82,156</b>	<b>\$ 114,313</b>

Principal repayments required are as follows: 2003 - \$35,462; 2004 - \$70,000; 2005 - \$44,313.

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**9. CONVERTIBLE DEBENTURE**

During the quarter the company issued convertible debentures in the amount of \$500,000. The debentures are unsecured and bear interest, payable semi-annually, at 8% per annum and are subordinate to all financing arrangements with commercial lenders. The debentures are convertible, at the holder's option, into securities of the Company until their maturity date, June 12, 2008, at a conversion price of \$0.25 per share. If converted prior to June 12, 2005 the holder also receives one-half share purchase warrant exercisable at \$0.40 during the first year following conversion and \$0.50 during the second year. No warrants are issued if conversion occurs subsequent to June 12, 2005.

Commencing June 12, 2004 the debentures automatically convert if over a 30 day period the company's average closing stock price exceeds \$.33 per share.

The principal amount of \$500,000 has been apportioned to its liability and equity components, using the residual value method based on discounted future cash flows at a rate of 20% per annum at the date of issuance as follows: \$326,300 to long-term debt and \$173,700 to equity. The \$326,300 will be accreted to its face value of \$500,000 through the recording of additional interest expense over the term of the debenture.

**10. CAPITAL STOCK**

a) Authorized  
 145,635,962 common shares

b) Issued

	<b>Number of shares</b>	<b>\$</b>
	<hr/>	<hr/>
Balance, December 31, 2002	47,628,042	23,335,041
Issued	40,000	8,000
Balance, June 30, 2003	<hr/> 47,668,042	<hr/> \$ 23,343,041

During the quarter the company issued 40,000 common shares as payment for a finders fee related to the convertible debenture (see Note 9). The value of common shares issued is based on their market value on date of issue.

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**10. CAPITAL STOCK** (continued)

c) Stock options and warrants

Under the terms of the company's incentive stock option plan, options are granted upon approval by the Board of Directors and the exercise price of each option is determined by reference to the market price of the company's stock. Options are normally exercisable within 10 years from the date of grant or a lesser period as determined by the Board and within 30 days of termination of employment. Options generally vest upon grant date, however the Board reserves the right to attach vesting periods to stock options granted.

	Stock options		Warrants
	Number	Weighted average price	
Outstanding at December 31, 2002	3,639,000	0.90	2,917,120
Granted/issued	115,000	0.28	20,000
Exercised	-	-	-
Cancelled/expired	(695,000)	2.17	-
End of the period	3,059,000	0.57	2,937,120
Exercisable, end of the period	2,909,000	0.60	2,937,120
Weighted average fair value of options granted during the period	\$	0.40	

At June 30, 2003, 2,597,120 warrants are exercisable at \$0.41 per share and expire September 11, 2003; 320,000 warrants are exercisable at \$2.40 per share and expire September 11, 2003; and 20,000 warrants are exercisable at \$0.40 per share until June 12, 2004 and then \$0.50 per share until June 12, 2005.

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**10. CAPITAL STOCK** (continued)

The following table summarizes information about stock options outstanding at June 30, 2003:

Range of exercise prices	Number of options	Weighted average remaining contractual life	Weighted average exercise price
Vested			
\$.17 - \$.28	1,470,000	4.0 years	\$ 0.20
\$.40	200,000	3.8 years	\$ 0.40
\$.85 - \$1.15	1,139,000	1.8 years	\$ 1.00
\$2.18	100,000	6.9 years	\$ 2.18
	2,909,000	3.3 years	\$ 0.60
Non-vested			
\$.28	150,000	4.4 years	\$ 0.28
	3,059,000	3.4 years	\$ 0.57

d) Pro forma stock-based compensation

During the quarter the company issued 115,000 stock options to employees. The company discloses the pro forma effect as if the fair value method of accounting had been used for stock options granted to employees. The estimated fair value of these options has been calculated using the Black Scholes model; stock price volatility of 82%, no dividend yield, and a 3% risk free interest rate over the expected option life of 5 years.

	Quarter ended June 30, 2003	6 months ended June 30, 2003
Net income (loss), as reported	\$ 10,650	\$ (367,592)
Net loss, pro forma	\$ (2,648)	\$ (380,890)
Earnings (loss) per share, as reported	\$ -	\$ (0.01)
Earnings (loss) per share, pro forma	\$ -	\$ (0.01)

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**11. SEGMENTED INFORMATION**

The company operates in one industry segment, which is the manufacture and distribution of coatings removal products and wood restoration products in Canada and internationally. Within this general industry segment the company distributes to both retail and industrial sectors. Sales of the company's Biowash products are distributed through retail outlets and the company's SARA/RemovAll products are predominantly distributed via industrial/commercial relationships. All of the company's capital assets are located in Canada.

	<b>Quarter ended June 30</b>		<b>Six months ended June 30</b>	
	<b>2003</b>	<b>2002</b>	<b>2003</b>	<b>2002</b>
Sales by region				
Canadian	\$ <b>1,075,000</b>	\$ 1,071,000	\$ <b>1,671,000</b>	\$ 1,700,000
International	<b>1,492,000</b>	2,188,000	<b>2,423,000</b>	3,510,000
Total sales	<b>\$ 2,567,000</b>	\$ 3,259,000	<b>\$ 4,094,000</b>	\$ 5,210,000
Sales by product line				
Biowash	\$ <b>1,500,000</b>	\$ 1,886,000	\$ <b>2,385,000</b>	\$ 2,762,000
Sara/RemovAll	<b>1,067,000</b>	1,373,000	<b>1,709,000</b>	2,448,000
	<b>\$ 2,567,000</b>	\$ 3,259,000	<b>\$ 4,094,000</b>	\$ 5,210,000

**12. COMMITMENTS AND CONTINGENCY**

The company leases its premises and certain office equipment under operating leases. The aggregate minimum rental payments under these leases over the next five years are approximately 2003 - \$173,000; 2004 - \$314,000; 2005 - \$340,000; 2006 - \$342,000, 2007- \$204,000.

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**NAPIER ENVIRONMENTAL TECHNOLOGIES INC.**

**INTERIM CONSOLIDATED SCHEDULES**  
**(UNAUDITED - Prepared by Management)**

**SELLING AND MARKETING EXPENSES**

	Three month period ended June 30		Six month period ended June 30	
	2003	2002	2003	2002
Advertising	\$ 67,298	\$ 31,776	\$ 106,621	\$ 66,272
Commissions	71,718	114,479	130,873	184,695
Consulting and other	35,336	7,084	79,663	10,187
Retail service fees	56,791	44,483	72,717	44,483
Promotional materials	46,064	138,646	85,762	207,751
Salaries and wages	289,022	290,039	551,117	594,522
Telecommunications	15,357	17,827	28,279	31,095
Travel, training and tradeshows	99,828	129,563	205,434	253,865
	<b>\$ 681,414</b>	<b>\$ 773,897</b>	<b>\$ 1,260,466</b>	<b>\$ 1,392,870</b>

**GENERAL AND ADMINISTRATIVE EXPENSES**

	Three month period ended June 30		Six month period ended June 30	
	2003	2002	2003	2002
Amortization	\$ 26,577	\$ 26,454	\$ 53,354	\$ 52,757
Consulting	11,613	1,830	13,490	3,775
Insurance	51,544	49,149	102,186	93,680
Financing costs	33,052	23,385	58,556	43,628
Occupancy	28,277	27,964	59,322	51,106
Office	14,370	19,762	26,852	29,562
Professional fees	31,790	62,373	50,316	121,092
Regulatory and filing fees	10,038	4,848	15,508	7,686
Salaries and wages	142,210	178,311	315,256	353,067
Telecommunications	6,871	7,036	13,753	13,600
Travel and corporate relations	28,736	47,751	34,732	55,711
	<b>\$ 385,078</b>	<b>\$ 448,863</b>	<b>\$ 743,325</b>	<b>\$ 825,664</b>

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