

INTERNATIONAL
WATER-GUARD
INDUSTRIES INC.
THE WATER KNOWLEDGE COMPANY



Annual Report - Fiscal 2001



PRESIDENT'S MESSAGE

To Our Shareholders,

As I look back on the events of Fiscal Year 2001, I find myself in the unusual position of reflecting upon a full year of business activity and yet feeling drawn to characterize that year, and the one to come, in light of a single day. Our fiscal year ended less than three weeks after the tragedy of September 11, and so the gratifying results presented in this report were achieved before the widespread impact of that day's events could be felt.

More than five months have passed since our fiscal year end; months that have seen economic shock waves circle the globe. While no enterprise can be completely protected from a downturn of this magnitude, it is with pleasure that I can report that the results of Fiscal 2001 have placed IWG in a position to not only withstand the economic shock, but to prosper as well. IWG is entering this era of uncertainty with a strong base of sales and with achievable short-term goals ahead of us.

A primary feature of Fiscal 2001 is the fact that IWG continued on its path of steady growth. Our sales are again up dramatically, and corporate aviation, our major focus market, is experiencing a strong level of activity that is predicted to continue well into the future. Industry predictions of growth in corporate aviation are being made despite the negative effects of September 11 on the world's commercial aviation industry.

As the attached financial documents show, IWG's earnings for Fiscal 2001 were \$205,423 on sales of \$3,874,604. This compares to a loss in Fiscal 2000 of \$573,002 on sales of \$2,385,684. These results also translate to Fiscal 2001 earnings of \$0.03 per share on both a basic and fully diluted basis, compared to last year's loss of \$0.10 per share.

The \$778,425 improvement in operating results is primarily due to a 62% increase in sales. Perhaps just as importantly, the Company's net expenses were held to a 7% increase year over year.

A number of factors combined to generate the sales increases in 2001, and demonstrable progress in marketing IWG's products and systems to the corporate aviation industry once again heads the list.

In addition to increased 'stand-alone' product sales, IWG's patent-pending circulating potable water system (PWS) made the jump from advanced design to a proven, certified kit during the past year. IWG's initial PWS installation on a Bombardier Global Express aircraft was completed, and received all-important Supplemental Type Certificates (STC) from both Transport Canada and the U.S. Federal Aviation Administration (FAA). The STC's allow IWG to install the PWS on other Global Express aircraft without the massive paper burden of the initial installation. Since the STC relates to an aircraft that is in service, it constitutes a documented 'proof of concept' that is being used to secure further system sales.

Another factor contributing to the Fiscal 2001 results stems from IWG's commitment to product research and development. An example of this is the Company's investment of \$1 million in circulating PWS design and certification. Financing for this investment was provided by both internally generated funds and the issuance of common shares. The PWS is a major example of R&D efforts, but IWG also completed and certified an upgrade to our successful NPS-A3 product, as well as delivering a pre-production prototype NPS-A4 unit to a corporate jet manufacturer for evaluation.

The good news is not restricted to our efforts in corporate aviation. As with aviation, Research and Development are also an important component of our Industrial products team. During Fiscal 2001, the IWG team completed the development of a new 'open channel' ultraviolet water disinfection system. The open channel system can handle much larger flow rates than our traditional closed chamber designs and was undertaken at the request of an aquaculture customer. Several installations of this efficient new system have been made at locations on Vancouver Island.

Because of its higher flow rates, the open channel design is also well-suited to disinfect both potable water and waste water for small municipalities. During the year, IWG began to explore opportunities for joint efforts in this market with a regional utility subsidiary.

A new design, high-intensity closed chamber unit was also developed in Fiscal 2001, and initial sales were recorded with salmon hatcheries in Chile's large and growing aquaculture industry. Along with the open channel units, the new high intensity design considerably broadened IWG's product mix, and made a significant contribution to the year's positive results.

The development of new markets has always been a part of our business plan, and major steps were taken in this direction during Fiscal 2001. I have discussed both the circulating PWS that has made IWG a full systems supplier as well as a product manufacturer, and the new product sales to the Chilean aquaculture industry. The other major market development project underway in the year was in China. Various IWG members made several trips to Fujian Province, where our potential partner is located, and collectively laid the groundwork for a mutually beneficial

relationship between the two parties. We expect to report further about our involvement in the world's largest aquaculture market in mid-Fiscal 2002.

New products and new markets are important aspects of our approach to business, but just as important to our success are new people. During Fiscal 2001, we were fortunate to welcome three senior members to the IWG team. Ryaz Shariff, an accomplished investment professional with expertise in restructuring and financing early stage companies, accepted an invitation to join our Board of Directors. Ryaz holds the Chartered Financial Analyst designation. Our aerospace engineering expertise took a major step forward with the addition of Barry De Bruyn and David Pohl. Barry is IWG's Director of Plans and Programs Management, and has 41 years' experience in managing military and civil aerospace engineering projects. David brings an additional 18 years of Program Management experience in U.S. military and Canadian civil aerospace engineering projects. . All three have been working hard on behalf of IWG, and we are experiencing the positive effects of their contributions.

In addition to new Board and staff members, IWG has also developed a relationship with three new 'virtual team' members. TAG Aerospace of Delta, BC, provides a wealth of engineering capabilities to augment IWG's own staff engineers. TAG's collective resume includes expertise in complex aerospace engineering design, finite element modeling, stress analysis, and damage tolerance analysis. To further assist in the design of lightweight titanium aircraft potable water tanks, IWG is also working closely with D3 Technologies, of Mukilteo, Washington. This team of experts in airframe, propulsion, aircraft systems, aircraft interiors, tooling and mechanical equipment design provide state of the art engineering solutions for several prestigious OEM aircraft companies and after-market aircraft modification centres. The third significant addition to the IWG team is High-Tech Welding Services of El Cajon, California. High-Tech has developed unique 'Super Plastic Forming' (SPF) techniques that are ideal for the manufacture of strong, lightweight titanium water tanks.

As I mentioned at the beginning of this message, I feel extremely fortunate to be able to share good news at a time when, for so many individuals and companies, it is hard to come by. But in business, good news doesn't just happen. It is the result of a great deal of hard work by a number of people inside and outside the company. With this in mind, I would like to close by not only sincerely thanking all of the IWG staff and our virtual team members, but also our shareholders, customers, suppliers, advisors, and members of the Board of Directors for their continued support.

On Behalf of the Board

"C.W.Coote"

Bill Coote
President and CEO

BUSINESS DESCRIPTION

Overview

International Water-Guard Industries Inc. IWG is poised to be the dominant supplier of on-board water systems and water treatment equipment to the aviation industry. Aircraft water systems and water treatment equipment represent a \$1 billion (Cdn) annual market (\$220 million for corporate aircraft and \$780 million for commercial aircraft). These market forecasts were made prior to the terrorist attacks of September 11, 2001. Despite the aviation industry downturn since then, IWG provides its products primarily to corporate aviation, which has seen a surge of interest from corporations and individuals moving away from commercial carriers toward their own business aircraft. The company is therefore well positioned to take advantage of the aviation industry's one positive sector.

IWG is unique in that it is the only company currently supplying flight certified water purification equipment and circulating potable water system (PWS) kits to the aviation industry. Its participation in this market represents a major market opportunity in the next few years. As referenced above. The Company's initial marketing efforts in aviation have been focused on corporate aircraft, and to date, over 600 NPS-A2 and NPS-A3 water disinfection units have been installed on business jets worldwide.

IWG's own design of anew circulating PWS was installed on a Bombardier Global Express corporate jet at the aircraft completion facilities of The Jet Center in Van Nuys, California, in January 2001. The Company has since obtained Supplemental Type Certificates in the U.S. and Canada for PWS installations on this aircraft model. A circulating potable water system based on the IWG design and using IWG pumps and disinfection equipment has been operating flawlessly since September of 1999 on a Boeing Business Jet (BBJ) completed by Lufthansa Technik (a major international aircraft completion company). IWG remains the sole supplier of these components for Lufthansa Technik under the terms of a long-term contract.

Ongoing discussions are underway with the major manufacturers of corporate aircraft to have the Company's equipment or circulating PWS incorporated as standard equipment. The Company believes these goals are achievable in the near future, which will enable IWG to capture a significant share of the annual aircraft market for on board aircraft water systems. Once the Company's circulating PWS is established as a standard issue water system on business aircraft, the Company anticipates that it will be in a position to move its products into the larger commercial airline market

The Company's expertise in potable water equipment and systems for aircraft is based on developing systems and stand alone water treatment equipment for industrial and commercial customers. These applications include aquaculture and fish farming facilities, small municipal plants, pharmaceutical plants, film processing plants, aquariums and food processing plants. The aquaculture and wastewater UV industrial market sectors in which the Company operates, while quite segmented, represents an estimated \$225 million annual market in North America and the Company anticipates expanding its market share in the next few years. Additionally, IWG is assessing a very large opportunity for its aquaculture products in China following initial sales during the past year.

AVIATION PRODUCTS

Aircraft Circulating Potable Water System Kits

IWG's circulating aviation potable water system was designed to address the major problems associated with the water systems currently in use on aircraft – water quality and freezing. It was also designed to weigh less and take up less space on aircraft than existing water systems. IWG's circulating PWS occupies 25% to 40% fewer cubic feet and weighs from 80 to 200 pounds less than existing systems, depending on which aircraft model is considered. This saving provides more space and weight allocation for paying cargo, including passengers. The IWG circulating PWS also has greater reliability due to the simplicity of its design and a reduced number of components.

The circulating PWS is comprised of aviation potable water treatment equipment (NPS-A2's or NPS-A3's) to disinfect on-board water, pumps to circulate the water in aircraft, tanks that conform to the shape of the aircraft (thereby saving space), piping and related distribution equipment and associated sensors and controls. The essence of the new system design for aircraft is to constantly circulate potable water within the system, continually upgrading the quality of the water and essentially maintaining all parts of the system itself at a constant temperature. The first example of this new system was installed onboard a Boeing Business Jet (BBJ) in the last quarter of 1999 and has operated flawlessly since then.

IWG has installed and certified on a Bombardier Global Express air-craft at The Jet Center in Van Nuys, California. In 1998, the Company filed a patent application in the U.S.A. (with corresponding foreign filings) outlining this totally new approach to aircraft potable water treatment and water management.



The Bombardier Global Express business jet at The Jet Center's facility in Van Nuys, California during installation of the IWG circulating PWS.

The Aviation Potable Water System Pump

In collaboration with an established aviation specialist company in the United States, IWG has designed and built a new aircraft potable water system pump based on the same technology as the



The IWG-specified aircraft potable water system pump.

current highly successful aircraft fuel pumps. The design was aimed at continuously circulating potable water, thereby eliminating the need for water line heating systems on aircraft travelling long distances at high altitudes. The water pump has no dynamic seals, is thermally protected, and provides infinitely variable flow with no need of active controls. This pump is an essential part of IWG's circulating aviation potable water system.

The initial IWG water pump project, completed in 1999, resulted in a highly reliable, aviation standard water pump with a guarantee of 100,000 hours mean time between failure (MTBF). Since 1999, two new versions of the pump have been designed to match the requirements of different aircraft and customer needs.

NPS-A2 and NPS-A3 Aircraft Water Treatment Units

The NPS-A2 and NPS-A3 provide on-board water disinfection, and are the only known ultraviolet disinfection units in the world qualified to be marketed for corporate and commercial aircraft. These products have U.S. Federal Aviation Administration (FAA) and Transport Canada approval in the form of Supplemental Type Certificates for corporate aircraft. Additionally, Transport Canada has certified IWG as an approved organization for the Manufacturing, Certification, and Maintenance of aeronautical products.

The NPS-A2 and NPS-A3 were designed to address the problem of water quality on aircraft, and can be installed on both existing aircraft as a retrofit by fleet operators or by OEMs as original equipment.

Airline operators are properly reluctant to take on water from many parts of the world due to growing concerns about various aspects of source contamination. The NPS-A2 and NPS-A3 water treatment units provide added insurance of water quality to the operators (and their passengers) of any aircraft loading water from virtually any approved municipal source.

IWG believes that the installation of the NPS-A2 and NPS-A3 as potable water tank exit devices will become an increasingly cost effective measure for airlines and other commercial operators based on regulatory trends. The potable water systems of Interstate Commercial Carriers - including those of commercial airlines - may soon be viewed by U.S. regulatory bodies such as the Environmental Protection Agency (EPA) and the Food and Drug Administration (FDA) as public water systems. As such, the water in these systems would have to be tested monthly and, if required, immediate system cleansing would have to be undertaken at a very significant cost due to the loss in aircraft operational hours. Independent analysis has calculated that the break-even point for installation of NPS-A2's and NPS-A3's on commercial aircraft ranges from 2.60 to 27.75 months depending on the aircraft involved and its particular operating parameters.



IWG's original model NPS-A2 aircraft potable water disinfection unit.



The new NPS-A3 combines disinfection with filtration.

As of January, 2002, over 600 NPS-A2 and NPS-A3 units have been installed on virtually every type of private, corporate and head of state jets around the world, including privately owned airliners.

INDUSTRIAL AND COMMERCIAL MARKET

Industrial/Commercial Ultraviolet Disinfection Units

The Company manufactures a series of "closed chamber" UV disinfection units ranging in flow rate from 1 US gallon per minute (USGPM) to 850 USGPM. These units are designed to exceed the operational and disinfection standards of the National Sanitation Foundation (NSF). The NSF sets standards and grants certification for water treatment equipment in the U.S.

The Company has established sales channels in Canada and the U.S. on which to build a stronger sales base over the next few years. For example, either on a direct sale basis or through agents, IWG equipment has been integrated into numerous coastal hatcheries, seafood processors or aquariums, such as Scotian Halibut in Nova Scotia, Fanny Bay Oysters on Vancouver Island, the San Diego Aquarium and the New Orleans' Aquarium of the Americas. To meet medical biotech water processing requirements, IWG equipment provides a quality solution for the B.C.-based facilities of Response Laboratories, Stem Cell Technology and for Mitro Flow (heart valve) Laboratories.

During Fiscal 2001, IWG continued to develop its new high throughput "open channel" ultraviolet water treatment system for the treatment of potable or wastewater. In addition to pursuing the open channel system's original market in aquaculture, the Company worked to expand into the small municipal market. The open channel system's flow rates of 200 to 2000 US Gallons per

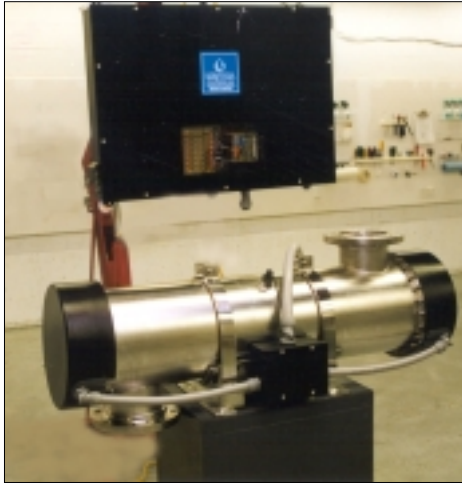


The photos above illustrates IWG's new open channel ultraviolet water treatment modules installed at the Big Tree Creek Hatchery on Vancouver Island. Each module contains 14 lamps arranged in a new, more effective pattern providing better ultraviolet dosage with fewer lamps than competing models. The IWG system can be installed in series or parallel depending on customer needs.

minute make it attractive for small communities seeking an alternative to chlorine disinfection. Rather than take on the full cost of new market development, IWG has formed a close relationship with the subsidiary of a regional utility company that is offering turnkey water system 'build and operate' contracts to small municipalities in British Columbia and Alberta.

The new open channel systems (patent pending) are modular in construction for installation flexibility, and can be employed to disinfect water or for ozone destruction, or 'quenching.'

IWG staff also designed and manufactured new models of the "XL" series of closed chamber ultraviolet disinfection units that were successfully introduced into the Chilean aquaculture market last fiscal year. The "XL" series employs a longer, high intensity lamp to achieve the flow rates required by some of our industrial customers.



Prototype stainless steel ultraviolet unit with 'amalgam lamps'.

Design work also began on two new stainless steel models that will employ the longer, high intensity lamps as well as new 'amalgam' lamps. Work also began on an update of the company's standard "15 Series" closed chamber units. All of these developments are in response to current or anticipated changes in the marketplace, and are designed to maintain IWG's competitive edge.

The Company continues to explore the possibility of a Joint Venture in China with a manufacturer based in Fujian Province. Fujian is one of the most active aquaculture regions in China, which taken as a whole, is the world's largest aquaculture market. Representatives of IWG and our potential partner have met both here in Canada and in Fujian during the last fiscal year to advance the project. As of this publication, a contract had not been signed, but both parties continue to work toward that end.

Management Discussion and Analysis

MANAGEMENT DISCUSSION AND ANALYSIS

Overview

Comments in this analysis should be read in conjunction with the comparative audited financial statements included in this annual report for the fiscal year ended September 30, 2001. Such comments also apply to the financial information summarized in the Company's Annual Information Form. The following discussion, and the information elsewhere in this report, is intended to provide the reader with an understanding of the Company's business and factors underlying its financial results.

International Water-Guard Industries Inc. ("IWG") designs, manufacturers, sells, installs and services potable and process water treatment/management equipment and systems, for niche markets to aviation, industrial and commercial customers in a number of areas of the world. The principal technology embodied in IWG's products is irradiation by ultraviolet ("UV") light, with filtration, ancillary systems and controls designed by the Company.

The Company is emerging from several years of operating as a development company, with a base operation and revenues covering a portion of its product and market development costs, new equity has provided for the Company's capital commitments and working capital requirements. Sales, operations, business opportunities and capital requirements are increasing at a planned but significant rate, which will require additional equity and working capital financing, and the best skills of its expanded management team to steer several new projects to successful implementation.

Operating results

The Company reported earnings for the fiscal year ended September 30, 2001 of \$205,423 on sales of \$3,874,604. Fiscal 2001 results compare to a loss in the prior year ended September 30, 2000 of \$573,002 on sales of \$2,385,684. Fiscal year 2001 earnings of \$0.03 per share compares to the fiscal 2000 loss of \$0.10 per share, on both a basic and fully diluted basis.

IWG adopted, retroactive to fiscal 2000, the new accounting standard for earnings per share calculations as explained in the notes to the financial statements, which standard excludes contingently issued shares, such as the Company's performance common shares.

The \$778,425 improvement in operating results over the prior year was primarily due to a 62% increase in sales. Net expenses were held to a 7% increase year over year. The increase in sales resulted from higher product unit deliveries in both the aviation and industrial/commercial sectors. New product variants developed during the last two years, enabled IWG to expand its sales base and benefit from the market and product development efforts undertaken during the current and prior years.

Included in fiscal 2001 results is the delivery of the Company's first aircraft circulating potable water system, installed on a Bombardier Global Express aircraft. The Global Express potable water

system design was certified by both Transport Canada and the U.S. Federal Aviation Administration during the summer of 2001.

Sales

The sales increases experienced by the Company occurred principally after the first quarter and in both markets in which IWG operates. Increases were provided by both established and new customers, and from new products introduced during the year.

Sales of aviation products, representing 76% of total fiscal 2001 sales, increased by 56% over fiscal 2000. This increase represents a higher adoption rates of IWG's water disinfection units on-board business aircraft manufactured by Bombardier and Gulfstream, new contracts with Lufthansa Technik completion center for Boeing business jets, and other business aircraft manufacturers. This year represented the first full year that the Company's NPS-A3 water treatment unit was available, having been introduced in fiscal 2000. Fiscal 2001 also included the installation of IWG's new complete aircraft circulating potable water system for a Global Express customer, which system was certified by Transport Canada and the US Federal Aviation Administration authorities in the summer of 2001.

Industrial sales to the aquaculture and other water process applications, representing 24% of fiscal 2001 sales, increased by 89% over the prior year. This increase represents a higher number of UV based water treatment units and spare parts to both existing and new markets, either directly to the customer, through value added distributors or water treatment facility engineering firms, primarily in Canada and the United States. However, initial sales through such channels have also been made to customers in Chile and China for aquaculture applications. Introduction of IWG's new Open Channel modular UV water treatment equipment in fiscal 2001, for use in both aquaculture and waste water applications, formed part of the Company's sales increase in the year.

Sales to customers in Canada represented 33% of the Company's sales (vs. 24% in 2000) with 67% of sales exported, primarily to United States (vs. 76% in 2000).

Direct sales margins

Aggregate direct sales margins increased in line with sales, although at a slightly lower percentage rate than in fiscal 2000. Sales margins vary from product to product so sales mix will determine the overall margin result from period to period. In fiscal 2001, direct gross margin of 65% was slightly less than the 66% experienced in fiscal 2000. This year's results were affected by lower margins on the initial sale of both the new open channel product and on the first aircraft circulating water system installed during this year.

Operating expenses

Selling expenses of \$581,536 were 15% less than the \$684,735 in fiscal 2000. The reduction was due principally to the one time attendance by the Company at the Dubai Aerospace Trade Show in the fall of 1999; combined with a period of fewer sales personnel until mid-year 2001.

Research and development expenses charged to earnings of \$447,214 were the same as in the prior year. Such costs are directed to product technology enhancements and new product variants.

Such continuing efforts are in response to customer feedback and stated requirements, and to address known future market requirements as opportunities emerge.

General, administration and occupancy expenses totaled \$1,182,803, a 24% increase over the \$957,668 incurred in fiscal 2000. The costs of new staff and compensation increases were required to position the Company for emerging growth in sales activity; legal fees increases were related to intellectual property matters; and facility costs increased due to additional space planned in conjunction to the Company's new leased facility.

As more fully described in the notes to the financial statements, income taxes have not been recorded, due in essence to the availability of losses carried forward and the tax value of capital assets. The Company has adopted the new income tax accounting standards in fiscal 2001, under which income taxes will be recorded in the future when the value of such tax assets are certain to be realized.

Capital expenditures

Fiscal 2001 marked the launch by the Company to design and certify specific aircraft model circulating potable water systems ("CPWS") for sale to business aircraft manufacturers, completion centers and owners. In the fall of 2000, the Company commenced the design and supply of a circulating potable water system, under a contract, for installation on a Global Express customer's aircraft to be certified for use on future Global Express business aircraft. The installation was completed during the third quarter of fiscal 2001, and following flight test, the system was certified in the fourth quarter. Initial steps have also been taken for the design of the water system for a Boeing business jet.

To September 30, 2001, the Company had expended \$1,049,082 on such designs, including the certification of its first design for the Global Express aircraft and commencement of a Boeing business jet aircraft CPWS. These initial designs will provide IWG with the certification ("STC") necessary to permit it to provide CPWS to aircraft of the same type on a recurring basis in the future. These costs include preliminary and detail design engineering costs, stress analysis, certification efforts by designated airworthiness engineers, component testing and project management. Although the costs of such initial design and supply contracts are significant, they are necessary in order to enable the Company to achieve its goal of becoming the dominant supplier of water systems to business and, subsequently, commercial aircraft manufacturers.

Under current accounting conventions, such costs have been deferred and capitalized and will be amortized over future aircraft water system kit deliveries as explained in the notes to the financial statements.

In prior years, IWG made significant expenditures on initial research and development to establish the marketability of the Company's design and to supply complete CPWS kits to the full range of corporate aircraft in the near future.

Liquidity and capital resources

During the year, the Company's working capital requirements were met by operating cash flow and a credit line from a factoring agency. The working capital position at the fiscal year end amounted to \$627,716 of which \$76,434 was in cash. IWG raised \$1,153,555 from the private placement of new common share equity and the exercise of options applied principally to the new aircraft water system designs.

The Company is taking further steps to acquire working capital and long-term financing necessary to fund additional aircraft design costs, systems, infrastructure and working capital growth from expanded sales.

The benefit of IWG's product and market development efforts is reflected in the Company's sales backlog, including options, that was \$3.3 million as at September 30, 2001.

Risks and Uncertainties

IWG recognizes that certain risks are inherent in its business plan and has chosen to implement the following strategies to address them:

Competition

At present, the Company is not aware of any direct competitors to its aviation UV water treatment equipment. However, other companies also provide water systems for aircraft, at least one of which is based on IWG's design concepts and incorporate IWG's equipment into their systems. There are also much larger and better financed companies that supply water tanks and other components of the originally designed water systems to aircraft manufacturers, and these companies, such as Goodrich, should be considered competition to the Company. However, such companies may also become customers for IWG's products.

To secure a dominant position in the aviation water system market, the Company will attempt to protect its competitive position by maintaining its lead in product technology development, securing intellectual property protection (where possible) for its equipment and systems. Further, the Company will secure and maintain all certifications necessary for the manufacture and use of its equipment in the aviation market, pricing its products competitively with current products, and entering into long term agreements with aircraft manufacturers and others. In addition, IWG will enter into alliances with major aircraft design firms and aviation suppliers to participate in systems designed for each aircraft model, thereby adding personal depth and skills to the Company's development capacity.

The industrial and commercial market is very large and dominated by companies much larger, better financed and with better distribution channels than IWG. Typically, these companies are focused on large projects such as municipal drinking water or wastewater treatment. The Company has chosen to target only niche markets for which it has a competitive position, special knowledge or technology, and ally itself with specific project providers in niche markets. Competitors include Trojan, Zenon, Aquafine, Atlantic Ultraviolet and Ultra Dynamics.

Foreign Exchange

Most of the Company's sales are invoiced in U.S. dollars, while only a portion of its product costs are in U.S. dollars. Fluctuations in the Canadian to U.S. dollar foreign exchange rates will have an impact on sales revenue, gross margins and net earnings reported by IWG. 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 will be implemented.

Outlook

The market and product 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 market requirements. Significant requirements for such products and systems have been identified in both the Company's aviation and industrial/commercial markets and are being pursued to obtaining near term and long term contracts, consistent with the Company's business plan. While significant aircraft water system design costs for contracts and infrastructure expenditures allied with sales growth will require additional financing, the required working capital and equity financing is being pursued.

International Water-Guard Industries, historically a developer of ultraviolet based water treatment equipment for several niche markets supported by equity financing and a base level of revenues, is becoming an operating manufacturer of engineered ultraviolet based water treatment products and systems. With its certified and proven business aircraft circulating potable water system, IWG expects to become the principal provider of water systems or disinfection units to most of the well known mid to larger business aircraft available in the market.

Financial Statements of

International Water-Guard Industries Inc.

Years ended September 30, 2001 and 2000



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AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the balance sheets of International Water-Guard Industries Inc. as at September 30, 2001 and 2000 and the statements of operations and deficit and cash flows for the years then ended. 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 financial statements present fairly, in all material respects, the financial position of the Company as at September 30, 2001 and 2000 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 (British Columbia), we report that, in our opinion, these principles have been applied, after giving retroactive effect to the change in calculating earnings (loss) per share as explained in note 2(i) and the change in accounting for income taxes as explained in note 2(g), on a consistent basis.

KPMG LLP (signed)

Chartered Accountants

Vancouver, Canada

December 7, 2001



KPMG LLP, a Canadian owned limited liability partnership established under the laws of Ontario, is a member firm of KPMG International, a Swiss association.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Balance Sheets

September 30, 2001 and 2000

	2001	2000
Assets		
Current assets:		
Cash	\$ 76,434	\$ 27,597
Accounts receivable	763,562	410,696
Inventory (note 3)	729,651	584,710
Prepaid expenses	7,419	11,830
	<u>1,577,066</u>	<u>1,034,833</u>
Fixed assets (note 4)	156,649	173,548
Deferred foreign exchange loss	12,250	-
Deferred aviation system design costs, net of accumulated amortization of \$55,000	994,082	-
	<u>\$ 2,740,047</u>	<u>\$ 1,208,381</u>

Liabilities and Shareholders' Equity (Deficiency)

Current liabilities:		
Accounts payable and accrued liabilities	\$ 607,837	\$ 515,600
Demand loan (note 5)	100,000	-
Current portion of note payable (note 7)	241,513	143,943
	<u>949,350</u>	<u>659,543</u>
Convertible debenture (note 6)	-	500,000
Note payable (note 7)	124,813	241,932
	<u>1,074,163</u>	<u>1,401,475</u>
Shareholders' equity (deficiency):		
Share capital (note 8)	4,461,791	2,808,236
Deficit	(2,795,907)	(3,001,330)
	<u>1,665,884</u>	<u>(193,094)</u>
	<u>\$ 2,740,047</u>	<u>\$ 1,208,381</u>

Contingencies and commitments (note 10)

See accompanying notes to financial statements.

Approved on behalf of the Board:

"C.W. Coote" Director

"D.M. Hall" Director

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Statements of Operations and Deficit

Years ended September 30, 2001 and 2000

	2001	2000
Sales	\$ 3,874,604	\$ 2,385,684
Cost of goods sold (note 3)	1,372,787	803,541
Gross profit	2,501,817	1,582,143
Expenses:		
Selling expenses	581,536	684,735
Research and development	447,214	442,694
General, administrative and occupancy	1,182,802	957,668
Amortization	84,674	30,759
Interest and bank charges	76,822	99,462
Government assistance	(76,654)	(60,173)
	2,296,394	2,155,145
Net earnings (loss)	205,423	(573,002)
Deficit, beginning of year	(3,001,330)	(2,428,328)
Deficit, end of year	\$ (2,795,907)	\$ (3,001,330)
Earnings (loss) per share amounts (note 8(e)):		
Basic	\$ 0.03	\$ (0.10)
Diluted	0.03	(0.10)

See accompanying notes to financial statements.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Statements of Cash Flows

Years ended September 30, 2001 and 2000

	2001	2000
Cash flows from (used by):		
Operations:		
Net earnings (loss)	\$ 205,423	\$ (573,002)
Amortization, an item not involving cash	84,674	30,759
	290,097	(542,243)
Change in non-cash operating working capital:		
Accounts receivable	(352,866)	281,733
Inventory	(144,941)	(348,040)
Prepaid expenses	4,411	19,755
Accounts payable and accrued liabilities	92,237	320,519
	(111,062)	(268,276)
Investments:		
Purchase of fixed assets	(12,775)	(143,966)
Deferred aviation system design costs	(1,049,082)	-
	(1,061,857)	(143,966)
Financing:		
Proceeds (repayment) of demand loan	100,000	(195,761)
Convertible debenture issued	-	500,000
Repayment of note payable	(31,799)	-
Issue of common shares for cash	1,153,555	-
	1,221,756	304,239
Increase (decrease) in cash	48,837	(108,003)
Cash, beginning of year	27,597	135,600
Cash, end of year	\$ 76,434	\$ 27,597
Supplementary information:		
Interest paid	\$ 68,046	\$ 27,960
Income taxes paid	-	-
Non-cash transactions:		
Settlement of accounts payable through issue of note payable	-	385,875
Conversion of debenture into common shares	500,000	-

See accompanying notes to financial statements.

1. Operations:

The Company was incorporated on September 22, 1989 under the Company Act (British Columbia). The Company's principal business operations relate to the development, manufacture and sale of water purification systems.

The Company has an accumulated deficit of \$2,795,907 as at September 30, 2001 as a result of losses incurred in past years. These financial statements are prepared on a going

concern basis that assumes the Company will realize its assets and discharge its liabilities in the normal course of business. The Company will be required to maintain ongoing profitable operations and the financing necessary to continue its research, development and operating activities to continue as a going concern.

2. Significant accounting policies:

(a) Basis of presentation and operations:

The Company's financial statements are prepared in accordance with Canadian generally accepted accounting principles. These principles require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Significant estimates used in the preparation of these financial statements primarily relate to the assessment of the net realizable value of inventory and the recoverability of deferred aviation system design costs. Actual results could differ from these estimates.

(b) Inventory:

Inventory is valued at the lower of cost, determined on a first-in, first-out basis, and estimated net realizable value. Raw materials inventory includes parts to be used in the manufacturing process. Finished goods inventory includes the cost of raw materials, direct labour, freight and other direct manufacturing costs.

(c) Fixed assets:

Fixed assets are stated at cost. Amortization on molds and equipment is provided using the declining-balance method at a rate of 20% per annum. Leasehold improvements are amortized over the term of the lease on a straight-line basis.

(d) Revenue recognition:

Revenue is recognized when persuasive evidence of a contractual arrangement exists, all of the products and services have been delivered to the customer and there are no significant vendor obligations remaining, the price is fixed or determinable, and collectibility is reasonably assured.

2. Significant accounting policies (continued):

(e) Government assistance:

The Company receives payments from time to time under various government assistance programs. These payments are recorded in the period during which the associated expenditure is incurred. Payments received in respect of operating expenditures are deducted from expenses and payments relating to capital additions are applied to reduce the cost of such additions. Under certain government assistance programs, the Company is required to pay future royalties to the government as a condition of receiving the grant (note 10(b)). Royalty payments are expensed when incurred.

(f) Research and development:

Research costs are expensed as incurred. Product development costs are expensed as incurred unless certain specified criteria for deferral have been met. The Company applies a stringent interpretation of these criteria, with the result that only costs associated with completing product applications already accepted by the market may be deferred.

Aviation system design costs include the cost of designing, testing and certifying the Company's new potable water system for a specified aircraft model type and are deferred until the system is certified for installation in aircraft by relevant authorities. Deferred system design costs are amortized based on future estimated aviation potable water system sales during a maximum period of six years. Routine alterations to existing products are expensed as incurred.

(g) Income taxes:

Effective January 1, 2000 the Canadian Institute of Chartered Accountants changed the accounting standards relating to the accounting for income taxes. Under the new standard, future income tax assets and liabilities are determined based on temporary differences between the accounting and tax basis of the assets and liabilities, and are measured using the tax rates expected to apply when these differences reverse. A valuation allowance is recorded against any future tax asset if it is more likely than not that the asset will not be realized.

Prior to the adoption of this new standard, the Company accounted for income taxes using the deferral method. Under such method, deferred income tax expense was determined based on timing differences between the accounting and tax treatment of items of expense or income, and was measured using tax rates in effect in the year the differences originated. Certain deferred tax assets were not recognized, principally the benefit of losses carried forward, unless there was virtual certainty that they would be realized.

The Company has adopted the new income tax accounting standard in fiscal 2001 retroactively to September 30, 2000. However, the Company has determined that there is no effect on prior year's results. The Company's future tax assets consist primarily of losses carried forward which are presently offset by a valuation allowance.

2. Significant accounting policies (continued):

(h) Stock-based compensation plans:

The Company has a stock-based compensation plan, which is described in note 8(c). No compensation expense is recognized for this plan when stock options are issued to employees. Any consideration paid by employees on exercise of stock options is credited to share capital.

(i) Earnings per share:

Effective September 30, 2001, the Company adopted the new accounting standard for earnings per share calculations issued by the Canadian Institute of Chartered Accountants. The new Section affects the calculation of basic earnings per share amounts as a result of the exclusion of contingently issuable shares, such as those discussed in note 8(b), which are no longer included in the weighted average number of common shares outstanding. The new section also affects the calculation of diluted per share amounts requiring the use of the treasury stock method of calculating the dilutive effect of outstanding warrants and options. Securities such as stock options and warrants are included in the calculation of diluted per share amounts only if the market price of the underlying common shares exceeds the exercise price. Further, it requires additional disclosure with respect to the earnings per share calculations.

This change in accounting policy has been applied retroactively and comparative per share amounts have been restated. The new standards resulted in an increase in basic loss per share from \$0.06 to \$0.10 for the year ended September 30, 2000.

(j) Foreign exchange translation:

Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at the rates of exchange in effect at the balance sheet date. Non-monetary assets and liabilities are translated at historical rates of exchange. Revenues and expenses are translated into the Canadian dollars at the rates of exchange in effect at the dates of the transactions. Gains or losses arising from foreign exchange translation are included in the results from operations, except for gains or losses on translation of long-term monetary items with fixed and determinable lives, which are deferred and amortized over the term to maturity of the long-term monetary item.

3. Inventory:

	2001	2000
Raw materials and work in process	\$ 477,955	\$ 488,670
Finished goods	251,696	96,040
	<u>\$ 729,651</u>	<u>\$ 584,710</u>

Cost of goods sold is determined as follows:

	2001	2000
Opening inventory	\$ 584,710	\$ 236,670
Manufacturing costs:		
Parts	1,186,218	873,058
Direct labour, freight and other	331,510	278,523
	<u>1,517,728</u>	<u>1,151,581</u>
Available for sale	2,102,438	1,388,251
Closing inventory	729,651	584,710
Cost of goods sold	<u>\$ 1,372,787</u>	<u>\$ 803,541</u>

4. Fixed assets:

	2001	2000
Molds	\$ 60,546	\$ 60,546
Manufacturing and distribution equipment	90,948	90,149
Furniture and office equipment	138,550	120,547
Leasehold improvements	94,996	101,023
	<u>385,040</u>	<u>372,265</u>
Accumulated amortization	228,391	198,717
Net book value of fixed assets	<u>\$ 156,649</u>	<u>\$ 173,548</u>

5. Demand loan:

During the year ended September 30, 2001 the Company entered into a credit facility agreement to fund current working capital requirements, which facility provides for the Company, maximum advances of \$300,000. Outstanding amounts are repayable on demand, bear interest at 3% per month and are secured by accounts receivable of the Company.

As at September 30, 2001, the Company has \$100,000 (U.S. \$63,750) outstanding under the credit facility.

6. Convertible debenture:

On October 13, 1999, the Company issued a convertible debenture having a principal amount of \$500,000 and bearing interest at the rate of 10% per annum calculated semi-annually. The convertible debenture had a maturity date of October 13, 2001 and was convertible at the option of the holder at \$0.60 per share up to and including October 13, 2000 and thereafter at \$0.70 per share to the maturity date. If the market price of the Company's common shares on each of 20 consecutive trading days was \$1.25 or more, the entire principal amount of the convertible debenture would have been automatically converted on the first business day after the 20th day of such consecutive trading days. On issuance, the value attributable to the conversion option was not material.

On October 11, 2000, the entire principal amount of the debenture was converted into 833,333 common shares.

7. Note payable:

On September 20, 2000, the Company issued a promissory note, denominated in US dollars, with a principal amount of U.S. \$257,250 (Cdn. \$385,875) in settlement of accounts payable for services rendered prior to September 1, 2000. The note payable bears interest at the rate of 10% per annum calculated monthly, commencing October 1, 2000. The principal amount is repayable in monthly installments with the final payment due on April 1, 2003. The noteholder has the option to convert 50% of the outstanding balance of the note into common shares of the Company at the rate of \$0.85 per share. In addition, a shareholder of the Company allotted 277,250 of the issued performance shares described in note 8(b) to the noteholder in connection with this settlement. The Company has not made the required quarterly payments during the year. The noteholder has agreed that prior to October 1, 2002 he will not take any action to accelerate any payments due after September 30, 2002 as a result of this non-payment. Payments totaling U.S. \$50,000 (Cdn. \$78,500), consisting of principal payments of U.S. \$20,254 (Cdn. \$31,799) and interest of U.S. \$29,746 (Cdn. \$46,701) have been made towards the repayments owed during the year ended September 30, 2001. On issuance, the value attributable to the conversion option was not material.

8. Share capital:

(a) Authorized:

20,000,000 common shares without par value

5,000,000 preference shares with a par value of \$1 each

(b) Issued common shares:

	Number of shares	Amount
Balance, September 30, 1999 and 2000	9,471,261	\$ 2,808,236
Issued on conversion of convertible debenture	833,333	500,000
Issued for cash in private placements of common shares	2,491,600	1,145,955
Issued for cash on exercise of stock options	15,000	7,600
Balance, September 30, 2001	12,811,194	\$ 4,461,791

The Company previously issued 3,679,884 performance shares which are releasable from escrow based upon the satisfaction of certain pre-determined cumulative cash flow tests. Release from escrow is subject to regulatory approval. Any escrowed shares not released by October, 2004 will be cancelled. Pursuant to the escrow agreement, holders of the performance shares may exercise all voting rights attached thereto, except on a resolution to cancel any of the shares, and have waived their rights to receive dividends or to participate in the assets and property of the Company on a winding-up or dissolution of the Company.

(c) Stock options:

The Company, from time to time, grants stock options to employees, directors, officers and certain consultants under the Company's stock option plan approved by the Company's shareholders on March 28, 2001. The maximum amount of options available for issue is 2,000,000 common shares. These stock options are granted at the discretion of the Board of Directors and have terms and conditions as directed by the Board of Directors. Stock options generally vest over a period of three years following the date of grant.

8. Share capital (continued):

(c) Stock options (continued):

A summary of the status of the Company's stock option plan as at September 30, 2001 and 2000 and changes during the years ending on those dates is presented below:

	2001		2000	
	Shares	Weighted average exercise price	Shares	Weighted average exercise price
Outstanding, beginning of year	483,750	\$ 0.82	705,000	\$ 0.80
Granted	2,668,750	0.60	-	-
Exercised	(15,000)	(0.50)	-	-
Cancelled or expired	(1,222,500)	(0.84)	(221,250)	(0.74)
Outstanding, end of year	1,915,000	\$ 0.50	483,750	\$ 0.82
Options exercisable, end of year	657,000	\$ 0.50	483,750	\$ 0.82

Stock options outstanding and exercisable at September 30, 2001:

Number of stock options outstanding	Options exercisable	Exercise price	Weighted average remaining contractual life
1,915,000	657,000	\$0.50	7.33 months

(d) Share purchase warrants:

In connection with the issue of the convertible debentures (note 6), the Company issued 200,000 share purchase warrants, all of which remained outstanding as at September 30, 2001. The issued share purchase warrants were exercisable into common shares at \$0.60 until October 13, 2000 and \$0.70 to October 13, 2001, the date of expiry. These warrants expired on October 13, 2001 without being exercised.

In connection with private placements of common shares (note 8(b)), the Company issued 695,750 share purchase warrants, all of which remained outstanding as at September 30, 2001. Of these issued share purchase warrants, 325,000 share purchase warrants are exercisable into common shares at \$0.50 until January 11, 2003, 325,000 share purchase warrants are exercisable at \$0.50 until February 14, 2003, and 45,750 share purchase warrants are exercisable at \$0.70 until December 12, 2001 and then at \$0.85 until December 12, 2002.

8. Share capital (continued):

(e) Earnings (loss) per share:

	2001			2000		
	Earnings	Weighted average shares	Per share amounts	Loss	Weighted average shares	Per share amounts
Earnings (loss) available to common shareholders	\$ 205,423	11,089,143		\$ (573,002)	9,471,361	
Contingently issuable shares (note 8(b))	-	(3,679,884)		-	(3,679,884)	
Basic earnings (loss) per share	205,423	7,409,259	0.03	(573,002)	5,791,477	(0.10)
Effect of dilutive securities:						
Convertible debenture	1,781	29,680		-	-	
Note payable	44,040	215,486		-	-	
Diluted earnings (loss) per share	\$ 251,244	7,654,425	\$ 0.03	\$ (573,002)	5,791,477	\$ (0.10)

For the year ended September 30, 2001, 1,915,000 options and 895,750 warrants were not included in the calculation of earnings per share amounts as the fair market value of the underlying shares was less than the exercise price. For the year ended September 30, 2000, 483,750 options, 200,000 warrants and 1,060,318 shares potentially issuable on conversion of convertible debentures and note payable, were not included in the calculation of diluted loss per share as their effects are anti-dilutive.

9. Related party transactions:

Included in accounts receivable is \$60,577 (2000 - \$30,268) receivable from shareholders of the Company. Included in accounts payable and accrued liabilities is \$10,437 (2000 - \$10,437) payable to shareholders and companies controlled by directors of the Company. During the year, the Company paid \$50,000 (2000 - \$45,833) to a company owned by an officer and shareholder for the provision of services.

10. Contingencies and commitments:

- (a) In 1995, an unrelated party asserted that the Company's use of the word "WaterGuard" in the United States violated registered trademark rights of that party in the United States. An action was filed in October 2000 with respect to this assertion. Management believes the action is without merit and is responding to the assertions claimed. As the outcome and the amount of any loss to the Company cannot yet be determined, no amount has been accrued with respect to this action. Any loss incurred will be recorded when determinable.
- (b) The Company has entered into an agreement with Technology Partnerships Canada ("TPC"), whereby TPC will assist in the funding of the development of its NPS-A3 potable water treatment system to the extent of the lesser of 30% of eligible costs and \$235,845. As a condition of this agreement, the Company has agreed to pay TPC a royalty of 2% of the gross revenues from the sale of NPS-A3 systems until September 30, 2005, or if the royalty payments to that date do not exceed \$365,180, then until the limit of \$365,180 is reached. Accumulated royalties paid or payable to September 30, 2001 totaled \$41,829 (2000 - \$19,982).
- (c) The Company entered into a long-term operating lease for premises expiring October 31, 2009. The Company also has several equipment leases expiring at various dates to 2003. The future annual lease payments, exclusive of property taxes and expenses directly payable by the Company:

2002	\$	81,757
2003		69,671
2004		64,438
2005		65,903
2006		68,910
Thereafter to 2009		228,281

11. Income taxes:

Income tax expense (recovery) attributable to earnings (losses) differs from the amounts computed by applying the combined Canadian federal and provincial income tax rate of 44.62% (2000 - 45.62%) to earnings (loss) before income taxes as follows:

	2001	2000
Net earnings (loss) before income taxes	\$ 205,423	\$ (573,002)
Expected income tax expense (recovery)	\$ 91,659	\$ (261,404)
Tax effect of:		
Change in tax rates	291,213	-
Change in valuation allowance	(386,018)	264,221
Other	3,146	(2,817)
Income tax expense (recovery)	\$ -	\$ -

11. Income taxes (continued):

The tax effects of temporary differences that give rise to future tax assets are presented below:

	2001	2000
Future income tax assets:		
Non-capital losses carried forward	\$ 1,290,674	\$ 1,303,008
Fixed assets	69,144	75,018
Total gross future income tax assets	1,359,818	1,378,026
Valuation allowance	(992,008)	(1,378,026)
Net future income tax assets	367,810	-
Future income tax liabilities:		
Deferred aviation system design costs	(367,810)	-
Net future income tax assets	\$ -	\$ -

In assessing the ability to realize future income tax assets, management considers whether it is more likely than not that some or all of the future tax assets will be realized. The ultimate realization of the future tax assets is dependent on the generation of taxable income during periods in which the temporary differences reverse. As at September 30, 2001, evidence does not exist to support a conclusion that it is more likely than not that the future income tax assets will be realized, a valuation allowance has been recorded against all of the future tax assets.

The Company has non-capital loss carry forwards of approximately \$3,585,000 which are available to offset taxable income otherwise calculated through 2008.

12. Financial instruments:

(a) Fair values:

As at September 30, 2001, the fair value of the note payable is not materially different from its carrying value based on interest rates for comparable debt instruments. Financial instruments also consist of cash, accounts receivable, accounts payable and accrued liabilities and customer deposits, the carrying values of which are considered by management to approximate their fair values due to their ability for prompt liquidation or short-term to maturity.

(b) Credit risk:

The Company is exposed to credit risk only with respect to uncertainties as to the timing and collectibility of accounts receivable. At September 30, 2001, six customers (2000 - five) represented approximately 78% (2000 - 78%) of accounts receivable. The Company mitigates credit risk through regular credit assessment and collection policies.

12. Financial instruments (continued):**(c) Currency risk:**

At September 30, 2001, approximately 85% (2000 - 61%) of accounts receivable and 43% (2000 - 21%) of liabilities are denominated in United States dollars. In addition, the note payable (note 7) is repayable in United States dollars. The Company has not entered into foreign exchange contracts to hedge against gains or losses from foreign exchange fluctuations.

13. Segmented information:

The Company's principal business operations relate to the development, manufacturing and sales of water purification systems and accordingly the Company has only one reportable segment. All manufacturing operations and assets are located in Canada. In 2001, approximately 33% (2000 - 24%) of sales revenue was generated by customers in Canada and 67% (2000 - 76%) by customers in other countries, primarily the United States.

CORPORATE INFORMATION

DIRECTORS AND OFFICERS

C.W. (Bill) Coote
President, CEO, and Director

Jim Dobie
Vice President and Director

David Hall
Director

Ken Mellquist
Director

Ryaz Shariff
Director

Gerald Eiers
General Manager

C. Edward Butterfield
Chief Financial Officer

ANNUAL GENERAL MEETING

The Company's Annual General Meeting of shareholders will be held at 2 p.m. on Thursday, March 28, 2002, at the Sutton Place Hotel (Chateau Belair), 845 Burrard Street, Vancouver, BC.

CAPITAL STRUCTURE

(as at September 30, 2001)

Authorized: 20,000,000 Common Shares
5,000,000 Preference Shares
Issued: 12,811,194 Common Shares

STOCK EXCHANGE

Canadian Venture Exchange
Trading Symbol: "IWG"

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THE WATER KNOWLEDGE COMPANY



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