

**NAPIER ENVIRONMENTAL
TECHNOLOGIES INC.**

**CONSOLIDATED
INTERIM FINANCIAL STATEMENTS**

MANAGEMENT'S DISCUSSION AND ANALYSIS

MARCH 31, 2005

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.**INTERIM CONSOLIDATED BALANCE SHEETS
(UNAUDITED - Prepared by Management)**

| | March 31 2005 | December 31 2004 |
|--|---------------------|---------------------|
| ASSETS | | |
| Current | | |
| Cash | \$ 62,431 | \$ 73,163 |
| Accounts receivable (Note 3) | 962,925 | 362,710 |
| Inventory (Note 4) | 763,585 | 943,950 |
| Prepaid expenses | 45,241 | 14,141 |
| | 1,834,182 | 1,393,964 |
| Capital assets (Note 5) | 511,010 | 550,625 |
| | \$ 2,345,192 | \$ 1,944,589 |
| LIABILITIES | | |
| Current | | |
| Accounts payable | \$ 3,678,326 | \$ 3,348,703 |
| Deferred revenue (Note 6) | 33,250 | 33,250 |
| Loans payable (Note 7) | 174,719 | 225,778 |
| Current portion of capital lease obligations | 50,619 | 50,619 |
| | 3,936,914 | 3,658,350 |
| SHAREHOLDERS' EQUITY | | |
| Capital stock (Note 8) | 23,368,041 | 23,368,041 |
| Contributed surplus (Note 8) | 299,484 | 296,279 |
| Deficit | (25,259,247) | (25,378,081) |
| | (1,591,722) | (1,713,761) |
| | \$ 2,345,192 | \$ 1,944,589 |
| Continuing Operations (Note 1) | | |

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.**INTERIM CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT
(UNAUDITED - Prepared by Management)**

| | Three month period ended March 31 | |
|---|-----------------------------------|-----------------|
| | 2005 | 2004 |
| Sales | \$ 1,628,158 | \$ 1,601,281 |
| Cost of sales | 892,456 | 917,302 |
| Gross profit | 735,702 | 683,979 |
| | 45.2% | 42.7% |
| Expenses | | |
| Selling and marketing (Schedule) | 157,105 | 644,023 |
| General and administrative (Schedule) | 404,552 | 434,231 |
| Research and product development | 49,049 | 53,700 |
| | 610,706 | 1,131,954 |
| Operating income (loss) | 124,996 | (447,975) |
| Other items | | |
| Equity loss in investment | - | (17,655) |
| Gain on sale of investment | - | 60,000 |
| Gain on disposal of capital assets | - | 159,991 |
| Foreign exchange gain (loss), interest and other income | (6,162) | 5,714 |
| | (6,162) | 208,050 |
| Net income (loss) for the period | 118,834 | (239,925) |
| Deficit at beginning of the period | (25,378,081) | (23,081,556) |
| Deficit at end of the period | \$ (25,259,247) | \$ (23,321,481) |
| Weighted average shares outstanding | 47,728,042 | 47,683,598 |
| Net income (loss) per share, basic and fully diluted | \$ 0.00 | \$ (0.01) |

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

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

| | Three month period ended March 31 | |
|--|-----------------------------------|--------------------|
| | 2005 | 2004 |
| Operating activities | | |
| Net income (loss) for the period | \$ 118,834 | \$ (239,925) |
| Items not involving cash | | |
| Depreciation and amortization | 39,615 | 42,396 |
| Accretion of convertible debenture | - | 5,570 |
| Stock based compensation | 3,205 | 31,025 |
| Equity loss in investment | - | 17,655 |
| Gain on sale of investment | - | (60,000) |
| Gain on disposal of capital assets | - | (159,991) |
| | 161,654 | (363,270) |
| Change in non-cash operating working capital | | |
| Accounts receivable | (600,215) | (923,142) |
| Inventory | 180,365 | (167,935) |
| Prepaid expenses | (31,100) | (43,909) |
| Accounts payable | 329,623 | 108,732 |
| Deferred revenue | - | 33,250 |
| | (121,327) | (993,004) |
| | 40,327 | (1,356,274) |
| Financing activities | | |
| Loans payable, net | (51,059) | 1,169,118 |
| Repayment of capital lease obligations | - | (18,034) |
| | (51,059) | 1,151,084 |
| Investing activities | | |
| Proceeds on disposal of capital assets | - | 161,750 |
| Proceeds on sale of investment | - | 60,000 |
| | - | 221,750 |
| Change in cash during the period | (10,732) | 16,560 |
| Cash and cash equivalents | | |
| at beginning of the period | 73,163 | 96,217 |
| Cash and cash equivalents | | |
| at end of the period | \$ 62,431 | \$ 112,777 |
| Supplemental information | | |
| Interest paid | \$ 24,931 | \$ 26,022 |

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO FINANCIAL STATEMENTS

MARCH 31, 2005

(UNAUDITED – Prepared by Management)

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 accompanying unaudited interim financial statements of the Company have been prepared by and are the responsibility of the Company's management.

The Company's independent auditor has not performed a review of the comparative figures in these financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO FINANCIAL STATEMENTS

MARCH 31, 2005

(UNAUDITED – Prepared by Management)

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 the end of the first quarter, the company successfully renegotiated its unsecured debt obligations (Note 10). While the reduction of its unsecured debt obligations 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, the adjustments would be necessary to the carrying values of assets and liabilities, the reported net income 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 FINANCIAL STATEMENTS

MARCH 31, 2005

(UNAUDITED – Prepared by Management)

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 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 charge occurs including any change in applicable future tax rates.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO FINANCIAL STATEMENTS

MARCH 31, 2005

(UNAUDITED – Prepared by Management)

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.

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 8. Fully diluted net income (loss) per share is the same as basic income (loss) per share as the exercise of options and warrants would reduce the net income (loss) per share.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO FINANCIAL STATEMENTS

MARCH 31, 2005

(UNAUDITED – Prepared by Management)

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 March 31, 2005, the company had factored \$623,000 of accounts receivable under the factoring facility.

At March 31, 2005, the company is not in compliance with the financial covenants on the factoring facility as described in Note 7.

Subsequent to the first quarter 2005, I.C.T.C. Investments Corporation acquired the balance of the loan and the factoring facility from Century Services Inc. (“CSI”) and, pursuant to a forbearance agreement to extend the repayment of the facility, increased the interest rate to 2.5% per month.

4. INVENTORY

Inventory is comprised of:

| | March 31 2005 | December 31 2004 |
|----------------|-------------------|---------------------|
| Raw materials | \$ 427,197 | \$ 485,687 |
| Finished goods | 336,388 | 458,263 |
| | <u>\$ 763,585</u> | <u>\$ 943,950</u> |

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO FINANCIAL STATEMENTS

MARCH 31, 2005

(UNAUDITED – Prepared by Management)

5. CAPITAL ASSETS

| | March 31 2005 | | December 31 2004 | |
|-------------------------|---------------------|-----------------------------|---------------------|-------------------|
| | Cost | Accumulated Amortization | Net Book Value | Net Book Value |
| Machinery and equipment | \$ 1,001,179 | \$ 742,435 | \$ 258,745 | \$284,431 |
| Furniture and fixtures | 211,300 | 112,941 | 98,359 | 104,649 |
| Leasehold improvements | 277,544 | 123,638 | 153,906 | 161,545 |
| | <u>\$ 1,490,023</u> | <u>\$ 979,014</u> | <u>\$ 511,010</u> | <u>\$ 550,625</u> |

6. 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 FINANCIAL STATEMENTS

MARCH 31, 2005

(UNAUDITED – Prepared by Management)

7. LOANS PAYABLE

| | March 31 2005 | December 31 2004 |
|-----------------------|-------------------|---------------------|
| Demand operating loan | \$ 142,142 | \$ 190,579 |
| Term loan | 32,576 | 35,199 |
| | <u>\$ 174,719</u> | <u>\$ 225,778</u> |

Loans payable to CSI are secured by inventory and machinery and equipment and bear interest at 2% per month.

At March 31, 2005, 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.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO FINANCIAL STATEMENTS

MARCH 31, 2005

(UNAUDITED – Prepared by Management)

8. CAPITAL STOCK

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

| | <u>Number of Shares</u> | <u>\$</u> |
|---|-------------------------|------------|
| Balance, December 31, 2004 and March 31, 2005 | 47,768,042 | 23,368,041 |

- 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 March 31, 2005.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO FINANCIAL STATEMENTS

MARCH 31, 2005

(UNAUDITED – Prepared by Management)

8. CAPITAL STOCK (continued)

| | Number | Weighted average price |
|---|-----------|------------------------------|
| Outstanding, December 31, 2004 | 1,788,000 | \$0.44 |
| Granted | - | - |
| Cancelled/expired | (104,000) | 0.99 |
| March 31, 2005 | 1,684,000 | 0.41 |
| Exercisable, at March 31, 2005 | 1,684,000 | \$0.41 |
| Options reserved for issuance under stock option plan | 2,671,000 | |

The following table summarizes information about stock options outstanding at March 31, 2005:

| Range of exercise prices | Number of options | Weighted average remaining contractual life | Weighted average exercise price |
|-----------------------------|----------------------|--|------------------------------------|
| Vested | | | |
| \$0.08 - \$0.28 | 1,307,000 | 2.6 years | \$0.17 |
| \$0.40 | 90,000 | 1.6 years | \$0.40 |
| \$1.10 | 187,000 | 1.0 years | \$1.10 |
| \$2.18 | 100,000 | 5.1 years | \$2.18 |
| | 1,684,000 | 2.5 years | \$0.41 |

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO FINANCIAL STATEMENTS

MARCH 31, 2005

(UNAUDITED – Prepared by Management)

8. CAPITAL STOCK (continued)

d) Warrants

| | |
|---|------------------|
| Balance, December 31, 2004 and March 31, 2005 | <u>2,987,120</u> |
|---|------------------|

At March 31, 2005, 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 \$0.40 per share until June 12, 2004 and then \$0.50 per share until June 12, 2005.

9. 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.

| | March 31 2005 3 months | March 31 2004 3 months |
|-----------------|------------------------------|------------------------------|
| Sales by region | | |
| Canadian | \$ 292,061 | \$ 431,662 |
| International | 1,336,097 | 1,169,619 |
| Total Sales | <u>\$ 1,628,158</u> | <u>\$ 1,601,281</u> |
| Sales by sector | | |
| Consumer | \$ 1,271,913 | \$ 811,000 |
| Industrial | 356,245 | 790,281 |
| | <u>\$ 1,628,158</u> | <u>\$ 1,601,281</u> |

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO FINANCIAL STATEMENTS

MARCH 31, 2005

(UNAUDITED – Prepared by Management)

10. SUBSEQUENT EVENTS

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 the 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 the first quarter and concurrent with the closing of the financing, up to \$5 million of which \$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 the 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 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.

INTERIM CONSOLIDATED SCHEDULES (UNAUDITED- Prepared by Management)

SELLING AND MARKETING EXPENSES

| | Three Month Period ended March 31 | |
|-----------------------------|-----------------------------------|------------|
| | 2005 | 2004 |
| Salaries and wages | \$ 94,103 | \$ 250,942 |
| Advertising | 22,668 | 67,759 |
| Travel and entertainment | 22,452 | 122,413 |
| Commissions | 9,662 | 55,786 |
| Promotional materials | 7,191 | 48,010 |
| Consulting and other | 7,133 | 38,709 |
| Telecommunications | 4,642 | 52,990 |
| Retail service fees | - | 7,414 |
| Bad debt expense (recovery) | (10,746) | - |
| | \$ 157,105 | \$ 644,023 |

GENERAL AND ADMINISTRATIVE EXPENSES

| | Three Month Period ended March 31 | |
|--------------------------------|-----------------------------------|------------|
| | 2005 | 2004 |
| Salaries and wages | \$ 87,353 | \$ 160,345 |
| Professional fees | 76,870 | 25,808 |
| Insurance | 55,559 | 58,692 |
| Financing Costs | 52,161 | 56,441 |
| Consulting | 51,059 | 49,305 |
| Amortization | 23,607 | 27,150 |
| Travel and corporate relations | 21,359 | 10,181 |
| Office | 15,972 | 17,751 |
| Occupancy | 14,242 | 10,497 |
| Telecommunications | 4,213 | 5,616 |
| Regulatory and filing fees | 2,157 | 12,445 |
| | \$ 404,552 | \$ 434,231 |