



COMPANY PROFILE

Seprotech Systems Incorporated (the “Company”) provides small and mid-sized package sewage and water treatment plants for a wide range of domestic and foreign water and wastewater markets.

Through its innovative technology, dedicated manufacturing and service capabilities, and the depth of management expertise and experience, Seprotech can meet all of the water and wastewater requirements for a diverse clientele; from government and military contracts, to residential and recreational land developers, to the global mining industry requirements, to the solutions required in third world environments. Our ROTORDISK® and Clementine™ technology and our expertise in self-contained and communal systems continue to provide our clients with flexible and cost efficient solutions. The Company’s historical participation and ongoing innovations in membrane water treatment, ensure that we will continue to provide effective solutions for current needs while opening future avenues for growth in all fields of our present endeavor, as well as new, as-yet unknown challenges.

It is the Company’s goal to be a leading technology provider in all aspects of medium to low-flow communal and industrial water and wastewater systems.

MESSAGE TO OUR SHAREHOLDERS

Your Company achieved several important milestones during the year ended August 31, 2004: we experienced revenue growth of 24%; launched our new Clementine™ transportable containerized wastewater treatment system; achieved further milestones towards becoming a prime supplier to the Department of National Defence; and launched a totally renewed website, www.seprotech.com, which we encourage you to visit.

Our persistence in focusing on selected markets has produced good sales results. The first three-quarters were encouraging both from a revenue and profit point of view. However, sales expectations for the fourth quarter were not met, primarily due to delays in potential customers making purchasing decisions, particularly in the land development sector, and delays in the repair and overhaul contracts with the Department of National Defence. We expect these sales to be achieved in 2005.

The Department of National Defence award of a repair and overhaul contract for their Reverse Osmosis Water Purification Units (ROWPU) confirmed Seprotech's status as a prime supplier to DND. Seprotech now holds Repair and Overhaul contracts with both the Canadian Navy and Canadian Army. Units expected to be shipped to Seprotech in the 2004 fiscal year, were not received from the Navy until after year-end and the execution of the ROWPU contract with the Canadian Army awaits Government confirmation.

Seprotech continues to expand its activities in the mining sector. In 2004, this market accounted for about half of our wastewater treatment system revenue. The launch of our Clementine™ containerized wastewater treatment plant is being well received in this market and reinforces our position. We anticipate that the mining industry will remain buoyant and Seprotech will continue to focus on this important sector.

Going forward, management believes that our focus on military, mining and land development markets will generate consistently improving results and strong growth. This focused approach was developed over the course of the last two years and we are at the early stages of reaping the benefits of this initiative. In addition we are carefully exploring sales potential in East Africa in order to build on our earlier success in Rwanda. We expect to create value for our shareholders and grow our business through customer service (directly and through our expanding group of representatives), geographical expansion and the addition of new products which complement our offerings and provide additional value for our customers.

We continue to invest in people by selectively adding sales and engineering staff. We believe that the constant upgrading of personnel and their skill sets is an essential ingredient to our long-term growth prospects. Your Board of Directors has been strengthened through the addition of two experienced independent directors and a non-executive Chairman. Harry Marshall, our former Chairman, will continue to provide his services to the Company as a director and consultant. We would like to thank him for his contributions while in the role of Chairman over the past two years.

We appreciate the continued efforts and diligence of our employees, the time and commitment of our directors, and the support of our shareholders. 2005 promises to be an exciting year for your Company.

Gilles R. Turcotte
President and Chief Executive Officer
December 1, 2004

Justin A. Connidis
Chairman of the Board

FINANCIAL HIGHLIGHTS

For the year ended August 31

	2004	2003	2002
Total Revenue	\$ 4,464,967	\$ 3,598,686	\$ 814,065
Gross Margin	\$ 1,131,902	\$ 788,918	\$ 239,571
Gross Margin Percentage	25%	22%	29%
Total Operating Expenses	\$ 1,734,670	\$ 1,355,280	\$ 959,293
Operating Loss	\$ 602,768	\$ 566,362	\$ 719,722
Net Loss	\$ 545,809	\$ 549,728	\$ 718,006
Loss per Share	\$ (0.02)	\$ 0.02	\$ 0.11
Total Assets	\$ 2,537,060	\$ 3,131,063	\$ 161,759
Working Capital Deficiency	\$ (663,155)	\$ (244,269)	\$ (1,204,747)
Long Term Debt	\$ -	\$ 380,418	\$ -
Shareholders' Equity / (Deficiency)	\$ 1,299,236	\$ 1,315,542	\$ (1,131,072)

FINANCIAL HIGHLIGHTS DISCUSSION

Management believes that the following Management's Discussion and Analysis provides information that is relevant to an assessment and understanding of the Company's consolidated results of operations and financial condition. Management has prepared this document in conjunction with its broader responsibilities for the accuracy and reliability of the financial statements. In support of this responsibility, management maintains appropriate information systems and internal controls to ensure that the financial information is complete and reliable.

The Audit Committee of the Board of Directors has reviewed this document. This discussion should be read in conjunction with the Consolidated Financial Statements and accompanying Notes. Certain statements contained in the Management's Discussion and Analysis of financial condition and results of operations contain forward-looking statements that are based on management's forecasts and projections. Forward-looking statements are not guarantees of future performance. They involve risks, uncertainties and assumptions, and the Company's actual results may differ materially from those anticipated in these forward-looking statements.

MANAGEMENT'S DISCUSSION AND ANALYSIS

December 1, 2004

Our Vision

We believe that the water and wastewater markets will converge into a single water market. We are committed to leading efforts to convert treated wastewater into a valuable and marketable commodity. Seprotech will be a leading supplier of packaged water solutions to the military, mining industry, land developers and smaller communities.

Our business strategy is based on ROTORDISK®, our proprietary wastewater technology. It will be used as the main platform to attract and retain performing representatives for packaged sewage treatment and potable water systems. As sales increase, a more extensive distribution network will be put in place.

Our products are sold using a variety of channels, including direct sales and a network of representatives. Geographically, Seprotech will concentrate on completing and re-enforcing its agent network in the eastern part of North America, particularly Ontario, Quebec, the Maritimes and the eastern USA-Canada border states. In order to see less seasonality in our results, efforts will also be devoted to support new territories in the Carolinas and Florida. The Company is also carefully expanding in East Africa, building on its earlier success in Rwanda.

All of Seprotech's operations are managed from our head office located in Ottawa, Ontario. In addition, the Company maintains a Sales and Marketing office in Toronto.

Significant Events

In September 2002, the Company completed the acquisition of CMS Group Inc. This allowed Seprotech to reposition itself strongly in the packaged sewage treatment systems business.

Change in Accounting Policies

There were no new accounting policies implemented in the fiscal 2004.

RESULTS OF OPERATIONS

Revenue / Margins

Revenue increased by 24% during the year ended August 31, 2004 to \$4.5m. Sales of wastewater treatment equipment, primarily ROTORDISK® have climbed by over 40%, to finish the year at \$2.4m, despite a significant revenue shortfall in the fourth quarter due to delays in contract awards. Sales of water treatment products and services generated revenues of \$1.4m, a decline of 14% due primarily to a reduction in government expenditures and scheduling issues internal to the Department of National Defence relating to SROD equipment. Subsequent to year-end we received delivery of the units for overhaul that had been expected in the 4th quarter. We were awarded a contract in March 2004 to repair and overhaul Reverse Osmosis Water Purification Units (ROWPU) for the Canadian Army and were anticipating a prompt execution. However, the contract has not yet started and the Government has not confirmed timing of this project. Targeting the military market was a significant factor in growing our Parts & Service business by 172% to \$674k. Having witnessed an increase in activity in the ROTORDISK® market and the resumption of repair and overhaul work on SROD equipment for the Canadian Navy, an increase in revenue in all product lines is anticipated starting with the second quarter of fiscal 2005.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Quarterly results for the year ended August 31, 2004 are as follows:

2004 Quarterly Results \$000's

	Q1	Q2	Q3	Q4
Revenue	1,344	1,284	1,439	398
Gross Margin	392	343	487	(90)
Operating Expenses	374	349	469	543
Other Revenue		(11)	68	
Net Income	18	(17)	86	(633)

2003 Quarterly Results \$000's

	Q1	Q2	Q3	Q4
Revenue	196	608	1,059	1,736
Gross Margin	32	174	228	355
Operating Expenses	323	389	315	328
Other Revenue				16
Net Income	(291)	(215)	(87)	43

Revenues from ROTORDISK[®] sales accounted for 53% of our total revenues. Revenues from water treatment products & services, which were primarily from SROD equipment overhauls, represented 32% of total revenues, the balance was attributable to sales of Parts & Service. Revenues were derived mainly from Canada (69%) with the balance coming from the United States (8%) and South America (23%).

Gross Margins have increased to 25% compared to 22% in the previous year. Our standardization processes implemented to date have achieved respectable margin improvements. However, rising steel prices, currency fluctuations, as well as contract cost overruns on projects in the fourth quarter have partially offset the achievements. As our product standardization evolves, tighter execution schedules and increased precision in material and manufacturing requirements will continue to generate improvements in gross margin.

Seprotech finished the year with a backlog of \$630k, which will convert to revenue in the 2005 fiscal year. The sales network is continuing to focus on specific markets that will produce revenues in the short term. In addition to this, work has now resumed on the \$6.9M DND contract for the repair and overhaul of SROD's for the Canadian Navy. The Company anticipates revenue growth in all product areas. Within the ROTORDISK[®] family, a new product, the "Clementine[™]" was launched this year. The Clementine[™], which is a containerized wastewater treatment system, is designed for remote locations. We are currently targeting the mining industry but this product could be used in other industries using temporary / remote installations.

Operating Expenses

Sales and marketing expenses increased by \$131k (25%). During the fourth quarter, the Company incurred a one-time expense of \$127k relating to a settlement reached with a former employee. The agreement calls for the Company to issue 175,000 common shares with a trading restriction of four months and 175,000 common shares with a trading restriction of twenty-four months and to pay \$5,000 per quarter for eight quarters commencing December 31, 2004.

General operations and administrative expenses increased by \$216k (28%) over the previous year due primarily to staff increases in engineering, operations and manufacturing. The increases in personnel are deemed to be an essential ingredient to our long-term growth prospects.

MANAGEMENT'S DISCUSSION AND ANALYSIS

In total, operating expenses increased by \$379k (28%) during the year to \$1,735k. The higher operating expenses are attributable to increases in staff who were hired to meet the increased demands resulting from higher sales, and restructuring costs incurred within our sales group.

Interest expense has increased by \$33k (55%) due primarily to interest on the \$416,000 convertible debentures, which were issued mid-year in 2003.

Operating expenses are expected to increase moderately, primarily in the sales and marketing areas, in conjunction with the projected increase in revenues.

Other Revenues

The Company had contract sales which called for payment in U.S. dollars. The resulting foreign exchange exposure was partially offset by the Company purchasing material from U.S. suppliers. The net foreign exchange risk was not hedged. The company realized a gain of \$56k on foreign currency exchange upon conversion of a \$US receivable into \$CDN cash.

Income Taxes

The Company does not anticipate incurring income tax expense for the foreseeable future as it has tax losses of \$5.8m expiring between 2005 and 2014, which are available to reduce future years' income for tax purposes.

Net Loss

The net loss for the year was \$546k, comparable to the previous year's loss of \$550k. The performance in the fourth quarter was very disappointing with weak revenues caused by delays in ROTORDISK® contract awards, negligible repair and overhaul work with the Department of National Defence and the deferral by the Canadian Army of a contract for ROWPU refurbishment.

The fourth quarter was also impacted by gross margin slippages and restructuring costs within our sales group. Prior to the fourth quarter, the Company has shown dramatic improvement in the previous four quarters compared to historical results.

Management is confident that our focus on the military, mining and land developer markets in conjunction with our improved efficiencies currently being implemented, will result in a significant improvement to the financial results in the next fiscal year.

Liquidity

The cash position increased by \$44k as a result of the issuance of convertible debentures (\$568k), a reduction in restricted cash (\$21k) and issuance of shares on exercise of options (\$6k), offset by the net loss (\$337k net of "non-cash items"), increases in non-cash working capital items (\$108k), purchases of capital equipment (\$50k) and repayments of long-term debt (\$52k) and capital leases (\$4k). On July 31, 2004, debentures with a principal value of \$416k and accrued interest of \$50k were converted into 4,410,594 common shares. On August 16, 2004, the Company issued \$568k of convertible debentures to members of management, the Board of Directors and existing shareholders. The convertible debentures mature on March 31, 2005, and bear interest at 12% per annum, payable on maturity or prepayment, and are convertible at the option of the debenture holder, at any time at \$0.20 per common share. Debenture holders also received two purchase warrants for every dollar invested, each warrant entitling the holder to purchase a common share of the Company at \$0.20 per share, expiring on March 31, 2005. The Company has secured a \$250k line of credit to finance operations. The operating line of credit was secured by Capital Alliance Ventures Inc., a company owning over 10% of Seprotech's shares. As of August 31, 2004, the Company had a working capital deficiency of \$663k and a deficit of \$8,078k as a result of recurring losses. The financial statements were prepared by the Company on a going concern basis, which assumes the realization of assets and liquidation of liabilities in the normal course of business. The application of the going-concern concept is dependent on the

MANAGEMENT'S DISCUSSION AND ANALYSIS

Company's ability to generate future profitable operations and retire the debentures. Management expects the working capital position to strengthen with the projected revenue growth and margin improvement.

Related Party Transactions

During the year, Castle Corporation, a company controlled by a Seprotech director, Harry Marshall, was paid \$42,210 (2003 – \$37,750) for consulting services of Harry Marshall and \$3,854 (2003 - \$7,172) for reimbursement of expenses. These services were measured at the exchange amount.

During the year, Seprotech obtained legal services at a cost of \$42,142 (2003 – \$8,084) from a law firm in which one of Seprotech's directors is a principal. The legal services were measured at the exchange amount.

During fiscal 2004, the Company issued 168,333 (2003 - Nil) common shares to board members for services performed in 2004 and 2003. The Company recorded expense of \$40,800 (2003 - \$23,000) included in general operations and administrative expense. As at August 31, 2004, the Company has a liability to its directors of \$13,300 (2003 - \$23,000) included in accounts payable and accrued liabilities. These services were measured at the exchange amount.

During the year, Capital Alliance Ventures Inc., a company owning over 10% of Seprotech's shares, was paid \$6,000 for guarantee fees associated with securing a \$250,000 line of credit for the Company.

Dividend Policy

The Company did not declare dividends on its common shares in the current fiscal period and does not expect to pay dividends in the foreseeable future.

RISKS AND UNCERTAINTIES

General

An investment in the securities of Seprotech must be considered speculative and entails significant risks. A potential investor should devote particular attention to the risks set forth below.

New Product Development

The wastewater treatment and water purification businesses are characterized by ongoing technological developments and changing customer needs. As a result, Seprotech's success and continued growth depend on its ability to develop or acquire rights to new products and introduce them to the market in a timely manner. There can be no assurance that Seprotech will be successful in its new product development implementation.

Technological and Regulatory Changes

The wastewater treatment and water purification businesses are characterized by changing technology, competitively imposed process standards and regulatory requirements. Any of the above events could render some of Seprotech's products obsolete. Seprotech's ability to anticipate changes in technology and regulatory standards and to respond to these changes in a timely manner will be a significant factor in its success. There can be no assurance that Seprotech will be able to achieve the technological advances that may be necessary to prevent its products from becoming obsolete.

Competition

Competition in the markets is based on a number of factors, including price, technology, application experience, availability of financing, reputation, product warranties, reliability, service and distribution. Some of Seprotech's competitors have financial and other resources greater than those of the Corporation.

Risks Associated with Implementing Business Strategy

Seprotech's strategic plan should be considered in light of the risks, expenses and difficulties encountered in growing a business enterprise. Successful implementation of the business strategy will depend on numerous

MANAGEMENT'S DISCUSSION AND ANALYSIS

factors, many of which are beyond the control of Seprotech, including economic, competitive and other conditions. No assurance can be given that Seprotech will be successful in implementing its business strategy.

Regulatory-Driven Demands

Demands for some of Seprotech's products and services to some degree are created by the enactment or enforcement of environmental regulations and standards affecting Seprotech's customers. Delays in the introduction of new regulations or decreased government enforcement action relating to existing regulations may result in a decreased demand for these products and services. In many jurisdictions, it will be necessary or desirable for products to receive certification or regulatory approval from the relevant authorities. Such certification or approval may not be granted or may not be achieved within the time anticipated by Seprotech. In certain jurisdictions, such certification or approval may be dependent upon political and other considerations not related to the performance or cost of the technology.

Key Personnel

Seprotech's business success depends to a large degree on the experience and ability of its officers and other key personnel. Should some of these individuals die, become seriously ill or disabled, or become unwilling to serve any longer, it might prove difficult to secure equally suitable replacements.

Capital Investment

Seprotech's business depends in part upon capital purchasing by its customers. In many cases such capital expenditures are substantial in relation to the customer's operating budget. Seprotech's technologies frequently represent a new solution to the customer's water treatment problems, leading to a need to educate the customer. As a result, a significant proportion of Seprotech's business is made up of orders that are large in relation to Seprotech's total revenues, are subject to selling periods which may exceed one year and are subject to deferral and cancellation.

Cyclical and Seasonality

The sale of water and wastewater treatment systems is cyclical and influenced by various economic factors including interest rates and general fluctuations in the business cycle. In addition, sales of such systems are subject to seasonal fluctuations in temperate climates.

Product Liability Claims

Seprotech faces the inherent risk of product failure and/or product liability claims with respect to products that it produces or designs. A claim which is not covered by insurance or which exceeds the policy limit may materially adversely affect the operation and/or viability of Seprotech.

MANAGEMENT'S REPORT

Management is responsible for the preparation of the Company's financial statements. Management believes that the financial statements fairly reflect the form and substance of transactions and that the financial statements reasonably present the Company's financial condition and results of operations in conformity with Canadian generally accepted accounting principles.

Deloitte & Touche LLP, the independent auditors appointed by the shareholders of the Company, have audited the Company's financial statements in accordance with Canadian generally accepted auditing standards. The auditors provide an objective independent review of the fairness of reported operating results and financial position of the company.

The Board of Directors of the Company, along with the Audit Committee, have reviewed and approved the financial statements contained in this Annual Report.



Gilles R. Turcotte
President & CEO
Ottawa, Ontario
November 11, 2004



Robert J. Searle
Chief Financial Officer

AUDITORS' REPORT

To the Shareholders of
Seprotech Systems Incorporated

We have audited the consolidated balance sheets of Seprotech Systems Incorporated as at August 31, 2004 and 2003 and the consolidated statements of operations and deficit and of 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 consolidated financial statements present fairly, in all material respects, the financial position of the Company as at August 31, 2004 and 2003 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.



Chartered Accountants
Ottawa, Ontario
November 11, 2004

CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

For the years ended August 31
(Canadian dollars)

	2004	2003
Sales	\$ 4,464,967	\$ 3,598,686
Cost of sales	3,333,065	2,809,768
Gross margin	1,131,902	788,918
Operating expenses		
Sales and marketing	653,321	522,511
General operations and administrative	988,901	773,303
Interest expense	92,448	59,466
Total operating expenses	1,734,670	1,355,280
Operating loss	(602,768)	(566,362)
Other revenue		
Gain on foreign currency exchange	56,959	16,634
NET LOSS	(545,809)	(549,728)
DEFICIT, BEGINNING OF PERIOD	(7,532,118)	(6,982,390)
DEFICIT, END OF PERIOD	\$ (8,077,927)	\$ (7,532,118)
Net loss per basic and diluted share (Note 11)	\$ (0.02)	\$ (0.02)
Weighted average number of basic and diluted shares outstanding	29,260,800	28,605,938

The accompanying Notes are an integral part of these financial statements.

CONSOLIDATED BALANCE SHEETS

As at August 31
(Canadian dollars)

CURRENT ASSETS	2004	2003
Cash	\$ 82,031	\$ 37,680
Restricted cash	-	20,785
Accounts receivable	210,830	680,046
Unbilled revenues	175,659	186,531
Inventories	49,034	195,973
Prepaid expenses and deposits	53,971	69,818
	571,525	1,190,833
CAPITAL ASSETS (Note 4)	116,512	81,803
GOODWILL (Note 14)	1,655,525	1,655,960
INTANGIBLE ASSETS (Note 5)	193,498	202,467
	\$ 2,537,060	\$ 3,131,063
CURRENT LIABILITIES		
Accounts payable and accrued liabilities	\$ 481,345	\$ 948,603
Obligation under capital lease (Note 6)	6,680	-
Deferred revenue	146,621	394,100
Term loan (Note 7)	40,400	92,400
Convertible subordinated debentures (Note 8)	559,634	-
	1,234,680	1,435,103
OBLIGATION UNDER CAPITAL LEASE (Note 6)	3,144	-
CONVERTIBLE SUBORDINATED DEBENTURES (Note 8)	-	380,418
	1,237,824	1,815,521
CONTINGENT LIABILITIES (Note 16)		
SHAREHOLDERS' EQUITY		
Share capital (Note 9)	9,389,846	8,872,051
Deferred stock-based compensation (Note 9)	(12,683)	(24,391)
Deficit	(8,077,927)	(7,532,118)
	1,299,236	1,315,542
	\$ 2,537,060	\$ 3,131,063

APPROVED BY THE BOARD:



Gilles R. Turcotte, Director



Richard Charlebois, Director

The accompanying Notes are an integral part of these financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended August 31
(Canadian dollars)

	2004	2003
NET INFLOW (OUTFLOW) OF CASH RELATED TO THE FOLLOWING ACTIVITIES:		
OPERATING		
Net loss	\$ (545,809)	\$ (549,728)
Items not affecting cash		
Amortization of capital assets	28,925	25,230
Amortization of intangible assets	8,969	8,969
Stock-based compensation expense	11,708	10,732
Accretion of convertible subordinate debenture	23,127	13,520
Shares issued for services	27,500	-
Shares issued in exchange for interest costs	31,792	-
Obligation to issue shares to former employee	77,000	-
	(336,788)	(491,277)
Changes in non-cash operating working capital items		
Accounts receivable	469,216	(424,242)
Unbilled receivables	10,872	(186,532)
Inventories	146,939	(46,327)
Prepaid expenses and deposits	15,847	(51,338)
Accounts payable and accrued liabilities	(502,931)	346,105
Deferred revenue	(247,479)	359,426
	(444,324)	(494,185)
INVESTING		
Purchase of capital assets	(50,245)	(7,350)
Cash provided by CMS acquisition (net of acquisition costs)	-	150,252
Decrease (increase) in restricted cash	20,785	(20,785)
	(29,460)	122,117
FINANCING		
Repayment of capital lease	(3,565)	-
Repayment of long-term debt	(52,000)	-
Decrease in bank indebtedness	-	(6,252)
Issuance of shares on exercise of options	6,200	-
Issuance of convertible subordinated debentures	567,500	416,000
	518,135	409,748
NET CASH INFLOW	44,351	37,680
CASH POSITION, BEGINNING OF YEAR	37,680	-
CASH POSITION, END OF YEAR	\$ 82,031	\$ 37,680
Supplementary information		
Interest paid	\$ 22,553	\$ 18,535
Income taxes paid	-	-

Non-cash transactions (Note 18)

The accompanying Notes are an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS

1. GOING CONCERN

These financial statements have been prepared on the basis of accounting principles applicable to a going concern. However, certain adverse conditions and events cast substantial doubt upon the validity of this assumption.

Seprotech Systems Incorporated ("the Company") has incurred significant operating losses over the past several years and currently has an accumulated deficit of \$8,077,927. The Company is also in violation of certain covenants of the term loan and convertible subordinated debentures. The Company's continued existence is dependent upon attaining profitable operations.

In September 2002, the Company completed a merger with CMS Group Inc. ("CMS") of Concord, Ontario. With the merger, the Company gained access to commercial and residential wastewater markets with proprietary technology. Management is confident that sales will continue to increase and that the financial results will significantly improve over the next fiscal year. There can be no certainty that this will occur.

If the going concern assumption were not appropriate for these financial statements, then adjustments would be necessary in the carrying amounts of assets and liabilities, the accumulated deficit and the balance sheet classifications used.

2. DESCRIPTION OF BUSINESS

The Company specializes in packaged systems that provide customers with an integrated, single source solution to solve diverse water quality problems. These include water treatment equipment, wastewater treatment and purification process applications. The Company's proprietary technology, ROTORDISK®, is a proven technology that has been applied in every type of environment from municipal wastewater treatment to high-end mining applications. Installation environments range from the equator to the arctic using equipment that is simple and cost effective to operate.

The Company also develops, manufactures, markets and provides services in the industrial wastewater treatment marketplace and has particular expertise in the application of crossflow membrane technologies.

3. ACCOUNTING POLICIES

The consolidated financial statements have been prepared with Canadian generally accepted accounting principles and reflect the following significant accounting policies:

Basis of presentation

The financial statements are for Seprotech Systems Incorporated and its wholly-owned subsidiary, CMS. All inter-company transactions have been eliminated.

Inventories

Inventories, consisting primarily of raw materials, are stated at the lower of cost and replacement cost with cost being determined on a first-in, first-out basis.

Capital assets

Capital assets are stated at cost. Amortization is calculated using the diminishing-balance method over the anticipated lives of the assets as follows:

Test and demonstration systems	25%
Tools, dies and equipment	20 - 40%
Computer hardware and software	30%
Leased computer software	30%
Office furniture and equipment	20%
Vehicles	30%

NOTES TO THE FINANCIAL STATEMENTS

3. ACCOUNTING POLICIES (Continued)

The Company's policy is to review all long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable, the Company will estimate the future cash flows expected to result from the use of the assets and their eventual disposition and record an impairment loss if required.

Patents and trademarks

Patents are recorded at cost and are amortized on a straight-line basis over their expected useful life of four years. Trademarks are recorded at their estimated present value on the date of acquisition using a discounted cashflow of expected future revenues. Trademarks are amortized on a straight-line basis over their useful life of 25 years. Management reviews the unamortized balance of intangible assets on an annual basis, or more frequently if events or changes in circumstances indicate that the asset might be impaired, and recognizes any impairment in carrying value in the period of impairment.

Goodwill

Goodwill represents the excess of the purchase price over the estimated fair value of net assets acquired. Goodwill is evaluated for impairment on an annual basis, or more frequently if events or changes in circumstances indicate that the asset might be impaired, and recognizes any impairment in carrying value in the period of impairment.

Revenue recognition

Revenue from sales of products, consulting and analysis services is recognized at the time of shipment or upon completion of the service. A provision for potential warranty claims is provided for at the time of sale, based on warranty terms and prior claims experience. Revenue from long-term manufacturing contracts is recognized on the percentage of completion basis, comparing costs incurred to the estimated final cost to complete the contract. Amounts received in advance of revenue recognition are recorded as deferred revenue.

Foreign currency translation

Transactions denominated in foreign currencies are translated into Canadian dollars at the exchange rate in effect at the time of the transaction. Monetary assets and liabilities are translated into Canadian dollars at the exchange rate in effect at the balance sheet date and the resulting foreign exchange gains and losses are included in earnings.

Foreign exchange risk

The Company has contract sales which call for payment in U.S. dollars. The resulting foreign exchange exposure is partially offset by the Company purchasing material from U.S. suppliers. The net foreign exchange risk has historically not been hedged.

Credit risk

The Company provides credit to its customers in the normal course of business. The Company performs ongoing credit evaluations of its customers and maintains reserves for potential credit losses, which when realized, have been within the range of management's expectations.

Interest rate risk

The Company has current debt with interest rates subject to fluctuations with the prime rate. The Company is not exposed to other significant interest rate risk due to the short-term maturity of its monetary assets and liabilities.

Use of accounting estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires the Company's management to make estimates that affect the reported amounts of assets and liabilities as at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods presented. Estimates are used when accounting for items and matters such as long-term contracts, allowance for uncollectible accounts receivable, inventory obsolescence, product warranty, amortization, asset valuations, impairment assessments, taxes and contingencies. Actual results could differ from the estimates made by

NOTES TO THE FINANCIAL STATEMENTS

3. ACCOUNTING POLICIES (Continued)

Income taxes

The Company follows the asset and liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are recognized based on the expected future tax consequences of differences between the financial reporting and tax bases of assets and liabilities and are measured using the substantively enacted rates and laws that will be in effect when the differences are expected to reverse. Future income tax assets are recognized to the extent that they are more likely than not to be realized.

Stock-based compensation

Effective September 1, 2002, the Company adopted CICA Handbook section 3870 "Stock-based Compensation and Other Stock-based Payments" ("HB 3870"), which requires that a fair value based method of accounting be applied to all stock-based payments to non-employees and to employee awards that are direct awards of stock, awards that call for settlement in cash or other assets, or are stock appreciation rights that call for settlement by the issuance of equity instruments. HB 3870 permits the Company to continue its existing policy of treating all other employee stock options as capital transactions (the settlement method), but requires pro-forma disclosure of net earnings and per share information as if the Company had accounted for employee stock options under the fair value method. The fair value of stock options issued in the period is determined using the Black-Scholes option pricing model. Proforma disclosures omit the effects of awards granted prior to September 1, 2002.

Loss per share

Basic loss per share is computed using the weighted average number of common shares outstanding during the period. Diluted loss per share is computed using the treasury stock method and assumes that if a dilutive effect is produced, all dilutive securities had been exercised at the later of the beginning of the fiscal period and the security issue date.

4. CAPITAL ASSETS

	2004			2003
	Cost	Accumulated Amortization	Net Book Value	Net Book Value
Test and demonstration systems	\$ 171,199	\$ 160,383	\$ 10,816	\$ 13,481
Tools, dies and equipment	188,768	152,989	35,779	21,308
Computer hardware	147,921	121,538	26,383	17,591
Computer software	76,326	65,494	10,832	5,247
Leased computer software	13,389	3,626	9,763	-
Office furniture and equipment	173,989	151,502	22,487	23,530
Vehicles	13,553	13,101	452	646
	\$ 785,145	\$ 668,633	\$ 116,512	\$ 81,803

5. INTANGIBLE ASSETS

	2004			2003
	Cost	Accumulated Amortization	Net Book Value	Net Book Value
Patents	\$ 2,436	\$ 1,218	\$ 1,218	\$ 1,827
Trademarks	209,000	16,720	192,280	200,640
	\$ 211,436	\$ 17,938	\$ 193,498	\$ 202,467

NOTES TO THE FINANCIAL STATEMENTS

6. OBLIGATION UNDER CAPITAL LEASE

	<u>2004</u>	<u>2003</u>
Capital lease repayable in monthly installments of principal and interest of \$639, bearing interest rate of 14.6%. The capital lease is secured by the underlying capital assets	\$ 10,863	\$ -
Less interest	(1,039)	-
	<u>9,824</u>	-
Less current portion	(6,680)	-
Long-term portion	<u>\$ 3,144</u>	<u>\$ -</u>

7. TERM LOAN

Term loan payable to Business Development Bank of Canada. The repayment terms were re-negotiated in July 2004 with principal payments of \$5,000 per month concluding in November 2004 followed by one payment in December 2004 of \$25,400; bearing interest at daily floating interest plus 4% with additional interest in the form of a royalty on sales equal to 0.1169% of gross sales. The loan is guaranteed by the Company and certain shareholders and requires the Company to maintain certain financial ratios. As of August 31, 2004 the Company was in violation of these financial covenants.

	<u>2004</u>	<u>2003</u>
	\$ 40,400	\$ 92,400

8. CONVERTIBLE SUBORDINATED DEBENTURES

Convertible subordinated debentures with a principal value of \$416,000 were issued on February 17, 2003. The debentures accrued interest at 8%, compounded annually, and were to mature on February 17, 2005. The principal amount of the debentures was convertible after one year from date of issue, at the option of the holders, into Seprotech common shares at a price of \$0.10 per common share. On July 31, 2004, the principal amount of the debentures was converted into 4,160,000 common shares. At the time of conversion, the carrying amount of the liability was \$402,951. The Company accreted a discount of \$22,533 during fiscal 2004 (2003 - \$13,520). The related interest of \$50,119 was converted into 250,594 common shares.

On August 16, 2004, the Company issued \$567,500 of convertible debentures to members of management, the Board of Directors and existing shareholders. The convertible debentures mature on March 31, 2005, and bear interest at 12% per annum, payable on maturity or prepayment, and are convertible at the option of the debenture holder, at any time at \$0.20 per common share. Debenture holders also received two purchase warrants for every dollar invested, each warrant entitling the holder to purchase a common share of the Company at \$0.20 per share, expiring on March 31, 2005. Upon conversion, the interest then accrued and outstanding shall be paid in cash. The debentures hold a negative pledge prohibiting the Company from incurring any additional indebtedness without the consent of the debenture holders.

As at August 31, 2004, the Company was in violation of certain covenants of the debenture agreements. The debenture holders have agreed to waive their rights pursuant to the violation until March 31, 2005.

NOTES TO THE FINANCIAL STATEMENTS

8. CONVERTIBLE SUBORDINATED DEBENTURES (Continued)

The Company has assigned carrying amounts to the liability and equity elements of the above financial instrument in accordance with the substance of the contractual arrangement. The Company has determined the carrying amount of the financial liability by discounting the stream of future cash payments of interest and principal at an estimated market rate of 15% for a similar liability that does not have an associated equity component. The carrying amount of the equity component of the convertible debenture was \$8,460 at the date of issuance.

During fiscal 2004, the Company expensed \$2,985 of interest on the debentures and accreted \$593 of the \$8,460 discount on the convertible debenture. As of August 31, 2004, \$7,867 remains a reduction of the financial liability component of the convertible debenture to be accreted in fiscal 2005. Accrued interest of \$2,985 is included in accrued liabilities.

In the event the debentures are not converted, the Company would have a debt repayment of \$567,500 in fiscal 2005.

9. SHARE CAPITAL

Authorized

An unlimited number of common shares

An unlimited number of special shares, non-voting, issuable in series with rights, privileges, restrictions and conditions to be determined by the Board of Directors without shareholder action.

These may rank senior to common shares if so determined by the Board of Directors.

	Common Shares	
	<u>Number</u>	<u>Amount</u>
Shares outstanding August 31, 2002	6,353,554	\$ 5,851,318
Shares issued pursuant to acquisition of CMS Group Inc. (Note 14)	17,007,667	1,887,565
Shares issued pursuant to conversion of debentures	5,244,717	1,048,943
Deferred stock-based compensation	-	35,123
Equity component of convertible subordinated debenture (Note 8)	-	49,102
Shares outstanding August 31, 2003	28,605,938	8,872,051
Shares issued pursuant to conversion of convertible subordinated debentures (Note 8)	4,160,000	402,951
Shares issued to satisfy interest payable on convertible subordinated debentures (Note 8)	250,594	50,119
Shares issued pursuant to exercise of stock options	51,666	6,200
Shares issued for services (Note 15)	168,333	50,500
Shares cancelled pursuant to price adjustment for acquisition of CMS Group Inc. (Note 14)	(1,345,666)	(435)
Equity component of convertible subordinated debenture (Note 8)	-	8,460
Shares outstanding August 31, 2004	31,890,865	\$ 9,389,846

NOTES TO THE FINANCIAL STATEMENTS

9. SHARE CAPITAL (Continued)

The Company has an obligation to issue 350,000 common shares to a former employee. Of these, 175,000 common shares will be restricted from trading for a period of four months and the remaining 175,000 shares will be restricted for twenty-four months. The Company has recorded a liability of \$77,000 and increased sales and marketing expenses with respect to this obligation.

Stock options

The Company has established a stock option plan applicable to directors, officers, employees and consultants of the Company. The options are granted at the Company's then current fair market value of the common shares of the Company under terms and conditions determined by the Board. The Company may issue up to 2,800,000 of its outstanding common shares as options under its stock option plan. The options carry a five-year life and typically vest over a three-year period.

Activity in the stock option plan is summarized as follows:

	Number	Options Price	Weighted Average Exercise Price
Options outstanding, August 31, 2002	585,000	\$0.20 - \$0.55	\$0.44
Granted	1,575,000	\$0.12 - \$0.20	\$0.13
Cancelled	(289,000)	\$0.50 - \$0.55	\$0.50
Options outstanding, August 31, 2003	1,871,000	\$0.12 - \$0.50	\$0.16
Granted	350,000	\$0.25 - \$0.26	\$0.25
Exercised	(51,666)	\$0.12	\$0.12
Cancelled	(149,334)	\$0.12 - \$0.50	\$0.20
Options outstanding, August 31, 2004	2,020,000	\$0.12 - \$0.50	\$0.18

These options expire at various dates between September 2004 and March 2009, with a weighted average remaining life of 2.95 years.

A summary of options outstanding at August 31, 2004 is as follows:

Exercise Price	Total Outstanding		Total Exercisable	
	Number of Options	Weighted Average Remaining Contractual Life	Number of Options	Weighted Average Remaining Contractual Life
\$0.12	1,320,000	3.00	1,080,000	3.00
\$0.20	200,000	2.05	200,000	2.05
\$0.25	200,000	4.83	-	-
\$0.26	150,000	4.54	-	-
\$0.50	150,000	0.04	150,000	0.04
	2,020,000	2.95	1,430,000	2.56

NOTES TO THE FINANCIAL STATEMENTS

9. SHARE CAPITAL (Continued)

Stock-based compensation

The CICA Handbook section 3870 requires pro forma disclosure of the net income and earnings per share, as if the Company had accounted for its stock-based compensation issued using a fair-value based method. The disclosures in the following table show the Company's net loss and loss per share on a pro forma basis using a fair value-based method, on a straight-line basis, as determined using the Black-Scholes option pricing model:

	<u>2004</u>	<u>2003</u>
Net loss - as reported	\$ (545,809)	\$ (549,728)
Estimated stock-based compensation	(81,200)	(20,500)
Pro forma net loss	<u>\$ (627,009)</u>	<u>\$ (570,228)</u>
Basic and diluted loss per share		
- as reported	\$ 0.02	\$ 0.02
- pro forma	\$ 0.02	\$ 0.02

This weighted average fair value of options granted during the year of \$0.22 (2003 - \$0.12) was calculated using the Black-Scholes option pricing model and the following assumptions:

	<u>2004</u>	<u>2003</u>
Risk free interest rate	3%	4 %
Expected life in years	5	4.5
Volatility	121%	209 %
Dividends	-	-

During fiscal 2003, 300,000 options were granted to a consultant to compensate for services to be performed. The options expire on August 31, 2007 and vest over three years commencing August 31, 2003. The fair market value of the unvested options has been determined using the Black-Scholes model based on the fair value of the common shares remeasured at each reporting date. The amount of stock-based compensation expense for the current fiscal year is \$11,708 (2003 - \$10,732). The following assumptions were used: four-year life, interest rate of 4%, volatility of 167%, no dividends and fair value of common shares of \$0.20 per share.

10. INCOME TAXES

The reported income tax recovery differs from the amount computed by applying the Canadian statutory rate to loss before income taxes for the following reasons:

	<u>2004</u>	<u>2003</u>
Loss before income tax expense	\$ (545,809)	\$ (549,728)
Expected tax recovery at the combined basic Canadian federal and provincial income tax rate of 36.29% (2003 - 37.3%)	198,056	205,049
Benefit of tax losses not recorded	(193,637)	(192,959)
Other	(4,419)	(12,090)
Reported income tax recovery	<u>\$ -</u>	<u>\$ -</u>

NOTES TO THE FINANCIAL STATEMENTS

10. INCOME TAXES (Continued)

Investment tax credits

Investment tax credits of approximately \$9,800 (2003 - \$112,800) are available to reduce future years' Canadian federal income taxes payable. No recognition has been given in these financial statements to the potential tax benefits associated with the balance of these investment tax credits. These credits expire as follows:

2005	\$	1,400
2006		3,000
2008		5,400

Income tax loss carry forwards

The Company has tax loss carry forwards available to reduce future years' income for tax purposes, the benefits of which have not been recorded in these financial statements. These loss carry forwards expire as follows:

	Federal	Provincial
2005	\$ 345,000	\$ 357,000
2006	1,265,000	1,265,000
2007	1,030,000	1,037,000
2008	1,079,000	1,068,000
2009	760,000	770,000
2010	628,000	628,000
2014	648,000	648,000
	<u>\$ 5,755,000</u>	<u>\$ 5,773,000</u>

The future tax asset of the Company is comprised of as follows:

	<u>2004</u>	<u>2003</u>
Benefit of loss carryforwards and investment tax credits	\$ 2,088,000	\$ 2,681,000
Tax basis of asset in excess of accounting basis	400,000	460,000
Other	31,000	80,000
	<u>2,519,000</u>	<u>3,221,000</u>
Valuation allowance	<u>(2,519,000)</u>	<u>(3,221,000)</u>
	<u>\$ -</u>	<u>\$ -</u>

11. LOSS PER SHARE

As a result of the net losses for fiscal 2004 and 2003, potentially dilutive options of 566,211 (2003 - 29,500), shares of 2,837,500 (2003 - 4,160,000) issuable on conversion of the convertible subordinated debentures and 9,329 warrants (2003 - Nil) were not included in the calculation of dilutive loss per share because to do so would have been anti-dilutive.

Options that are anti-dilutive because the exercise price is greater than the average market price of the shares are not included in the computation of diluted earnings per share. For fiscal 2004, 270,833 stock options were excluded from the computation of diluted earnings per share because they were anti-dilutive (2003 - 346,000).

NOTES TO THE FINANCIAL STATEMENTS

12. COMMITMENTS

Under the terms of various operating and capital lease agreements, the Company is required to make the following payments during the following fiscal years:

	<u>Operating</u>	<u>Capital</u>
2005	\$ 45,000	\$ 8,000
2006	34,000	3,000

13. SEGMENTED DISCLOSURES

The Company derives its revenues from the sales of fluid treatment and filtration systems and related services to various industrial, institutional, land development and government markets. Segmented industry information is not provided as the Company is considered by management to operate in one segment. Sales reported by customer location are as follows:

	<u>2004</u>	<u>2003</u>
Canada	\$ 3,059,408	\$ 2,999,450
United States	380,217	141,078
International	1,025,342	458,158
	<u>\$ 4,464,967</u>	<u>\$ 3,598,686</u>

Of this revenue, approximately 26% (2003 - 44%) was derived from one customer.

During the period, the Company recorded revenue associated with the following products and services:

	<u>2004</u>	<u>2003</u>
Wastewater treatment equipment	\$ 2,376,571	\$ 1,707,449
Parts and service	674,386	247,575
Water treatment equipment	1,414,010	1,643,662
	<u>\$ 4,464,967</u>	<u>\$ 3,598,686</u>

14. ACQUISITION OF CMS GROUP INC.

On September 1, 2002, the Company issued 17,007,667 common shares in exchange for all of CMS's outstanding shares. Subsequent to the acquisition of CMS by Seprotech, there were three principal groups of shareholders - existing CMS shareholders, new CMS investors and existing Seprotech shareholders. The existing Seprotech shareholders as a group retained the larger portion of the voting rights of the combined enterprise. CMS completed a private offering immediately prior to the acquisition which is closely related to the acquisition of CMS's shares by Seprotech. Seprotech's existing senior management team will oversee the combined entity. Current Seprotech Board members will comprise at least 50% of the new Board of Directors immediately following the acquisition. Therefore, though this constitutes a reverse-takeover from a legal perspective, Seprotech has been identified as the acquirer for accounting purposes.

NOTES TO THE FINANCIAL STATEMENTS

14. ACQUISITION OF CMS GROUP INC. (continued)

The following table summarizes the purchase price allocation, which was performed by the Company based on internal appraisals of the fair value of the tangible and intangible assets acquired:

Assets acquired	
Cash	\$ 215,516
Accounts receivable	195,238
Inventory	137,240
Prepays	3,370
Capital assets	26,006
Trademarks	209,000
Patents	2,436
Total assets acquired	<u>788,806</u>
Less liabilities assumed	
Current liabilities	399,537
BDC Loan	92,400
Total liabilities assumed	<u>491,937</u>
Net assets acquired	296,869
Goodwill	<u>1,655,525</u>
Purchase price	<u>\$ 1,952,394</u>
15,662,001 shares issued at \$0.12	\$ 1,887,130
Acquisition costs	<u>65,264</u>
Purchase price	<u>\$ 1,952,394</u>

The share purchase agreement provided that 1,500,000 of the issued shares be held in an escrow account pending determination of actual working capital contributed by CMS. As at August 31, 2004, the Company and CMS had reached final agreement on contingent consideration related to working capital contributed by CMS. As a result, 1,345,666 shares were cancelled and 154,335 shares were released from escrow. In addition, 1,157,496 shares issued to principals of CMS which had been held in a general escrow to cover unknown liabilities have been released. The majority of these adjustments were taken into consideration during fiscal 2003. During fiscal 2004, a reduction in goodwill for \$435 resulted when 1,345,666 shares were cancelled (Note 9).

15. RELATED PARTY TRANSACTIONS

During fiscal 2004, Castle Corporation, a company controlled by a Seprotech director, Harry Marshall, was paid \$42,210 (2003 - \$37,750) for consulting services of Harry Marshall and \$3,854 (2003 - \$7,172) for reimbursement of expenses. These services were measured at the exchange amount.

During fiscal 2004, the Company obtained legal services at a cost of \$42,142 (2003 - \$8,084) from a law firm in which one of Seprotech's directors is a principal. The legal services were measured at the exchange amount.

During fiscal 2004, the Company issued 168,333 (2003 - Nil) shares to board members for services performed in 2004 and 2003. The Company recorded expenses of \$40,800 (2003 - \$23,000) included in general operations and administrative expense. As at August 31, 2004, the Company has a liability of \$13,300 (2003 - \$23,000) included in accounts payable and accrued liabilities. These services were measured at the exchange amount.

NOTES TO THE FINANCIAL STATEMENTS

15. RELATED PARTY TRANSACTIONS. (continued)

During fiscal 2004, Capital Alliance Ventures Inc., a company owning over 10% of Seprotech's shares, was paid \$6,000 for a guarantee fee associated with securing a \$250,000 line of credit for the Company.

16. CONTINGENT LIABILITIES

CMS has reactivated a lawsuit against the City of Ottawa and a consulting engineering firm relating to a request for proposal for a sewage treatment plant in Munster Hamlet in the amount of \$2.7 million. The consulting engineering firm had filed a counter-claim against CMS for \$4.2 million. This counter claim has been settled by CMS for no consideration. The Company has not recorded any asset or liability relating to this issue. The former CMS Group shareholders have provided an undertaking to reimburse 50% of costs in the event of an adverse ruling to a maximum of \$37,154.

17. FINANCIAL INSTRUMENTS

The carrying amounts for accounts receivable, unbilled revenues, accounts payable and accrued liabilities, deferred revenue and term loan approximate fair market value because of the short-term maturity of these instruments.

The fair values of obligation under capital lease and convertible subordinated debentures are determined by discounting future cash flows using rates that reflect those that the Company could currently obtain on the market, for loans with similar terms, conditions and maturities. The carrying value of all financial instruments was similar to fair value.

18. NON-CASH TRANSACTIONS

	2004	2003
Capital asset additions financed by capital lease	\$ 13,389	\$ -
Shares issued in exchange for Board services received	50,500	-
Shares issued in consideration of interest costs accrued on convertible subordinated debenture	50,119	-
Shares issued on conversion of convertible subordinated debenture	402,951	1,048,943
Liability to issue shares to former employee	77,000	-
Shares issued on acquisition of CMS Group Inc.	(435)	1,887,565
	\$ 593,524	\$ 2,936,508