



INTERNATIONAL  
**Water-Guard**

Interim Financial Statements of

**INTERNATIONAL WATER-GUARD  
INDUSTRIES INC.**

Six months ended March 31, 2006

**Interim Financial Statements of**

**INTERNATIONAL WATER-GUARD INDUSTRIES INC.**

**Notice of no auditor review of interim financial statements to March 31, 2006**

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 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.

**INTERNATIONAL WATER-GUARD INDUSTRIES INC.**  
**BALANCE SHEETS**

	March 31 <u>2006</u>	September 30 <u>2005</u>
<b>ASSETS</b>		
Current assets:		
Cash	\$ 237,157	\$ 354,804
Accounts receivable	591,563	508,776
Inventory	255,404	282,922
Prepaid expenses	<u>23,539</u>	<u>31,928</u>
	1,107,663	1,178,430
 Equipment and furniture	 <u>204,621</u>	 <u>34,492</u>
	 <u>\$ 1,312,284</u>	 <u>\$ 1,212,922</u>
 <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 267,987	\$ 226,020
Demand loan	150,500	367,900
Current portion of capital lease obligations and loan	<u>24,374</u>	<u>8,292</u>
	442,861	602,212
 Obligations under capital leases and other loan	 <u>84,649</u>	 <u>24,875</u>
 Shareholders' equity:		
Share capital	7,508,539	7,508,539
Contributed surplus	73,749	60,574
Deficit	<u>(6,797,514)</u>	<u>(6,983,278)</u>
	784,774	585,835
	 <u>\$ 1,312,284</u>	 <u>\$ 1,212,922</u>

These financial statements have been prepared by management and are unaudited.  
See accompanying notes to financial statements.

On behalf of the Board:

"J. D. Lawson"                      Director

"D. C. Fox"                          Director

**INTERNATIONAL WATER-GUARD INDUSTRIES INC.**  
**STATEMENTS OF OPERATIONS AND DEFICIT**  
**Six months ended March 31**

	Three months ended March 31		Six months ended March 31	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Sales	\$ 925,738	\$ 824,778	\$ 1,719,317	\$ 1,595,727
Cost of goods sold	<u>382,711</u>	<u>379,779</u>	<u>679,855</u>	<u>726,532</u>
Gross profit	<u>543,027</u>	<u>444,999</u>	<u>1,039,462</u>	<u>869,195</u>
Expenses:				
Selling expenses	87,834	74,150	201,054	140,115
Research & development	91,332	96,858	207,418	178,310
General & administration	217,205	179,489	381,242	366,279
Stock option compensation	5,703	7,643	13,175	18,098
Amortization	11,597	7,025	13,444	14,049
Interest & bank charges	<u>15,714</u>	<u>46,046</u>	<u>37,365</u>	<u>98,421</u>
	<u>429,385</u>	<u>411,211</u>	<u>853,698</u>	<u>815,272</u>
Earnings from operations, before undernoted	113,642	33,788	185,764	53,923
Gains on settlement of notes and accounts payable	-	590,674	-	590,674
Gain on sale of commercial division assets	-	164,063	-	164,063
Write-down of furniture and equipment	<u>-</u>	<u>(15,000)</u>	<u>-</u>	<u>(15,000)</u>
Net earnings for the period	113,642	773,525	185,764	793,660
Deficit, beginning of period	<u>6,911,156</u>	<u>7,834,298</u>	<u>6,983,278</u>	<u>7,854,433</u>
Deficit, end of period	<u>\$ 6,797,514</u>	<u>\$ 7,060,773</u>	<u>\$ 6,797,514</u>	<u>\$ 7,060,773</u>
Earnings per share amounts:				
Basic	<u>\$ -</u>	<u>\$ 0.04</u>	<u>\$ 0.01</u>	<u>\$ 0.04</u>
Diluted	<u>\$ -</u>	<u>\$ 0.04</u>	<u>\$ 0.01</u>	<u>\$ 0.04</u>
Weighted average shares outstanding	<u>33,302,194</u>	<u>20,481,194</u>	<u>33,302,194</u>	<u>20,481,194</u>

These financial statements have been prepared by management and are unaudited.  
See accompanying notes to financial statements.

# INTERNATIONAL WATER-GUARD INDUSTRIES INC.

## STATEMENTS OF CASH FLOWS

Six months ended March 31

	Three months ended March 31		Six months ended March 31	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Cash flows from (used by):				
Operating activities:				
Net earnings (loss) for the period	\$ 113,642	\$ 773,525	\$ 185,764	\$ 793,660
Items not involving cash -				
Gain on settlement of Notes and other liabilities		(590,674)		\$ (590,674)
Book value of assets sold		135,937		\$ 135,937
Unrealized foreign exchange gains		(6,036)	-	\$ (28,036)
Compensation related to stock option plan	5,703	7,643	13,175	\$ 18,098
Interest accrued	-	15,447	-	\$ 34,961
Amortization and equipment write-down	11,597	22,025	13,444	29,049
	<u>130,942</u>	<u>357,867</u>	<u>212,383</u>	<u>392,995</u>
Changes in non-cash operating working capital:				
Accounts receivable	(126,513)	(22,835)	(82,787)	177,390
Inventory	24,346	27,558	27,518	95,953
Prepaid expenses	2,492	-	8,389	1
Accounts payable and accrued liabilities	48,559	(289,880)	41,967	(398,687)
Customer deposits	-	-	-	-
Cash flow from operations	<u>79,826</u>	<u>72,710</u>	<u>207,470</u>	<u>267,652</u>
Investing activities:				
Purchase of equipment and leaseholds	<u>(98,888)</u>	<u>(530)</u>	<u>(103,571)</u>	<u>(948)</u>
Financing activities:				
Proceeds (repayment) of demand loan	(147,000)	(49,000)	(217,400)	(209,500)
Proceeds (repayment) of other loans payable	-	(33,333)	(4,146)	(33,333)
	<u>(147,000)</u>	<u>(82,333)</u>	<u>(221,546)</u>	<u>(242,833)</u>
Increase (decrease) in cash	(166,062)	(10,153)	(117,647)	23,871
Cash beginning of period	<u>403,219</u>	<u>98,860</u>	<u>354,804</u>	<u>64,836</u>
Cash end of period	<u>\$ 237,157</u>	<u>\$ 88,707</u>	<u>\$ 237,157</u>	<u>\$ 88,707</u>

These financial statements have been prepared by management and are unaudited.  
See accompanying notes to financial statements.

**INTERNATIONAL WATER-GUARD INDUSTRIES INC.****STATEMENTS OF COST OF GOODS SOLD****Six months ended March 31**

	Three months ended		Six months ended	
	March 31		March 31	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Opening inventory	\$ 279,750	\$ 355,231	\$ 282,922	\$ 423,626
Manufacturing costs:				
Materials	192,877	84,170	346,126	199,731
Labour, freight and other	59,534	94,302	111,744	180,017
Manufacturing overhead	<u>105,954</u>	<u>78,527</u>	<u>194,467</u>	<u>155,609</u>
Cost of goods available for sale	638,115	612,230	935,259	958,983
Closing inventory	<u>255,404</u>	<u>232,451</u>	<u>255,404</u>	<u>232,451</u>
Cost of goods sold	<u>\$ 382,711</u>	<u>\$ 379,779</u>	<u>\$ 679,855</u>	<u>\$ 726,532</u>

These financial statements have been prepared by management and are unaudited.  
See accompanying notes to financial statements.

# INTERNATIONAL WATER-GUARD INDUSTRIES INC.

## Notes to Interim Financial Statements, March 31, 2006

### 1. Significant accounting policies:

These interim statements are prepared in a manner consistent with the accounting policies and methods applicable to the Company's audited annual financial statements. However, these interim financial statements do not include all disclosure in notes normally provided in annual financial statements, consequently this report should be read in conjunction with the Company's audited financial statements for the year ended September 30, 2005.

In management's opinion, the unaudited financial information includes all normal adjustments necessarily to present fairly such information. Interim results are not necessarily indicative of the results expected for the fiscal year.

### 2. Reclassification of prior year expenses and Retroactive adoption of Stock Based Compensation:

- a) Certain comparative figures have been reclassified to conform to the presentation of manufacturing expenses adopted in the fourth quarter of the prior year, which expenses were previously included in selling, research development, administration and occupancy.
- b) In the fourth quarter of fiscal 2005, the Company adopted, retroactively to fiscal 2004, the amended guidelines for recording the fair value of Stock Options vesting during a reporting period. Accordingly, the stock option compensation benefits recorded for fiscal 2005 has been reflected in the comparative results for stock options vesting in the periods reported for both fiscal 2005 and 2006.

### 3. Equipment and furniture:

Equipment under capital leases	\$ 86,981
Leasehold improvements	87,177
Other equipment	<u>205,909</u>
	380,067
Accumulated amortization	<u>(175,446)</u>
Net book value	<u>\$204,621</u>

### 4. Obligations under capital leases and other loans, long term portion:

Obligation under capital leases	\$59,774
Loan payable	<u>24,875</u>
	<u>\$84,649</u>

The company entered into several capital lease agreements to acquire equipment for its new facility and expansion. These lease obligations have terms from 27 to 53 months, each with purchase options approximating 10% of the equipment cost at the completion of the lease period. The present value of the lease obligation is recorded as a liability. The current portion is included in current liabilities.

### 5. Share capital:

- a) Authorized capital of the Company as at March 31, 2006 includes an unlimited number of common shares and of preferred shares of which 33,302,194 common shares and no preferred shares were issued and outstanding.

- b) At the Company's Annual General Meeting held on March 7, 2006, shareholders approved an amendment to the Company's stock option plan increasing by 902,000 the number of shares issueable under the plan. There were 2,270,000 options outstanding as of March 31, 2006 held by directors, officers, and employees, exercisable at various dates to April 7, 2009, as follows:

Exercise Price Per Share	Number Outstanding	Average Remaining Life in Years	Number Exercisable at March 31st
\$0.18	580,000	1.1	580,000
\$0.115	460,000	2.2	184,000
\$0.10	890,000	1.4	890,000
\$0.075 - \$0.09	340,000	2.5	42,000
Total	2,270,000	1.5	1,696,000

- c) Warrants to purchase 320,000 common shares were outstanding as at March 31, 2006. These warrants were issued to finders with the private placement of common shares completed on May 5<sup>th</sup>, 2005, exercisable at \$0.10 each. Of these, 247,500 warrants were exercised on April 28<sup>th</sup> while the remaining 72,500 warrants expired on May 4<sup>th</sup> without being exercised.

6. Commitments:

- a) The Company has entered into a lease commitment agreement for new operating premises effective for five and one-half years, plus a renewal option, commencing June 1, 2005. Obligations under the lease agreement for rentals, taxes and operating costs aggregate \$ 112,515 during the first year and aggregate \$778,050 during the term of the lease.
- b) Apart from the capital lease agreements described in note 4, other contractual obligations of the Company are unchanged from those described within the notes to the audited financial statements.



**INTERNATIONAL WATER-GUARD INDUSTRIES INC.**

**MANAGEMENT'S DISCUSSION  
AND ANALYSIS**

**Second Quarter Ended**

**March 31, 2006**

dated: May 10, 2006

# **INTERNATIONAL WATER-GUARD INDUSTRIES INC.**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS Second Quarter to March 31, 2006**

### **Overview**

Comments in this analysis should be read in conjunction with the comparative interim financial statements for the six months ended March 31 2006. The following discussion, and the information elsewhere in this report, is intended to provide the reader with a further understanding of the Company's business and factors underlying its financial results.

International Water-Guard Industries Inc. ("IWG") designs, manufactures, sells and services potable water treatment/management equipment and systems for international aviation customers. The principal technology embodied in IWG's products is irradiation by ultraviolet ("UV") light, with filtration, ancillary systems and controls designed by the Company.

### **Operating results**

The Company reported sales during the second quarter in fiscal 2006 of \$925,738, an increase of 12% above the previous year which included \$91,239 from the now divested industrial/commercial division. Second quarter earnings were \$113,642 compared to earnings from operations of \$33,788 (restated and before special items) in the prior year's second quarter.

Six month sales to March 31<sup>st</sup> were \$1,719,317 compared to \$1,595,727 in the prior year, again including \$200,148 in sales from the industrial/ commercial division. Six month earnings were \$185,764 compared to earnings from operations of \$53,923 (restated and before special items) a year earlier. Special gains reported in the second quarter of the prior year were \$739,737.

The results for the quarter provide \$nil net earnings per share in the current quarter (\$0.01 year to date), compared to net earnings of \$0.04 per share (including special items) in the second quarter of the prior year (\$0.04 year to date) on both a basic and fully diluted basis.

### **Sales**

Sales of aviation water treatment equipment continue to increase. The second quarter shows a volume growth of 29% from the previous year, notwithstanding a negative shift of 6% in the US/ Canadian exchange rate between the two quarters.

### **Direct sales margins**

Margin rates on equipment and parts sales have increased by about 5% year to year. This improvement is attributable to lower manufacturing expenses (salaries and rentals) and the growth in sales.

### **Reclassification of prior year expenses and the retroactive adoption of Stock Based Compensation guidelines:**

Certain comparative figures have been reclassified to conform to the presentation of manufacturing expenses adopted in the final quarter of the prior year, which expenses were previously included in selling, research development, administration and occupancy.

In the fourth quarter of fiscal 2005, the Company adopted, retroactively to fiscal 2004, the amended guidelines for recording the fair value of Stock Options vesting during a reporting period. Accordingly, the stock option compensation benefits recorded for fiscal 2005 has been reflected in the adjusted comparative results for stock options vesting in the each quarter of fiscal 2005.

### Operating expenses

Selling expenses of \$87,834 for this quarter increased 18% over the comparable period of the prior year. The increase arose principally from trade-show costs incurred during the second quarter.

Engineering and product development expenses of \$91,332 in the second quarter decreased by 5% for compensation and contracted work, although on a year to date basis there was a net increase of 16% above the prior year due to continued emphasis on product improvements and proposal work in recent periods.

General, administration and information technology expenses totaled \$217,205, a 21% increase from the same quarter in the prior year. This increase was primarily attributed to moving costs, legal fees, and compensation increases since the prior year.

### Quarterly information

The following summary information is taken from the Company's quarterly and annual financial reports covering the last eight reporting quarters.

#### Quarterly Results Reported for: (\$000's except per share amounts)

	Fiscal year 2006		Fiscal year 2005				Fiscal year 2004	
	Mar 31	Dec 31	Sep 30	Jun 30	Mar 31	Dec 31	Sep 30	Jun 30
Sales	\$926	\$794	\$816	\$723	\$825	\$771	\$753	\$934
Earnings (loss) from operations, before under noted	114	72	50	42	41	31	(60)	(162)
Gains on asset sales and debt settlements				10	755			
Write down of deferred and other assets					(15)		(3,834)	
Net income (loss)	\$114	\$72	\$50	\$52	\$781	\$ 31	\$(3,894)	\$(162)
Earnings (loss) per share, basic and fully diluted	\$0.00	\$0.00	\$0.01	\$0.00	\$0.04	\$0.00	\$(0.21)	\$(0.01)

There are no factors which may be used to predict future performance in either sales or in net income or loss on a quarter to quarter basis.

## **Liquidity and capital resources**

There have been several important changes to the balance sheet during the second quarter, mainly attributable to the completion of leasehold improvements, investment in infrastructure at the Company's new location and reduction in the demand loan.

### **Cash position:**

Cash reduced by \$117,051 to \$237,157 due to investment in leaseholds and equipment, a reduction in the demand loan, financed in part by operating cash flow.

### **Cash flow from operations:**

Cash provided from operating activities, before non-cash operating working capital, was \$130,942 in the current quarter compared to \$212,383 cash provided in the same quarter of the prior year that included special items. Increased sales have led to additional working capital required to finance receivables during the quarter.

### **Capital expenditures:**

In total, capital expenditures of \$178,890 were incurred during the second quarter to purchase equipment and fund leasehold improvements as the company moved into its final new facility. Approximately 50% of these costs were financed with long term capital leases.

### **Cash utilized for debt reduction:**

A \$147,000 repayment in the second quarter was made under the Company's credit line, to a factoring company, to utilize a portion of the company's cash reserves. The available credit line may be drawn down as required. Also, a \$4,146 payment was made towards the Company's equipment loan while new capital leases were obtained to finance new equipment as noted above.

### **Working capital position:**

The Company completed its second quarter ended March 31, 2006 with working capital of \$664,802, a further improvement from the position of \$576,218 at its fiscal year end. This improvement of \$88,584 was primarily attributed to improved cash flow during the periods.

### **Contractual obligations**

The new five and 1/2-year premises lease agreement, as amended, has been entered into by the Company effective with the termination of its previous lease on June 1<sup>st</sup>, 2005, and at financial terms similar to that of the prior lease. The Company's other contractual obligations have not changed materially from that stated in its audited financial statements and MD&A for the fiscal year ended September 30, 2005.

## **Share capital**

The Company has 33,549,694 common shares outstanding as at the date of this report. In addition, there are 2,270,000 options outstanding under the Company's stock option plan. Subsequent to March 31<sup>st</sup>, 247,500 warrants were exercised at \$0.10 each while 72,500 warrants expired. These warrants related to private placements of common shares in May 2005. Details of these options and warrants are included in the notes to the financial statements.

## **Related party transactions**

There are no reportable related party transactions that occurred in the quarter being reported.

## **Risks and Uncertainties**

IWG recognizes that certain risks are inherent in its business plan:

### **Aircraft markets**

The Company's primary customers are business use aircraft manufacturers, owners and operators. Such markets are cyclical over time although often differing from the cycles for commercial aircraft. Sales are made on a standard or optional basis and are dependent upon the production rates and customization of new aircraft or the requirement for upgrading existing aircraft by owners.

### **Competition**

#### **Aviation - Potable Water Treatment**

At this time, there are no other companies of significance supplying flight certified potable water disinfection equipment to the aircraft industry, and IWG dominates the market. It is expected that competition will come, although IWG intends to remain the dominant player in this field because of its significant head start, and by developing new products, pricing new and existing products as though competition exists, and continuing to seek customer input. From time to time very small players attempt to penetrate the market, but none have been successful. A variety of water filters are used by some airlines and operators, but these do not actively treat and disinfect the water.

#### **Aviation - Potable Water Systems**

Currently, IWG is aware of several major full water systems providers in addition to itself. Their focus tends to be on the airliner/ regional jet markets, whereas the Company currently places most of its attention on the corporate/ VIP jet market. At least one of the companies competes directly in the corporate/ VIP market. A variety of companies provide components to aircraft manufacturers for inclusion in their potable water system designs, but only IWG and these firms are offering aircraft manufacturers a full system solution as a kit

## **Foreign Exchange**

Generally, fluctuations in the Canadian to United States dollar exchange rate are recorded as transactions occur and at the end of the period financial results are reported. The details of the Company's foreign exchange policy are included in the notes to the annual audited financial statements.

A majority of the Company's sales are invoiced in U.S. dollars, which are offset to some extent by the portion of its product costs that are also in U.S. dollars. Consequently, fluctuations in the Canadian to U.S. dollar foreign exchange rates will impact sales revenue, gross margins and net earnings reported by IWG. With the shift in US/ Canada exchange rates in recent periods, this is an area of risk that has been mitigated to some degree by carefully considered price increases.

The Company has not previously employed any financial instruments to hedge its foreign exchange position, because its past sales contracts generally have been short term. However, as the Company succeeds in securing longer-term production supply contracts, hedging of future foreign exchange requirements may be implemented.

## **Financial Resources**

During fiscal 2005, important milestones were achieved in stabilizing the company's financial situation. Since that time, a positive cash flow has continued and sufficient cash is available to fund its current capital expenditures and level of operations, providing a base on which the company can continue its growth in the aviation market. Continuing growth may require additional capital beyond that generated from operations.

This is not an exhaustive list of the various risk factors that may be faced by the Company, but is a specific reference to the major risk factors addressed by the Company.

## **Business outlook**

Development activity pursued by IWG in recent years has assured that its UV based water treatment products and systems are at the leading edge of aviation market requirements. The business outlook on the aviation sector is strong, and potable water quality is being perceived as an increasingly important issue, as evidenced by recent EPA reports.

International Water-Guard Industries, historically a developer of UV-based water treatment equipment for several niche markets has become a primary supplier of engineered water treatment units and systems for the aviation market. IWG's goal is to significantly grow its business as a provider of water systems and disinfection units to the aviation industry.

## **Other information**

Additional information relating to the Company is available under the Company's name on SEDAR at [www.sedar.com](http://www.sedar.com).