# ENVIRONMENTAL WASTE INTERNATIONAL INC.

## CONSOLIDATED FINANCIAL STATEMENTS

## FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

# ENVIRONMENTAL WASTE INTERNATIONAL INC.

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## DECEMBER 31, 2006

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# AUDITORS' REPORT

**To the Shareholders of**
**Environmental Waste International Inc.**

We have audited the consolidated balance sheet of ENVIRONMENTAL WASTE INTERNATIONAL INC. as at December 31, 2006 and the statements of operations and deficit and cash flows for the year 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 audit.

We conducted our audit 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 December 31, 2006 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

The 2005 comparative figures were audited by another Chartered Accountant.

Rich Rotstein *LLP*

**RICH ROTSTEIN LLP**
**Chartered Accountants**
**Licensed Public Accountants**

Toronto, Canada
April 12, 2007

# ENVIRONMENTAL WASTE INTERNATIONAL INC.

## CONSOLIDATED BALANCE SHEET
## AS AT DECEMBER 31, 2006 and 2005

### ASSETS

| | 2006<br>$ | 2005<br>$ |
|---|---|---|
| **Current Assets** | | |
| Cash | 420,430 | 232,090 |
| Accounts receivable | 6,110 | 4,951 |
| Prepaid expenses and sundry | 49,437 | 35,464 |
| Government assistance receivable | 0 | 67,123 |
| | 475,977 | 339,628 |
| **Capital Assets** (note 4) | 3,973 | 1,119,597 |
| **Deferred Financing Charges** (note 9) | 0 | 10,694 |
| **Technology Rights** (note 5) | 300,000 | 350,000 |
| **Total Assets** | **779,950** | **1,819,919** |

Approved by the Board:

"Stephen Simms" Director "Wm. Bateman" Director

The accompanying notes are an integral part of these financial statements

# ENVIRONMENTAL WASTE INTERNATIONAL INC.

## CONSOLIDATED BALANCE SHEET
## AS AT DECEMBER 31, 2006 AND 2005

### LIABILITIES

| | 2006<br>$ | 2005<br>$ |
|---|---|---|
| **Current Liabilities** | | |
| Accounts payable and accrued liabilities | 237,695 | 215,503 |
| Loans payable (note 8) | 367,000 | 48,100 |
| Deferred income - current (note 6) | 43,307 | 0 |
| Deferred revenue - current (notes 1(d) and 7) | 66,731 | 0 |
| | 714,733 | 263,603 |
| **Long-term Liabilities** | | |
| Deferred income (note 6) | 171,922 | 0 |
| Loans payable (note 8) | 0 | 367,000 |
| Mortgages payable (note 9) | 0 | 1,128,000 |
| | 171,922 | 1,495,000 |
| **Total Liabilities** | 886,655 | 1,758,603 |
| **SHAREHOLDERS' EQUITY (DEFICIENCY)** | | |
| Capital stock (note 10(b)) | 35,657,624 | 35,145,408 |
| Contributed surplus (note 10(f)) | 1,540,040 | 1,178,558 |
| Convertible debt (notes 8 and 9) | 163,000 | 335,000 |
| Deficit | (37,467,369) | (36,597,650) |
| | (106,705) | 61,316 |
| **Total Liabilities and Shareholders' Equity (Deficiency)** | **779,950** | **1,819,919** |

**Going Concern (Note 2)**

**Contingent Liability (Note 16)**

**Commitments (Note 13)**

The accompanying notes are an integral part of these financial statements

**ENVIRONMENTAL WASTE INTERNATIONAL INC.**

## CONSOLIDATED STATEMENT OF OPERATIONS AND DEFICIT
## FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

| | 2006<br>$ | 2005<br>$ |
|---|---|---|
| **REVENUE** | | |
| Sales and other | 72,384 | 237,895 |
| Amortization of deferred income (note 6) | 1,304 | 0 |
| Foreign exchange gain (loss) | 1,530 | (9,580) |
| | 75,218 | 228,315 |
| **EXPENSES** | | |
| Operating, labour and manufacturing expenses | 649,762 | 874,549 |
| Research and development costs | 392,233 | 500,175 |
| Stock based compensation (note 10) | 143,698 | 226,502 |
| Mortgage interest and financing costs (note 9(b)) | 136,425 | 89,033 |
| Amortization of capital assets and technology rights | 89,897 | 93,995 |
| Loan interest (note 8) | 51,670 | 68,839 |
| Recovery of GST previously disallowed | 0 | (146,992) |
| Scientific research and investment tax credits (note 11) | (188,475) | (66,422) |
| | 1,275,210 | 1,639,679 |
| **LOSS BEFORE THE UNDERNOTED** | (1,199,992) | (1,411,364) |
| **OTHER ITEMS** | | |
| Settlement of law suit (note 12(b)) | (37,383) | 0 |
| Gain on sale of real property (notes 12(a) and 6) | 409,019 | 0 |
| **NET LOSS FOR THE YEAR** | (828,356) | (1,411,364) |
| **DEFICIT, BEGINNING OF YEAR** | (36,597,650) | (35,186,286) |
| Distributions paid on convertible debt equity component (notes 8 and 9) | (41,363) | 0 |
| **DEFICIT, END OF YEAR** | (37,467,369) | (36,597,650) |
| **BASIC AND DILUTED LOSS PER SHARE** | (0.012) | (0.022) |
| **WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING** | **66,318,187** | **62,748,324** |

The accompanying notes are an integral part of these financial statements

# ENVIRONMENTAL WASTE INTERNATIONAL INC.

## CONSOLIDATED STATEMENT OF CASH FLOWS
## FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

| | 2006<br>$ | 2005<br>$ |
|---|---|---|
| **OPERATING ACTIVITIES** | | |
| Net loss for the year | (828,356) | (1,411,364) |
| Items not affecting cash | | |
| Amortization | 89,897 | 93,995 |
| Gain on disposal of capital assets | (409,019) | 0 |
| Amortization of deferred income | (1,304) | 0 |
| Stock based compensation | 143,698 | 226,502 |
| Amortization of deferred financing charges | 10,694 | 5,750 |
| | (994,390) | (1,085,117) |
| Changes in non-cash working capital items | | |
| Accounts receivable | (1,159) | 55,132 |
| Government assistance receivable | 67,123 | 565,696 |
| Prepaid expenses and sundry | (13,973) | 8,456 |
| Deferred revenue | 66,731 | 0 |
| Accounts payable and accrued charges | 22,191 | 5,943 |
| CASH USED IN OPERATING ACTIVITIES | (853,477) | (449,890) |
| **INVESTING ACTIVITIES** | | |
| Proceeds on disposal of capital assets, net of expenses | 1,701,280 | 0 |
| CASH PROVIDED BY INVESTING ACTIVITIES | 1,701,280 | 0 |
| **FINANCING ACTIVITIES** | | |
| Repayment of loans | (48,100) | (448,195) |
| Proceeds from loans | 0 | 430,000 |
| (Decrease) increase in long-term debt (note 9) | (1,300,000) | 450,000 |
| Proceeds from issuance of common stock | 730,000 | 0 |
| Distributions paid on convertible debt equity component | (41,363) | 0 |
| CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES | (659,463) | 431,805 |
| **NET INCREASE (DECREASE) IN CASH** | 188,340 | (18,084) |
| Cash - beginning of year | 232,090 | 250,174 |
| **CASH - END OF YEAR** | **420,430** | **232,090** |
| **OTHER CASH FLOW INFORMATION:** | | |
| Interest paid | 209,865 | 157,872 |
| Distributions paid on convertible debt equity component | 41,363 | 0 |

The accompanying notes are an integral part of these financial statements

1. **NATURE OF BUSINESS**

Environmental Waste International Inc. ("EWI") is incorporated under the Ontario Business Corporations Act. The Company's business is the design, development and sale of environmentally sound devices utilizing EWI's patented Reverse Polymerization and dealing with environmental waste disposal, including the development, advancing, licensing and sale of its technology and related machines throughout the world.

2. **GOING CONCERN**

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles applicable to a going concern which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business. Recurring sources of revenue have not yet proven to be sufficient. The Company needs to obtain additional financing to enable it to continue its business. In the absence of additional financing, the Company may not have sufficient funds to meet its obligations. Management continues to monitor the cash needs and consider various alternatives to raise additional financing. However, management is reasonably confident but can offer no guarantee that it will be able to secure the necessary financing to enable the Company to continue as a going concern. These financial statements do not give effect to adjustments that would be necessary should the Company be unable to continue as a going concern. There is no assurance that this will be successful.

If the going concern basis is not appropriate, material adjustments may be necessary in the carrying amounts and/or classification of assets and liabilities and the loss for the period reported in these financial statements.

3. **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

(a) Use of Estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities, at the date of the financial statements and the reported amounts of revenues and expenses during the period. Such estimates include providing for amortization of property, plant and equipment and technology rights. Actual results could differ from these estimates.

(b) Basis of Consolidation

The consolidated financial statements include the accounts of the Company and it's 100% owned subsidiaries, Environmental Waste Management Corporation "EWMC" and Jaguar Carbon Sales Limited. All inter-company transactions and balances have been eliminated on consolidation. The activities of the subsidiaries are currently immaterial.

(c) Technology Rights

Technology represents the cost of acquired technology. The technology rights valuation is tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. In 2002, the Company incurred a charge of $2,659,587 representing recognition of impairment. Commencing January 1, 2003, the remaining unamortized technology rights balance is being amortized equally over a 10 year period, the estimated useful life of these rights.

(d) Revenue Recognition

For sales contracts involving production, customization and installation, revenues are recognized under the percentage-of-completion method using milestones or engineering approvals to determine the percentage complete. Provisions for estimated contract losses are recognized in the year the loss becomes probable and can be reasonably estimated. Service revenue such as maintenance and support is recognized when the services are performed. The timing of revenue recognition may differ from the contract payment schedules, resulting in revenues that have been earned but not billed.

Certain contracts require the customer to provide deposits. Deposits are deemed to be forfeited by the customer when certain contractual obligations are not met and are brought into revenue.

Any other billings or cash received in advance of sales are being recorded as deferred revenue.

Other revenue is recognized at the time ownership transfers or services are rendered to the customer.

Provision for the potential warranty claims, if any, is provided for at the time revenue is recognized, based on warranty terms and claims experience as a deduction from revenue.

(e) Stock Based Compensation

The Company has a stock-based compensation plan. It maintains a stock-based compensation plan for employees, directors, officers and consultants of the Company. Effective January 1, 2003, the Company follows the fair-value method (using the Black-Scholes option pricing model) to record compensation expense with respect to stock options and warrants granted. The fair value of each option or warrant granted is estimated on the date of date of grant and provision for the cost is provided for as contributed surplus over the term of the vesting period of the respective options. The consideration received by the Company on the exercise of share options is recorded as an increase to the share capital together with corresponding amounts previously recognized in contributed surplus.

(f) Basic and Diluted Loss Per Share

Basic loss per share has been computed by dividing net earnings (loss) by the weighted average shares outstanding during the year. Weighted average number of shares is determined by relating the portion of time within the year that common shares have been outstanding to the total time in the year.

Diluted per share amounts are calculated using the treasury stock method. Diluted loss per share is computed similar to basic loss per share except that the weighted average shares outstanding are increased to include additional shares from the assumed exercise of stock options, warrants and compensation options or dilutive instruments. In computing the loss per share on a fully diluted basis, the treasury stock method assumes that proceeds received from in-the-money stock options are used to repurchase common shares at the prevailing market rate. The weighted average number of shares outstanding is then adjusted by the net change.

(g) Government Assistance / Investment Tax Credits ("ITCs")

Government assistance is available to the Company through income tax investment and innovation tax credits. ITCs and other governmental incentives relating to capital assets acquired for research and development, are deducted from the cost of the assets. ITCs and other incentives relating to current research and development expenditures are disclosed as government assistance on the statement of earnings. The Company recognizes ITCs and other incentives when earned, and when there is reasonable assurance of realization.

(h) Research and Development Costs

Research costs are expensed as incurred. Development costs that meet the criteria for deferral under Canadian generally accepted accounting principles for products that are expected to provide future benefits, with reasonable certainty, are deferred and amortized over the anticipated periods of sales revenue of the products.

(i) Translation of Foreign Currencies

Monetary assets and liabilities denominated in foreign currencies are converted to Canadian dollars at the appropriate rates of exchange ruling at the balance sheet date, while other assets and liabilities are converted at the rates of exchange applicable at the dates acquired or incurred. Revenue and expenses are translated into Canadian dollars at rates of exchange applicable during the periods in which they were earned or expensed. All gains and losses are included in the consolidated statements of operations and deficit as they arise.

(j) Capital Assets

Capital assets are recorded at cost. Repairs and maintenance are charged against income as incurred. Expenditures which extend the estimated life of an asset are capitalized. When a capital asset no longer contributes to the Company's ability to provide services, its carrying amount is written down to residual value.

Amortization is provided annually on capital assets, other than land, at rates designed to charge the cost of the assets over their estimated useful lives, as follows:

| | | |
|---|---|---|
| Computer equipment | - | 30% declining balance |
| Building | - | 5% declining balance |
| Equipment | - | 30% declining balance |

One-half of annual depreciation and amortization is charged on net assets acquired during the fiscal year. Government assistance is recorded as a reduction of the related assets.

(k) Impairment of Long-lived Assets

Long-lived assets, including capital assets, are amortized over their useful lives. The Company reviews long-lived assets for impairment when events or changes in circumstances indicate that the carrying amount may not be recoverable. If the sum of the undiscounted cash flows expected to result from the use and eventual disposition of a group of assets is less than its carrying amount, it is considered impaired. An impairment loss is measured as the amount by which the carrying amount of the group of assets exceeds its fair value. At December 31, 2006, no such impairment has occurred.

(l) Leases

Leases are classified as either capital or operating leases. Leases that transfer substantially all of the benefits and inherent risks of ownership of property to the Company are accounted for as capital leases. At the time a capital lease is entered into, an asset is recorded together with its related long term obligation to reflect the acquisition and financing. Equipment recorded under capital leases is amortized on the same basis as described above. Rental payments under operating leases are expensed as incurred.

(m) Financial Instruments

The Company's financial instruments consist of cash, accounts receivable, accounts payable and accrued liabilities, loans payable and long-term debt. Unless otherwise noted, it is management's opinion that the Company is not exposed to significant interest, currency or credit risks. The Company's long term debt is not publicly traded, therefore quoted market prices are not available.

(n) Income Taxes

The Company uses the asset and liability method of accounting for income taxes, under which future tax assets and liabilities are recognized for differences between the financial statement carrying amounts of existing assets and liabilities, and their respective tax bases. Future tax assets and liabilities are measured using substantively enacted tax rates in effect in the year in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized as part of the provision for income taxes in the year that includes the enactment date. A valuation allowance is recorded to the extent there is uncertainty regarding realization of future tax assets.

(o) Segmented Information

The Company has determined that it has one operating segment. During fiscal 2006, all revenues from operations were derived from sources located in United States and all identifiable assets were located in Canada.

(p) Concentration of Credit Risk

The Company derived net sales from 1 (2005 - 2) major customer amounting to approximately $42,541 representing 57% of total revenues (2005 - $204,184 representing 89% of total revenues). Accounts receivable from the above significant customer at December 31, 2006 is nil.

## 4. CAPITAL ASSETS

| December 31, 2006 | Cost | Accumulated Amortization | Net Book Value |
|---|---|---|---|
| | $ | $ | $ |
| Land | 0 | 0 | 0 |
| Building | 0 | 0 | 0 |
| Computer equipment | 11,583 | 7,610 | 3,973 |
| Equipment | 5,893 | 5,893 | 0 |
| | 17,476 | 13,503 | 3,973 |

| December 31, 2005 | Cost | Accumulated Amortization | Net Book Value |
|---|---|---|---|
| | $ | $ | $ |
| Land | 331,125 | 0 | 331,125 |
| Building | 1,036,078 | 254,246 | 781,832 |
| Computer equipment | 11,583 | 5,908 | 5,675 |
| Equipment | 13,626 | 12,661 | 965 |
| | 1,392,412 | 272,815 | 1,119,597 |

## 5. TECHNOLOGY RIGHTS

| | 2006 | 2005 |
|---|---|---|
| | $ | $ |
| 2002 Value | 500,000 | 500,000 |
| Accumulated amortization | (200,000) | (150,000) |
| | 300,000 | 350,000 |

## 6. DEFERRED INCOME

The amortization is calculated on a straight line basis over the initial lease term of the Company's premises, being 60 months.

| | $ |
|---|---|
| Opening balance | 0 |
| Balance deferred during the year (note 12(a)) | 216,533 |
| Amortization during the year | (1,304) |
| | 215,229 |
| Less current portion | (43,307) |
| Long-term portion | 171,922 |

## 7. DEFERRED REVENUE

Deferred revenue represents a customer deposit of $66,731 on a unit to be delivered to the customer in 2007. This deposit will be recognized as income upon delivery.

## 8. LOANS PAYABLE

All loans bear monthly interest at the rate of 12%. The interest is payable monthly. The loans consist of the following:

| | | 2006<br>$ | 2005<br>$ |
|---|---|---|---|
| (a) | Loan from relative of the president of the Company convertible for common shares at the rate of $0.25 per share and matures on November 1, 2007. | 186,000 | 186,000 |
| (b) | Loan from relative of a director. The original maturity date was December 8, 2005. The maturity date has been extended to November 1, 2007. | 100,000 | 100,000 |
| (c) | Loans from directors convertible to common shares at the rate of $0.25 per share, maturing on November 12, 2007. | 81,000 | 81,000 |
| (d) | Loan from a director bearing interest at 12% per annum and is due on demand. | 0 | 48,100 |
| | Total long-term debt | 367,000 | 415,100 |
| | Less: current portion | (367,000) | (48,100) |
| | | 0 | 367,000 |

In 2004, as required by Canadian generally accepted accounting principles, the Company classified the convertible loans as having both a liability component and an equity component. The classification between debt and equity was determined using the relative fair value approach, with fair value determined by discounting estimated cash flows at a rate of 20%, for a debt instrument of comparable maturity and credit facility. The equity component, which consists of a conversion feature, was determined using the Black-Scholes option pricing model, and was based on a risk free annual interest rate of 3.68%, an expected life of approximately 2 years, an expected volatility of 136% and a dividend yield rate of nil. As a result, the Company had allocated $267,000 of the gross proceeds received to debt and $163,000 to equity. Interest payments in the year on the convertible loan were allocated between interest expense on the liability component, and the distributions paid on the equity component, by proportioning the liability component to the face value over the term of the convertible loans, based on an annual interest rate of 12%. During the year, $19,593 interest paid on the equity portion was allocated to equity as a distribution on the equity component.

## 9. MORTGAGES PAYABLE

| | | 2006 $ | 2005 $ |
|---|---|---|---|
| (a) | First mortgage bearing effective interest at 8.5%, due on October 31, 2007. This mortgage was paid in full during the year. | 0 | 850,000 |
| (b) | Second mortgage bearing interest at 12%, convertible to common shares at the rate of $0.225 per share, due on November 1, 2007. Prior year amount represents the liability component only. This mortgage was paid in full during the year. | 0 | 278,000 |
| | Total long-term debt | 0 | 1,128,000 |

For accounting purposes, the second mortgage contains both a liability component and an equity component being the holder's conversion right, which has been separately presented on the consolidated balance sheets. The Company has allocated the $430,000 face value of the convertible loans issued on October 23, 2005, to the liability and equity components, proportionately, based on their respective fair values. The fair value of the liability component was determined by discounting the stream of future payments of interest and principal at the estimated prevailing market rate of 20%, for a debt instrument of comparable maturity and credit quality, but excluding any conversion privilege by the holder. The fair value of the convertible right was measured using the Black-Scholes option pricing model, and was based on a risk free annual interest rate of 3.68%, an expected life of approximately 2 years, an expected volatility of 136% and a dividend yield rate of nil. As a result, the Company has allocated $278,000 of the gross proceeds received to debt and $172,000 to equity. Interest expense is normally recognized by proportioning the liability component to the face value over the term of the convertible loans, based on an annual interest rate of 12%.

Since the mortgages were paid in full during the year, the equity component of the second mortgage, being $172,000, was repaid with the debt component, and the mortgage was discharged upon sale of the real property. Second mortgage interest payments of $56,960, up until the discharge of the mortgage, were classified between the debt component and equity component as $35,190 of interest expense, and $21,770 as distributions on the equity component.

The deferred financing charges represented costs associated with the setup of the first mortgage and were being amortized to income straight line over the term of the mortgage. Upon discharge of the above noted mortgage, the unamortized balance of the deferred financing charges were written off as interest expense.

10. **CAPITAL STOCK**

(a) Authorized:
Unlimited common shares

(b) Issued and outstanding:

| | Number of Shares | Amount $ |
|---|---|---|
| Balance at December 31, 2005 | 62,720,316 | 35,145,408 |
| Prior year adjustment (1) | 28,008 | 0 |
| Restated balance at December 31, 2005 | 62,748,324 | 35,145,408 |
| Private placement March 14, 2006 (2) | 4,000,000 | 480,000 |
| Private placement November 7, 2006 (3) | 2,500,000 | 250,000 |
| Cost of equity financing | 0 | (217,784) |
| Balance at December 31, 2006 | 69,248,324 | 35,657,624 |

(1) During the year, management determined there was a mathematical error in the number of shares outstanding at December 31, 2005. The net effect of this error is an increase in the number of shares issued and outstanding of 28,008 as at December 31, 2005.

(2) Private placement: 4,000,000 common shares at $0.12 per share

(3) Private placement: 2,500,000 common shares at $0.10 per share

During 2004, the Company issued a private placement for 1,000,000 units consisting of one common share at $0.40 and one half warrant. Each warrant entitles the holder to acquire one additional common share at $0.60 per share before April 27, 2006. None of these warrants were exercised in 2006.

The Company has placed a stop trade order on 1,000,000 of the issued and outstanding shares.

The private placement on March 14, 2006 totalling of 4,000,000 units consisted of one common share at $0.12 and one half warrant. Each warrant entitles the holder to acquire one additional common share at $0.16 per share before March 13, 2008.

The private placement for 2,500,000 units on November 7, 2006 consisted of one common share at $0.10 and one warrant. Each warrant entitles the holder to acquire one additional common share at $0.20 per share before October 31, 2008.

(c) Stock Options:

The Board of Directors have established a stock option plan under which options to purchase shares are granted to directors, employees, officers and consultants of the Company. The number of options and exercise price thereof is set by the Board of Directors at the time of grant, provided that the exercise price shall not be less than the market price of the common shares on the day immediately preceding the grant of the options, on the stock exchange on which such shares are then traded.  All the options issued to date vest immediately and generally expire from one (1) to five (5) years from the date of Grant.

The following options to purchase shares are held by directors, employees, officers and consultants of the Company at December 31, 2006. In all cases, one option entitles the holder to purchase 1 common share at the designated exercise price.

| | 2006 | | 2005 | |
|---|---|---|---|---|
| | Number of options | Weighted average exercise price $ | Number of options | Weighted average exercise price $ |
| Balance at December 31, 2005 | 4,269,000 | 0.30 | 4,994,000 | 0.39 |
| Exercised | 0 | 0.00 | 0 | 0.00 |
| Forfeited | (1,139,000) | (0.28) | (2,500,000) | (0.44) |
| Granted during the year | 1,955,000 | 0.11 | 1,775,000 | 0.22 |
| Outstanding at December 31, 2006 | 5,085,000 | 0.23 | 4,269,000 | 0.30 |

A summary of stock options outstanding at December 31, 2006 is set out below:

| Outstanding Stock Options | | | | Exercisable Stock Options | |
|---|---|---|---|---|---|
| Exercise price $ | Number of options | Weighted average remaining contractual life | Weighted average exercise price $ | Number of options | Weighted average exercise price $ |
| less than 0.25 | 2,735,000 | 3.51 years | 0.14 | 2,735,000 | 0.14 |
| 0.25 - 0.30 | 1,025,000 | 0.60 years | 0.25 | 1,025,000 | 0.25 |
| 0.35 - 0.40 | 1,325,000 | 2.08 years | 0.37 | 1,325,000 | 0.37 |
| | 5,085,000 | 2.07 years | 0.26 | 5,085,000 | 0.26 |

The fair value of these options was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions: expected dividend yield 0%; expected volatility of 260%; risk free interest rate of 4.01%; and a weighted average expected life of 2.07 years. This generated an expense to stock-based compensation of $143,698 (2005 - $226,502).

(d) Warrants:

During the year ended December 31, 2006, there were 4,500,000 warrants issued by the Company. On March 14, 2006, the Company issued 2,000,000 warrants, each warrant entitles the holder to acquire an additional common share at $0.16 and expiring on March 13, 2008. Subsequently, on November 7, 2006, the Company issued an additional 2,500,000 warrants, each warrant entitles the holder to acquire an additional common share at $0.20 and expiring on October 31, 2008.

A summary of the status of the Company's warrants as at December 31, 2006 and changes during the year ended on that date are:

| | 2006 | |
|---|---|---|
| | Warrants # | Weighted average exercise price $ |
| Balance at December 31, 2005 | 500,000 | 0.60 |
| Issued during the year | 4,500,000 | 0.18 |
| Exercised during the year | 0 | 0.00 |
| Expired during the year | (500,000) | 0.60 |
| Outstanding at December 31, 2006 | 4,500,000 | 0.18 |

A summary of warrants outstanding at December 31, 2006 is set out below:

| Warrants outstanding | | | | Exercisable Warrant Options | |
|---|---|---|---|---|---|
| Exercise price $ | Number of options | Weighted average remaining contractual life | Weighted average exercise price $ | Number of options | Weighted average exercise price $ |
| 0.16 | 2,000,000 | 0.53 years | 0.16 | 2,000,000 | 0.16 |
| 0.20 | 2,500,000 | 1.02 years | 0.20 | 2,500,000 | 0.20 |
| | 4,500,000 | 1.55 years | 0.18 | 4,500,000 | 0.18 |

The fair value of these options was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions: expected dividend yield 0%; expected volatility of 141%; risk free interest rate of 4.1% and an expected life of 1.55 years. This generated a stock-based compensation cost of $217,784 (2005 - $0). These costs are recorded as share issue costs with an offsetting amount being credited to contributed surplus.

(e) Per Share Amounts:

For the year ended December 31, 2006, the weighted average number of shares were 66,318,187 (2005 - 62,748,324). Diluted earnings per share reflect the exercise of options, warrants and convertible debt as if issued at the later of the date of grant or beginning of the year. Given the share price at December 31, 2006, no options or warrants were considered to be anti-dilutive and therefore were not factored into weighted average number of shares.

(f) Contributed Surplus:

| | 2006 $ | 2005 $ |
|---|---|---|
| Balance, beginning of year | 1,178,558 | 952,056 |
| Stock options granted and/or vested during the period: | | |
| Net options issued and expired | 143,698 | 226,502 |
| Warrants issued | 217,784 | 0 |
| Balance, end of year | 1,540,040 | 1,178,558 |

## 11. SCIENTIFIC RESEARCH AND EXPERIMENTAL DEVELOPMENT TAX CREDITS

The company has an outstanding claim for scientific research and experimental development tax credits (SR&ED tax credits) for the fiscal years 2004, 2005 and 2006, the value of which is approximately $425,000. Since these claims have not been formally approved, the benefit hereof has not been reflected in these financial statements. The tax credits will be recorded in the year when reasonable assurance of their realization exists.

During fiscal 2006, the company recognized SR&ED tax credits of $188,475 related to fiscal years 2002 and 2005, for which no accounting benefit was previously recognized. These SR&ED tax credits have been recorded as reduction of expenses in the year of receipt.

## 12. OTHER ITEMS

(a) Sale of Real Property

During the fourth quarter of 2006, the Company disposed of land and building under the terms of a sale-leaseback transaction. Of the pre-tax gain of $625,552, as calculated below, $216,533 has been deferred and is being amortized to income over the term of the lease (note 6).

| | $ |
|---|---|
| Sale price | 1,765,000 |
| Less: net book value | (1,075,728) |
| Less: selling expenses | (63,720) |
| Sub-total | 625,552 |
| Less amount of gain deferred as a result of sale-leaseback transaction | (216,533) |
| Net gain | 409,019 |

The Company leased back approximately 18% of the building. In accordance with Canadian Institute of Chartered Accountants ("CICA") emerging issue number 25, the net present value of the minimum lease payments over the lease term is deferred and amortized to income over the lease term. The amount of $216,533 has been deferred.

(b) Settlement of Law Suit

During the 2004 year, a supplier commenced an action against the Company relating to unpaid amounts under a contract for components approximating $60,000. In a court negotiated settlement, this law suit was settled for $40,000 during the year, and has been recorded as an expense net of sales tax in these financial statements.

| | $ |
|---|---|
| Cost of settlement of law suit | (37,383) |

## 13. COMMITMENTS

The Company is committed under a long-term lease for premises which expires in September 2011.

Minimum annual rentals (exclusive of requirement to pay taxes, insurance and maintenance costs), for each of the next five years, are approximately as follows:

| | $ |
|---|---|
| 2007 | 49,800 |
| 2008 | 49,800 |
| 2009 | 49,800 |
| 2010 | 49,800 |
| 2011 | 49,800 |

## 14. RELATED PARTY TRANSACTIONS

During the year, the Company engaged in transactions in the normal course of operations with the following related parties, the total of these expenses included in the consolidated statement of operations and deficit as follows:

Interest and distributions paid to the directors - $22,851 (2005 - $20,919) and to a relative of the president - $36,000 (2005 - $36,888) and $12,000 (2005 - $12, 000) to relative of a director.

The Company incurred legal expenses with a law firm, which has a partner, who is also a member of the Board of Directors. The amount expensed during the year is $4,763 (2005 - nil).

## 15. INCOME TAXES

(a) Provision of Income Taxes

The provision for income taxes differs from that calculated by applying statutory rates for the following reasons:

| | 2006<br>$ | 2005<br>$ |
|---|---|---|
| Net loss before income taxes | (828,356) | (1,411,364) |
| Expected income tax recovery based upon the combined Canadian federal and provincial expected tax rates of 36.12% and (2005 - 36.12%) | (299,202) | (509,785) |
| Adjustments to tax benefit resulting from: | | |
| Permanent differences (items not deductible or taxable for tax purposes) | (51,240) | 92,786 |
| Timing differences | 224,750 | 236,034 |
| Valuation allowance | 125,692 | 180,965 |
| Provision for income taxes | 0 | 0 |

(b) Future Income Tax Balances

The tax effect of temporary differences that gives rise to future income tax assets and liabilities at December 31, 2006 and 2005 are as follows:

| | 2006<br>$ | 2005<br>$ |
|---|---|---|
| Non-capital losses | 5,170,000 | 5,044,019 |
| SR&ED tax credits available | 366,480 | 260,265 |
| SR&ED expenditures applicable to future years | 551,044 | 474,665 |
| Timing differences resulting in potential future income taxes | (105,147) | (173,154) |
| Total net future tax assets | 5,982,377 | 5,605,795 |
| Valuation allowances | (5,982,377) | (5,605,795) |
| Total net future tax assets | 0 | 0 |

(c) Tax Benefits Available

The Company has incurred the undernoted non-capital losses and has $1,525,000 of scientific research expenses for tax purposes, which are available to reduce future taxable incomes. The potential benefit of amounts, if any, are expected to approximate to 36%. Given the uncertainty of realization, no future asset or benefit has been recognized in these financial statements.

The estimated losses expire as follows:

| | $ |
|---|---|
| 2007 | 2,182,000 |
| 2008 | 2,122,000 |
| 2009 | 8,365,000 |
| 2010 | 794,000 |
| 2015 | 501,000 |
| 2026 | 348,000 |
| | 14,312,000 |

16. **CONTINGENT LIABILITIES**

In 2000, a former officer commenced a wrongful dismissal action against the Company for $1,000,000 plus costs. In 2001, the former officer commenced a second claim against the Company relating to unpaid loans. The Company denies liability in either action, and has made no provision in the financial statements.

During the 2004 year, the Company recognized approximately $1,700,000 as revenue related to non-refundable deposits. During the year, one of the customers has commenced legal action to recover approximately $280,000 (US $225,000). Management is of the opinion that the threatened action is without merit and has made no provision for the claim.

In 2005, a former officer commenced a wrongful dismissal action against the Company for approximately $400,000 plus costs. The Company denies liability in this action, and has made no provision in the financial statements.

Warranties and Guarantees

In 2005, the Company sold a limited warranty expiring December 7, 2009 on an installed system. In 2006, $23,176 was amortized to income. As at December 31, 2006, accounts payable includes a liability of $65,432 (2005 - $88,608) for future warranty costs. Management's best estimate is that this amount is an adequate provision against future potential liabilities.

Director/Officer Indemnification

Under its by-laws, the Company indemnifies its directors / officers, former directors / officers and individuals who have acted at the Company's request to be a director / officer of an entity in which the Company is a shareholder, to the extent permitted by law, against any and all charges, costs, expenses, amounts paid in settlement and damages incurred by the directors and officers as a result of any lawsuit, or any judicial, administrative or investigative proceeding in which the directors and officers are sued as a result of their service. Indemnification claims will be subject to any statutory or other legal limitation period. There are no indemnification claims known to the Company at this time. The Company has purchased directors' and officers' liability insurance. No amount has been accrued in these financial statements with respect to any indemnifications.

## 17. COMPARATIVE FIGURES

Certain 2005 comparative figures have been reclassified to conform to the current year's financial statement presentation. The 2005 comparative numbers were audited by another chartered accountant.