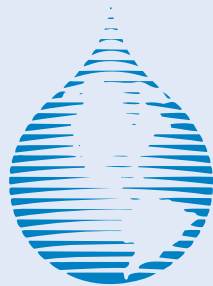


International Water-Guard Industries Inc.



INTERNATIONAL
WATER-GUARD
INDUSTRIES INC.
THE WATER KNOWLEDGE COMPANY

Annual Report - Fiscal 2003



PRESIDENT'S MESSAGE

The past fiscal year has again been an eventful one for IWG, with a number of developments: some that have helped to solidify our position as "The Water Knowledge Company," especially in aviation; and others that have presented us with challenges to overcome.

Primary among the latter is the fact that our sales for the 2003 fiscal year lagged behind 2002 as the full impact of the September 11, 2001 terrorist attacks reached our main aviation supply market.

Sales for the fiscal year ended September 30, 2003 of \$3,050,097 compared to prior year sales of \$4,048,939. The fiscal 2003 loss was \$727,974 (\$0.05 per share) compared to a loss of \$395,717 (\$0.03 per share) in the prior year. The per share loss is on both a basic and fully diluted basis.

Once again, to a large extent, these results are attributable to the continued downturn in the corporate aviation market. The General Aviation Manufacturers Association (GAMA) has reported that annual billings in 2003 were the lowest since 1998, owing to a 26.7 percent decline in corporate jet deliveries over 2002.

In addition, although we expanded the reach of our patented Circulating Potable Water System (C-PWS™) to include our first airliner-type aircraft, this turn of events required a significant investment in front-end development costs.

Notwithstanding our disappointing performance in fiscal 2003, we worked toward the achievement of several goals that have placed us in a much better position to take advantage of the expected aviation industry upturn.

In January of 2003 we passed a milestone in our development as a member of the international aviation industry when the Joint Aviation Authorities (JAA) certified IWG for the maintenance of our products in Europe. JAA certification not only adds credibility to our marketing efforts, but makes it much easier for IWG to provide service to our European customers.

As referenced above, we added a new aircraft type to the list of those equipped with our C-PWS™. This welcome development was an order from Air Canada Technical Services for five C-PWS™ 'modification kits' to be installed on the Airbus A310 aircraft operated by a third-party maintenance customer. By the end of the 2003 calendar year, those kits were installed on the first two aircraft, and IWG had received a Supplemental Type Certificate (STC) from Transport Canada for the installation. The STC is significant because it allows us to offer a certified system to other operators of the A310 aircraft.

A number of business development programs were underway and making good progress during fiscal 2003. Recognizing the ongoing downturn in business aviation, we commenced a marketing program aimed at specific head-of-state/VIP aircraft operated by a number of countries around the world. The program was undertaken with the assistance of Canada's overseas Trade Commissioners, who have been extremely helpful in providing contact information for those in charge of VIP aircraft, and in some cases, have made contact on our behalf. Like all aviation marketing efforts, this is a long-term exercise, however we have received several early expressions of interest.

We also continued to work closely with aircraft manufacturers like Dassault, Gulfstream, and Raytheon to have our water treatment units either included on their aircraft as a standard installation, or to have them added to the list of standard options from which prospective aircraft buyers choose components for their new aircraft. Although no agreements were concluded by the end of the fiscal year, we are confident that these efforts will bear fruit early in Fiscal 2004.

To multiply our marketing power, we also began working with several aircraft manufacturers on joint marketing agreements for both Circulating Potable Water Systems and water treatment units. These talks are long-term efforts, but the first steps have been taken, and we see no reason why these goals should not also be attainable in the near future.

At the end of a fiscal year that falls short of expectations, we can all be forgiven if sometimes we feel like long-suffering prairie grain farmers: always living in "next year country." But in fact, IWG has been on a steady growth trend for a number of years. The signs for the first quarter of 2004 are looking positive, and our optimism for the future remains undimmed. As always, there are challenges before us, but they are vastly outnumbered by the opportunities.

To close this message, I would like to thank those who have helped us to generate those opportunities, and who will help us seize them: our staff and virtual team members, as well as our shareholders, customers, suppliers, and members of the Board of Directors.

On Behalf of the Board,

A handwritten signature in black ink, appearing to read "Bill Coote". The signature is fluid and cursive, with a prominent initial "B" and a long, sweeping tail.

Bill Coote
President and CEO

COMPANY OVERVIEW

International Water-Guard Industries Inc. (IWG, or “the Company”) designs, manufactures, and markets ultraviolet (UV) water disinfection equipment for two primary markets: aviation and industrial commercial applications, particularly aquaculture. Disinfection by ultraviolet light is a proven process that kills harmful bacteria and viruses in water without the use of chemicals.

The Company is the world’s only supplier of flight-certified ultraviolet potable water disinfection units, and currently has four models in production: the NPS-A2 , NPS-A3, NPS-A4, and NPS-A6. There are more than 900 of these products flying in aircraft around the world.

Apart from water quality, weight and space are the primary economic factors in aircraft operations. The Company recognized that to increase its product sales, it would be beneficial to offer weight reduction as well as ultraviolet disinfection. Consequently, IWG designed a completely new concept in aircraft water systems with ultraviolet units as a component. In its first installation, this new Circulating Potable Water System (C-PWS™) cut the installed weight by more than half compared to the manufacturer’s water system, while occupying about 60% less space.

Ultraviolet disinfection of water is a well-established technology with increasing worldwide acceptance. Ultraviolet light at the proper intensity destroys micro-organisms like bacteria and viruses by disrupting their DNA or RNA molecules and rendering them unable to reproduce. Ultraviolet disinfection is highly effective against emerging health threats like *E. coli*, the bacteria that tragically infected the water system in Walkerton, Ontario in 2000, and *Cryptosporidium*, the waterborne organism that caused over 100 deaths in Milwaukee, Wisconsin in 1993.

In the aviation sector, the Company has traditionally focused on the corporate aircraft market with its UV products and the C-PWS™. IWG has also taken initial steps toward addressing the larger opportunity presented by the world’s airlines.

The Company’s water treatment units are currently offered as standard options by the three largest corporate jet manufacturers: Bombardier Aerospace, Dassault Falcon Jet, and Gulfstream Aerospace Corporation. The remaining manufacturers are targeted for similar programs. IWG will also maintain its focus on the world’s aircraft completion centers, where both new production aircraft and older models are modified for use in corporate aviation.

The IWG circulating potable water system (C-PWS™) design has received U.S. and Canadian aviation regulatory approval, and is being offered to aircraft owners and operators whose aircraft are at a completion center for final interior outfitting. The business jet sector generally leads the industry in terms of adopting new technology for two main reasons: the first being a proactive mindset generated by the need to customize each new aircraft for its corporate owner, as well as the fact that these owners face fewer financial constraints than airlines.

The first installation of the new C-PWS™ (July 2001) was aboard a Bombardier Global Express aircraft completed by The Jet Center in Van Nuys, California. IWG has also (October, 2002) installed the C-PWS™ on a Gulfstream G-IV aircraft at Gulfstream’s Savannah, GA, completiions facility. In addition, IWG has installed and certified a C-PWS™ “mod kit” on the first of five Airbus A310 VIP/Transport aircraft (September 2003). The company has also begun a C-PWS™ installation on a Boeing BBJ aircraft (October, 2003) at the Associated Air Center completions facility in Dallas, Texas.

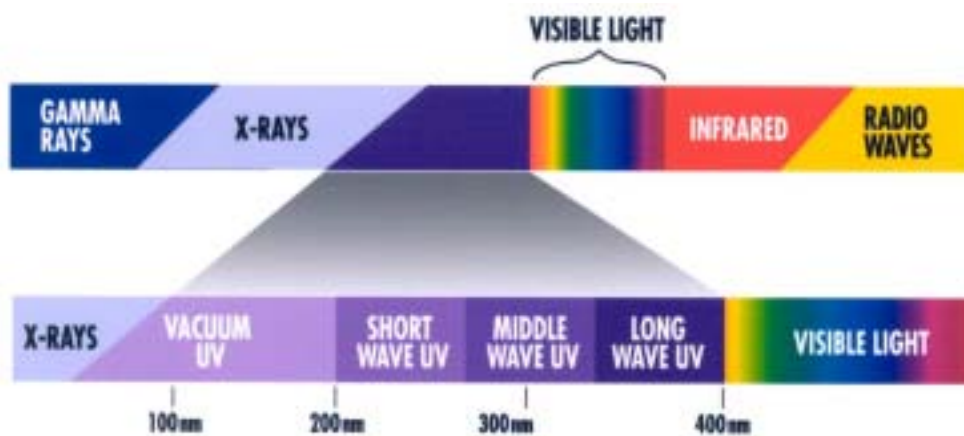
The C-PWS™ concept is applicable to any corporate aircraft with a potable water system, a market that IWG estimates at \$150 million annually in new aircraft water system sales. The C-PWS™ is being presented to corporate aircraft manufacturers as a replacement for the heavier, more complex water systems currently in use. The weight reduction and increased cargo/system space that the C-PWS™ provides can allow it to pay for itself. The reduced maintenance requirements of the simpler IWG C-PWS™ and its increased reliability also provide the aircraft operator with a tangible payback compared to existing systems.

As the system is established in corporate jet service, it is being marketed to the airlines and commercial jet manufacturers. The airlines could incorporate the C-PWS™ at a scheduled maintenance interval, while the manufacturers would 'roll back' the system into their production process. IWG estimates the current commercial aircraft water system market (new production and retrofit) at \$600 million annually.

The Company's expertise in potable water equipment and systems for aircraft originated from 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 annual market of several hundred millions in North America and the Company anticipates expanding its market share in the next few years.

TECHNOLOGY

Ultraviolet radiation is actually high energy light. The wavelengths in the ultraviolet spectrum are too short for the human eye to resolve and ultraviolet light is therefore invisible. The ultraviolet spectrum ranges from 40 to 400 Nanometers (nm), with the most effective spectral region for germicidal purposes being between 250 and 265 nm. At the proper intensity, UV light is fatal to all micro-organisms known to inhabit water.



Mercury arc lamps generate the ultraviolet radiation for water disinfection, with low-pressure lamps being the most common and effective type. Since normal glass blocks ultraviolet, the lamp and its protective sleeve are generally made of fused silica or quartz, which readily transmit the germicidal ultraviolet rays. Low-pressure mercury arc lamps are efficient producers of ultraviolet rays in the 254 nm range lethal to microbes. This wavelength is very effective in the destruction of all known micro-organisms, including emerging health threats like *E. Coli*, *Cryptosporidium*, and *Giardia*. IWG also employs high intensity and amalgam ultraviolet lamps in specific applications requiring those types of technological solutions.

Studies show that DNA molecules in the nucleus of the organism absorb ultraviolet light. The organism is inactivated when sufficient dosage has been absorbed to modify the molecular structure in the DNA. This results when exposure to ultraviolet light causes two thymine molecules to form an inappropriate bond, or dimer. The effect of numerous thymine dimers forming along the DNA chain inhibits replication of the organism. It may not be killed instantly, but the scrambling of the genetic code in the nucleus prevents reproduction, rendering it non-viable and harmless to humans.

Filtration alone does not destroy waterborne pathogens, it merely removes unwanted material suspended in the water, such as sediment and chemicals like Chlorine. In fact filters can become a good breeding ground for micro-organisms if not changed regularly.

However, ultraviolet disinfection and filtration work extremely well together, since UV needs clear water to allow the light to penetrate to its maximum effect. The result is clean, safe, good-tasting water that rivals and even exceeds the quality of bottled water.

PRODUCTS

Aircraft Water Treatment Units

The NPS-A2, NPS-A3, NPS-A4 and NPS-A6 provide on-board potable water disinfection, and are the only known ultraviolet disinfection units in the world qualified for use on corporate and commercial aircraft. Transport Canada has certified IWG as an approved organization for the Manufacturing, Certification, and Maintenance of aeronautical products. Additionally, Europe's Joint Airworthiness Authority (JAA) has certified IWG as an accepted organization for the maintenance of its units in Europe.

IWG's aircraft water treatment units were specifically 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 manufacturers 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. IWG's four models of water treatment units provide added assurance of water quality to the operators (and their passengers) of any aircraft loading water from almost any approved municipal source.

There are currently no regulations requiring disinfection of potable water on commercial airliners. However, IWG believes that the installation of its potable water treatment units will become an increasingly cost effective measure for airlines and other commercial operators based on regulatory trends. For example, in May of 2002 Transport Canada issued an advisory circular (No. 0208) informing aircraft operators that they should pay closer attention to the condition of aircraft water systems and the quality of water in them. 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.

The quality of potable water all over the world, including that delivered to airplanes, is generally deteriorating. The risks of waterborne diseases associated with more aircraft carrying more people to more international destinations, whether commercial or corporate, are therefore increasing.

"We packed sample vials and took to the skies, hopping on 14 different flights everywhere from Atlanta to Sydney, Australia. On each, we collected water from the galley and lavatory taps, sealed them up and sent them to a lab for analysis. The results of our water-quality snapshot: a long list of microscopic life you don't want to drink, from Salmonella and Staphylococcus to tiny insect eggs. Worse, contamination was the rule, not the exception: Almost all of the bacteria levels were tens, sometimes hundreds, of times above U.S. government limits."
Source – "How Safe Is Airline Water? The Wall Street Journal, November 1, 2002.

As attention is brought to bear on this issue, IWG finds itself uniquely positioned to supply product and system solutions for aircraft on-board water treatment.

More than 900 of the Company's water treatment units are flying on business jets and privately registered airliners around the world.

The NPS-A2 was designed in collaboration with Boeing in the late 1970's by a predecessor company later acquired by IWG in 1989, prior to the airline market depression of the early 1990s.

The NPS-A3 received its Transport Canada certification in 2000. It is designed for smaller spaces and includes both filtration and disinfection features. Other improvements include improved electronics, as well as reduced size and weight. Other "A series" product variants for special aircraft model requirements have also been developed.

An example is the "NPS-A4" which was developed at the request of Dassault Falcon Jet, and is now a standard customer option on its 900 and 2000 series corporate jets. This new product is essentially an NPS-A3 with the filter feature removed in order to meet specific needs. The NPS-A6 is similar in design to the NPS-A3 but is constructed of stainless steel and has a higher flow rate. Both the NPS-A3 and the NPS-A6 are covered by the same U.S. Patent issued in September, 2002.



Aircraft Circulating Potable Water System (C-PWS™) Kits

The C-PWS™ is comprised of aviation potable water treatment equipment to disinfect on-board potable water, pumps to circulate the water in the 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 patented 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 Company believes this new potable water system has the potential to become a global aviation industry standard, and the Company is in a unique position to become the dominant supplier of full systems, system equipment or licenses to the aviation industry.

In 1998, the Company filed a patent application in the U.S.A. (with corresponding foreign filings) outlining this totally new approach to potable water treatment and water management on aircraft. The patent was received in October, 2002.

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 up to 60% less space and weighs from 80 to 200 pounds less than existing systems, depending on which aircraft model is considered.



Airbus A310: original three pressurized water tanks in position in the aircraft cargo hold.



Airbus A310: after C-PWS™ modification to: pumps and water treatment units installed, one tank removed.

Because it is simpler, with fewer components that are of high reliability, the C-PWS™ also provides reductions in operating and maintenance costs. Inflight freezing, a major problem facing aircraft water systems, has been eliminated by the circulating concept.

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. disinfection unit.

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.



The IWG Household Wastewater Treatment Unit

IWG also has available a higher throughput modular “open channel” ultraviolet water treatment system prototype to treat drinking water, aquaculture/industrial process water or wastewater at flow rates ranging from 200 USGPM to at least 2000 USGPM. The new open channel systems are modular in construction for installation flexibility, and can be employed to disinfect water or for ozone destruction, or ‘quenched’.

The Company’s disinfection units also have important application in the increasingly important wastewater market. IWG designs, fabricates/assembles, tests, installs and services specialized small scale systems for customers with a wide variety of potable and wastewater treatment and water management applications. An example of a recent wastewater treatment installation is the Riverport Industrial Park in Richmond, BC.

Replacement Parts and Service

The Company sells replacement parts (including spares) and services to customers with their own installed base of IWG systems and products. UV lamps, and the quartz sheaths that enclose them, are subject to gradual degradation over time. The Company is in regular contact with its customers, both to ensure that operational efficiency of its equipment is not compromised due to degraded parts and also to determine what new water treatment/management needs they may have. The Company also has annual service agreements with a number of its larger customers.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Fiscal Year 2003

Overview

Comments in this analysis should be read in conjunction with the comparative audited financial statements included in the annual report for the fiscal year ended September 30, 2003. Such comments also apply to the financial information summarized in this 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, manufactures, 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 substantially a development company, with a base operation and revenues covering a portion of its product, aviation water systems and market development costs. New equity issues have provided the remainder of the Company's capital commitments and working capital requirements. Sales trends are subject to both industry cycles and customer adoption of the Company's technology. Operations, business opportunities and capital requirements have increased 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 sales in fiscal 2003 of \$3,050,097, a decrease of 25% from the previous year. A loss of \$727,974 was incurred for the year, 84% above that of the previous year. Approximately 22% of the loss is attributed to the write down of the Company's interest in its China joint venture assets.

Apart from the write down of the Company's China investment, the remaining loss of \$566,134 was attributed to reduced sales, offset in part by lower operating costs. The decrease in unit sales by both its markets was aggravated by a loss in sales value due to the weaker U.S. dollar (offset by lower costs of U.S. dollar purchases) that led to the increased loss for the year. The economic impact continued in the Company's major market in aviation products following the September 11th, 2001 crisis which occurred as the Company was gearing up capacity for earlier increasing sales trends and a promising outlook for capturing several C-PWS™ kit sales have not yet materialized.

However, included in fiscal 2003 results is the delivery of the Company's third aircraft circulating potable water system, this one installed on an Airbus A310 aircraft that has been certified by Transport Canada. This installation was the first of a five-system contract for A310 aircraft.

Sales

Lower sales levels evident in the latter half of fiscal 2002 continued through fiscal 2003, primarily in the aircraft industry. Approximately \$180,000 or 4% of the sales decrease was attributed to the lower value of the U.S. dollar, the currency in which some 85% of the Company's sales are made.

Sales of aviation products (representing 79% of total fiscal 2003 sales) decreased by 23% from fiscal 2002. The general reduction in global airline and business jet markets only impacted IWG's sales midway through fiscal 2002 and continued through 2003. As in fiscal 2002, fiscal 2003 included the installation of a new aircraft circulating potable water system, the Company's third system.

The softening aviation sales trend, which became most evident in the third quarter of fiscal 2002, continued into fiscal 2003. The introduction of IWG's next aviation product, the higher throughput volume NPS-A6, a version of the successful NPS-A3, assisted in part to offset other slower aviation sales. The Company also views the sale of additional C-PWS™ kits important to its longer-term sales growth.

Industrial sales to the aquaculture and other water process applications, representing 21% of fiscal 2003 sales, decreased by 32% from the prior year. This decrease resulted from reduced unit sales, in part due to a sluggish aquaculture

industry. The Company normally distributes its Industrial products directly to the customer and through value-added distributors, such as water treatment facility engineering firms, primarily in Canada and the United States.

Sales to customers in Canada represented 35% of the Company's sales (vs. 46% in 2002) with 65% of sales exported, primarily to United States (vs. 54% in 2002). This trend to lower Canadian sales was attributed primarily to lower Industrial unit sale that decreased more than the primarily aviation export market.

Direct Sales Margins

Aggregate direct sales margins were essentially unchanged year to year. Sales margins vary from product to product so sales mix will determine the overall margin result from period to period. While the weaker U.S. dollar reduced reported sales prices, the decrease was substantially offset with reduced U.S. dollar purchases and from recorded gains on revaluing U.S. denominated debt. This year's results were affected by a reduction in sales of higher margin aviation equipment proportionately more than for aviation systems and industrial market equipment.

Operating Expenses

Selling expenses of \$379,223 were 42% less than in fiscal 2002. The decrease was due principally to the prior year's attendance at two additional Aerospace Trade Shows in the third quarter of fiscal 2002. The Company also reduced its travel costs principally to its European customer base.

Engineering and development expenses charged to earnings of \$554,668 was a 15% decrease from the prior year. Supported by a sales trend in prior years and anticipated requirements to support the goal of delivering several C-PWS™ kits during the year, IWG had increased its engineering resources to support its investment in the aviation systems design activities. However, the sale of C-PWS™ kits has not yet reached anticipated quantities. These costs are also directed to product technology enhancements and new product variants. Such efforts are in response to customer feedback and stated requirements, and to address future market requirements as marketing opportunities result in new C-PWS™ sales.

General, administration, information technology and occupancy expenses totaled \$1,269,454, a 11% decrease from fiscal 2002. This decrease was primarily attributed to decreased legal fees related to having concluded several important intellectual property matters early in the year.

Capital Expenditures

Fiscal 2003 include significant but lower costs than in the prior year to design and certify specific aircraft model circulating potable water systems (C-PWS™) for sale to business aircraft manufacturers, completion centers and owners. Substantial progress has been made towards the design of the water system for a Boeing Business Jet, but suspended in the fall of 2002. The design of the Airbus A310 C-PWS Mod-kit, sponsored by an initial five aircraft contract agreement commenced in mid-year and under which the first kit was delivered in the fourth quarter of the year. The other four kits will be delivered in the first and second quarter of fiscal 2004. Subsequent to the year-end, the Company contracted for and recommenced the task of finalizing its BBJ C-PWS™ design, which system will be delivered and certified in the second quarter of fiscal 2004.

To September 30, 2003, the Company has expended a net accumulated cost of \$2,985,191 (\$2,383,220 at September 30, 2002) on such designs. These designs include the certification of its first design for the Global Express, then the G-IV aircraft, the Airbus A310 and the substantial completion of a Boeing Business Jet aircraft C-PWS™ design. These initial designs will provide IWG with the certification (STC) necessary to permit it to provide C-PWS™ 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 leading supplier of water systems to business aircraft and, subsequently, commercial aircraft manufacturers. The costs associated with each aircraft model design will be recovered over several years from the ongoing supply of C-PWS™ kits under contracts expected to be completed with IWG's customers.

In prior years, IWG made significant expenditures on initial market and product research and on water system development to establish the marketability of the Company's design concept. It is clear from this assessment that IWG's C-PWS™ will meet or exceed the business aircraft owners' and manufacturers' requirements for significant improvements

to on-board water systems. Consequently, IWG has committed to develop a complete C-PWS™ kit for a full range of business aircraft to meet these market opportunities. System design 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.

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

The only other known companies supplying circulating potable water distribution systems to the aircraft industry are aircraft completion centers or a manufacturer that incorporate IWG's equipment and design concepts into their system design. There are indications that some other parties are looking at alternatives to traditional aircraft water systems, including the suppliers of such system designs. Goodrich Corp. and MAN Technologies AG are supplying variations on the 50-year-old pressurized designs. These are much larger and better-financed companies, which will be an advantage to such companies. However, such companies are also customers for IWG's products.

To secure a leading 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. The Company will also assert its Intellectual Property position with any manufacturers or suppliers that may be providing similar circulating potable water system concepts. 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. Such agreements are intended to assure that third parties are only able to utilize the Company's Intellectual Property under proper commercial contracts. IWG also intends to 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

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 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, consulting and contractor costs that are also in U.S. dollars. Consequently, fluctuations in the Canadian to U.S. dollar foreign exchange rates will have some 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 may be implemented.

Financial Resources

The continued growth and viability of IWG will be affected by its ability to achieve profitable operations, the continued support of its debt holders, and to attract additional capital. While the Company has negotiated long term debt agreements with two contractors and for extended terms with suppliers as it seeks new and longer term contracts for aviation product sales and water systems contracts. The subject is also addressed under the separate section on Liquidity and Capital Resources.

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.

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 and benefits of 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 targets will require additional financing, the required working capital and equity financing is being pursued as noted elsewhere.

International Water-Guard Industries, historically a developer of UV-based water treatment equipment for several niche markets (supported by equity financing and a base level of revenues) has become a niche market supplier and manufacturer of engineered ultraviolet based water treatment products and systems. With its certified and proven business aircraft circulating potable water system, IWG's goal is to become the leading provider of water systems or disinfection units to most of the well known mid to larger business aircraft available.

Liquidity and Capital Resources

The Company completed its 2003 fiscal year with \$862,515 in negative working capital, a further increase of \$715,591 over the prior year. During the year, the Company's working capital requirements were partially met by operating cash flow and a credit line from a factoring finance company. While an important factor in the near term cash flow will be a return to an anticipated increasing sales performance, the Company will be seeking additional equity financing to assure its planned marketing efforts and water systems and product development can resume.

In recent years, IWG has operated as a development company with its base revenues from operations covering only a portion of its product and market development costs and increased working capital requirements. The additional equity issued in fiscal 2002 and credit line of US\$280,000, have enabled the Company to maintain its operations and to complete its aircraft circulating water system design and certification. In the prior two years, the Company had raised \$2,281,322 in new financings. Negotiations were completed with two of the Company's associates and larger creditors for long term repayment agreements covering approximately \$1,118,000 of its unsecured debt.

Financial commitments by IWG during fiscal 2003 for aircraft water system design expenditures were substantially less than in 2002 as the Company was able to concentrate primarily on delivery contracts for existing aircraft model C-PWS™ designs.

The Company's ability to maintain its current level of operations and research and development activities will continue to be governed by a return to the required sales level that provides a positive cash flow, and the eventual issue of long term debt or equity capital.

Summary

The significant efforts undertaken by the Company in recent years to secure a leading position in the design and installation of aircraft water systems has, and will continue to have, a material impact on the Company's sales and earnings in fiscal 2004 and beyond.

Expenditures on market development, product development and certification prior to any significant sales of such new aviation products were largely responsible for reported losses and debt levels in fiscal 2002 and in fiscal 2003. Investment in aircraft model specific circulating potable water system design and certification costs have been significant, but are anticipated to be significantly less in the near term. As illustrated from increased revenues starting in fiscal 2001, it is anticipated that greater revenue increases resulting from these development efforts should have a material positive impact upon the Company's earnings in fiscal 2004 and beyond. However, due to their significant impact on IWG's business activity, the timing of the signing and implementation of multiple C-PWS™ kit contracts, will determine the timing of these revenue increases.

A return to the sales trend experienced prior to 2002 will be required to achieve positive cash flow. In the meantime, the Company continues to review and revise its cost structure, implementing changes as able and necessary.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The financial statements of International Water-Guard Industries Inc. for the fiscal year ended September 30, 2003 and all other information in the annual report and annual information form are the responsibility of management and have been approved by the Board of Directors.

The financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. When alternative accounting methods exist, management has chosen those it deems most appropriate in the circumstances. The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly in all material respects. Management has also prepared the financial information presented elsewhere in the Annual Report and Annual Information Form and has ensured that it is consistent with that in the financial statements.

The Company maintains a system of internal control designed to provide reasonable assurance that financial information is reliable and accurate and that assets are safeguarded.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting, and is ultimately responsible for reviewing and approving the financial statements. The Board carries out this responsibility, principally through its Audit Committee. The Board appoints the Audit Committee, and the majority of its members are outside directors. The Audit Committee meets periodically with management, as well as the external auditors, to discuss internal controls over the financial reporting process, auditing matters and financial reporting issues, to satisfy itself that each party is properly discharging its responsibilities, and to review the Annual Report, the financial statements and the external auditors' report.

KPMG LLP, the Company's external auditors, have audited the financial statements in accordance with Canadian generally accepted auditing standards on behalf of the shareholders to provide reasonable assurance that the financial statements are presented fairly and in accordance with Canadian generally accepted accounting principles. KPMG LLP have full and unrestricted access to the Audit Committee to discuss their audit and related findings as to the integrity of the Company's financial reporting.

"C. William Coote"
President, CEO and Director

"C. Edward Butterfield"
Chief Financial Officer

Financial Statements of

**INTERNATIONAL WATER-GUARD
INDUSTRIES INC.**

Years ended September 30, 2003 and 2002



KPMG LLP
Chartered Accountants
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Canada

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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, 2003 and 2002 and the statements of operations and deficit and cash flow 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, 2003 and 2002 and the results of its operations and its cash flow 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 on a consistent basis.

KPMG LLP (signed)

Chartered Accountants

Vancouver, Canada

December 16, 2003



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

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Balance Sheets

September 30, 2003 and 2002

	2003	2002
Assets		
Current assets:		
Cash	\$ -	\$ 55,580
Accounts receivable	291,745	1,054,850
Inventory (note 3)	630,814	867,921
Prepaid expenses	5,529	5,529
	<u>928,088</u>	<u>1,983,880</u>
Furniture and equipment (note 4)	145,691	167,814
Deferred development costs, net of accumulated amortization of \$110,000 (2002 - \$80,000)	2,865,191	2,410,211
	<u>\$ 3,938,970</u>	<u>\$ 4,561,905</u>

Liabilities and Shareholders' Equity

Current liabilities:		
Bank indebtedness	\$ 48,188	\$ -
Accounts payable and accrued liabilities	861,434	1,670,346
Customer deposits	348,257	-
Demand loan (note 5)	151,150	55,975
Current portion of notes payable (note 6)	381,574	404,483
	<u>1,790,603</u>	<u>2,130,804</u>
Notes payable (note 6)	445,240	-
Loan payable (note 7)	33,167	33,167
	<u>2,269,010</u>	<u>2,163,971</u>
Shareholders' equity:		
Share capital (note 8)	5,589,558	5,589,558
Deficit	(3,919,598)	(3,191,624)
	<u>1,669,960</u>	<u>2,397,934</u>
	<u>\$ 3,938,970</u>	<u>\$ 4,561,905</u>

Contingencies and commitments (note 10)
Subsequent event (note 8(e))

See accompanying notes to financial statements.

Approved on behalf of the Board:

"C.W. Coote" Director

"R.Z. Shariff" Director

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Statements of Operations and Deficit

Years ended September 30, 2003 and 2002

	2003	2002
Sales	\$ 3,050,097	\$ 4,048,939
Cost of goods sold (note 3)	1,226,982	1,562,103
Gross profit	1,823,115	2,486,836
Expenses:		
Selling expenses	379,224	658,184
Research and development	554,668	649,543
General, administrative and occupancy	1,269,454	1,435,621
Amortization	57,203	57,192
Write-down of joint venture assets (note 12)	161,840	-
Interest	128,700	82,013
	2,551,089	2,882,553
Loss for the year	(727,974)	(395,717)
Deficit, beginning of year	(3,191,624)	(2,795,907)
Deficit, end of year	\$ (3,919,598)	\$ (3,191,624)
Loss per share amounts (note 8(f)):		
Basic	\$ (0.05)	\$ (0.03)
Diluted	(0.05)	(0.03)

See accompanying notes to financial statements.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Statements of Cash Flow

Years ended September 30, 2003 and 2002

	2003	2002
Cash flows from (used by):		
Operations:		
Loss for the year	\$ (727,974)	\$ (395,717)
Items not involving cash:		
Amortization	57,203	57,192
Foreign exchange loss	-	12,250
Write-down of joint venture assets	161,840	-
	<u>(508,931)</u>	<u>(326,275)</u>
Changes in non-cash operating working capital:		
Accounts receivable	707,982	(295,116)
Inventory	208,682	(138,270)
Prepaid expenses	-	1,118
Accounts payable and accrued liabilities	(143,476)	1,062,509
Customer deposits	348,257	-
	<u>612,514</u>	<u>303,966</u>
Investments:		
Purchase of furniture and equipment	(9,681)	(38,757)
Deferred development costs	(591,971)	(1,441,129)
	<u>(601,652)</u>	<u>(1,479,886)</u>
Financing:		
Increase in demand loan	95,175	-
Repayment of demand loan	-	(44,025)
Repayment of notes payable	(209,805)	-
Proceeds of notes payable	-	38,157
Proceeds of loan payable	-	33,167
Issue of common shares for cash, net of issue costs	-	1,127,767
	<u>(114,630)</u>	<u>1,155,066</u>
Decrease in cash	(103,768)	(20,854)
Cash, beginning of year	55,580	76,434
Cash, end of year	<u>\$ (48,188)</u>	<u>\$ 55,580</u>
Cash is defined as cash less bank indebtedness.		
Supplementary information:		
Interest paid	\$ 141,200	\$ 43,856
Non-cash transactions:		
Notes payable issued for settlement of accounts payable	665,436	-

See accompanying notes to financial statements.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2003 and 2002

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 \$3,919,598 as at September 30, 2003 as a result of losses incurred in past years. In addition the Company has negative working capital of \$862,515 as at September 30, 2003, compared to negative working capital of \$146,924 at the 2002 year end. 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 ability of the Company to continue as a going concern is dependent on its ability to obtain the financing necessary to continue its research and development activities and operations and ultimately on the attainment of consistent profitable operations. The recoverability of deferred development costs is dependent on the Company continuing as a going concern and achieving sufficient sales volumes with the specific products to generate net cash flow in excess of costs incurred to date. The Company has renegotiated extended payment terms on its amounts payable to its two largest engineering contractors and continues to negotiate with its other suppliers and lenders in order to establish extended payment terms on its remaining liabilities. In addition, on an ongoing basis, the Company identifies and evaluates external financing opportunities including government grants and equity financing. There can be no guarantee that sufficient sales volumes will be achieved to recover all deferred development costs, to reschedule its outstanding liabilities or that such external financing will be available when needed.

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 and in Canadian dollars. 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 development costs. Actual results could differ from these estimates.

These financial statements include the Company's 50% proportionate interest in the Gold Bill Water Treatment Technology Co. Ltd. joint venture (note 12).

(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. Work-in-process and finished goods inventory includes the cost of raw materials, direct labour, freight and other direct manufacturing costs.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2003 and 2002

2. Significant accounting policies (continued):

(c) Furniture and equipment:

Furniture and equipment 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, 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. Amounts received from customers in advance of an arrangement satisfying all revenue recognition criteria are classified as "customer deposits" on the balance sheet.

(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 amounts are received or receivable. Payments received in respect of operating expenditures are deducted from expenses and in respect of furniture and equipment and deferred aviation system design cost 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(a)). Royalty payments are recognized and 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 specific product applications where an identifiable market exists are deferred. Routine alterations to existing products are expensed as incurred.

Deferred development costs includes \$2,865,191 (2002 - \$2,303,220) representing the cost, net of government funding and accumulated amortization, of designing, testing and certifying the Company's new potable water system for specified aircraft model types. These costs are deferred until the system is certified for installation in aircraft by relevant authorities. Deferred system design costs are then amortized based on future estimated aviation potable water system sales during a maximum period of six years.

(g) Income taxes:

Income taxes are accounted for using the asset and liability method. Future income tax assets and liabilities are determined based on temporary differences between the accounting and tax bases of existing 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.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2003 and 2002

2. Significant accounting policies (continued):

(h) Stock-based compensation plans:

The Company has a stock-based compensation plan, which is described in note 8(d).

Effective October 1, 2002, the Company adopted the new Canadian Institute of Chartered Accountants' Handbook Section 3870, "*Stock-Based Compensation and Other Stock-Based Payments*", which requires all stock-based payments to non-employees, and employee awards that are direct awards of stock, call for settlement in cash or other assets, or are stock appreciation rights that call for settlement by issuance of equity instruments granted on or after October 1, 2002 be accounted for using the fair value method. The new standard permits the Company to continue its existing policy of recording no compensation cost on the grant of stock options to employees. In the year ended September 30, 2003, all stock options granted by the Company were to employees. The Company discloses the pro forma effect of accounting for share awards under the fair value method in note 8(d). The adoption of this new standard has resulted in no changes to amounts previously reported.

Prior to adoption of the new standard, no compensation expense was recorded by the Company for stock options when granted. Any consideration paid by employees and non-employees was credited to share capital.

(i) Earnings (loss) per share:

Earnings (loss) per share amounts have been calculated based on the weighted average number of shares outstanding. Contingently issuable shares, such as those described in the first paragraph of note 8(c), are excluded from the calculation of weighted average number of common shares outstanding until the conditions for their release from escrow are satisfied. Fully diluted per share amounts have been calculated using the treasury stock method, which takes into account 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.

(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.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2003 and 2002

3. Inventory:

	2003	2002
Raw materials and work-in-process	\$ 420,385	\$ 513,642
Finished goods	210,429	354,279
	\$ 630,814	\$ 867,921

Cost of goods sold is determined as follows:

	2003	2002
Opening inventory	\$ 867,921	\$ 729,651
Manufacturing costs:		
Parts	549,242	1,250,662
Direct labour, freight and other	440,633	449,711
	989,875	1,700,373
Available for sale	1,857,796	2,430,024
Closing inventory	630,814	867,921
Cost of goods sold	\$ 1,226,982	\$ 1,562,103

4. Furniture and equipment:

	2003	2002
Molds	\$ 61,390	\$ 61,390
Manufacturing and distribution equipment	104,058	94,264
Furniture and office equipment	170,995	175,709
Leasehold improvements	97,034	97,034
	433,477	428,397
Accumulated amortization	(287,786)	(260,583)
	\$ 145,691	\$ 167,814

5. Demand loan:

The Company has a credit facility agreement with a private company to fund current working capital requirements, which facility provides for maximum advances of US\$280,000 (CDN\$378,000). Outstanding amounts are repayable on demand, bear interest at 3% per month and are secured by accounts receivable and other assets of the Company. As at September 30, 2003, the Company has \$151,150 (US\$111,963) outstanding under the credit facility (2002 - \$55,975 (US\$35,653)).

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2003 and 2002

6. Notes payable:

Effective January 1, 2003, the Company entered into an agreement with a contractor to whom it owed US\$320,000 for services rendered. Under the agreement, the Company issued a promissory note, denominated in US dollars, with a term to June 15, 2004 as settlement for the amount owed. The promissory note bears interest at 5% per annum calculated monthly and provides for monthly payments as prescribed in the agreement commencing February 15, 2003. A late payment fee of 1.5% of the payment is charged if payments are not received as prescribed. For the year ended September 30, 2003, the Company made all required payments totaling US\$91,000 (CDN\$126,869). The promissory note is secured by a 10% interest in any sales revenue earned from certain of the Company's products.

On May 10, 2003, the Company issued an unsecured promissory note, denominated in US dollars, with a principal amount of US\$380,000 (CDN\$553,726) to reschedule the maturity date of a previous promissory note to a contractor and in settlement of other amounts payable for services rendered prior to April 1, 2003. The promissory note bears interest at 7% per annum calculated monthly, with principal repayment at US \$3,500 per month until April 24, 2004 and then at US \$5,000 thereafter, with the final payment due on September 30, 2005. The Company is required to pay additional monthly payments of 10% of revenue earned from certain of the Company's products. The noteholder has the option to convert 50% of the outstanding balance of the note into common shares of the Company subject to terms to be approved by the Company's Board of Directors and regulators. In the year ended September 30, 2003, the Company made all required payments totaling US\$58,028 (CDN\$82,936). On issuance, no value was attributable to the conversion option which was not material.

7. Loan payable:

During 2002, the Company received funds from Technology Partnership Canada. The loan is non-interest bearing and repayable in eight equal annual installments commencing on December 31, 2004.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2003 and 2002

8. Share capital:

(a) Authorized:

100,000,000 common shares without par value

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

(b) Issued common shares:

At September 30, 2003 and 2002, the Company has issued 14,921,194 common shares at a stated capital of \$5,589,558.

On April 10, 2002, the Company completed a private placement of 2,000,000 common share units at a price of \$0.60 per unit for gross proceeds of \$1,200,000. Each unit consisted of one common share and one non-transferable purchase warrant to purchase a second share at \$0.75 per share for a period of twenty-four months, subject to certain provisions, none of which have been met at September 30, 2003, that would force conversion. In addition, 240,000 agents warrants, exercisable at \$0.60 each for a period of eighteen months, were issued as well as payment of an 8.5% fee on the gross proceeds of the financing.

(c) Shares in escrow:

The Company previously issued 3,679,884 performance shares which were releasable from escrow based upon the satisfaction of certain pre-determined cumulative cash flow tests. Release from escrow was subject to regulatory approval. Any escrowed shares not released by October, 2004 would 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.

In response to an application by the Company, on February 26, 2002, the TSX Venture Exchange approved a revised escrow agreement wherein 10% of the escrowed shares were released from escrow on February 26, 2002, and a further 15% will be released on each six month anniversary of such date, until all of the escrowed shares have been released from escrow. As at September 30, 2003, 1,655,947 common shares remain held under the revised escrow agreement.

(d) 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. The maximum amount of options available for issue is 2,562,000 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.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2003 and 2002

8. Share capital (continued):

(d) Stock options (continued):

A summary of the status of the Company's stock option plan as at September 30, 2003 and 2002 and changes during the years ending on those dates is presented below:

	2003		2002	
	Shares	Weighted average exercise price	Shares	Weighted average exercise price
Outstanding, beginning of year	1,870,000	\$ 0.50	1,915,000	\$ 0.50
Granted	110,000	0.20	75,000	0.64
Exercised	-	-	(110,000)	(0.50)
Cancelled or expired	(160,000)	(0.50)	(10,000)	(0.64)
Outstanding, end of year	1,820,000	0.48	1,870,000	\$ 0.50
Options exercisable, end of year	1,710,000	\$ 0.51	1,652,000	\$ 0.50

Stock options outstanding and exercisable at September 30, 2003:

Number of stock options outstanding	Options exercisable	Exercise price	Weighted average remaining contractual life
1,645,000	1,645,000	\$0.50	8.5 months
65,000	65,000	0.64	15.5 months
110,000	-	0.20	30.0 months
1,820,000	1,710,000		10.0 months

Had compensation expense for stock options granted to employees in the year ended September 30, 2003 been determined using their fair values at the date of grant recognized straight-line over their vesting period, the Company's net loss and loss per share would have been \$744,474 and \$0.05, respectively.

The compensation expense was calculated using the Black-Scholes option pricing model assuming a risk-free interest rate of 3.40%, a dividend yield of 0.0%, an expected volatility of 104.40% and expected life of stock options of three years. The weighted average grant date fair value of options granted during the year ended September 30, 2003 was \$0.15.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2003 and 2002

8. Share capital (continued):

(e) Share purchase warrants:

The following share purchase warrants were outstanding as of September 30, 2003:

Expiry date	Number of warrants	Exercise price
April 10, 2004	2,000,000	\$0.15
April 10, 2004	240,000	0.60
	2,240,000	

These warrants were originally issued in conjunction with the private placement discussed in note 8(b). On October 1, 2003, the expiry date of the 240,000 warrants was extended from October 10, 2003 to April 10, 2004. On October 16, 2003, the exercise price of the 2,000,000 warrants was reduced from \$0.75 to \$0.15. These amendments were approved by the securities regulators. During the period between October 17, 2003 and December 5, 2003, the 2,000,000 warrants were exercised at the amended price of \$0.15 for proceeds of \$300,000.

(f) Earnings (loss) per share:

	2003			2002		
	Earnings	Weighted average shares	Per share amounts	Loss	Weighted average shares	Per share amounts
Earnings (loss) available to common shareholders	\$ (727,974)	14,921,194		\$ (395,717)	13,818,563	
Contingently issuable shares (note 8(c))	-	-		-	(1,492,117)	
Basic earnings (loss) per share	(727,974)	14,921,194	\$ (0.05)	(395,717)	12,326,446	\$ (0.03)
Effect of dilutive securities:						
Convertible debenture	-	-		-	-	
Note payable	-	-		-	-	
Diluted earnings (loss) per share	\$ (727,974)	14,921,194	\$ (0.05)	\$ (395,717)	12,326,446	\$ (0.03)

For the years ended September 30, 2003 and 2002, all options and warrants were not included in the calculation of diluted loss per share as their effects are anti-dilutive.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2003 and 2002

9. Related party transactions:

Included in accounts receivable is \$71,251 (2002 - \$71,541) receivable from shareholders of the Company. Included in accounts payable and accrued liabilities is \$10,438 (2002 - \$10,437) payable to shareholders and companies controlled by directors of the Company. During the year, the Company paid \$50,000 (2002 - \$50,000) to a company owned by an officer and shareholder for the provision of services. The services provided were in the normal course of business and valued at amounts agreed to by the parties.

10. Contingencies and commitments:

(a) 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, 2007, 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, 2003 totaled \$92,928 (2002 - \$66,838).

An agreement has also been entered into with the National Research Council Canada ("NRC/IRAP"), whereby NRC/IRAP assisted in the funding to further develop the Company's potable water systems for certain aircraft (C-PWSTM) in the amount of \$495,000. As a condition of this agreement, the Company has agreed to pay NRC/IRAP a royalty of 2% of the Company's gross revenues earned each quarter from April 1, 2005 and until December 31, 2008, or if the royalty payments to that date do not equal the maximum of \$742,500 payable, then until total payments of \$742,500 or the date of April 1, 2014 is reached.

(b) 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 2007. The future annual lease payments, exclusive of property taxes and expenses directly payable by the Company:

2004	\$	84,083
2005		86,839
2006		82,376
2007		77,913
2008		79,421
Thereafter to 2009		81,440
	\$	492,072

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2003 and 2002

11. Income taxes:

Income tax recovery attributable to losses differs from the amounts computed by applying the combined Canadian federal and provincial income tax rate of 37.62% (2002 - 39.62%) to loss before income taxes as follows:

	2003	2002
Net loss before income taxes	\$ (727,974)	\$ (395,717)
Expected income tax recovery	\$ (273,864)	\$ (156,783)
Tax effect of:		
Expired losses	181,039	287,068
Change in valuation allowance	78,824	(174,766)
Change in tax rates	14,560	37,948
Other	(559)	6,533
Income tax recovery	\$ -	\$ -

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

	2003	2002
Future income tax assets:		
Non-capital losses carried forward	\$ 1,715,288	\$ 1,557,039
Furniture and equipment, undepreciated tax costs in excess of net book value	92,110	80,610
Research and development and investment tax credits	109,249	-
Total gross future income tax assets	1,916,647	1,637,649
Valuation allowance	(896,066)	(817,242)
Net future income tax assets	1,020,581	820,407
Future income tax liabilities:		
Deferred aviation system design costs	(1,020,581)	(820,407)
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, 2003, 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.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2003 and 2002

11. Income taxes (continued):

The Company has non-capital loss carry forwards of approximately \$4,815,000 which will expire at various dates through 2010. The Company also has Scientific Research and Development expenditures of approximately \$307,000 which are available to offset taxable income indefinitely.

12. Investment in joint venture:

The Company has a 50% interest in Gold Bill Water Treatment Technology Co. Ltd., a joint venture being formed between the Company and Mindong Jinding Ocean & Fisheries Research Institute established under the Joint Venture laws of the People's Republic of China. The purpose of the joint venture is to develop, manufacture, sell and service water treatment products for industrial and commercial use and consumption in China. Summarized financial information of the Company's proportionate share of the assets, liabilities and cash flows of the joint venture are as follows:

	2003	2002
Current assets	\$ -	\$ 100,448
Equipment and other assets	-	64,402
Cash flows	-	-

During the fourth quarter of fiscal 2003, the Company and its joint venture partner suspended active pursuit of its business plan for China. Accordingly, the Company recorded a provision of \$161,840 to write down the Company's proportionate share of the joint venture assets and deferred costs to zero.

13. Financial instruments:

(a) Fair values:

As at September 30, 2003, the fair value of the notes and loan payable is not considered by management to be materially different from their carrying value. 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, 2003, six customers (2002 - six) represented approximately 72% (2002 - 72%) of accounts receivable. The Company mitigates credit risk through regular credit assessment and collection policies.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2003 and 2002

13. Financial instruments (continued):

(c) Currency risk:

At September 30, 2003, approximately 77% (2002 - 85%) of accounts receivable and 30% (2002 - 71%) of liabilities are denominated in United States dollars. In addition, the notes payable (note 6) are repayable in United States dollars. The Company has not entered into foreign exchange contracts to hedge against gains or losses from foreign exchange fluctuations.

14. Government assistance:

The Company received government assistance totalling \$40,409 in 2003 (2002 - \$545,058) of which \$35,300 (2002 - \$55,167) was included in results from operations as a reduction of research and development expenses and \$5,109 (2002 - \$489,891) was included as a reduction of deferred aviation system design costs.

15. Segmented information:

The Company's principal business operations relate to the development, manufacturing and sales of water treatment systems and, accordingly, the Company has only one reportable segment. In 2003, sales from six customers (2002 - 3 customers) represent approximately 72% (2002 - 40%) of total revenue. 100% of the Company's furniture and equipment are located in Canada. In 2003, approximately 35% (2002 - 46%) of sales revenue was generated by customers in Canada and 65% (2002 - 54%) by customers in other countries, primarily the United States.

CORPORATE INFORMATION

DIRECTORS AND OFFICERS

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

David M. Hall
Director

John (J.D.) Lawson
Director

Kennith A. Mellquist
Director

Ryaz Z. Shariff
Director

Gerald P. 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 25, 2004, at the Sutton Place Hotel, 845 Burrard Street, Vancouver, BC.

CAPITAL STRUCTURE

(as at February 1, 2004)

Authorized: 100,000,000 Common Shares
5,000,000 Preference Shares
Issued: 16,921,194 Common Shares

STOCK EXCHANGE

TSX Venture Exchange
Trading Symbol: "IWG"

HEADQUARTERS

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INDUSTRIES INC.
THE WATER KNOWLEDGE COMPANY



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