

Above All... Water Quality.



INTERNATIONAL
Water·Guard

Aircraft Water Solutions

Fiscal 2005 Results

Financial Statements of

**INTERNATIONAL WATER-GUARD
INDUSTRIES INC.**

Years ended September 30, 2005 and 2004



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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, 2005 and 2004 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, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants

Vancouver, Canada

December 2, 2005

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Balance Sheets

September 30, 2005 and 2004

	2005	2004
Assets		
Current assets:		
Cash	\$ 354,804	\$ 64,836
Accounts receivable	508,776	592,467
Inventory (note 4)	282,922	423,626
Prepaid expenses	31,928	5,529
	<u>1,178,430</u>	<u>1,086,458</u>
Furniture and equipment (note 5)	34,492	75,586
	<u>\$ 1,212,922</u>	<u>\$ 1,162,044</u>
Liabilities and Shareholders' Equity (Deficiency)		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 226,020	\$ 1,018,965
Factoring loan (note 7)	367,900	449,500
Shareholder loan (note 11(a))	-	256,507
Current portion of notes payable (note 8(a))	-	727,425
Current portion of loan payable (note 9)	8,292	4,146
	<u>602,212</u>	<u>2,456,543</u>
Loan payable (note 9)	24,875	29,021
	<u>627,087</u>	<u>2,485,564</u>
Shareholders' equity (deficiency):		
Share capital (note 10)	7,508,539	6,530,913
Contributed surplus	60,574	42,956
Deficit	(6,983,278)	(7,897,389)
	<u>585,835</u>	<u>(1,323,520)</u>
	<u>\$ 1,212,922</u>	<u>\$ 1,162,044</u>

Contingencies and commitments (note 12)

See accompanying notes to financial statements.

Approved on behalf of the Board:

"D. C. Fox" Director

"R.Z. Shariff" Director

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Statements of Operations and Deficit

Years ended September 30, 2005 and 2004

	2005	2004
Sales	\$ 3,134,809	\$ 3,641,463
Cost of goods sold (note 4)	1,447,104	1,773,115
Gross profit	1,687,705	1,868,348
Expenses:		
Selling expenses	300,604	307,880
Research and development	362,948	295,290
General, administrative and occupancy	678,122	1,000,565
Stock-based compensation	18,098	26,456
Amortization	21,213	178,833
Interest	143,123	186,303
	1,524,108	1,995,327
Earnings (loss) from operations, before undernoted	163,597	(126,979)
Gains on settlement of notes and accounts payable (notes 8(a) and 8(b))	601,451	-
Gain on sale of commercial division assets (note 3)	164,063	-
Write-down of deferred development costs (note 6)	-	(3,786,834)
Write-down of furniture and equipment	(15,000)	(47,478)
Net earnings (loss) for the year	914,111	(3,961,291)
Deficit, beginning of year:		
As previously reported	(7,897,389)	(3,919,598)
Cumulative effect of change in accounting policy for stock-based compensation (note 2(i))	-	(16,500)
As restated	(7,897,389)	(3,936,098)
Deficit, end of year	\$ (6,983,278)	\$ (7,897,389)
Earnings (loss) per share amounts:		
Basic	\$ 0.04	\$ (0.21)
Diluted	0.04	(0.21)
Weighted average shares outstanding	25,772,764	18,644,398

See accompanying notes to financial statements.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Statements of Cash Flows

Years ended September 30, 2005 and 2004

	2005	2004
Cash flows from (used by):		
Operations:		
Earnings (loss) for the year	\$ 914,111	\$ (3,961,291)
Items not involving cash:		
Amortization	21,213	178,833
Compensation related to stock option plan	18,098	26,456
Accrued interest on notes payable	6,507	58,546
Accrued interest on shareholder loan	14,221	6,507
Gain on settlement of notes and accounts payable	(601,451)	-
Gain on sale of commercial division	(164,063)	-
Unrealized foreign exchange gain	-	(42,849)
Write-down of deferred development costs (note 5)	-	3,786,834
Write-down of furniture and equipment	15,000	47,478
	223,636	100,514
Changes in non-cash operating working capital:		
Accounts receivable	63,691	(300,722)
Inventory	45,482	207,188
Prepaid expenses	(26,399)	-
Accounts payable and accrued liabilities	(593,126)	157,531
Customer deposits	-	(348,257)
	(286,716)	(183,746)
Investments:		
Purchase of furniture and equipment	(15,834)	(1,207)
Proceeds on sale of commercial division	300,000	-
Deferred development costs	-	(1,076,642)
	284,166	(1,077,849)
Financing:		
Increase (decrease) in factoring loan	(81,600)	298,350
Increase in notes payable	70,685	-
Repayment of notes payable	(384,985)	(115,086)
Proceeds from shareholder loan	-	250,000
Issuance of capital stock	688,418	941,355
	292,518	1,374,619
Increase in cash	289,968	113,024
Cash, beginning of year	64,836	(48,188)
Cash, end of year	\$ 354,804	\$ 64,836
Cash is defined as cash less bank indebtedness.		
Supplementary information:		
Interest paid	\$ -	\$ 163,522
Non-cash transactions:		
Shares issued for settlement of notes payable	18,000	-
Shares issued for settlement of shareholder loan	270,728	-

See accompanying notes to financial statements.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2005 and 2004

1. Operations:

The Company is incorporated under the Business Corporations Act (British Columbia). The Company's principal business operations relate to the development, manufacture and sale of aircraft water purification equipment and systems.

The Company has an accumulated deficit of \$6,983,278 as at September 30, 2005 as a result of losses incurred in prior years with associated negative cash flows from product development and operations. Operations in 2005 were profitable, cash flow was positive and the Company's creditor issues have been settled. 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, and sustain a level of equipment sales to ensure such ongoing profitability.

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, except where otherwise indicated. 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 revenue 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 realizability of future income tax assets. 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. Work-in-process and finished goods inventory includes the cost of raw materials, direct labour, freight and other direct manufacturing costs.

(c) Furniture and equipment:

Furniture and equipment is stated at cost. Amortization on tooling 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) Impairment of long-lived assets:

The Company tests long-lived assets, such as furniture and equipment and deferred development costs for impairment when events or circumstances indicate that an impairment exists. Long-lived assets are impaired if the undiscounted cash flows expected to be earned from their use is less than their carrying amount, at which time, long-lived assets are written down to their fair value.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2005 and 2004

2. Significant accounting policies (continued):

(e) 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 deferred.

(f) 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 capital expenditures 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 12(a)). Royalty payments are recognized and expensed when incurred.

(g) 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 technological feasible product applications having a continuing identifiable market with best estimates of net cash flows in excess of the carrying value of the costs incurred are deferred. Routine alterations to existing products are expensed as incurred.

(h) 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 when appropriate.

(i) Stock-based compensation plans:

The Company has a stock-based compensation plan, which is described in note 10(d).

In November 2003, the Canadian Institute of Chartered Accountants amended handbook Section 3870 - "*Stock-Based Compensation and Other Stock-Based Payments*" ("HB 3870"). Amended HB 3870 requires that stock-based compensation related to stock options granted to employees and directors be accounted for using the fair value method and recognized as stock-based compensation in results from operations over the vesting period. Effective for the Company's fiscal year beginning October 1, 2004, the Company adopted the fair value requirements of HB 3870 for stock options granted on or after October 1, 2002. As permitted by HB 3870, the Company has retroactively adopted the fair value method of accounting for these awards with a restatement of prior periods.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2005 and 2004

2. Significant accounting policies (continued):

(i) Stock-based compensation plans (continued):

Adoption of HB 3870 resulted in an increase to the opening deficit and contributed surplus as of October 1, 2003 of \$16,500 to reflect the cumulative effect of the change on prior periods, and increase in stock-based compensation expense for the year ended September 30, 2004 of \$26,456.

Prior to adoption of amended HB 3870, the Company recognised stock based compensation for options granted to employees and directors using the settlement method. Under the settlement method, stock based compensation is recognised to the extent that the market price of the underlying common shares exceeds the exercise price on the date of grant. As the Company only issued options with the exercise price equal to the market price of common shares, no compensation was recorded related to stock options granted to employees and directors prior to adoption of amended HB 3870.

(j) Earnings (loss) per share:

Earnings (loss) per share amounts have been calculated based on the weighted average number of shares outstanding. 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.

(k) 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. Revenue and expenses are translated into 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 of operations. For the year ended September 30, 2005, foreign exchange gains included in net earnings (loss) totaled \$22,849 (2004 - \$57,190).

(l) Comparative figures:

Certain comparative figures have been reclassified to conform to the presentation adopted in the current year. In particular, expenses attributed to the manufacturing process previously included in selling expenses, research development and general administration and occupancy, have been re-classified to manufacturing overhead costs.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2005 and 2004

3. Disposal of commercial division:

The Company disposed of all of the assets of its commercial division, including inventory and furniture and equipment with a book value of \$95,212 and \$20,715 respectively, for total consideration of \$300,000.

4. Inventory:

	2005	2004
Raw materials and work-in-process	\$ 201,080	\$ 290,825
Finished goods	81,842	132,801
	<u>\$ 282,922</u>	<u>\$ 423,626</u>

Cost of goods sold is determined as follows:

	2005	2004
Opening inventory	\$ 423,626	\$ 630,814
Manufacturing costs:		
Parts	661,497	867,752
Direct labour, freight and other	335,416	418,714
Manufacturing overhead	309,487	279,461
	<u>1,306,400</u>	<u>1,565,927</u>
Available for sale	1,730,026	2,196,741
Closing inventory	282,922	423,626
Cost of goods sold	<u>\$ 1,447,104</u>	<u>\$ 1,773,115</u>

5. Furniture and equipment:

	2005	2004
Tooling	\$ 3,877	\$ 61,390
Manufacturing and distribution equipment	40,418	104,821
Furniture and office equipment	152,198	171,154
Leasehold improvements	-	97,319
	<u>196,493</u>	<u>434,684</u>
Accumulated amortization and write-down	<u>(162,001)</u>	<u>(359,098)</u>
	<u>\$ 34,492</u>	<u>\$ 75,586</u>

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2005 and 2004

6. Deferred development costs:

In prior years, the Company deferred certain costs associated with the designing, testing and certifying the Company's potable water systems for specified aircraft models. Management believes that the market for these systems continue to represent a significant opportunity for the Company but sales volume has taken longer to materialize than anticipated. Accordingly, in 2004 the Company determined that previously capitalized costs should be written off as they no longer meet the criteria for deferral under Canadian generally accepted accounting principles. As a result, the Company wrote off deferred costs in the amount of \$3,786,834 as of September 30, 2004.

7. Factoring 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\$350,000 (CDN\$445,000). The facility allows the Company to sell accounts receivable on a with-recourse basis. The loan is reduced by the related accounts receivable when collected by the purchaser of the accounts receivable. The purchaser has the option to return accounts receivable purchased to the Company if amounts are not collected in a reasonable time period. As the Company retains significant risks relating to the accounts receivable sold, the accounts receivable remain in the Company's financial statements and the amounts advanced by the purchaser are recognized as a factoring loan. Outstanding amounts are repayable on demand, bear interest at 2.75% per month and are secured by accounts receivable and other assets of the Company. As at September 30, 2005, the Company has US\$314,400 (CDN\$367,900) outstanding under the credit facility (2004 - US\$350,000 (CDN\$449,500)).

8. Settlement of notes and accounts payable:

(a) In fiscal 2003, the Company entered into agreements with two contractors to whom it owed a total of US\$700,000 for services rendered. Under the agreements, the Company issued promissory notes, denominated in US dollars of US\$320,000 and US\$380,000, with maturity dates of June 15, 2004 and September 30, 2005 respectively, as settlement for the amounts owed. The promissory notes bore interest at 5% and 7%, respectively per annum calculated monthly, plus certain penalties, and provided for monthly payments as prescribed in the agreements until the end of their terms.

During the year ended September 30, 2005, the Company settled the remaining principal and interest owed under these promissory notes, then totaling \$720,510, for cash of \$300,878 and common shares valued at \$18,000. The Company recognized a total gain on settlement of these notes payable of \$401,632.

(b) The Company settled accounts payable totaling \$491,371 for cash of \$291,552 and recognized a gain of \$199,819 on settlement.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2005 and 2004

9. Loan payable:

During 2002, the Company received funds from Technology Partnership Canada ("TPC"). The loan is non-interest bearing and repayable in eight equal annual installments commencing on December 31, 2004. Interest at TPC's prescribed rates plus 300 bonus points is charged on late payments. The installment due in fiscal 2005 was paid subsequent to September 30, 2005.

10. 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:

	Number of shares	Amount
Balance, September 30, 2003	14,921,194	\$ 5,589,558
Issued for cash in private placements of common shares, net of issue costs	3,000,000	501,355
Issued for cash on exercise of warrants	2,560,000	440,000
Balance, September 30, 2004	20,481,194	6,530,913
Issued for cash in private placement of common shares, net of issue costs	9,187,900	686,018
Issued for settlement of shareholder loan (note 11(a))	3,384,100	270,728
Issued for settlement of a note payable (note 8(a))	225,000	18,000
Issued for cash on exercise of options	24,000	2,880
Balance, September 30, 2005	33,302,194	\$ 7,508,539

On May 5, 2005, the Company completed a private placement of 12,572,000 common shares at a price of \$0.08 per share for gross proceeds of \$1,005,760. This private placement consisted of 9,187,900 shares issued for cash and 3,384,100 shares issued for settlement of a shareholder loan. In addition, 320,000 finder's warrants were issued as a finder's fee, exercisable at \$0.10 per share for a period of one year after closing.

(c) Shares in escrow:

The Company previously issued 3,679,884 performance shares which were releasable from escrow with 10% of the escrowed shares released from escrow on February 26, 2002, and a further 15% were released on each six month anniversary, until all of the escrowed shares had been released from escrow on February 28, 2005.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2005 and 2004

10. Share capital (continued):

(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 eighteen months following the date of grant.

A summary of the status of the Company's stock option plan as at September 30, 2005 and 2004 and changes during the years ending on those dates is presented below:

	2005		2004	
	Shares	Weighted average exercise price	Shares	Weighted average exercise price
Outstanding, beginning of year	1,930,000	\$ 0.14	1,820,000	\$ 0.48
Granted	530,000	0.10	1,820,000	0.13
Exercised	(24,000)	(0.10)	-	-
Cancelled or expired	(236,000)	(0.19)	(1,710,000)	(0.49)
Outstanding, end of year	2,200,000	0.13	1,930,000	\$ 0.14
Options exercisable, end of year	1,648,000	0.13	522,000	\$ 0.18

Stock options outstanding and exercisable at September 30, 2005:

Number of stock options outstanding	Options exercisable	Exercise price	Weighted average remaining contractual life
100,000	100,000	0.20	6.3 months
580,000	544,000	0.18	19.5 months
990,000	990,000	0.10	22.3 months
70,000	14,000	0.08	29.0 months
400,000	-	0.11	31.7 months
2,200,000	1,648,000		20.4 months

During the year ended September 30, 2005, the Company recognized \$18,098 (2004 - \$26,456) in stock-based compensation related to options granted on or after October 1, 2002.

The compensation expense was calculated using the Black-Scholes option pricing model assuming a weighted average risk-free interest rate of 2.98% (2004 - 3.55%), a dividend yield of 0.0%, a weighted average expected volatility of 84.8% (2004 - 50.8%) and expected life of stock options of 2.25 years (2004 - 2.25 years). The weighted average grant date fair value of options granted during the year ended September 30, 2005 was \$0.05 (2004 - \$0.13).

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2005 and 2004

10. Share capital (continued):

(e) Share purchase warrants:

On March 15, 2004, in conjunction with a private placement of common shares, the Company issued 1,500,000 share purchase warrants exercisable at \$0.25 and expiring on September 16, 2005. In May 2004, 560,000 of these warrants were exercised for proceeds of \$140,000 and on September 16, 2005 the remaining warrants expired without being exercised.

Under the private placement of common shares completed on May 5, 2005 (note 10(b)), finder's warrants to purchase 320,000 common shares, exercisable at \$0.10 each, were issued of which 247,500 warrants expire on April 29, 2006 and 72,500 warrants expire on May 4, 2006. All of these warrants were outstanding as of September 30, 2005.

11. Related party transactions:

(a) Loan payable:

A shareholder loan of \$250,000 of principal and accrued interest of \$20,728 was applied by the holder as partial payment for the subscription of common shares completed on May 5, 2005 (note 10(b)).

(b) Other:

Included in accounts payable and accrued liabilities is nil (2004 - \$37,450) payable to shareholders and companies controlled by directors of the Company. During the year, the Company paid \$48,685 (2004 - \$99,510) 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.

12. 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 revenue 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, 2005 totaled \$162,179 (2004 - \$120,886).

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2005 and 2004

12. Contingencies and commitments (continued):

(a) Continued:

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-PWS™) 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 revenue earned each quarter from January 1, 2005 to June 30, 2005 and then from July 1, 2007 through June 30, 2011, or if the royalty payments to that date do not equal the maximum of \$742,500 payable, then until the earlier of total payments of \$742,500 or the date of April 1, 2014 is reached. Accumulated royalties paid or payable to September 30, 2005 totaled \$30,962 (2004 - nil).

(b) The Company entered into a long-term operating lease for premises expiring November 30, 2010. The Company also has several equipment leases expiring at various dates to 2008. The future annual lease payments, exclusive of property taxes and expenses directly payable by the Company:

2006	\$ 114,472
2007	119,312
2008	107,632
2009	104,325
2010	105,300
Thereafter	17,550
	<u>\$ 568,591</u>

13. 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 35.24% (2004 - 35.62%) to loss before income taxes as follows:

	2005	2004
Net earnings (loss) before income taxes	\$ 914,111	\$ (3,961,291)
Expected income tax recovery	\$ 322,133	\$ (1,411,012)
Tax effect of:		
Expired losses	-	222,813
Change in valuation allowance	(381,831)	1,191,122
Change in tax rate	79,278	-
Other	(19,580)	(2,923)
Income tax expense (recovery)	\$ -	\$ -

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2005 and 2004

13. Income taxes (continued):

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

	2005	2004
Future income tax assets:		
Non-capital losses carried forward	\$ 1,478,223	\$ 1,815,197
Furniture and equipment, undepreciated tax costs in excess of net book value	89,927	115,702
Scientific research and development expenditures	123,835	150,946
Share issue costs	13,372	-
Accrued liabilities	-	5,343
Total gross future income tax assets	1,705,357	2,087,188
Valuation allowance	(1,705,357)	(2,087,188)
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, 2005, 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 \$4,335,000 which will expire at various dates through 2011. The Company also has Scientific Research and Development expenditures of approximately \$363,152 which are available to offset taxable income indefinitely.

14. Financial instruments:

(a) Fair values:

Financial instruments include cash, accounts receivable, accounts payable and accrued liabilities, 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, 2005, six customers (2004 - six) represented approximately 95% (2004 - 87%) of accounts receivable. The Company mitigates credit risk through regular credit assessment and collection policies.

(c) Currency risk:

At September 30, 2005, 100% (2004 - 88%) of accounts receivable and nil (2004 - 41%) of liabilities are denominated in United States dollars. In addition, the factoring loan (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.

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

Notes to Financial Statements

Years ended September 30, 2005 and 2004

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 2005, sales to six customers (2004 - six customers) represent approximately 82% (2004 - 71%) of total revenue. 100% of the Company's furniture and equipment are located in Canada. In 2005, approximately 25% (2004 - 45%) of sales revenue was generated by customers in Canada and 75% (2004 - 55%) by customers in other countries, primarily the United States.



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INTERNATIONAL WATER-GUARD INDUSTRIES INC.

**MANAGEMENT'S DISCUSSION
AND ANALYSIS**

Fiscal Years Ended

September 30, 2005 and 2004

Dated: December 15, 2005

INTERNATIONAL WATER-GUARD INDUSTRIES INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS Fiscal Year 2005

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, 2005. The following discussion, and the information elsewhere in this report, is intended to provide the reader with a further understanding of the Company's business and factors underlying its financial results.

International Water-Guard Industries Inc. ("IWG") is a Canadian based international aerospace company focused on the design, manufacture, sale and service of aircraft potable water treatment/management equipment and systems. The principal technology embodied in IWG's products is irradiation by ultraviolet ("UV") light, with filtration, ancillary systems and controls designed by the Company.

Until recently, the Company had been substantially a development company, with base operations and revenues covering a portion of its product, aviation water systems and market development costs. New equity issues provided the remainder of the Company's capital commitments and working capital requirements.

In fiscal 2005 IWG completed several important transactions as a result of the strategy initiated in fiscal 2004 to restructure its finances and focus solely on its leading position in the aviation water treatment market. During the second and third quarters of fiscal 2005, IWG:

- Sold its commercial/industrial business and assets for \$300,000;
- Settled \$1,212,000 of supplier and noteholder debt in exchange for \$611,000 cash and equity shares, for a net gain aggregating \$601,000;
- Issued new equity shares for net cash of \$686,000 and exchanged a \$271,000 shareholder loan for equity shares;
- Moved to a new manufacturing facility more suitable for production of aerospace products and systems; and
- Embarked on a series of product improvements to further enhance its product performance.

During each of the four quarters of fiscal 2005, the Company has been able to report earnings and positive cash flow from operations. The Company held cash of \$354,804 at September 30th, 2005 to enable it to support growth in sales and investment in certain equipment and leasehold costs.

SELECTED ANNUAL FINANCIAL INFORMATION (\$000's except per share amounts)

Fiscal year September 30 th	2005	2004	2003
Total revenues	\$3,135	\$3,641	\$3,050
Earnings (loss) from operations before special items	163	(127)	(566)
Gains on asset sales and debt settlements, less deferred cost and asset write-downs	751	(3,834)	(178)
Net income (loss)	\$ 914	\$(3,961)	\$(744)
Earnings (loss) per share, basic and fully diluted	\$0.04	\$(0.21)	\$(0.05)
Dividends per share	Nil	Nil	Nil
Total assets	\$1,213	\$1,162	\$3,939
Long term debt	\$25	\$29	\$478

The foregoing summary of annual financial results for the Company is extracted from the Company's annual audited financial statements, while a more detailed analysis of the latest statements follow. However, amounts for fiscal years 2004 and 2003 have been restated to reflect the retroactive adoption of expensing the fair value of stock options vesting in the respective years. Additional information relating to the Company is also available under the Company's name on SEDAR at www.sedar.com.

Operating results

The Company reported sales in fiscal 2005 of \$3,134,809, with an operating profit of \$163,597 before special items, compared to an operating loss of (\$126,979) in the prior year. Net earnings of \$914,111 for the year compared to a net loss of (\$3,961,291) in the previous year.

Current year net earnings includes gains of \$750,514 from the sale of the company's industrial/commercial division assets and from the settlement of debts, less certain asset write-downs related to a move to a new manufacturing facility.

Sales

Sales of aviation water treatment equipment and parts grew during the year by 32%. In the prior year, five aircraft circulating potable water systems were delivered against specific contracts, and the US dollar reduced in value, hence total aviation product sales in 2005 of \$2,937,546 decreased by 7% from fiscal 2004's aviation sales of \$3,153,106.

Industrial sales of \$197,263 related to aquaculture and other water process applications, prior to the sale of this division on February 11, 2005, represented only 6% of fiscal 2005 sales and was 60% less than Industrial sales for the whole of the prior year.

Sales to customers in Canada represented 25% of the Company's sales (vs. 45% in 2004) with 75% of sales exported, primarily to United States (vs. 55% in 2004).

Expense re-classification

During fiscal 2005, the Company assessed its classification of expenses incurred in support of its manufacturing operations and has determined that certain manufacturing overhead costs are more suitably classified with cost of sales. These expenses primarily include staff support costs, facility and insurance. These changes were made in reporting the annual results for 2005 and comparative information for 2004 have been re-classified to conform with the new classification.

Gross margins

Total gross margin, while less than in 2004 due to lower sales, provided an improved margin percentage. Overall, the weaker U.S. dollar served to reduce average realized sales prices by 6% below the prior year.

With the move to new more suitable manufacturing facilities, new manufacturing and/or support staff have and will be added in response to growth. The Company will continue to procure product components for assembly into the Company's own designed products, which strategy provides supply chain capacity as required.

Operating expenses

Selling expenses of \$300,604 were essentially unchanged from fiscal 2004. In order to expand the Company's presence in the aviation sector, the company is again increasing its marketing

efforts through increased travel, attendance at trade shows and additional sales personnel compared to previous years.

Engineering and product development expenses charged to earnings of \$362,948 represents a 23% increase above the prior year. Increased engineering staff and testing costs reflects further efforts by the company to increase capacity and assure its product quality and features are the best available to meet customer needs. All product development costs have been expensed, and none has been capitalized.

General, administration, information technology and regulatory related expenses totaled \$678,122, a 32% decrease from fiscal 2004. This decrease was primarily attributed to decreased administration staff, consultants, legal and other general expenses.

Capital expenditures

Capital expenditures of \$15,834 incurred by the Company for equipment, while not significant, in fiscal 2005, is attributed to improvements in capability as the company moved to new leased facilities prior to the fourth quarter of fiscal 2005. Leasehold costs of some \$75,000 will be incurred during fiscal 2006.

Quarterly information

The Company delivered sales of \$815,741 during the fourth quarter ended September 30th, 2005, compared to \$752,400 in the prior year for the same period. Earnings from operations of \$50,035 are reported versus a loss, before special write-downs, of \$59,812 a year earlier.

During this 4th quarter, the Company adopted the accounting policy related to stock-based compensation and as a result, included in reported amounts are expenses of \$18,098 and \$26,456 respectively on a retroactive basis. These expenses relate to the vesting of stock options during the respective periods. Further details on this new policy are covered in the notes to the company's financial statements.

The summary information which follows is taken from the Company's quarterly and annual financial reports covering the last two fiscal years. Information for fiscal 2004 has been restated to reflect the retroactive adoption of the policy of expensing the fair value of options vesting in that year.

Fiscal year ended September 30 (\$000's except per share amounts)

	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Year
Fiscal 2005:					
Sales	\$771	\$825	\$723	\$816	\$3,135
Earnings from operations before special items	31	41	41	50	163
Gains on asset sales and debt settlements, less asset write-downs	-	740	11	-	751
Net income	31	781	52	50	914
Earnings per share, basic and fully diluted	\$0.00	\$0.03	\$0.00	\$0.01	\$0.04
Fiscal 2004:					
Sales	\$1,163	\$791	\$934	\$753	\$3,641
Earnings (Loss) from operations before special items	91	4	(162)	(60)	(127)
Deferred costs and asset downs				(3,834)	(3,834)
Net income (loss)	91	4	(162)	(3,894)	(3,961)
Earnings (loss) per share, basic and fully diluted	\$0.01	\$0.00	\$(0.01)	\$(0.21)	\$(0.21)

Fluctuations in sales from quarter to quarter in fiscal 2004 were mainly related to the delivery of the Company's Circulating Potable Water System™. There are no other factors which may be used to predict future performance in either sales or in net income on a quarter to quarter basis.

Risks and Uncertainties

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

Aircraft markets

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

Competition

Aviation - Potable Water Treatment

At this time, there are no other companies of significance supplying flight certified potable water disinfection equipment to the aircraft industry. It is expected that competition will come, although IWG intends to remain the dominant player in this field because of its significant head start, and by developing new products, pricing new and existing products as though competition exists, and continuing to seek customer input. From time to time very small players attempt to penetrate the market, but none have been successful. There is an initiative by a company to enter the market with a system tailored specifically to the Airbus A380 using an alternate water treatment

technology. A variety of water filters are used by some airlines and operators, but these do not actively treat and disinfect the water.

Aviation - Potable Water Systems

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

Foreign Exchange

Generally, fluctuations in the Canadian to United States dollar exchange rate are recorded as transactions occur and adjusted at the end of the period that 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 that are also in U.S. dollars. Consequently, fluctuations in the Canadian to U.S. dollar foreign exchange rates will impact sales revenue, gross margins and net earnings reported by IWG. With the shift in US/ Canada exchange rates in recent periods, this is an area of risk.

The Company has not previously employed 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 maintain profitable operations, and by its ability to attract additional capital as needed. The Company has negotiated settlement agreements with several creditors and noteholders, sold its industrial/commercial business and raised additional capital during 2005. These events have enabled IWG to establish both working capital and shareholder's equity, placing it in a much stronger financial position than in the past and able to better finance its future growth.

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.

Liquidity and capital resources

Cash flow from operations:

Cash provided from operating activities, before non-cash operating working capital, was \$223,636 in 2005. Settlement of liabilities, less a reduction in operating assets, utilized \$510,352 during the year, which was enabled by the proceeds of the sale of the industrial/commercial division and the private placement of equity shares.

Cash flow from financing activities:

The Company issued common shares in a private placement and exercise of options during the year for net proceeds of \$688,418. In addition, the proceeds on sale of the industrial/commercial division provided \$300,000. These financings were sufficient to provide the majority of the Company's cash flow requirements and enabled the company to complete the settlement of debts with several note-holders and trade creditors during the year, and provide a cash reserve for future operations and growth.

Working capital position:

The Company completed its 2005 fiscal year with \$576,218 in working capital, a significant improvement from the negative working capital of \$1,370,085 existing in the prior year. This improvement was primarily attributed to the settlement of notes payable and certain trade creditors, in turn made possible from cash provided from asset sales and equity financings described elsewhere. Working capital requirements were also supplemented by the application of a shareholder loan to the purchase of shares equity during the financing described elsewhere. The Company has begun fiscal 2006 by operating on a cash positive basis and a cash reserve available to finance growth in operations.

Share capital

The Company has 33,302,194 common shares outstanding as at the date of this report. This number includes the 12,572,000 shares issued in the private placement of shares completed on May 5, 2005. In addition, there are 2,330,000 options now outstanding under the Company's stock option plan and 320,000 warrants outstanding related to the private placement of common shares in May 2005. Further details of these options and warrants are included in the notes to the financial statements.

Business outlook

International Water-Guard Industries, historically a developer of UV-based water treatment equipment for several niche markets has become a primary supplier of engineered ultraviolet based water treatment products and systems for the aviation market.

IWG has become the leading provider of potable water treatment equipment to the aviation industry, expanding its position in the business aircraft market and working to establish a position in the emerging commercial airline market. In addition, IWG is capitalizing on its investment in its certified and proven aircraft circulating potable water system through initiatives aimed at both retrofit and new aircraft markets.

With the continued growth in the aviation industry, and increased emphasis on water quality on board aircraft, IWG is now focused on generating future results from its portfolio of aircraft water treatment products and systems.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The financial statements of International Water-Guard Industries Inc. for the fiscal year ended September 30, 2005 and all other information in the annual report 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, in all material respects, 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.

"David C. Fox"
President, CEO and Director

"C. Edward Butterfield"
Chief Financial Officer



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