

Consolidated Financial Statements of

**NAPIER ENVIRONMENTAL
TECHNOLOGIES INC.**

December 31, 2004

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AUDITORS' REPORT

The Shareholders,
Napier Environmental Technologies Inc.

We have audited the consolidated balance sheets of Napier Environmental Technologies Inc. as at December 31, 2004 and 2003 and the consolidated statements of operations and deficit and cash flows for the years ended December 31, 2004 and 2003. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2004 and 2003 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles. As required by the Company Act of British Columbia, we report that, in our opinion, these principles have been applied on a basis consistent with that of the preceding year.

“Deloitte & Touche LLP”

Chartered Accountants
Vancouver, British Columbia

August 16, 2005

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The accompanying consolidated financial statements of Napier Environmental Technologies Inc. are the responsibility of management and have been approved by the Board of Directors.

The financial statements have been prepared by management conforming to accounting principles generally accepted in Canada. These statements include some amounts that are based on best estimates and judgements. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly, in all material respects.

The company maintains a system of internal control, which provides management with reasonable assurance that assets are safeguarded and that reliable financial records are maintained.

The Board of Directors carries out its responsibility for the financial statements principally through its Audit Committee, consisting of a majority of outside directors. The Audit Committee meets periodically with management, as well as the external auditors, to review the financial statements and to satisfy itself that each party is properly discharging its responsibilities.

The external auditors, Deloitte & Touche LLP, have been appointed by the shareholders to render their opinion on the financial statements. The auditors have full and free access to the Audit Committee and their report is included herein.

signed: "Steve Balmer"
President

signed: "Anthony Traub"
Secretary

August 16, 2005

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

CONSOLIDATED BALANCE SHEETS

DECEMBER 31

| | 2004 | 2003 |
|---|---------------------|---------------------|
| ASSETS | | |
| Current | | |
| Cash | \$ 73,163 | \$ 96,217 |
| Accounts receivable (Note 3) | 362,710 | 342,178 |
| Inventory (Note 4) | 943,950 | 1,438,734 |
| Prepaid expenses | 14,141 | 157,120 |
| | 1,393,964 | 2,034,249 |
| Investments (Note 5) | - | 17,655 |
| Deferred charges | - | 51,549 |
| Capital assets (Note 6) | 550,625 | 639,951 |
| | \$ 1,944,589 | \$ 2,743,404 |
| LIABILITIES | | |
| Current | | |
| Accounts payable (Note 16) | \$ 3,348,703 | \$ 1,794,502 |
| Deferred revenue (Note 7) | 33,250 | - |
| Loans payable (Note 8) | 225,778 | - |
| Current portion of capital lease obligations (Note 9) | 50,619 | 69,989 |
| | 3,658,350 | 1,864,491 |
| Capital lease obligations (Note 9) | - | 44,979 |
| Convertible debenture (Note 10) | - | 337,440 |
| | 3,658,350 | 2,246,910 |
| DEFICIENCY IN ASSETS | | |
| Capital stock (Note 11) | 23,368,041 | 23,343,041 |
| Convertible debenture (Note 10) | 165,014 | 173,700 |
| Contributed surplus (Note 11) | 131,265 | 61,309 |
| Deficit | (25,378,081) | (23,081,556) |
| | (1,713,761) | 496,494 |
| | \$ 1,944,589 | \$ 2,743,404 |

Continuing Operations (Note 1)

Approved by the Directors

signed: "Anthony Traub"

signed: "Steve Balmer"

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.**CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT
YEAR ENDED DECEMBER 31**

| | 2004 | 2003 |
|--|-----------------|-----------------|
| Sales | \$ 6,674,512 | \$ 6,951,632 |
| Cost of sales | 4,301,023 | 4,217,033 |
| Gross profit | 2,373,489 | 2,734,599 |
| | 35.6% | 39.3% |
| Expenses | | |
| Selling and marketing (Schedule) | 2,234,557 | 2,485,875 |
| General and administrative (Schedule) | 2,345,094 | 1,628,332 |
| Research and product development | 227,854 | 223,560 |
| | 4,807,505 | 4,337,767 |
| Operating loss | (2,434,016) | (1,603,168) |
| Other items | | |
| Equity loss in investment | (17,655) | (93,930) |
| Foreign exchange loss | (65,917) | (62,585) |
| Loss on sale of capital assets | (1,259) | - |
| Gain on sale of intangible asset | 166,250 | - |
| Gain on sale (write down) of investments | 55,000 | (50,000) |
| Interest and other | 1,072 | 9,656 |
| | 137,491 | (196,859) |
| Net loss for the year | (2,296,525) | (1,800,027) |
| Deficit at beginning of the year | (23,081,556) | (21,281,529) |
| Deficit at end of the year | \$ (25,378,081) | \$ (23,081,556) |
| Weighted average shares outstanding | 47,754,343 | 47,649,850 |
| Loss per share, basic and fully diluted | \$ (0.05) | \$ (0.04) |

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

**CONSOLIDATED STATEMENTS OF CASH FLOWS
YEAR ENDED DECEMBER 31**

| | 2004 | 2003 |
|---|--------------------|--------------------|
| Operating activities | | |
| Net loss for the year | \$ (2,296,525) | \$ (1,800,027) |
| Items not involving cash | | |
| Amortization | 158,183 | 166,724 |
| Amortization of deferred charges | 51,549 | 9,947 |
| Accretion of convertible debenture | 153,874 | 11,140 |
| Stock based compensation | 69,956 | 21,419 |
| Equity loss in investment | 17,655 | 93,930 |
| (Gain on sale) of intangible asset | (166,250) | - |
| (Gain on sale) write down of investments | (55,000) | 50,000 |
| Loss (gain) on sale of capital assets | 1,259 | (50) |
| | (2,065,299) | (1,446,917) |
| Change in non-cash operating working capital | | |
| Accounts receivable | (20,532) | 274,988 |
| Inventory | 494,784 | 135,569 |
| Prepaid expenses | 142,979 | 35,959 |
| Accounts payable | 1,079,201 | 857,503 |
| Deferred revenue | 33,250 | - |
| | 1,729,682 | 1,304,019 |
| | (335,617) | (142,898) |
| Financing activities | | |
| Bank indebtedness | - | (353,000) |
| Loans payable, net | 225,778 | - |
| Convertible debenture issued net of fees | - | 439,227 |
| Repayment of capital lease obligations | (64,349) | (79,378) |
| | 161,429 | 6,849 |
| Investing activities | | |
| Purchase of capital assets | (70,670) | (52,881) |
| Proceeds on disposal of capital assets | 554 | 50 |
| Proceeds on sale of intangible asset | 166,250 | - |
| Proceeds on sale of investment | 55,000 | - |
| | 151,134 | (52,831) |
| Change in cash during the year | (23,054) | (188,880) |
| Cash at beginning of the year | 96,217 | 285,097 |
| Cash at end of the year | \$ 73,163 | \$ 96,217 |
| Supplemental information | | |
| Interest paid | \$ 322,747 | \$ 101,214 |

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

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.

While the consolidated financial statements of the company have been prepared on the basis of accounting principles applicable to a going concern, several adverse conditions and events cast substantial doubt upon the continued validity of this assumption.

On November 3, 2004 as the company was unable to meet its ongoing obligations it filed a Notice of Intention to File a Proposal subject to the Bankruptcy and Insolvency Act. This afforded the company a period of time, under Court protection, to deal with its unsecured debt obligations.

Subsequent to year end, the company successfully renegotiated its unsecured debt obligations (Note 16). While the reduction of its unsecured debt obligations and additional financing should assist the company in the future, the company's continued existence is dependent upon its ability to restore and maintain profitable operations and to receive continued support from its lenders.

If the going concern assumption were not appropriate for these consolidated financial statements, then adjustments would be necessary to the carrying values of assets and liabilities, the reported net loss and the balance sheet classifications used.

2. SIGNIFICANT ACCOUNTING POLICIES

a) Basis of presentation

These consolidated financial statements include the accounts of the company and its wholly owned subsidiary. Inter-company balances and transactions are eliminated on consolidation.

The preparation of 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.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

b) Inventory

Raw materials are valued at the lower of cost and replacement cost. Finished goods are valued at the lower of cost and net realizable value.

c) Investments

Investments over which the company exercises significant influence are accounted for using the equity method. Other long-term investments are recorded at the lower of cost and estimated net realizable value.

d) Capital assets and amortization

Capital assets are recorded at cost. Amortization is provided under the straight-line method at annual rates varying from 2 to 10 years.

e) Deferred charges

Deferred financing costs are being amortized over the original term of the convertible debenture.

f) Revenue recognition

Revenue is recognized when goods are shipped, significant risks and benefits of ownership are transferred, and collection is reasonably assured.

g) Income taxes

Income taxes are accounted for using the liability method whereby future income tax assets and liabilities are recognized for temporary differences between the tax and accounting bases of assets and liabilities as well as for the benefit of tax losses that are likely to be realized. Future income tax assets and liabilities are measured using enacted tax rates that are expected to be effective when recovered or settled. The net change in recorded future income tax assets and liabilities is recognized in income in the period in which the change occurs including any change in applicable future tax rates.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

h) Stock options

Effective January 1, 2003 the company adopted on a prospective basis the fair value based method of accounting for employee stock based compensation. The fair value based method requires the company to estimate compensation costs on the date options are granted, using an option- pricing model.

For employee stock options granted during 2002 the company has disclosed the pro-forma effect as if the fair value based method had been used (Note 11 (d)).

i) Foreign currency translation

The functional currency of the company's operations is the Canadian dollar. Transactions and account balances originally stated in currencies other than the Canadian dollar have been translated into Canadian dollars using the temporal method as follows:

- Revenue and expense items at the rate of exchange in effect on the dates they occur;
- Non-monetary assets and liabilities at historical exchange rates; and
- Monetary assets and liabilities at the exchange rate at the balance sheet dates.

Exchange gains and losses are included in the determination of income in the period in which they occur.

j) Loss per share

Loss per share is calculated based on the weighted average number of shares outstanding during the period. Potentially dilutive items are described in Note 11. Fully diluted loss per share is the same as basic loss per share as the exercise of options and warrants would reduce the loss per share.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

3. ACCOUNTS RECEIVABLE

In January 2004 the company replaced its revolving arrangement to sell eligible receivables to a major financial institution with a \$2.0 million Factoring Facility which provides for funds on a recourse basis, of 80% of the invoice value in exchange for a minimum fee of 0.9% or, 0.06% per day that the amount is outstanding. The Factoring Facility can be terminated on 30 days notice by either party. This facility contains standard covenant clauses for financial ratios, payment of priority payables, and financial reporting. At December 31, 2004, the company has factored \$216,000 of accounts receivable under the factoring facility.

At December 31, 2004, the company is not in compliance with the financial covenants on the factoring facility as described in Note 8.

4. INVENTORY

Inventory is comprised of:

| | <u>2004</u> | <u>2003</u> |
|----------------|-------------------|---------------------|
| Raw materials | \$ 485,687 | \$ 592,295 |
| Finished goods | 458,263 | 846,439 |
| | <u>\$ 943,950</u> | <u>\$ 1,438,734</u> |

5. INVESTMENTS

| | <u>2004</u> | <u>2003</u> |
|--|-------------|------------------|
| Investment in Ecoprogress, beginning of the year | \$ 17,655 | \$ 111,585 |
| Equity share of losses | (17,655) | (93,930) |
| Investment in Ecoprogress, end of the year | - | 17,655 |
| Investment in Radical Elastomers Inc. at written down cost | - | 50,000 |
| Write down Radical Elastomers Inc. | - | (50,000) |
| Total investments, end of the year | <u>\$ -</u> | <u>\$ 17,655</u> |

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

5. INVESTMENTS (continued)

In March 2004 the company sold its investment in Consolidated Ecoprogress Technology Inc. for proceeds of \$55,000.

In 2003 the investment in Radical Elastomers was written off. This company filed for bankruptcy in January 2004.

6. CAPITAL ASSETS

| | 2004 | | 2003 | |
|-------------------------|---------------------|--------------------------|-------------------|-------------------|
| | Cost | Accumulated Amortization | Net Book Value | Net Book Value |
| Machinery and equipment | \$ 1,001,179 | \$ 716,748 | \$ 284,431 | \$317,769 |
| Furniture and fixtures | 211,300 | 106,651 | 104,649 | 130,082 |
| Leasehold improvements | 277,544 | 115,999 | 161,545 | 192,100 |
| | \$ 1,490,023 | \$ 939,398 | \$ 550,625 | \$ 639,951 |

7. 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.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

8. LOANS PAYABLE

Loans payable to Century Services Inc. (“CSI”) are secured by inventory and machinery and equipment and bear interest at 2% per month.

At December 31, 2004, the company was in default of certain covenants pursuant to these loans and the factoring facility and entered into a forbearance agreement with CSI.

On April 20, 2005 I.C.T.C. Investments Corporation (“ICTC”) acquired the loans payable from Century Services Inc. Under the terms of the loan agreements, these loans were repayable on April 29, 2005. On that date ICTC entered into a forbearance agreement with the company to further extend the maturity date of these loans to June 28, 2005 in return for a forbearance fee and an adjustment of the interest rate from 2% to 2.5% per month. On June 28, 2005 ICTC agreed to a further extension to allow the Courts to deal with a proposal put before the Courts pursuant to a meeting of the unsecured creditors. On July 14, 2005 these loans, together with the factoring facility, were paid in full.

9. CAPITAL LEASE OBLIGATIONS

| | <u>2004</u> | <u>2003</u> |
|--|-----------------|------------------|
| Capital lease obligations repayable in aggregate monthly instalments of \$7,123 including interest averaging 11.73% per annum due in 2005. | \$ 50,619 | \$ 114,968 |
| Less current portion | <u>(50,619)</u> | <u>(69,989)</u> |
| | <u>\$ -</u> | <u>\$ 44,979</u> |

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

10. CONVERTIBLE DEBENTURE

During the year ended December 31, 2003 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 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 \$0.33 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.

During the year the company issued 100,000 common shares and 50,000 warrants on the conversion of \$25,000. On conversion, capital stock increased by \$25,000 and the liability and equity component of the debenture decreased by \$16,314 and \$8,686 respectively resulting in \$475,000 payable at maturity.

As a result of the restructuring subsequent to year end (Note 16) the liability component was accreted by \$153,874 (2003 – \$11,140) to reflect the debenture at its full face value of \$475,000. In addition the debenture has been reclassified to accounts payable and the deferred charges related to the debenture were written off during the year ended December 31, 2004.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

11. CAPITAL STOCK

a) Authorized
145,635,962 common shares

b) Issued

| | 2004 | | 2003 | |
|--------------------------------------|---------------------|-------------------|---------------------|------------|
| | Number of shares | \$ | Number of shares | \$ |
| Beginning of the year | 47,668,042 | 23,343,041 | 47,628,042 | 23,335,041 |
| Issued for services | - | - | 40,000 | 8,000 |
| Issued on conversion of debenture | 100,000 | 25,000 | - | - |
| End of the year | 47,768,042 | 23,368,041 | 47,668,042 | 23,343,041 |

During the year ended December 31, 2003, the company issued 40,000 common shares and 20,000 warrants as payment of a finder's fee for the convertible debenture. The value of common shares issued is based on the market value on date of issue. During the year ended December 31, 2004 100,000 common shares and 50,000 warrants were issued on conversion of \$25,000 of the convertible debenture (Note 10).

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

11. CAPITAL STOCK (continued)

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.

The following table summarizes the status and changes in stock options outstanding at December 31, 2004 and 2003:

| | 2004 | | 2003 | |
|--|--------------------|---------------------------------------|---------------|---------------------------------------|
| | Number | Weighted average price | Number | Weighted average price |
| Beginning of the year | 2,735,000 | \$0.49 | 3,639,000 | \$0.90 |
| Granted | 971,000 | 0.13 | 265,000 | 0.28 |
| Cancelled/expired | (1,918,000) | 0.36 | (1,169,000) | 1.71 |
| End of the year | 1,788,000 | 0.44 | 2,735,000 | 0.49 |
| Exercisable, end of the year | 1,788,000 | \$0.44 | 2,660,000 | \$0.50 |
| Options reserved for issuance under stock option plan | 2,567,000 | | 1,885,000 | |

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

11. CAPITAL STOCK (continued)

c) Stock options (continued)

The following table summarizes information about stock options outstanding at December 31, 2004:

| Range of exercise prices | Number of options | Weighted average remaining contractual life | Weighted average exercise price |
|--------------------------|-------------------|---|---------------------------------|
| \$.12 - \$.28 | 1,317,000 | 3.3 years | \$0.17 |
| \$.40 | 95,000 | 2.3 years | \$0.40 |
| \$1.10 - \$1.15 | 276,000 | .9 years | \$1.10 |
| \$2.18 | 100,000 | 5.4 years | \$2.18 |
| | 1,788,000 | 2.7 years | \$0.44 |

d) Stock-based compensation

During the year the company recorded compensation expense, with a corresponding credit to contributed surplus, of \$69,956 (2003 - \$21,419) relating to the 971,000 (2003 - 265,000) stock options granted during the year.

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

| | 2004 | 2003 |
|--|-----------|-----------|
| Dividend yield | 0% | 0% |
| Expected volatility | 75% - 79% | 79% - 80% |
| Expected life | 5 yrs | 5 yrs |
| Risk free rate of return | 3.5% | 3.7% |
| Weighted average fair value of options granted | \$ 0.07 | \$ 0.08 |

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 for all options granted since January 1, 2002. Pro forma compensation expense for 2004 and 2003 relates to 300,000 stock options issued during 2002 that vest over a two year period and were recorded using the intrinsic value based method.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

11. CAPITAL STOCK (continued)

d) Stock-based compensation (continued)

| | <u>2004</u> | <u>2003</u> |
|---------------------------------|----------------|----------------|
| Net loss, as reported | \$ (2,296,525) | \$ (1,800,027) |
| Additional compensation expense | (14,437) | (49,088) |
| Net loss, pro forma | \$ (2,310,962) | \$ (1,849,115) |
| | | |
| Loss per share, as reported | \$ (0.05) | \$ (0.04) |
| Loss per share, pro forma | \$ (0.05) | \$ (0.04) |

e) Warrants

| | <u>2004</u> | <u>2003</u> |
|-----------------------|-------------|-------------|
| Beginning of the year | 2,937,120 | 2,917,120 |
| Granted | 50,000 | 20,000 |
| End of the year | 2,987,120 | 2,937,120 |

During the year ended December 31, 2003 the company obtained regulatory approval to extend the expiry date of the 2,917,120 warrants to September 11, 2005.

At December 31, 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 at \$0.50 per share until June 12, 2005.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

12. INCOME TAXES

The approximate tax effect of temporary differences and tax loss carry forwards that give rise to the company's future income tax assets are as follows:

| | <u>2004</u> | <u>2003</u> |
|--------------------------|------------------|------------------|
| Capital assets | \$ 1,752,000 | \$ 1,330,000 |
| Investments and other | 57,000 | 251,000 |
| Tax loss carryforwards | <u>3,515,000</u> | <u>3,085,000</u> |
| | 5,324,000 | 4,666,000 |
| Less valuation allowance | <u>5,324,000</u> | <u>4,666,000</u> |
| | <u>\$ -</u> | <u>\$ -</u> |

The income tax recovery and change in valuation allowance differs from the amounts computed by applying Canadian statutory rates to loss before income taxes as follows:

| | <u>2004</u> | <u>2003</u> |
|--|----------------|----------------|
| Income tax recovery at statutory rate of 35.6% (2003 - 37.6%) | \$ (818,000) | \$ (648,000) |
| Manufacturing allowance | 86,000 | 69,000 |
| Amortization | 75,000 | 63,000 |
| Investments | 6,000 | 41,000 |
| Other | (19,000) | 5,500 |
| Valuation allowance | <u>670,000</u> | <u>469,500</u> |
| Income tax recovery | <u>\$ -</u> | <u>\$ -</u> |

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

12. INCOME TAXES (continued)

The company has loss carryforwards available for tax purposes as follows:

| <u>Expiry date</u> | <u>Amount</u> |
|--------------------|---------------------|
| December 31, 2005 | \$ 213,000 |
| December 31, 2006 | 181,000 |
| December 31, 2007 | 1,995,000 |
| December 31, 2008 | 3,000,000 |
| December 31, 2009 | 1,015,000 |
| December 31, 2010 | 1,478,000 |
| December 31, 2011 | 1,989,000 |
| | <u>\$ 9,871,000</u> |

The company has capital loss carryforwards available for tax purposes in the amount of \$1,194,000.

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.

| | <u>2004</u> | <u>2003</u> |
|------------------------|---------------------|---------------------|
| Sales by region | | |
| Canadian | \$ 2,253,606 | \$ 2,518,202 |
| U.S. and International | 4,420,906 | 4,433,430 |
| | <u>\$ 6,674,512</u> | <u>\$ 6,951,632</u> |
| Sales by sector | | |
| Consumer | \$ 3,495,263 | \$ 3,681,337 |
| Industrial | 3,179,249 | 3,270,295 |
| | <u>\$ 6,674,512</u> | <u>\$ 6,951,632</u> |

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

14. COMMITMENTS

The company leases its premises and certain office equipment under operating leases. The aggregate minimum rental payments under these leases are approximately 2005 - \$370,000; 2006 - \$373,000; 2007 - \$218,000.

15. FINANCIAL INSTRUMENTS

(a) Fair values

The carrying values of cash, accounts receivable and loans payable approximate their fair value based on their liquidity and short-term nature. The carrying value of accounts payable, after giving effect to the settlement outlined in Note 16, approximates its fair value based on its liquidity and short-term nature.

Capital lease obligations bear interest at current rates of interest, as a result their carrying values approximate their fair market value.

(b) Foreign exchange

The company is exposed to financial risk resulting from fluctuations in foreign exchange rates and the degree of volatility of these rates. The company does not use derivative financial instruments to reduce its exposure to rate changes.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2004 AND 2003

16. SUBSEQUENT EVENT

A formal proposal was presented and accepted by the unsecured creditors on July 5, 2005, approved by the courts on July 8, 2005 and closed on July 14, 2005. Management estimates the unsecured liabilities will be settled at a range of 40% to 50% of face value. The forgiveness of debt is estimated to be \$1,300,000 and is subject to final approval of claims submitted by the unsecured creditors.

The proposal included obtaining additional financing from companies controlled by individuals who became directors of Napier. Subsequent to year end and concurrent with the closing of the financing of up to \$5 million, \$3 million will be used to pay all fees and related costs and to satisfy all amounts owed by the company to its secured, preferred, unsecured and post-filing creditors. The balance of the loans will be used as working capital.

The loans have a first and only registered charge on all of the assets of the company and are a combination of \$1.5 million term loans and \$3.5 million revolving working capital loans, subject to certain conditions and covenants pursuant to the Loan Agreements. The loans bear interest at prime plus 10% until such time as warrants are issued to the lenders at which time the interest rate will change to prime plus 2%. The term loans have a five-year term and are repayable as to interest monthly and as to principal one-fifth on each of the anniversary dates of these loans. The revolving loans have a term of 364 days and are renewable for successive 364 day extensions at least 90 days prior to the expiry of the then applicable term expiry dates and subject to the consent of the lenders. As additional consideration for the granting of these loans, the company has agreed to grant to the lenders warrants entitling the lenders to purchase, from treasury, up to 60% of the shares of the company, calculated on a fully-diluted basis upon payment of \$0.01 per share at any time up to August 31, 2010. Such issuance is subject to approval by the Toronto Stock Exchange which has been obtained conditional upon the warrants being issued no later than August 31, 2005.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

CONSOLIDATED SCHEDULES SELLING AND MARKETING EXPENSES YEARS ENDED DECEMBER 31

| | 2004 | 2003 |
|-----------------------------|---------------------|---------------------|
| Salaries and wages | \$ 787,258 | \$ 1,093,626 |
| Travel and entertainment | 376,225 | 492,446 |
| Commissions | 184,390 | 196,288 |
| Advertising | 100,723 | 182,243 |
| Consulting and other | 320,084 | 246,286 |
| Retail service fees | 143,153 | 160,689 |
| Promotional materials | 162,328 | 157,576 |
| Telecommunications | 60,878 | 67,682 |
| Bad debt expense (recovery) | 99,518 | (110,961) |
| | \$ 2,234,557 | \$ 2,485,875 |

GENERAL AND ADMINISTRATIVE EXPENSES YEARS ENDED DECEMBER 31

| | 2004 | 2003 |
|--------------------------------|---------------------|---------------------|
| Salaries and wages | \$ 803,067 | \$ 696,113 |
| Insurance | 228,917 | 214,227 |
| Financing costs | 536,815 | 152,155 |
| Occupancy | 30,265 | 106,356 |
| Consulting | 191,050 | 101,428 |
| Professional fees | 182,030 | 77,927 |
| Office | 101,360 | 63,364 |
| Travel and corporate relations | 122,180 | 56,446 |
| Telecommunications | 22,574 | 31,103 |
| Regulatory and filing fees | 26,190 | 23,030 |
| Amortization | 100,646 | 106,183 |
| | \$ 2,345,094 | \$ 1,628,332 |