

**NAPIER ENVIRONMENTAL
TECHNOLOGIES INC.**

**CONSOLIDATED
INTERIM FINANCIAL STATEMENTS**

MANAGEMENT'S DISCUSSION AND ANALYSIS

SEPTEMBER 30, 2005

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

INTERIM CONSOLIDATED BALANCE SHEETS
(UNAUDITED - Prepared by Management)

	September 30, 2005	December 31, 2004 (Note 11)
ASSETS		
Current		
Cash	\$ 278,660	\$ 73,163
Accounts receivable	447,981	362,710
Inventory (Note 3)	831,629	943,950
Prepaid expenses	68,057	14,141
	1,626,327	1,393,964
Property, plant and equipment (Note 4)	440,342	550,625
	\$ 2,066,669	\$ 1,944,589
LIABILITIES		
Current		
Loans (Notes 5 and 10)	\$ 1,500,000	\$ 190,579
Accounts payable	449,224	3,348,703
Deferred revenue (Note 6)	33,250	33,250
Current portion of long term debt (Notes 7 and 10)	300,000	35,199
Capital lease obligations	-	50,619
	2,282,474	3,658,350
Long term debt (Notes 7 and 10)	1,200,000	-
	3,482,474	3,658,350
SHAREHOLDERS' DEFICIENCY		
Capital stock (Note 8)	23,368,041	23,368,041
Convertible debenture	-	165,014
Contributed surplus	333,917	131,265
Deficit	(25,117,763)	(25,378,081)
	(1,415,805)	(1,713,761)
	\$ 2,066,669	\$ 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 September 30,		Nine month period ended September 30,	
	2005	2004	2005	2004
		(Note 11)	(Note 11)	(Note 11)
Sales	\$ 896,833	\$ 1,673,352	\$ 3,774,064	\$ 5,860,463
Cost of sales (Note 3)	834,859	1,233,580	2,452,359	3,679,242
Gross profit	61,974	439,772	1,321,705	2,181,221
	6.9%	26.3%	35.0%	37.2%
Expenses				
General and administrative (Schedule)	529,214	303,018	1,020,521	1,082,532
Selling and marketing (Schedule)	143,362	580,904	478,260	1,879,567
Interest and finance costs	91,950	168,331	278,461	326,965
Research and development	21,159	54,111	148,797	169,939
	785,685	1,106,364	1,926,039	3,459,003
Operating loss	(723,711)	(666,592)	(604,334)	(1,277,782)
Other items				
Gain on settlement of debt, net of restructuring costs (Note 10)	1,170,658	-	881,752	-
Other income (expense)	(12,306)	(30,148)	(17,100)	(3,992)
Equity loss in investment	-	-	-	(17,655)
Gain on sale of investment	-	-	-	60,000
Gain on disposal of property, plant and equipment	-	535	-	160,526
	1,158,352	(29,613)	864,652	198,879
Net income (loss) for the period	434,641	(696,205)	260,318	(1,078,903)
Deficit at beginning of the period	(25,552,404)	(23,464,252)	(25,378,081)	(23,081,554)
Deficit at end of the period	\$ (25,117,763)	\$ (24,160,457)	\$ (25,117,763)	\$ (24,160,457)
Weighted average shares outstanding:				
Basic	47,768,042	47,728,042	47,768,042	47,713,078
Fully-diluted	68,904,302	47,728,042	54,280,855	47,713,078
Income (loss) per share:				
Basic	\$ 0.01	\$ (0.01)	\$ 0.01	\$ (0.02)
Fully-diluted	\$ 0.01	\$ (0.01)	\$ 0.00	\$ (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,	
	2005	2004 (Note 11)	2005 (Note 11)	2004 (Note 11)
Operating activities				
Net income (loss) for the period	\$ 434,641	\$ (696,205)	\$ 260,318	\$ (1,078,903)
Items not involving cash				
Depreciation and amortization	35,373	37,761	112,092	125,020
Accretion of convertible debenture	-	5,571	-	16,609
Stock based compensation	31,226	15,318	37,638	66,106
Equity loss in investment	-	-	-	17,655
Gain on sale of investment	-	-	-	(60,000)
Gain on disposal of property, plant and equipment	-	(535)	-	(160,526)
	501,240	(638,090)	410,048	(1,074,039)
Change in non-cash operating working capital				
Accounts receivable	519,104	910,045	(85,271)	(867,925)
Inventory	318,890	453,600	112,321	378,666
Prepaid expenses	(44,850)	(83,701)	(53,916)	(46,834)
Accounts payable	(3,920,831)	(112,179)	(2,899,479)	451,864
Deferred revenue	-	-	-	33,250
	(3,127,687)	1,167,765	(2,926,345)	(50,979)
	(2,626,447)	529,675	(2,516,297)	(1,125,018)
Financing activities				
Increase in (repayment of) loans	1,358,041	(484,952)	1,309,421	1,005,848
Repayment of capital lease obligations	(50,619)	(16,290)	(50,619)	(53,228)
Increase in long term debt	1,464,801	-	1,464,801	-
	2,772,223	(501,242)	2,723,603	952,620
Investing activities				
Purchase of property, plant and equipment	(1,809)	(15,566)	(1,809)	(68,882)
Proceeds on disposal of property, plant and equipment	-	535	-	162,285
Proceeds on sale of investment	-	-	-	60,000
	(1,809)	(15,031)	(1,809)	153,403
Change in cash during the period	143,967	13,402	205,497	(18,995)
Cash at beginning of the period	134,693	63,820	73,163	96,217
Cash at end of the period	\$ 278,660	\$ 77,222	\$ 278,660	\$ 77,222
Supplemental information				
Interest paid	\$ 95,940	\$ 80,813	\$ 177,021	\$ 238,486

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

**NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 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 INTERIM CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2005 (UNAUDITED – Prepared by Management)

1. CONTINUING OPERATIONS

The Company is governed by the *Business Corporations Act* (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.

During the three month period ended September 30, 2005, the Company successfully renegotiated its unsecured debt obligations. 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, adjustments would be necessary to the carrying values of assets and liabilities and the reported net income and the balance sheet classifications used.

2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

The unaudited interim consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the footnotes and disclosures required by Canadian generally accepted accounting principles for annual financial statements.

The unaudited interim consolidated financial statements reflect the same significant accounting policies described in the Company's annual consolidated financial statements for the year ended December 31, 2004, and should be read in conjunction with these statements.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2005 (UNAUDITED – Prepared by Management)

It is management's opinion that the unaudited interim consolidated financial statements reflect all adjustments (consisting of normal and recurring accruals) and reclassifications necessary to present fairly the Company's financial position, results of operations and cash flows.

The results of operations for the three and nine month periods ended September 30, 2005 are not necessarily indicative of the results for the full year.

3. INVENTORY

Inventory is comprised of:

	September 30, 2005	December 31, 2004
Raw materials	\$ 346,940	\$ 485,687
Finished goods	484,689	458,263
	<u>\$ 831,629</u>	<u>\$ 943,950</u>

Finished goods inventory contains an allocation of fixed operating costs based on the standard costing method of accounting for inventory and determination of cost of sales. Unallocated fixed operating costs are charged to cost of sales as they occur. As a result, the quarterly gross profit and related gross profit percentage, as it relates to sales, will vary based on the level of production in that quarter. Therefore, due to the cyclical nature of the Company's business, this results in lower gross margins during periods where production is lower.

4. PROPERTY, PLANT AND EQUIPMENT

	September 30,		December 31,	
	2005		2004	
	Cost	Accumulated Amortization	Net Book Value	Net Book Value
Machinery and equipment	\$ 1,002,988	\$ 787,494	\$ 215,494	\$ 284,431
Furniture and fixtures	211,300	125,081	86,219	104,649
Leasehold improvements	277,544	138,915	138,629	161,545
	<u>\$ 1,491,832</u>	<u>\$ 1,051,490</u>	<u>\$ 440,342</u>	<u>\$ 550,625</u>

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2005 (UNAUDITED – Prepared by Management)

5. LOANS

The loans consist of two loan facilities, each to a maximum of \$1,750,000 from each of 6408753 Canada Corporation and 6408788 Canada Corp. for a total of \$3,500,000. The term of each loan is 364 days and is renewable for successive 364-day terms by giving notice to the lenders and obtaining their consent, at least 90 days prior to the expiry. Interest is payable on the last day of each month at a rate of prime plus 2%. As partial consideration for these loans, warrants were issued to the lenders on August 30, 2005. Subsequent to the advancement of the loans on July 14, 2005 and until the warrants were issued on August 30, 2005, the interest rate was prime plus 10%.

As at September 30, 2005, each lender had advanced \$750,000 of these loans for a total outstanding balance of \$1,500,000.

These loans are subject to the following margins: (i) 50% of the aggregate amount of eligible inventory minus the aggregate amount of the borrowers accounts payable plus (ii) 75% of the aggregate amount of eligible accounts receivable.

As at December 31, 2004 the outstanding loan amount, pursuant to a prior loan facility, was \$190,579.

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 five years. The Company received a \$33,250 initial payment on this royalty that will be recognized as revenue when the royalty is earned. The purchaser of this formula has not begun to market the product; therefore, no revenue has been recognized as a result of this transaction.

7. LONG TERM DEBT

The term loans consist of two loans, each in the amount of \$750,000 from each of 6408753 Canada Corporation and 6408788 Canada Corp. for a total of \$1,500,000. The term of each loan is five years and interest is payable monthly at a rate of prime plus 2%. Annual principal repayments of one-fifth of the loan are required on each of the anniversary dates of the loans. As partial consideration of these loans, warrants were issued to the lenders on August 30, 2005. Subsequent to the advancement of the loans on July 14, 2005 and until the warrants were issued on August 30, 2005, the interest rate was prime plus 10%.

As at December 31, 2004 the outstanding term loan amount, pursuant to a prior loan facility, was \$35,199.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2005 (UNAUDITED – Prepared by Management)

8. CAPITAL STOCK

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

	Number of Shares	\$
September 30, 2005 and December 31, 2004	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 has the right to attach vesting periods to stock options granted.

The following table summarizes the status and changes in stock options outstanding at September 30, 2005:

	September 30, 2005		December 31, 2004	
	Number	Weighted average price	Number	Weighted average price
Outstanding, beginning of period	1,788,000	\$0.44	2,735,000	\$0.49
Granted	2,600,000	0.04	971,000	0.13
Cancelled / expired	(886,000)	0.36	(1,918,000)	0.36
Outstanding, end of period	3,502,000	0.10	1,788,000	0.44
Exercisable, end of period	1,802,000	\$0.16	1,788,000	\$0.44
Options reserved for issuance, under stock option plan	853,000		2,567,000	

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2005 (UNAUDITED – Prepared by Management)

8. CAPITAL STOCK (continued)

The following table summarizes information about stock options outstanding at September 30, 2005:

Range of exercise prices	Number of options	Weighted average remaining contractual life	Weighted average exercise price
\$0.04	2,600,000	4.9 years	\$0.04
\$0.15 - \$0.28	755,000	1.7 years	\$0.20
\$0.40	90,000	0.8 years	\$0.40
\$1.10	57,000	0.2 years	\$1.10
	3,502,000	4.0 years	\$0.10

d) Warrants

	September 30, 2005	December 31, 2004
Outstanding, beginning of period	2,987,120	2,937,120
Issued	82,153,700	50,000
Expired	(2,987,120)	-
Outstanding, end of period	82,153,700	2,987,120

Warrants issued during the three months ended September 30, 2005 entitle the holders to subscribe for and purchase one common share of the Company at a price of \$0.01 at any time up to August 31, 2010.

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.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2005 (UNAUDITED – Prepared by Management)

9. SEGMENTED INFORMATION (Continued)

	Three months ended September 30,		Nine months ended September 30,	
	2005	2004	2005	2004
Sales by region				
Canadian	\$ 394,279	\$ 591,782	\$ 1,311,955	\$ 1,932,183
U.S. and International	502,554	1,081,570	2,462,109	3,928,280
	<u>\$ 896,833</u>	<u>\$ 1,673,352</u>	<u>\$ 3,774,064</u>	<u>\$ 5,860,463</u>
Sales by sector				
Consumer	\$ 664,959	\$ 859,329	\$ 2,770,509	\$ 3,221,848
Industrial	231,874	814,023	1,003,555	2,638,615
	<u>\$ 896,833</u>	<u>\$ 1,673,352</u>	<u>\$ 3,774,064</u>	<u>\$ 5,860,463</u>

10. RELATED PARTY TRANSACTIONS AND SIGNIFICANT 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 resulting in forgiveness of debt totalling \$1,885,669. During the three and nine months ended September 30, 2005, the Company incurred certain costs directly related to the restructuring of its unsecured debt obligations. These non-recurring costs consist of legal fees, consulting fees paid to the chief restructuring officer, trustee fees, key employee retention bonuses and similar payments and are in the amounts of \$715,011 and \$1,003,917, respectively. The restructuring costs incurred during the six months ended June 30, 2005 were previously classified as general and administrative costs. These costs, amounting to \$288,906 and consisting of professional and consulting fees, have now been reclassified as restructuring costs.

The restructuring included obtaining additional financing, outlined in notes 5 and 7, from companies controlled by individuals who are directors and officers of the Company. As at September 30, 2005, \$3,000,000 has been advanced and was 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, as required from time to time.

As additional consideration for these loans, the Company granted the lenders warrants entitling the lenders to purchase, from treasury, up to 60% of the common 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.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS SEPTEMBER 30, 2005 (UNAUDITED – Prepared by Management)

10. RELATED PARTY TRANSACTIONS AND SIGNIFICANT EVENTS (Continued)

During the three months ended September 30, 2005, the Company entered into a management services agreement (the “Management Services Agreement”) with I.C.T.C. Holdings Corporation (“I.C.T.C.”), a company that is controlled by individuals who are directors and officers of the Company.

Pursuant to the Management Services Agreement, effective September 1, 2005, the Company will reimburse I.C.T.C. for certain costs incurred on the Company’s behalf. The Company will pay a variable monthly amount to I.C.T.C. under this agreement based on the actual costs incurred by I.C.T.C.

11. COMPARATIVE FIGURES

Certain of the prior year period comparative figures have been reclassified to conform to the current period presentation.

NAPIER ENVIRONMENTAL TECHNOLOGIES INC.

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

SELLING AND MARKETING EXPENSES

	Three Month Period ended September 30,		Nine Month Period ended September 30,	
	2005	2004	2005	2004
		(Note 11)	(Note 11)	(Note 11)
Salaries and wages	\$ 69,715	\$ 182,221	\$ 275,810	\$ 640,977
Marketing	29,306	155,017	89,517	408,344
Travel and entertainment	25,353	80,243	71,334	329,805
Commissions	1,518	61,922	22,265	216,038
Consulting	11,692	29,086	19,338	101,343
Communications and other	5,778	42,415	19,261	153,060
Bad debt expense (recovery)	-	30,000	(19,265)	30,000
	\$ 143,362	\$ 580,904	\$ 478,260	\$ 1,879,567

GENERAL AND ADMINISTRATIVE EXPENSES

	Three Month Period ended September 30,		Nine Month Period ended September 30,	
	2005	2004	2005	2004
		(Note 11)	(Note 11)	(Note 11)
Salaries and wages	\$ 174,594	\$ 157,169	\$ 341,812	\$ 480,331
Professional fees	146,080	14,618	216,661	97,021
Travel and corporate relations	57,290	7,975	103,441	52,587
Insurance	23,236	55,153	96,393	168,336
Office	41,551	13,244	80,939	51,903
Occupancy	14,014	6,240	41,764	23,320
Consulting	35,004	5,767	40,427	84,235
Regulatory and filing fees	10,388	10,918	17,318	24,034
Telecommunications	5,757	5,292	14,567	17,274
Amortization	21,300	26,642	67,199	83,491
	\$ 529,214	\$ 303,018	\$ 1,020,521	\$ 1,082,532