

**NAPIER ENVIRONMENTAL  
TECHNOLOGIES INC.**

**CONSOLIDATED  
INTERIM FINANCIAL STATEMENTS**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**SEPTEMBER 30, 2004**

**THIRD QUARTER 2004  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2004**

Napier Environmental Technologies Inc. manufactures and distributes highly effective, safe and environmentally advantaged chemicals for stripping paints/coatings, surface preparation as well as a complete line of wood restoration and protection products. Products are cost effective, user friendly and safe to use. As important, and especially in today's world Napier products are formulated and designed to be environmentally benign. Napier distributes products both domestically and internationally through an extensive network of distribution channels in the "Industrial" as well as "Consumer" markets. The underlying intellectual property for the products is protected through patents, trademarks and trade secrets.

Management's Discussion and Analysis (MD&A) for the quarter ended September 30, 2004 has been prepared to give shareholders and other stakeholders an assessment of what the company achieved in the quarter as well as an indication of initiatives underway and planned for this year. The MD&A for the quarter ended September 30, 2004 should be read in conjunction with the interim consolidated financial statements of the company and notes thereto for the periods ending September 30, 2004 and September 30, 2003 and the audited consolidated financial statements and annual MD&A for the fiscal year ended December 31, 2003.

**Notice of Intention to Make a Proposal to Creditors**

On November 3rd, 2004, the company filed a Notice Of Intention to Make a Proposal to its Creditors under the Bankruptcy and Insolvency Act (the "BIA"). Many of our customers are industry leaders and have experience in dealing with companies under creditor protection. New orders continue to be received and we anticipate this to continue based on the quality of our products. Several suppliers have agreed to continue working with Napier on new terms. We do not expect any business interruption to be caused by lack of raw materials.

The Notice of Intention filing allows Napier to maintain operations while completing necessary changes to improve its business and develop a restructuring proposal for creditors. During this period Campbell Saunders Ltd., an experienced Trustee, will monitor the activities of the company and assist it in formulating a proposal to its creditors. The following are key steps in the process:

- Pursuant to the regulations of the BIA, the Trustee provided a copy of the Notice of Intention to every supplier on November 8, 2004.
- By November 15, 2004 the company must provide the Trustee with a cash flow statement
- By December 3, 2004 the company must file a proposal to its creditors subject to extension periods that may be granted.
- By December 24, 2004, a meeting with creditors must be set up subject to extensions
- If the creditors approve the proposal, the court will approve the plan usually within a couple of weeks.

During the proposal period, the Trustee will report from time to time on the company's cash flow and other developments during the proceedings.

The filing allows the company to continue its operations, while proceedings against the company including steps to collect indebtedness incurred by the company prior to the filing date and actions to exercise control over its property are stayed. During this time, the company has the authority to pay outstanding and future employee obligations, the cost of goods and services including rent after the filing date and principal and interest on secured debt.

The filing process facilitates an orderly evaluation of alternatives to strengthen the company's business model and capital structure. During the proceedings, the company will seek input from its creditors and other stakeholders with a view to develop a comprehensive restructuring plan to

return the company to viability. There can be no assurance that the company will successfully emerge from its reorganization proceedings. Approval of a Plan and emergence from reorganization proceedings are subject to a number of conditions.

## **Results of Operations for the Quarter Ended September 30, 2004**

### *Sales*

Third quarter sales of \$1.7 million were \$0.1 million or 7.5% lower than the same quarter last year. Although sales to one major customer in the US more than doubled or increased \$0.2 million, the following offset this increase:

- (\$0.1) million – Lower US industrial sales to a major US customer
- (\$0.2) million – Lower Biowash consumer sales due to adverse weather in the East and loss of a major wood restoration customer

Geographically, sales in the US declined by 21%, export sales rose 80% and domestic sales remained the same in comparison to last year. Consumer and industrial sales were evenly split which is consistent with last year.

Sales to a major international coatings manufacturer, who was our first customer to private label our products and was engaged in an internal reorganization last year, have returned to normal levels and in fact, more than doubled in the quarter. Unfortunately this sales increase was partially offset by lower sales to another major customer due to timing. This customer stocked their warehouses earlier in the year and subsequent replenishment has not been necessary.

Export industrial sales improved in the third quarter due to timing of significant projects in the United Kingdom.

Biowash consumer sales, primarily coatings and wood restoration products, are down due primarily to the loss of a major customer which purchased a line of wood restoration products to market under their own label. In addition reduced demand for deck products has again resulted from wet weather in most of Canada.

### *Gross Profit*

Gross margins at 26% were 6 percentage points lower than the third quarter of last year. The margin decrease relates primarily to a \$151,000 provision to write down obsolete inventory. Gross profit at \$0.4 million was \$0.2million lower than last year due to this provision.

### *Selling, Marketing and Research Expenses*

Selling, Marketing and Research expenses at \$0.6 million were \$0.1 million less than last year. The reduction in expenses relate to direct selling cost for salaries and travel.

### *General and Administration Expenses*

General and administration expenses at \$0.4 million, which is about \$50,000 higher than last year due to costs related to the review of strategic and financing alternatives and restructuring.

#### *Other*

Interest expense for the second quarter was \$90,181 compared to \$28,230 for the same period of 2003. Interest expense relates to the new financing arrangements.

#### *Net Loss*

The company's net loss for the quarter, including non-cash items, at \$0.7 million was \$0.1 million higher than last year due to lower gross profit.

### **Results of Operations for the Nine Months Ended September 30, 2004**

#### *Sales*

Sales for the first nine months of the year at \$5.9 million were unchanged from last year. Sales from new business and expanded business from existing customers increased sales by \$0.9 million or 16% over last year. The following offset this success:

- (\$0.5) million – Lower Biowash consumer sales
- (\$0.3) million – Foreign exchange impact of weaker Canadian dollar on foreign sales
- (\$0.1) million – Sales lost due to product line sale in the first quarter

New and expanded business resulted in an 8% increase in US and export sales. Canadian sales were down by 15% for the year to date due primarily to lower consumer Biowash sales, which reduced to 55% of total sales from 56% for the same period last year. Industrial sales increased to 46% from 45% of total sales last year.

In the first nine months, sales gains realized through growth on the industrial side of the business have been offset by lower sales for wood restoration and coatings.

#### *Gross Profit*

Gross margins for the first nine months were 37% or 4 percentage points lower than the same period last year. The majority of the decrease is due to lower margins on wood restoration and coatings product lines and the provision to write down obsolete inventory. Gross profit at \$2.2 million is \$0.2 million less than last year.

#### *Selling, Marketing and Research Expenses*

Selling, Marketing and Research expenses at \$2.0 million were \$0.1 million less than 2003 due to a reduced level of in house sales staff.

#### *General and Administration Expenses*

General and administration expenses at \$1.2 million were \$0.1 million greater than 2003. Spending exceeded 2003 for restructuring consulting fees and expenses related to strategic initiatives and the refinancing.

#### *Other*

Interest expense for the second quarter was \$248,815 compared to \$60,349 for the same period of 2003. Interest expense relates to the new financing arrangements.

## Net Loss

The company's net loss for the year to date, including non-cash items, was \$1.1 million, which is the \$0.1 million higher than last year. The loss from operations increased by \$0.2 million from 2003 due to lower sales margins. Gains on the sale of an investment and capital assets partially offset the increased operating loss.

## Quarterly Information

Consolidated Quarterly Financial Results (unaudited) (\$ millions unless otherwise indicated)

	2004			2003			
	Q1	Q2	Q3	Q1	Q2	Q3	Q4
Sales	1.6	2.6	1.7	1.5	2.6	1.8	1.1
Operating income (loss)	(0.5)	(0.1)	(0.6)	(0.3)	0.1	(0.6)	(0.8)
Net income (loss) for the period	(0.3)	(0.1)	(0.7)	(0.4)	0.0	(0.6)	(0.9)
Earnings (loss) per share, basic and fully diluted - \$	(0.01)	0.00	(0.01)	(0.01)	0.00	(0.01)	(0.02)

## Critical Accounting Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount 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. These estimates and assumptions are developed based on the best available information and are believed by management to be reasonable under the existing circumstances. New events or additional information may result in the revision of these estimates over time. The company's significant accounting policies are described in Note 2 of the interim financial statements. The following discussion outlines what management believes to be the most critical accounting policies involving the use of significant estimates or assumptions.

### *Accounts Receivable, Allowance for doubtful accounts and product returns.*

The allowance for doubtful accounts is estimated based on historical trends. The company regularly reviews the age of accounts receivable in detail by customer and follows up delinquent accounts directly with the customer. Based on discussions with the customer, independent credit rating reports and past collection history, the company will estimate an appropriate allowance for doubtful accounts. A significant portion of sales is to a number of large customers with higher quality credit. This subjects the company to a greater exposure from any one particular customer. If the estimate of the allowance is understated, this could result in a charge to earnings in the future, should the account ultimately be not collectible. Over the past two years, accounts written off as a percent of sales were less than 0.5% in 2003 and 1.8% in 2002. The allowance for doubtful accounts at the end of the quarter is 1.1%.

The provision for product returns is estimated based on historic experience for particular products and customers taking into account among other things, obsolescence, age and demand. Over the past two years, product returns have represented about 0.5% of sales. The products return provision at the end of the quarter is 0.7% of sales. This increase in estimate at the end of the quarter takes into account new accounting recommendations described in accounting policy changes below. If the estimate for product returns is understated, this could result in a charge to future earnings should the actual experience for returns be greater than estimated.

#### *Property, Plant and Equipment/Depreciation and Amortization*

The estimated useful lives of assets are determined based on historical experience for comparable assets, technological obsolescence and asset utilization. If the company's estimated useful lives of assets were incorrect, the company could experience increased or decreased charges to depreciation and amortization in the future.

#### *Income taxes*

The company follows the liability method of accounting for income taxes whereby future income taxes are recognized based on the differences between the carrying amounts of assets and liabilities reported in the financial statements and their respective tax bases. Future income tax assets are comprised of temporary differences between the carrying amount and the tax basis of assets and liabilities as well as tax losses carried forward. In valuing the future income tax assets, consideration is given to the timing of reversal of the temporary differences, the tax rate enacted for the reversal period and the results of future operations. The value of future tax assets is based on the likelihood of realization of future taxable income against which the tax losses can be applied. Based on our loss history we do not have at this time, reasonable assurance of sufficient taxable income and a valuation allowance has been made equal to the full value of the future income tax assets.

The determination of the income tax assets and liabilities is an inherently complex process requiring management to interpret continually changing regulations and to make certain judgements. While income tax filings are subject to audits and reassessments, management believes the tax assets have been adequately provided. However, changes in the interpretations or judgements may result in increase or decrease in the Company's future income tax asset in the future.

#### **Accounting policy change**

##### Revenue Recognition

The company follows the new accounting recommendations for revenue recognition. Under the new guidelines reasonable assurance regarding the measurement of the consideration for the sale of goods must exist. This measurement is to take into account the extent to which goods may be returned or sales may be cancelled. If a contract is cancellable, the sales price can only be determined and therefore revenue can be recognized at the time the cancellation expires. If the sales transaction allows product to be returned then there is not reasonable assurance that the sales consideration is fixed and therefore the revenue should not be recorded. At the time of the sale, management is therefore required to provide an estimate for the value of future returns. The company has recorded an allowance for product returns as outlined above.

#### **Liquidity and Capital Resources**

As of September 30, 2004, the company's working capital included cash and cash equivalents of approximately \$0.1 million and the current ratio was negative at 0.8:1. The company does not have sufficient working capital to meet its obligations as they become due.

At the end of September, the company had advances and loans on a secured basis totalling \$1.0 million through its financing arrangement with an asset based lender. Default on a number of covenants pursuant to these arrangements was avoided when the secured lender provided a waiver for a forbearance period up to January 14, 2005.

On November 3, 2004, the company filed a Notice of Intention to Make a Proposal to its creditors. The Notice of Intention filing allows Napier to maintain operations while completing necessary changes to improve its business and develop a restructuring proposal for creditors. The asset based secured lender has agreed to continue to provide advances under the financing facilities, while the company completes its restructuring. Additional financing or investment may be required during the proposal period to ensure that the company can complete the restructuring process. The company is pursuing a number of financing and strategic alternatives in order to obtain the required financial resources.

### **Initiatives and Progress**

In the quarter, the company made a number of changes to improve profitability and reduce its selling and distribution costs. A new distribution agreement was signed with a third party logistics company that will distribute our products to a major Canadian mass retailer at a significantly reduced cost. Negotiations for 2005 pricing are underway with major customers. Further initiatives for the company will be determined based on the 100-day strategic review.

### **Management Outlook**

Napier's patented technology and trademarks are well recognized as leading wood restoration and surface preparation products. Over the past 18 months Napier has made substantial progress in developing new private label business with major coating suppliers. The company also developed a new generation of its highly successful patented SARA surface preparation technology for consumer markets.

Over the next 100 days the company will complete a strategic review to achieve a business model that delivers profitability at the existing level of sales. The business model going forward will focus on existing core technology, products and customers, and will entail a significant reduction in SG&A costs.

Management believes that the company is capable of moving forward with a solid plan that leverages the proven effectiveness of its products and the validation of some of the world's leading coating and home improvement companies. The will require the ongoing support of our customers, employees and suppliers to ensure we can restructure to the benefit of all stakeholders.

### **Governance and Management**

The company has engaged company director Wayne J. Henderson to lead the company on an interim basis as Chief Restructuring Officer. Mr. Henderson has been a member of the company's Board of Directors since July 2004 and is a corporate advisor. He has previously held executive positions in corporate and investment banking with a major Canadian financial institution. President and Chief Executive Officer Frank Dixon have resigned from the company and its Board of Directors. He will remain available to the company on a consulting basis during a transition period.

### **Risk Factors and Financial Management**

The company's ability to continue as a going concern is in substantially in doubt and dependent on its ability to restore and maintain profitable operations and successfully conclude its BIA

proceedings. There can be no assurance that the company will successfully emerge from its reorganization proceedings. Approval of a Plan and emergence from reorganization proceedings are subject to a number of conditions.

The restructuring plan will be submitted to creditors who will vote on the plan and if approved will be submitted to the court for approval. Should the plan not be approved by the creditor or the court, all debt obligations will then be due and payable immediately, or subject to acceleration, creating an immediate liquidity crisis which would in all likelihood lead to the liquidation of the company's assets.

To the extent that we are able, we have factored a stronger Canadian dollar into pricing for US customers. The company is exposed to foreign exchange risk to the extent we have not been successful in obtaining price increases for US customers. With our new factoring facility, advances for US and export sales are made in US dollars therefore eliminating the foreign exchange risk for amounts collected.

Other significant risks and uncertainties that face the company are common to other manufacturers operating in an international economy in the industrial and consumer sectors. The company must deal with business risks associated with product infringement, technological change, increased market penetration into established supply lines, locating and penetrating new markets, foreign currency fluctuations, unavailable raw materials, and economic conditions affecting large or potential customers and suppliers, to name a few of the normal but significant factors affecting the company's day to day business. To minimize some of these risks going forward, we continue to nurture our relationships with key customers and suppliers. Open, honest and straightforward communication has retained their loyalty and continued commitment to Napier. Management continually addresses the above business risks in a methodical and rational manner.

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; and 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.

This MD&A has been prepared by management and reviewed by the company's Board of Directors.

"Signed"

Lionel G. Dodd  
Chairman

November 12, 2004

# NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

## CONSOLIDATED BALANCE SHEETS (UNAUDITED - Prepared by Management)

	September 30 2004	December 31 2003
Current		
Cash and cash equivalents	\$ 77,222	\$ 96,217
Accounts receivable	1,210,102	342,178
Inventory (Note 4)	1,060,068	1,438,734
Prepaid expenses	203,954	157,120
	<b>2,551,347</b>	2,034,249
Investments (Note 5)	-	17,655
Capital assets (Note 6)	589,071	639,951
Deferred charges (Note 7)	41,501	51,549
	<b>\$ 3,181,918</b>	<b>\$ 2,743,404</b>

### LIABILITIES

Current		
Accounts payable	\$ 2,246,366	\$ 1,794,502
Loan Payable (Note 8)	714,318	-
Operating loan (Note 8)	247,381	-
Term loan (Note 8)	41,118	-
Deferred revenue (Note 9)	33,250	-
Current portion of long term debt	61,740	69,989
	<b>3,344,173</b>	1,864,491
Long term debt (Note 10)		44,979
Convertible debenture (Note 11)	337,731	337,440
	<b>3,681,904</b>	2,246,910

### SHAREHOLDERS' EQUITY

Capital stock (Note 12)	23,368,041	23,343,041
Convertible debenture (Note 11)	165,015	173,700
Contributed surplus (Note 12)	127,415	61,309
Deficit	(24,160,456)	(23,081,556)
	<b>(499,986)</b>	496,494
	<b>\$ 3,181,918</b>	<b>\$ 2,743,404</b>

Approved by the Directors

signed: Lionel Dodd

signed: Peter Jeffrey

**NAPIER ENVIRONMENTAL TECHNOLOGIES INC.**

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

	Three month period ended September 30		Nine month period ended September 30	
	2004	2003	2004	2003
Sales	\$ 1,673,352	\$ 1,808,940	\$ 5,860,463	\$ 5,902,680
Cost of sales	1,233,580	1,232,681	3,679,242	3,482,392
Gross profit	439,772	576,259	2,181,221	2,420,288
	26.3%	31.9%	37.2%	41.0%
Expenses				
Selling and marketing (Schedule)	580,904	703,762	1,879,567	1,964,228
General and administrative (Schedule)	381,168	333,534	1,160,682	1,044,742
Research and product development	54,111	62,293	169,939	173,073
	1,016,182	1,099,589	3,210,187	3,182,043
Operating loss before the undernoted	(576,411)	(523,330)	(1,028,967)	# (761,755)
Other items				
Interest expense	(90,181)	(28,230)	(248,815)	(60,349)
Equity loss in investment	-	(27,000)	(17,655)	(81,000)
Gain on sale of investment	-	-	60,000	-
Gain on disposal of capital assets	535	-	160,526	50
other income	(30,148)	400	(3,992)	(42,833)
	(119,794)	(54,830)	(49,936)	(184,132)
Net loss for the period	(696,204)	(578,160)	(1,078,902)	(945,885)
Deficit at beginning of the period	(23,464,252)	(21,649,254)	(23,081,554)	(21,281,529)
Deficit at end of the period	\$ (24,160,456)	\$ (22,227,414)	\$ (24,160,456)	\$ (22,227,414)
Weighted average shares outstanding	47,728,042	47,668,042	47,713,078	47,631,357
Loss per share, basic and fully diluted	\$ (0.01)	\$ (0.01)	\$ (0.02)	\$ (0.02)

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

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

	Three month period ended September 30		Nine month period ended September 30	
	2004	2003	2004	2003
<b>Operating activities</b>				
Net loss for the period	\$ (696,204)	\$ (578,160)	\$ (1,078,902)	\$ (945,885)
Items not involving cash	-	-	-	-
Depreciation and amortization	37,761	41,732	125,020	126,003
Accretion of convertible debenture	5,571	5,570	16,609	5,570
Stock based compensation	15,318	8,000	66,106	8,000
Equity loss in investment	-	27,000	17,655	81,000
Gain on sale of investment	-	-	(60,000)	-
Gain on disposal of capital assets	(535)	-	(160,526)	(50)
	<b>(638,089)</b>	<b>(495,858)</b>	<b>(1,074,038)</b>	<b>(725,362)</b>
<b>Change in non-cash operating working capital</b>				
Accounts receivable	910,046	763,591	(867,924)	(152,429)
Inventory	453,600	205,872	378,666	14,743
Prepaid expenses	(83,701)	(117,533)	(46,834)	(75,287)
Accounts payable	(112,179)	(358,843)	451,864	614,331
Deferred Revenue	-	-	33,250	-
	<b>1,167,765</b>	<b>493,087</b>	<b>(50,979)</b>	<b>401,358</b>
	<b>529,676</b>	<b>(2,771)</b>	<b>(1,125,017)</b>	<b>(324,004)</b>
<b>Financing activities</b>				
Bank indebtedness	-	-	-	(353,000)
Proceeds from loan payable	(409,155)	-	714,318	-
Proceeds on term loan	-	-	48,375	-
Convertible Debenture issued	-	-	-	500,000
Proceeds from operating loan, net	(75,797)	-	243,155	-
Repayment of long-term debt	(16,290)	(17,146)	(53,228)	(61,717)
	<b>(501,242)</b>	<b>(17,146)</b>	<b>952,620</b>	<b>85,283</b>
<b>Investing activities</b>				
Purchase of capital assets	(15,566)	(9,238)	(68,882)	(42,592)
Proceeds on disposal of capital assets	535	-	162,285	50
Proceeds on sale of investment	-	-	60,000	-
	<b>(15,031)</b>	<b>(9,238)</b>	<b>153,403</b>	<b>(42,542)</b>
Change in cash during the period	13,403	(29,155)	(18,994)	(281,263)
Cash and cash equivalents at beginning of the period	63,820	32,989	96,217	285,097
Cash and cash equivalents at end of the period	\$ 77,223	\$ 3,834	\$ 77,223	\$ 3,834
<b>Supplemental information</b>				
Interest paid	\$ 80,813	\$ 28,232	\$ 238,486	\$ 60,349

## **NAPIER ENVIRONMENTAL TECHNOLOGIES INC.**

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### **REVIEW OF INTERIM FINANCIAL STATEMENTS**

Under National Instrument 51-102, Part 4, subsection 4.3(3)(a), if an auditor has not performed a review of the interim financial statements, they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

The company's independent auditor has not performed a review of the figures in these financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for a review by an entity's auditor of interim financial statements prepared by management. The requirement for a review of interim financial statements is discretionary and it was determined that it was not required in light of the filing of a Notice of Intent to Make a Proposal to its Creditors.

# **NAPIER ENVIRONMENTAL TECHNOLOGIES INC.**

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2004 (UNAUDITED – Prepared by Management)**

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The company is incorporated under the Company Act of British Columbia. It manufactures and distributes highly effective, safe and environmentally advantaged chemicals for stripping paints/coatings, surface preparation as well as a complete line of wood restoration and protection products.

### **1. CREDITOR PROTECTION AND RESTRUCTURING**

Napier has experienced losses over many years in seeking to expand markets for the company's products. Weaker than anticipated sales conditions in the third quarter and a seasonal slowdown in the current quarter have further eroded the company's financial position, and it now has insufficient financial resources to meet all of its existing creditor obligations.

On November 3, 2004, the Company filed a Notice Of Intention to Make a Proposal to its Creditors under the Bankruptcy and Insolvency Act (the "BIA"). Campbell Saunders is appointed as trustee in the filing. The following are the key steps in the process:

- Pursuant to the regulations of the BIA, the trustee provided a copy of the Notice of Intention to every supplier on November 8, 2004.
- By November 15, 2004 the company must provide the trustee with a cash flow statement
- By December 3, 2004 the company must file a proposal to its creditors subject to extension periods that may be granted.
- By December 24, 2004, a meeting with creditors must be set up subject to extensions that may be granted.
- If the creditors approve the proposal, the court will approve the plan usually within a couple of weeks.

During this period, the trustee will monitor the operations of the company and report from time to time on the company's cash flow and other developments during the proceedings. The filing allows the company to continue its operations, while proceedings against the company including steps to collect indebtedness incurred by the company prior to the filing date and actions to exercise control over its property are stayed. During this time, the company has the authority to pay outstanding and future employee obligations, the cost of goods and services including rent after the filing date and principal and interest on secured debt.

The filing process facilitates an orderly evaluation of alternatives to strengthen the company's business model and capital structure. During the proceedings, the company will seek input from its creditors and other stakeholders with a view to develop a comprehensive

# **NAPIER ENVIRONMENTAL TECHNOLOGIES INC.**

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2004 (UNAUDITED – Prepared by Management)**

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### **1. CREDITOR PROTECTION AND RESTRUCTURING (CONTINUED)**

restructuring plan to return the company to viability. The restructuring plan will be submitted to creditors who will vote on the plan and if approved will be submitted to the court for approval. Should the plan not be approved by the creditors or the court, all debt obligations will then be due and payable immediately, or subject to acceleration, creating an immediate liquidity crisis which would in all likelihood lead to the liquidation of the company's assets.

### **2. GOING CONCERN**

There can be no assurance that the company will successfully emerge from its BIA proceedings. Approval of a plan and emergence from reorganization proceedings are subject to a number of conditions.

Default of a covenant, pursuant to the company's current financing arrangements, which would have resulted from the BIA proceedings, was avoided when the company entered into a forbearance agreement with its secured lender (See Note 8).

The accompanying consolidated financial statements have been prepared on a going concern basis, which assumes that the company will be able to realize its assets and discharge its obligations in the normal course of business. There is doubt about the appropriateness of the use of the going concern assumption because of the BIA proceedings and circumstances relating to this event, including the company's current debt structure, recent losses and cash flow. As such realization of assets and discharge of liabilities are subject to significant uncertainty.

The consolidated financial statements do not reflect adjustments that would be necessary if the going concern basis was not appropriate. If the going concern basis was not appropriate for these consolidated financial statements, then significant adjustments would be necessary in the carrying value of the assets and liabilities, the reported revenues and expenses, and the balance sheet classifications used. The appropriateness of the going concern basis is dependent upon, among other things, confirmation of a plan of reorganization, future profitable operations and the ability to generate sufficient cash from operations and financing arrangements to meet obligations.

If a plan is confirmed by the Court, and if the plan results in a substantial realignment of the non-equity or equity interests, then the company will be required to adopt fresh start accounting and report in accordance with Canadian GAAP. This accounting will require that the assets and liabilities be recorded at their fair value at the date of the emergence from the company's BIA proceedings. As a result, the reported amounts in the

# NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2004 (UNAUDITED – Prepared by Management)

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### 2. GOING CONCERN (CONTINUED)

consolidated financial statements could materially change, because they do not give effect to the adjustments to the carrying value of the assets and liabilities that may ultimately result from the adoption of fresh start accounting.

### 3. 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, 2003. 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, 2003 annual accounts. Certain of the comparative figures have been reclassified to conform to 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.

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. There is no reason to expect a change in this pattern during the current year.

### 4. INVENTORY

Inventory is comprised of:

	<b>September 30 2004</b>	<b>December 31 2003</b>
Raw materials	<b>\$ 496,923</b>	<b>\$ 592,295</b>
Finished goods	<b>563,145</b>	846,439
	<b><u>\$ 1,060,068</u></b>	<b><u>\$ 1,438,734</u></b>

In the current quarter, the company wrote down the value of obsolete finished goods and raw materials inventory by \$151,000.

# NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2004 (UNAUDITED – Prepared by Management)

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### 5. INVESTMENTS

	<b>September 30 2004</b>	<b>December 31 2003</b>
Investment in Ecoprogress, beginning of the period	\$ -	\$ 111,585
Equity share of losses	-	(93,930)
Sale of Ecoprogress	-	-
Investment in Ecoprogress, end of the period	<u>\$ -</u>	<u>\$ 17,655</u>

On March 31, 2004, the company sold 100% of its investment in Consolidated Ecoprogress Technology Inc. (“Ecoprogress”) for proceeds of \$60,000.

In 2003 the investment in Radical Elastomers Inc. was written off and in January of 2004, Radical Elastomers Inc, filed for bankruptcy.

### 6. CAPITAL ASSETS

	<b>September 30 2004</b>			<b>December 31 2003</b>
	<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Net Book Value</b>	<b>Net Book Value</b>
Machinery and equipment	\$ 999,445	\$ 690,518	\$ 308,927	\$317,769
Furniture and fixtures	211,300	100,340	110,960	130,082
Leasehold improvements	277,544	108,360	169,184	192,100
	<u>\$ 1,488,289</u>	<u>\$ 899,218</u>	<u>\$ 589,071</u>	<u>\$ 639,951</u>

# NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2004 (UNAUDITED – Prepared by Management)

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### 7. DEFERRED CHARGES

The deferred charges represent fees related to the debenture financing. These costs are being amortized over the life of the convertible debenture.

	September 30 2004		December 31 2003	
	Cost	Accumulated Amortization	Net Book Value	Net Book Value
Deferred Financing charges	\$ 58,000	\$ (16,499)	\$ 41,501	\$51,549

### 8. LOAN PAYABLE, OPERATING AND TERM LOANS

	September 30 2004	December 31 2003
Loan Payable	\$ 714,318	\$ -
Operating loan	247,381	\$ -
Term loan	41,118	-
	<u>\$ 1,002,817</u>	<u>\$ -</u>

On January 29, 2004 the company entered into a factoring agreement under which 75% of invoices from approved customers are advanced to the company. Advances are made on a recourse basis, at a minimum discount rate on the gross invoice of 0.9% or 0.06% per day that the amount is outstanding. Either party can terminate this agreement on 30 days notice. As of September 30, 2004, the loan payable under this factoring facility was \$714,318 for advances received against about \$1.0 million in invoice value.

The operating loan is authorized up to \$1.0 million, repayable on demand and secured by eligible inventory. Funding is based on 75% of the net orderly liquidation value and interest is payable on a monthly basis at a rate of 2% per month.

# NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2004 (UNAUDITED – Prepared by Management)

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### 8. LOAN PAYABLE, OPERATING AND TERM LOANS (CONTINUED)

The term loan of \$41,118 is repayable at \$1,209 per month plus interest at 2% per month and secured by capital assets. The term loan is repayable by January 31, 2005. Principal payments commenced in April 2004.

Default on a financial covenant was avoided by entering into a forbearance agreement with its secured lender. This forbearance agreement expires on January 14, 2005.

### 9. DEFERRED REVENUE

On March 30, 2004, the Company sold a formula for a non-strategic product for proceeds of \$166,250 and a 5% royalty based on sales over the next 5 years. The company received a \$33,250 initial payment on this royalty that will be recognized as revenue when the royalty is earned.

### 10. LONG TERM DEBT

	<u>September 30</u> <u>2004</u>	<u>December 31</u> <u>2003</u>
Capital lease obligations repayable in aggregate monthly instalments of \$6,530 including interest averaging 10.68% per annum due until August, 2005.	\$ 61,740	\$ 114,968
Less: current portion	<u>61,740</u>	<u>69,989</u>
	<u>\$ -</u>	<u>\$ 44,979</u>

Principal repayments required are as follows: 2004 - \$16,761; 2005 - \$44,979.

### 11. CONVERTIBLE DEBENTURE

On February 11, 2004 the company issued 100,000 common shares and 50,000 warrants on the conversion of \$25,000 of the convertible debenture. On conversion the equity component was reduced by \$8,685 and the liability component was reduced by \$16,315.

During the quarter, the liability component was accreted by \$ 5,571.

# NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2004 (UNAUDITED – Prepared by Management)

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### 12. CAPITAL STOCK

- a) Authorized  
145,635,962 common shares
- b) Issued

	<u>Number of shares</u>	<u>\$</u>
Balance, December 31, 2003	47,668,042	23,343,041
Issued on conversion of debentures	100,000	25,000
Balance, September 30, 2004	<u>47,768,042</u>	<u>23,368,041</u>

During the first quarter, the company issued 100,000 common shares on conversion of \$25,000 of the convertible debentures (Note 11).

- c) Stock options

Under the terms of the company's incentive stock option plan, options are granted to employees and directors 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.

# NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2004 (UNAUDITED – Prepared by Management)

### 12. CAPITAL STOCK (CONTINUED)

#### c) Stock options (continued)

	<b>Number</b>	<b>Weighted average price</b>
Outstanding, December 31, 2003	2,735,000	\$0.49
Granted	971,000	0.13
Cancelled/expired	(1,345,000)	0.42
September 30, 2004	<u>2,361,000</u>	<u>0.38</u>
Exercisable, at September 30, 2004	<u>1,902,667</u>	<u>\$0.41</u>
Options reserved for issuance under stock option plan	<u>2,259,000</u>	

The following table summarizes information about stock options outstanding at September 30, 2004:

Range of exercise prices	Number of options	Weighted average remaining contractual life	Weighted average exercise price
Vested			
\$ .12 - \$ .28	1,706,667	4.0 years	\$0.19
\$ .40	95,000	2.5 years	\$0.40
\$ .85 - \$ 1.15	276,000	1.0 years	\$1.10
\$ 2.18	100,000	5.6 years	\$2.18
	<u>2,177,667</u>	<u>3.4 years</u>	<u>\$0.41</u>
Non-vested			
\$ .12 - \$ .28	183,333	4.6 years	\$0.12
	<u>2,361,000</u>	<u>3.5 years</u>	<u>\$0.38</u>

# NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2004 (UNAUDITED – Prepared by Management)

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### 12. CAPITAL STOCK (CONTINUED)

#### d) Stock-based compensation

The company uses the fair value based method of accounting for stock-based compensation. During the first nine months, the company issued 971,000 options with a fair value of \$80,488. The company recognizes compensation expense over the vesting period of the options and has recorded \$67,818 in the first 9 months with the balance to be recognized over the average remaining 12 months.

The Black Scholes option-pricing model assumptions used to compute the fair value of options granted in the third quarter are as follows:

Dividend yield	0%
Expected volatility	75%
Expected life	5 yrs
Risk free rate of return	3.5%
Weighted average fair value of options granted	<u>\$ 0.05</u>

Prior to January 1, 2003 the company accounted for employee stock options using the intrinsic value based method and is required to disclose pro forma net loss and loss per share as if the fair value based method had been used. Pro forma compensation expense for 2004 and 2003 relate to 300,000 stock options issued during 2002 that vest over a two-year period and were recorded using the intrinsic value based method.

	<u>Quarter ended</u> <u>30-Sep-04</u>	<u>Nine months ended</u> <u>30-Sep-04</u>
Net loss, as reported	\$ (696,205)	\$ (1,078,903)
Additional compensation expense		(14,437)
Net loss, pro forma	<u>\$ (696,205)</u>	<u>\$ (1,064,466)</u>
Loss per share, as reported	\$ (0.01)	\$ (0.02)
Loss per share, pro forma	<u>\$ (0.01)</u>	<u>\$ (0.02)</u>

# NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2004 (UNAUDITED – Prepared by Management)

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### 12. CAPITAL STOCK (CONTINUED)

#### e) Warrants

During the first quarter, the company issued 50,000 warrants on conversion of \$25,000 of convertible debentures (Note 11).

Outstanding, December 31, 2003	<b>2,937,120</b>
Issued on conversion of debentures	<u>50,000</u>
Outstanding, September 30, 2004	<u><b>2,987,120</b></u>

At September 30, 2004, 2,597,120 warrants are exercisable at \$0.41 per share and expire September 11, 2005; 320,000 warrants are exercisable at \$2.40 per share and expire September 11, 2005; and 70,000 warrants are exercisable \$0.50 per share until June 12, 2005.

### 13. 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 or consumer and industrial sectors. All of the company's capital assets are located in Canada.

	Quarter ended September 30		Nine months ended September 30	
	2004	2003	2004	2003
Sales by region				
Canadian	<b>\$ 591,782</b>	\$ 596,885	<b>\$ 1,932,183</b>	\$ 2,268,087
International	<b>1,081,570</b>	1,212,055	<b>3,928,280</b>	3,634,593
Total Sales	<u><b>\$ 1,673,352</b></u>	<u>\$ 1,808,940</u>	<u><b>\$ 5,860,463</b></u>	<u>\$ 5,902,680</u>
Sales by sector				
Consumer	<b>\$ 859,329</b>	\$ 932,980	<b>\$ 3,221,848</b>	\$ 3,325,737
Industrial	<b>814,023</b>	875,960	<b>2,638,615</b>	2,576,943
	<u><b>\$ 1,673,352</b></u>	<u>\$ 1,808,940</u>	<u><b>\$ 5,860,463</b></u>	<u>\$ 5,902,680</u>

**NAPIER ENVIRONMENTAL TECHNOLOGIES INC.**

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

**SELLING AND MARKETING EXPENSES**

	<b>Three Month Period ended September 30</b>		<b>Nine Month Period ended September 30</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Salaries and wages	\$ 182,220	\$ 269,823	\$ 629,010	\$ 820,940
Travel and entertainment	80,243	99,828	329,805	358,519
Promotional materials, advertising and printing	70,961	113,362	260,102	251,101
Commissions	61,922	71,719	216,038	202,036
Communications and other	42,415	23,826	153,060	101,886
Retail service fee	84,056	56,791	148,242	133,797
Consulting	29,086	26,866	101,343	95,949
Bad debt expense	30,000	-	30,000	-
Stock option benefit	-	-	11,966	-
	<b>\$ 580,904</b>	<b>\$ 662,215</b>	<b>\$ 1,879,567</b>	<b>\$ 1,964,228</b>

**GENERAL AND ADMINISTRATIVE EXPENSES**

	<b>Three Month Period ended September 30</b>		<b>Nine Month Period ended September 30</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Salaries and wages	\$ 142,496	\$ 136,424	\$ 431,507	\$ 451,680
Insurance	55,153	54,140	168,336	159,815
Consulting and professional fees	40,750	30,353	181,256	94,159
Restructuring and financing fees	57,785	8,832	78,150	8,832
Travel and corporate relations	7,975	13,379	52,587	48,111
Office	13,244	27,306	51,903	77,108
Stock option benefit	14,673	-	48,824	-
Regulatory and filing fees	10,918	5,456	24,034	20,962
Occupancy	6,240	22,119	23,320	81,442
Telecommunications	5,292	9,111	17,274	22,864
Amortization	26,642	26,415	83,491	79,770
	<b>\$ 381,168</b>	<b>\$ 333,534</b>	<b>\$ 1,160,682</b>	<b>\$ 1,044,742</b>