

Seair Inc.
Consolidated Financial Statements
Year Ended August 31, 2005 and 2004

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SEAIR INC.

Years Ended August 31, 2005 and 2004

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An independent member firm



December 16, 2005
Edmonton, Alberta

Auditors' Report

To the shareholders of Seair Inc.:

We have audited the consolidated balance sheets of Seair Inc. as at August 31, 2005 and August 31, 2004 and the consolidated statements of loss and deficit and cash flow for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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, 2005 and August 31, 2004 and the results of its operations and the changes in its cash flow for the years then ended in accordance with Canadian generally accepted accounting principles.

A handwritten signature in cursive script that reads 'Kingston Ross Pasnak LLP'. The signature is written in dark ink and is positioned above a horizontal line.

Kingston Ross Pasnak LLP
Chartered Accountants

Consolidated Statements of Loss and Deficit

SEAIR INC.

Years Ended August 31, 2005 and 2004

	2005	2004
REVENUE	\$ 77,042	\$ 406,670
COST OF SALES		
Cost of units produced	37,484	136,329
Other production costs	4,767	18,989
Revaluation of inventory to net realizable value	-	27,343
	42,251	182,661
GROSS PROFIT	34,791	224,009
EXPENSES		
Salaries and benefits	292,454	394,775
Professional fees	46,935	67,323
Stock-based compensation	38,200	-
Product testing and trade shows	34,915	97,372
Rent	30,064	33,258
Contract services	28,757	14,903
Bad debts	26,950	75,461
Meals and entertainment	26,100	31,387
Interest and bank charges	21,643	12,051
Automotive	21,577	22,364
Compliance and investor relations	21,456	60,242
Office and shop	18,177	30,564
Amortization	17,485	16,559
Telephone	14,107	15,220
Fees and licenses	5,722	9,700
Miscellaneous	3,102	6,162
Consulting fees	-	74,688
Sub-contracts	-	2,857
	647,644	964,886
NET LOSS	(612,853)	(740,877)
DEFICIT, BEGINNING OF YEAR	(2,038,978)	(1,298,101)
RESTATEMENT (Note 4)	(359,517)	-
DEFICIT, RESTATED, BEGINNING OF YEAR	(2,398,495)	(1,298,101)
DEFICIT, END OF YEAR	\$ (3,011,348)	\$ (2,038,978)
BASIC LOSS PER SHARE (Note 15)	\$ (0.04)	\$ (0.05)
WEIGHTED AVERAGE NUMBER OF SHARES (Note 15)	16,664,523	15,080,720

Consolidated Balance Sheets

SEAIR INC.

August 31, 2005 and 2004

ASSETS

	2005	2004
CURRENT ASSETS		
Cash (Note 5)	\$ -	\$ 102,506
Accounts receivable	74,806	264,544
Inventory (Note 6)	248,580	231,105
Prepaid expenses	11,702	21,860
	335,088	620,015
PROPERTY AND EQUIPMENT (Note 7)	56,691	53,869
DEVELOPMENT COSTS (Note 8)	15,574	24,069
	\$ 407,353	\$ 697,953

LIABILITIES AND SHAREHOLDERS' EQUITY

CURRENT LIABILITIES		
Bank indebtedness (Note 5)	\$ 4,679	\$ -
Accounts payable and accrued liabilities (Note 9)	293,651	101,471
Current portion of convertible debenture (Note 10)	-	14,000
Advances from affiliates (Note 11)	21,118	28,147
	319,448	143,618
CONVERTIBLE DEBENTURE - LIABILITY PORTION (Note 10)	82,000	70,899
	401,448	214,517
COMMITMENTS (Note 12)		
CONVERTIBLE DEBENTURE (Note 10)	-	101
CONTRIBUTED SURPLUS (Note 14)	397,717	-
SHARE CAPITAL (Note 13)	2,619,536	2,522,313
DEFICIT	(3,011,348)	(2,038,978)
	5,905	483,436
	\$ 407,353	\$ 697,953

APPROVED BY THE BOARD

"John L. Yannitsos"

Director

"Barbara E. Fraser"

Director

Consolidated Statements of Cash Flow

SEAIR INC.

Years Ended August 31, 2005 and 2004

	<u>2005</u>	<u>2004</u>
CASH FLOW FROM OPERATING ACTIVITIES		
Cash received from customers	\$ 266,762	\$ 220,807
Cash paid to suppliers and contractors	(449,345)	(1,116,869)
Interest received	18	50
	<hr/> (182,565)	<hr/> (896,012)
CASH FLOW FROM INVESTING ACTIVITY		
Purchase of property and equipment	(11,813)	(30,249)
CASH FLOW FROM FINANCING ACTIVITIES		
Repayment of advances from affiliates	(7,030)	(392)
Share issue costs paid	(11,155)	-
Issuance of equity	7,000	-
Stock options exercised	101,378	658,503
Repayment of convertible debentures	(3,000)	(15,000)
Repayment of long term debt	-	(8,569)
	<hr/> 87,193	<hr/> 634,542
NET DECREASE IN CASH	(107,185)	(291,719)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	102,506	394,225
CASH AND CASH EQUIVALENTS, END OF YEAR	<hr/> \$ (4,679)	<hr/> \$ 102,506

Notes to the Consolidated Financial Statements

SEAIR INC.

Years Ended August 31, 2005 and 2004

Note 1

Going Concern Assumption

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles applicable to a going concern, which assumes that Seair Inc. (the "Company") will be able to realize its assets and discharge its liabilities in the normal course of business or achieve profitable operations. The use of such principles may not be appropriate as the Company has been unable to generate a profit from operations. The Company's current operations and credit facilities are not sufficient to fund working capital and other cash requirements to August 31, 2006. The Company's ability to continue as a going concern is dependent on accessing additional funding or achievement of profitable operations.

Management believes that the going concern basis is appropriate. Accordingly, these financial statements do not reflect adjustments to the carrying value of assets and liabilities, the reported revenues and expenses and balance sheet classifications used that would be necessary if the going concern assumption was not appropriate. Such adjustments could be significant.

Note 2

General

The Company was incorporated under the Alberta Business Corporations Act on April 12, 2001. The Company is a technology corporation which is based in Edmonton, Alberta. It is developing proprietary diffusion technology that may have global applications in several industry sectors.

The Company is engaged in the business of developing two primary product lines: a water diffuser and a water sterilization device. Since inception, the efforts of the Company have been devoted to the development of these two product lines and establishing a market. To date, the Company has not earned significant revenues and is considered to be in the development stage.

The Company has completed product testing on both the water diffuser and the water sterilizer.

Note 3

Significant Accounting Policies

These financial statements have been prepared by management in accordance with accounting principles generally accepted in Canada. Because the precise determination of many assets, liabilities, revenues and expenses are dependent on future events, the preparation of financial statements for a period necessarily includes the use of estimates and approximations which have been made using careful judgment. Actual results could differ from those estimates. These financial statements have, in management's opinion, been properly prepared within reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

Notes to the Financial Statements

SEAIR INC.

Years Ended August 31, 2005 and 2004

Note 3

Significant Accounting
Policies
Continued...

Basis of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiary, Seair Diffusion Systems Inc. All significant intercompany balances and transactions have been eliminated.

Revenue Recognition

Revenue is recognized when the product is shipped or delivered and collection is reasonably assured.

Inventory

Inventory consists of raw materials and finished goods, which is composed of water diffusion systems. Inventory is valued at the lower of cost and net realizable value, with cost being determined on an average cost basis.

Property and equipment

Property and equipment are recorded at cost less accumulated amortization. The Company provides amortization on its property and equipment using the following methods and rates:

	<u>Method</u>	<u>Rate</u>
Diffuser equipment	Diminishing balance	20 %
Office equipment	Diminishing balance	20 %
Machinery	Diminishing balance	15 %
Patent costs	Diminishing balance	25 %
Molds	Diminishing balance	75 %
Computer equipment	Diminishing balance	30 %

The Company regularly reviews its property and equipment to eliminate obsolete items. The Company records half the normal amortization in the year of addition, and no amortization in the year of disposal. No amortization is taken unless the assets are available for use.

Research and Development

Research and development expenditures are expensed as incurred with the exception of costs, which meet criteria whereby the product is clearly defined and its costs are identifiable, the product is technically feasible, management has indicated their intention to produce and market the product, the future market for the product is clearly defined and adequate resources exist to complete the project. If, at any time, it appears unlikely that capitalized development costs will be recovered through related future revenues from commercialisation, then the unamortized balance is written off as a charge to income in the year in which such a determination is made.

Development costs relate to some of the initial product development completed by the Company. In 2002, the product became commercially viable and the Company began amortizing on a straight-line basis over five years.

Notes to the Financial Statements

SEAIR INC.

Years Ended August 31, 2005 and 2004

Note 3

Significant Accounting
Policies
Continued...

Investment Tax Credits

The Company claims investment tax credits as a result of incurring scientific research and experimental development expenditures. Investment tax credits are recognized when the related expenditures are incurred, and there is reasonable assurance of their realization. Management has made a number of estimates and assumptions in determining the expenditures eligible for the investment tax credit claim. It is possible that the allowed amount of the investment tax credit claim could be materially different from the recorded amount upon assessment by Canada Revenue Agency. See Note 17 for the amount of investment tax credit.

Future Income Taxes

The Company follows the asset and liability method of accounting for income taxes. Under the asset and liability method, the change in the net future tax asset or liability is to be included in income. Future tax assets and liabilities are measured using enacted rates expected to apply to taxable income in the years in which the temporary differences are expected to be removed or settled. A valuation allowance is provided to the extent that it is more likely than not that a future tax asset will not be realized in the near term.

Leases

Leases are classified as capital or operating leases. A lease that transfers substantially all of the benefits and risks incidental to the ownership of property is classified as a capital lease. All other leases are accounted for as operating leases, wherein rental payments are expensed as incurred.

Translation of Foreign Currency Transactions

Accounts in foreign currencies have been translated into Canadian dollars using the temporal method. Under this method monetary assets and liabilities have been translated at the year end exchange rate. Non-monetary assets have been translated at the rate of exchange prevailing at the date of transaction. Revenues and expenses have been translated at the rates of exchange during the year.

Foreign exchange gains and losses on monetary assets and liabilities are included in the determination of earnings.

Notes to the Financial Statements

SEAIR INC.

Years Ended August 31, 2005 and 2004

Note 3 Significant Accounting Policies Continued...

Financial Instruments

a) Fair Value

The carrying values of accounts receivable, accounts payable and accrued liabilities, and management fees payable approximate their fair values due to the short-term maturity of these instruments. Financial instruments also include convertible debentures, long-term debt and advances from affiliates. Management considers that no events have occurred subsequent to the inception of these financing arrangements that would indicate that fair value differs substantially from carrying value.

b) Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily within accounts receivable. In the normal course of business, the Company evaluates the financial condition of its customers on a continuing basis and reviews the credit worthiness of all new customers. Management assesses the need for allowances for potential credit losses by considering the credit risk of specific customers, historical trends, and other information.

c) Interest Rate Risk

The Company is subject to interest rate risk on its \$82,000 of convertible debentures which is a floating rate instrument. The Company has not entered into financial instruments to hedge against this risk.

d) Foreign Currency Risk

The Company is exposed to currency risk with regards to its U.S. denominated accounts receivable. The Company has not engaged in any hedging activity to mitigate this risk.

Statement of Cash Flow

The Company is using the direct method in its presentation of the Statement of Cash Flow.

Measurement Uncertainty

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The significant estimates pertain to inventory obsolescence, the physical and economic lives of property and equipment and development costs, and the volatility applied in the calculation of stock-based compensation.

Notes to the Financial Statements

SEAIR INC.

Years Ended August 31, 2005 and 2004

Note 4 Restatement

Prior to September 1, 2004, the Company applied the fair value based method of accounting prescribed by CICA Handbook Section 3870, Stock-based Compensation and Other Stock-based Payments, only to stock based payments to non-employees and employee awards that were direct awards of stock, called for settlements in cash or other assets, or were stock appreciation rights and applied the settlement method of accounting to all other employee stock options. Under the settlement method, any consideration paid by employees on the exercise of stock options was credited to share capital and no compensation expense was recognized.

The CICA Accounting Standards Board has amended CICA Handbook Section 3870, and the Company is now required to account for employee stock options using the fair value based method, beginning September 1, 2004. Under the fair value based method, compensation cost is measured at fair value at the date of grant and is expensed over the award's vesting period.

In accordance with one of the transitional options permitted under amended Section 3870, the Company has retroactively applied the fair value based method to all employee stock options granted on or after September 1, 2002, with no prior period restatement. Under this option, prior periods are not restated and an adjustment of \$359,517 has been made to opening deficit and contributed surplus to reflect the cumulative change for all stock options granted to employees since September 1, 2002 to August 31, 2004. Stock based compensation is expensed as they vest.

The Company has committed to stock-based compensation plans, which are described in Note 13.

Fair Value Pro Forma Information:

Had the Company elected to recognize the cost of its stock-based compensation using the fair value method, there would be no effect on the 2004 income statement as all options to employees and directors were issued in the 2003 year end.

Note 5 Cash/Bank Indebtedness

	<u>2005</u>	<u>2004</u>
Bank Indebtedness is comprised of the following:		
Cash in bank	\$ 1,888	\$ 121,221
Cheques issued in excess of bank balance	(6,567)	(18,715)
	<u>\$ (4,679)</u>	<u>\$ 102,506</u>

Notes to the Financial Statements

SEAIR INC.

Years Ended August 31, 2005 and 2004

Note 6 Inventory

	<u>2005</u>	<u>2004</u>
Inventory is comprised of the following:		
Finished goods	\$ 153,385	\$ 140,056
Raw materials and parts	95,195	91,049
	<u>\$ 248,580</u>	<u>\$ 231,105</u>

Note 7 Property and Equipment

			<u>2005</u>	<u>2004</u>
	Cost	Accumulated Amortization	Net Book Value	Net Book Value
Diffuser equipment	\$ 41,394	\$ 30,404	\$ 10,990	\$ 13,737
Office equipment	20,444	6,804	13,640	17,051
Machinery	13,869	5,465	8,404	9,887
Patent costs	20,600	-	20,600	8,788
Molds	6,214	6,199	15	61
Computer equipment	5,112	2,070	3,042	4,345
	<u>\$ 107,633</u>	<u>\$ 50,942</u>	<u>\$ 56,691</u>	<u>\$ 53,869</u>

Amortization provided for in the current year totaled \$8,990; (2004 - \$8,064).

Note 8 Development Costs

	<u>2005</u>	<u>2004</u>
Development costs	\$ 42,475	\$ 42,475
Accumulated amortization	(26,901)	(18,406)
	<u>\$ 15,574</u>	<u>\$ 24,069</u>

Amortization provided for in the current year totaled \$8,495; (2004 - \$8,495).

Note 9 Accounts payable and accrued liabilities

	<u>2005</u>	<u>2004</u>
Trade payables	\$ 226,451	\$ 85,671
Management compensation payable	67,200	15,800
	<u>\$ 293,651</u>	<u>\$ 101,471</u>

Notes to the Financial Statements

SEAIR INC.

Years Ended August 31, 2005 and 2004

Note 10

Convertible Debentures

On October 31, 2002, the Company issued unsecured subordinated convertible debentures in the amount of \$135,000 to a director of the Company for cash advanced to the Company and services rendered.

The debentures bear interest at prime plus 4.0% per annum, with the first interest payment due January 1, 2003. The debentures are convertible, at the request of the shareholder, into common shares of the Company at conversion prices as follows:

\$0.35 per share within the first 2 years from the date issued
\$0.385 per share during the 3rd year from the date issued
\$0.4235 per share during the 4th year from the date issued
\$0.46585 per share during the 5th year from the date issued

The debt component has been calculated as the present value of the required interest payments discounted at a rate approximating the interest rate that would have been applicable to non-convertible debt at the time the debentures were issued. Interest expense is determined on the debt component, such component being reduced by the required monthly interest payments. The difference between the debt component and the face value of the debentures is classified as equity, net of issue costs adjusted for income taxes. The equity component of the debentures, net of the value ascribed to the holders' option, is increased over the term to the full face value by charges to retained earnings (deficit).

The amount owing as a result of the convertible debenture will come due thirteen months after the year-end of August 31, 2005.

	<u>2005</u>	<u>2004</u>
Opening balance	\$ 85,000	\$ 100,000
Convertible debentures issued	-	-
Convertible debentures repaid	(3,000)	(15,000)
	<u>\$ 82,000</u>	<u>\$ 85,000</u>

The equity and debt components is comprised as follows:

Current liability portion of convertible debenture	\$ -	\$ 14,000
Long term liability portion of convertible debenture	82,000	70,899
Equity portion of convertible debenture	-	101
	<u>\$ 82,000</u>	<u>\$ 85,000</u>

Notes to the Financial Statements

SEAIR INC.

Years Ended August 31, 2005 and 2004

Note 11 Advances from Affiliates

The advances are due on demand, are unsecured and have no specific terms of repayment. All advances bear no interest. The affiliated parties have indicated that they do not intend to materially reduce the loan balance within the next fiscal year. However, because the parties do not have a written contract or other postponements, the amount has been presented as a current liability. All affiliated parties are either controlling shareholders or companies controlled by these same shareholders.

Note 12 Commitments

The Company has obligations under two long-term leases for its office premises. The lease commitments are exclusive of operating costs. Minimum lease payments in future years are as follows:

2006	\$ 22,650
2007	18,000
	<u>\$ 40,650</u>

Note 13 Share Capital

Authorized:
Unlimited number of Common, voting shares
Unlimited number of Preferred shares

Issued Common shares:

	<u>2005</u>		<u>2004</u>	
	Number of Shares	Stated Capital	Number of Shares	Stated Capital
Opening	16,584,042	\$ 2,522,313	14,502,169	\$ 1,619,310
Private placement	20,000	7,000	-	-
Options exercised	289,650	101,378	1,592,873	658,503
Shares issued as settlement of debt	-	-	489,000	244,500
Share issue costs	-	(11,155)	-	-
	<u>16,893,692</u>	<u>\$ 2,619,536</u>	<u>16,584,042</u>	<u>\$ 2,522,313</u>

During the year ended August 31, 2005, 289,650 options to purchase shares were exercised for \$101,378 of cash proceeds. Also during the year ended August 31, 2005, the Company issued 20,000 shares at \$0.35 in a private placement for proceeds totaling \$7,000.

Notes to the Financial Statements

SEAIR INC.

Years Ended August 31, 2005 and 2004

Note 13 Share Capital Continued...

During the year ended August 31, 2004, 1,592,873 options to purchase shares were exercised for \$658,503 of cash proceeds. Also during the year ended August 31, 2004, the Company issued 466,500 shares at \$0.50 per share as settlement for accumulated unpaid management compensation of \$233,250 and an additional 22,500 shares as settlement at \$0.50 per share as settlement for other debt totaling \$11,250.

Warrants:

At August 31, 2005, there were 20,000 (2004 - zero) warrants outstanding. The warrants have an exercise price of \$0.45 per share and expired on October 31, 2005.

Escrow:

At August 31, 2005, the following amounts were held in escrow with CIBC Mellon Trust Company pursuant to the Company's Escrow Agreements dated January 24, 2003 and March 7, 2003. The Escrow Agreement provides that these items be released from escrow as follows:

	Common Shares	Convertible Debentures
February 5, 2006	1,243,889	42,750
August 5, 2006	1,243,889	42,750
	<u>2,487,778</u>	<u>85,500</u>

During the year ended August 31, 2005, the following shares were released from escrow:

	Common Shares	October 19, 2001 Options	October 31, 2002 Options	Convertible Debentures
February 5, 2005	1,243,889	33,000	150,000	42,750
August 5, 2005	1,243,889	33,000	150,000	42,750
	<u>2,487,778</u>	<u>66,000</u>	<u>300,000</u>	<u>85,500</u>

During the year ended August 31, 2005, the October 31, 2002 options expired so no options are recorded as being held in escrow.

Notes to the Financial Statements

SEAIR INC.

Years Ended August 31, 2005 and 2004

Note 13
Share Capital
Continued...

Stock options outstanding:

The Company has 1,640,400; (2004 - 2,395,210) outstanding stock options all of which are distributed to directors, officers and employees under the terms of its stock option plan.

The Company has reserved 48,969 of additional shares in Treasury to meet stock options not yet issued.

A summary of the status of the plan as at August 31, 2005 and 2004 and changes during the years then ended is presented below:

	<u>2005</u>		<u>2004</u>	
	<u>Options</u>	<u>Weighted Average Exercise Price</u>	<u>Options</u>	<u>Weighted Average Exercise Price</u>
Options outstanding, beginning of year	2,395,210	\$ 0.393	5,108,310	\$ 0.393
Granted	450,000	0.376	176,000	0.908
Exercised	(289,650)	0.350	(1,592,873)	0.413
Expired	(915,160)	0.350	(1,296,227)	0.512
Options outstanding and exercisable, end of year	<u>1,640,400</u>	<u>\$ 0.357</u>	<u>2,395,210</u>	<u>\$ 0.393</u>

The option prices and expiry dates of the 1,640,400 stock options outstanding as at August 31, 2005 are as follows:

<u>Expiry Date</u>	<u>Options</u>	<u>Option Price Per Share</u>
July 14, 2008	1,190,400	0.35
September 28, 2009	230,000	0.40
August 26, 2010	<u>220,000</u>	0.35
	<u>1,640,400</u>	

Notes to the Financial Statements

SEAIR INC.

Years Ended August 31, 2005 and 2004

Note 13 Share Capital Continued...

Stock-based compensation:

Options granted during the year:

During the year ended August 31, 2005, the Company granted options for a total of 230,000 and 220,000 common shares to certain directors and officers. Under the terms of the stock based compensation agreement the options expire on September 28, 2009 and August 26, 2010 respectively.

Grant Date	Expiry Date	Options	Option Price Per Share
Sept. 28, 2004	September 28, 2009	230,000	\$ 0.40
August 26, 2005	August 26, 2010	220,000	0.35

Expiry Date	Estimated Fair Value Per Option	Spot Rate	Strike Price	Aggregate Fair Value
September 28, 2009	\$ 0.08	\$ 0.36	\$ 0.40	\$ 18,400
August 26, 2010	0.09	0.33	0.35	19,800
				<u>\$ 38,200</u>

The common assumptions utilized in determining the fair values were a risk-free rate of 4.0%, volatility of 23.04% and a maturity period of 5.0 years for the options expiring on September 28, 2009 and a risk-free rate of 4.0%, volatility of 23.04% and a maturity period of 5 years for the options expiring on August 26, 2010.

Options granted during the prior year:

During the year ended August 31, 2004, the Company granted options for a total of 176,000 common shares to certain directors and officers. Under the terms of the stock based compensation agreement the options expired during that year.

Note 14 Contributed Surplus

	2005	2004
Contributed surplus, opening	\$ -	\$ -
Change in accounting policy (Note 3)	359,517	-
Stock-based compensation expense (Note 13)	38,200	-
Contributed surplus, ending	<u>\$ 397,717</u>	<u>\$ -</u>

Notes to the Financial Statements

SEAIR INC.

Years Ended August 31, 2005 and 2004

Note 15 Loss Per Share

Basic

Basic net loss per share is determined by dividing net loss available to common shareholders as reported in the Statement of Loss by the average daily number of common shares outstanding for the period.

	<u>2005</u>	<u>2004</u>
Net Loss	(612,853)	(740,877)
Weighted average number of shares outstanding for purposes of calculating basic loss per share	16,664,523	15,080,720
Basic loss per share	<u>\$ (0.04)</u>	<u>\$ (0.05)</u>

Diluted

The effects of all outstanding stock options, warrants and all convertible debentures were excluded from the loss per share calculation as the results would be anti-dilutive.

Note 16 Related Party Transactions

Included in the accounts payable are \$27,238; (2004 - \$18,626) due to companies controlled by directors and managers of the Company.

Included in the expenses is \$8,612; (2004 - \$8,889) of interest expense on a convertible debenture owned by a director of the company.

These transactions were measured at the exchange amount, which is the amount of consideration agreed to by the related parties and were incurred in the normal course of operations.

Notes to the Financial Statements

SEAIR INC.

Years Ended August 31, 2005 and 2004

Note 17 Income Taxes

As at August 31, 2005, the Company had income tax losses carried forward for tax purposes aggregating \$2,204,821 that are available for the reduction of future year's taxable income. No recognition has been given in these financial statements to any potential tax savings arising from application of these losses. The losses expire as follows:

2006	15,577
2007	20,511
2008	128,829
2009	248,379
2010	507,864
2011	624,353
2012	659,308
	<u>2,204,821</u>

The Company has investment tax credits carried forward arising from expenditures in Scientific Research and Experimental Development of \$124,493. These credits will be applied directly against taxes incurred. No future tax benefit has been recognized in these financial statements for any potential tax savings arising from these credits. The Company has \$552,501 (net of investment tax credits carried forward) of deductible Scientific Research and Experimental Development expenditures available for the reduction of future years' taxable income.

Future income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's future income tax assets and liabilities as of August 31, 2005 are as follows:

	<u>2005</u>	<u>2004</u>
Future income tax assets:		
Other long-term assets	\$ -	\$ -
Property and equipment	13,467	8,469
Non-capital losses	771,687	541,776
Capital losses	-	-
Valuation allowance against current loss carry forward	(779,703)	(541,821)
	<u>5,451</u>	<u>8,424</u>
Future income tax liabilities:		
Unbilled revenue	-	-
Property and equipment	-	-
Deferred development costs	5,451	8,424
Goodwill	-	-
	<u>5,451</u>	<u>8,424</u>
Net future tax assets (liabilities)	\$ -	\$ -

Notes to the Financial Statements

SEAIR INC.

Years Ended August 31, 2005 and 2004

Note 17 Income Taxes Continued...

The components of the income tax expense are as follows:

	<u>2005</u>	<u>2004</u>
Tax recovery at the statutory rate of 35%	\$ (214,499)	\$ (259,307)
Amortization claimed in excess of capital cost allowance	6,119	5,796
Non-deductible meals and entertainment expense	800	5,493
Scientific research expenses carried forward	-	54,995
Share issue costs	(26,281)	(25,500)
Non-capital losses carried forward	230,758	218,523
Other	3,103	-
	<u>\$ -</u>	<u>\$ -</u>

Note 18 Subsequent Events

Subsequent to year end, 55,000 options were exercised at price of \$0.35 per share by its directors pursuant to the Company's Stock Option Plan.

Seair Inc.
Management Discussion and Analysis
Year and Quarter Ending August 31, 2005

Forward-looking statements

Management's discussion and analysis contains certain forward-looking statements that are subject to risks and uncertainties that may cause actual results or events to differ materially from the results or events predicted in this discussion. In addition to the risks outlined in the Risk Management section at the end of the discussion, factors which could cause actual results or events to differ could include, but are not limited to: the impact of competition; consumer confidence and spending levels; general economic conditions; interest and currency exchange rates; the cost and availability of capital; and the ability of Seair to attract and retain quality employees. No assurances can be given that results, performance or achievement expressed in, or implied by, forward-looking statements within this disclosure will occur, or if they do, that any benefits may be derived from them.

This document should be read in conjunction with the audited consolidated financial statements for the years ending August 31, 2005 and 2004 and the notes contained therein. This document was prepared as of December 20, 2005.

Corporate Overview

Seair is a leading developer of proprietary diffusion and sterilization technologies. Seair's patent-pending technologies allow for the efficient diffusion of gases into a liquid, thereby facilitating numerous applications in a wide variety of industries, including waste water treatment, pulp and paper, aquaculture, agriculture/horticulture, sterilization, golf course irrigation and pond treatment, animal enhancement and oil and gas.

Seair's primary focus is developing and selling equipment that diffuses gases, such as oxygen, ozone or carbon dioxide, into a liquid, resulting in a supersaturate solution. The major difference between Seair and other diffusion technologies is Seair's ability to achieve extremely small gas bubble size, which in turn allows for the mass transfer of gas to fluid. The result is a stable condition where the gases remain in solution for extended periods of time, leading to increased productivity and lower operating costs.

Key Business Drivers

Seair is continuing the transition from a research and development orientation to a sales and customer support orientation. The core Seair technology is proven and the current business development phase is to integrate that core technology into industry specific solutions. In doing so, Seair must be able to promise and deliver a full customer service and support capability. To date Seair has frequently worked with third parties to address and service specific industry and geographic markets. Seair expects to continue to use this partnering model even though it means that Seair cannot always directly control the pace at which target

markets are pursued. Seair is actively investigating all potential mechanisms to strengthen its influence with key partners in order to accelerate market development and sales activities.

The heart of Seair's products is the patent-pending diffusion technology. Diffusion itself is not new, but Seair's approach is new and superior to traditional diffusion products. For many of Seair's potential customers the traditional diffusion technologies could not adequately address specific needs and, accordingly, they have sought out and adopted non-diffusion alternatives. Seair must overcome customer reluctance to adopt diffusion by satisfying them that not only is Seair's technology superior to traditional approaches to diffusion, but is also superior to non-diffusion alternatives at meeting the potential customer's specific needs. This technology proving and customer acceptance process is critical to the success of Seair. Seair must build a foundation of reference customers, augmented by independent endorsements, to establish a sustainable presence in selected industries. Furthermore, Seair must demonstrate within specific target industries the ability to work in conjunction with a myriad of legacy systems. Customers are often hesitant to discard old systems and replace them with something new, no matter how much benefit the new system can potentially yield. Accordingly, must often augment, rather than supplant, existing solutions.

Seair's products have applicability in a wide variety of industries. While this versatility is expected to prove to be beneficial in the long-term, it can lead to near-term problems in maintaining focus. Moreover, although Seair's technology is able to function in multiple industries with little or no modification, the specific end-use applications, customer terminology and business nuances vary considerably from industry to industry. As Seair transitions from research and development to sales it is essential that resources not be spread too thin to adequately cover and service the target markets. Collaboration with established players in the target markets is Seair's current approach to overcoming internal resource constraints.

Seair understands that credibility and acceptance must be established in each target market and that success in a particular target market will not automatically drive leads, credibility or acceptance in other target markets. As a result, Seair's technology generally must be proven via independent testing specific to particular target market parameters and utilizations before potential customers in that industry will seriously consider purchasing and using Seair's diffusion-based systems. Seair has invested considerable time, effort and money in these industry-specific independent testing regimes and, while the results have been extremely positive, the timing of technology acceptance and the placement of product orders by target customers is largely beyond Seair's control.

Seair has only recently commenced commercial sales of its diffusion-based solutions. Considerable financial resources were consumed in the research and development phase and Seair is left with limited cash and working capital. Realization of the product sales potential, or closing an additional round of financing, is necessary to bolster Seair's financial condition and facilitate initial penetration of the target markets. Prudent cash management and cost containment are imperative through the upcoming anticipated growth period.

Seair should have a strengthened balance sheet in order to complete and optimize market and customer development strategies. Furthermore, notwithstanding the use of a distributor model, Seair must recruit and retain experienced sales, support and technical personnel to fully exploit the Seair technology's market potential. The likelihood of successful recruitment and retention of qualified personnel improves should Seair's balance sheet be strengthened.

Managing the transaction loop, from purchase order to collection of cash and continuous customer support/follow-up, is essential to growing Seair's business. With the transition from research to sales it will take time to build a robust customer prospect list. Customer care and satisfaction are always important, but even more so with initial adopters. Seair, in conjunction with its business partners, must build and implement a customer screening and satisfaction process.

Since many of Seair's potential customers are seeking financing for their equipment purchases, Seair must be in a position to provide reasonable financing terms, either directly or via third parties, in order to resolve this obstacle to completed sales. Seair has now successfully linked customers to external financing, both for lease situations and with Canada's Export Development Corporation ("EDC") for international sales.

Results of Operations

Seair's consolidated sales and financial performance is summarized as follows:

	Q4 2005	Q4 2004	Change	2005	2004	Change
Revenue	\$ (7,803)	\$ 101,698	-108%	\$ 77,042	\$ 406,670	-81%
Gross profit	8,432	70,412	-88%	34,791	224,009	-84%
Net loss	(213,651)	(181,174)	18%	(612,853)	(740,877)	-17%
Basic loss per share	(0.01)	(0.01)	0%	(0.04)	(0.05)	-20%

Fiscal Year Ending August 31, 2005

Fiscal 2005 revenue of \$77,042 was 81% lower than fiscal 2004. For much of fiscal 2004 Seair employed a business model emphasizing direct sales to end customers. However in fiscal 2005 Seair determined that the direct model was unsustainable as the Company did not have the end-user industry expertise, nor the financial or human resources to build initial sales into a meaningful market share. As a result Seair shifted to a collaborative business model where third parties, acting as distributors, partners or similar forms of arrangement, assumed responsibility for end sales and first line customer support. Seair believes this collaborative model will facilitate Seair gaining strong market share in a number of targeted industries. That said, shifting responsibility for sales to third parties significantly reduces Seair's ability to influence the pace at which specific opportunities are pursued. Although distributor agreements generally include minimum sales targets that must be achieved to maintain the distributor status, by necessity these targets are spread over relatively long time frames in order to permit the distributor adequate time to develop the market. Seair's fiscal

2005 revenues were down from prior years as the Company's distributors were primarily focused on market development activities rather than specific sales. The Company expects distributor-based sales to increase as Seair's partners complete their initial market development.

Seair has de-emphasized the greenhouse market in favour of what are believed to be more lucrative and sustainable target markets. Seair's primary target markets include wastewater treatment, animal enhancement and golf course irrigation, pond water remediation and soil treatment. While shifting to these markets did result in a revenue decline, management believes the impact of Seair's technology in the current target applications will be significantly more profound, demonstrable and immediate than was the case with greenhouses. Considerable investment in industry specific independent testing and results verification is required to gain credibility and acceptance in the target industries. Seair continues to make those testing investments in its target markets.

The Company now has independent representatives in each of these target industries.

Although revenues for the year ending August 31, 2005 were lower than the prior year, the loss in the prior year was substantially larger. This is a direct result of Seair's efforts to preserve financial resources through cost cutting and other efficiencies while markets are being developed in conjunction with sales and distribution partners.

Operating expenditures totaled \$647,644 for the year ending August 31, 2005 versus \$964,886 for the year ending August 31, 2004. This \$317,242, or 33%, decline is primarily a result of reduced personnel costs. Current staffing levels are below those existing for much of fiscal 2004. In addition, management personnel costs decreased as a result of voluntary reductions in compensation rates. Seair's priority is to preserve financial resources until revenue levels justify increased spending.

Product testing and trade show costs stem from Seair's post-research phase marketing initiatives. The costs have decreased significantly (\$34,915 in fiscal 2005 compared to \$97,372 in fiscal 2004). While initial testing and trade show strategies were intended to create general awareness, Seair has narrowed its testing focus to align with the overall prioritization of target markets. Recent testing has been directed at specific industries and specific customers for purposes of proving Seair's applicability and results in particular sales opportunities. Positive results from these tests and demonstrations, which can be completed at virtually no cost to Seair, will significantly advance current opportunities through Seair's sales cycle.

Bad debts declined from \$75,461 in fiscal 2004 to \$26,950 in fiscal 2005. Fiscal 2004 bad debts included instances where resellers to the greenhouse industry were unable to integrate Seair's products into their traditional product lines and, accordingly, withdrew as resellers. Seair continues to pursue the amounts owed by these former resellers but, for financial statement purposes has cleaned up the accounts in conjunction with the strategic de-emphasis of the greenhouse industry. In spite of the substantial year-over-year decline, bad debts

remain a significant issue for Seair. The Company must continue to attempt to balance aggressive market penetration with tolerable receivable default risk.

Consulting fees, compliance and investor relations fees and professional fees all declined from fiscal 2004 to fiscal 2005. Seair has, to the maximum extent possible, brought in-house the functions formerly served by third parties. In addition, the Company's Calgary office has been closed to reduce costs.

Quarter Ending August 31, 2005

In the quarter ending August 31, 2005 Seair reversed a sale booked previously in the year in the amount of \$39,403. As a result of this adjustment, revenue for the fourth quarter was negative \$7,803. If not for this adjustment from a prior quarter, the fourth quarter revenue would have been \$31,600, or 69% lower than the same quarter in the prior year. Revenue levels will continue to fluctuate significantly until Seair and its sales and distribution partners advance from the market development phase to closing greater numbers of specific sales opportunities.

Gross profit exceeded revenue in the quarter ending August 31, 2005 as a result of reclassification to operating expenses of amounts previously reported as "other production costs" in cost of sales and the above-noted adjustment to revenue. After adjusting for this reclassification the gross profit percentage in the quarter was consistent with Seair's target of approximately 60% to 70%. Actual reported gross profit rates may continue to fluctuate significantly until Seair's overall revenue levels increase. At low sales levels unusual items can significantly impact the gross profit percentage.

Operating expenditures totaled \$222,083 for the quarter ending August 31, 2005 versus \$240,448 for the quarter ending August 31, 2004. This \$18,365 decline in operating expenditures, an 8% reduction, is attributable to Seair's continued emphasis on cost containment while market development activities are conducted in conjunction with the Company's sales and distribution partners. Total personnel related costs, excluding stock-based compensation, in the quarter were \$69,163 (versus \$69,754 for the quarter ending May 31, 2005 and \$79,190 for the quarter ending August 31, 2004). Seair continues to minimize personnel costs without compromising design, production, delivery and installation capabilities. Staffing, and therefore personnel costs, will need to increase when Seair's revenues begin to ramp-up.

Interest expense and bank charges include \$8,612 of interest on a convertible debenture held by a Director of the Company.

The year over year quarterly loss increased \$43,615, or 26%. However, if the impact of the fourth quarter reversal of previously booked revenue is excluded, the year-over-year quarterly loss declined modestly in spite of lowered revenues.

Seair's summarized results for the most recent eight quarters are as follows:

Quarter Ending	Revenue	Gross Profit	Net Loss	Basic Loss per Share
31-Aug-05	\$ (7,803)	\$ 8,432	\$ (213,651)	\$ (0.01)
31-May-05	17,413	12,619	(116,758)	(0.01)
28-Feb-05	46,085	10,348	(127,643)	(0.01)
30-Nov-04	21,374	3,392	(151,726)	(0.01)
31-Aug-04	101,698	70,412	(169,074)	(0.01)
31-May-04	63,831	41,748	(213,285)	(0.01)
29-Feb-04	44,313	2,341	(238,938)	(0.02)
30-Nov-03	196,828	109,508	(119,580)	(0.01)
31-Aug-03	(4,179)	15,160	(319,775)	(0.03)

Quarterly results vary significantly because Seair has only recently commenced building sales channels. To this point sales of one or two units in a quarter can dramatically impact revenue and gross profit trends. In general the quarterly losses have been narrowing since the peak, for the three months ending August 31 2003, when the company first went public. These reductions are generally a result of cost controls. However, there are no assurances that this trend will continue until such time that sustainable sales channels are in place.

Revenue for the quarter ending November 30, 2004 includes an \$11,000 credit granted to a greenhouse industry customer for equipment returned to Seair. This credit reduced the revenue that would otherwise have been reported for the six months ending February 28, 2005.

New Business Development

Seair's business development strategy is to progress from independent testing and trade show introduction to reference customers in high potential sectors. However, because Seair's technology has applicability across a broad range of industries, independent and simultaneous growth in all potential markets is beyond the current capacity of Seair. It is therefore Seair's intention to forge relationships with complementary partners in select industries. Seair's partners will be positioned to incorporate Seair's products into broader customer solutions. As a result Seair will be able to leverage the resources and reputation of key partners during the market penetration stage and be able to endure what can often be very lengthy sales cycles. An example of the partnership arrangement can be found in the marketing agreement signed with Praxair Canada Inc. in October 2004.

Seair's priority markets involve waste water remediation sterilization and animal enhancement applications. The positive impact of Seair's products in these applications can be observed almost immediately and, in most cases, there is considerable urgency on the part of potential customers to find solutions or improvements to contaminated environments.

Sear intends to add an equipment leasing option for its customers. This financing alternative will be provided through third parties specializing in such matters. Similarly, financing for international customers has been and will be available through Canada's Export Development Corporation ("EDC").

Liquidity and Capital Structure

Working capital at August 31, 2005 was \$15,640 down from \$476,397 at August 31, 2004 and down \$119,212 from working capital of \$134,852 at May 31, 2005. Sear continues to operate at a loss while the sales channel is being developed. Accordingly, additional working capital will be required until such time profitable operations are achieved. Strengthened working capital will enable Sear to systematically build market position in selected industries, optimize margins and terms of business and aggressively pursue new opportunities when warranted.

At August 31, 2005 Sear had 16,893,692 shares outstanding at a book value of \$2,619,536, or \$0.155 per share. A total of 289,650 shares were issued in connection with stock options exercised during the year ending August 31, 2005 for gross proceeds of \$101,378 (\$0.35 per share). Of these options, 145,000 were exercised during the quarter ending August 31, 2005 for gross proceeds of \$50,750 (\$0.35 per share).

Sear had 1,640,400 issued and outstanding stock options at August 31, 2005. Except for 230,000 options, which are exercisable at \$0.40 per share, all of these options are exercisable at \$0.35 per share. All of these options, which constitute 8.9% of the combined shares and options outstanding at August 31, 2005, have been issued to Sear officers, employees and directors.

Sear has recorded contributed surplus of \$397,917 as the estimated fair value of stock options issued since inception. Of this amount, \$38,200 was expensed in the year ending August 31, 2005 in conjunction with the 450,000 stock options issued during that period. All other contributed surplus was recorded as a one-time adjustment to opening deficit. No stock options were granted during the quarter ending August 31, 2005.

In 2002 Sear issued \$135,000 of prime + 4% convertible debentures to a director. At August 31, 2005 \$82,000 of this debenture remained outstanding, down from \$85,000 at August 31, 2004. The debenture is convertible into Sear common shares at escalating rates. The conversion rate at August 31, 2005 was \$0.385 per share. Sear has no other non-current indebtedness.

Sear intends to build working capital through achieving profitable operations. Until then it may be necessary to raise additional capital.

In pursuing profitable operations Sear is attempting to maintain strong product sales margins and minimize fixed overhead costs. Assuming maintenance of current product margins and the adequacy of existing infrastructure, management estimate operating cash flow will be positive once revenues reach \$1.5 million. However, because management's plan includes

investment in additional sales and customer support oriented resources, the actual revenue level required to achieve positive operating cash flows will likely be slightly higher than \$1.5 million.

Seair has obligations under several long-term leases for its premises. The lease commitments are exclusive of operating costs. Minimum lease payments in future years are as follows:

2006	\$22,650
2007	18,000

Seair has no other contractual obligations for convertible debt and operating leases.

Capital Expenditures

Seair's business does not require substantial investment in capital equipment. Total capital asset additions in the quarter were \$1,192 and for the year ending August 31, 2005 capital expenditures were \$11,813 (\$30,249 in fiscal 2004). The Company has no off-balance sheet arrangements that have, or are likely to have, a current or future effect on the results of operations or financial condition of the Company.

Risk Management

Seair is exposed to a number of risks in the normal course of its business that have the potential to affect its operating performance.

Technology Risk

Seair's core asset is its patented diffusion technology. Although Seair has completed its core research and development work and has market ready products, the technology and resulting products require continual refinement. Moreover, the versatility of Seair's products leads to use in many industries and many differing end applications. In many cases Seair must customize the integration of its equipment into these varying end applications. Failure to properly integrate and operate the equipment can lead to reduced performance or even failure. Seair intends to improve and document its equipment installation and operation process. Investment in trained technical personnel will ensure proper installation. Improved customer support is required to ensure customers optimize the results from Seair equipment without requiring frequent field visits by Seair personnel.

Financial Risk

Apart from technology, Seair also faces considerable financial risk. Additional working capital will need to be accessed to carry Seair through to profitable operations.

Seair has a considerable investment in accounts receivable (\$74,806 at August 31, 2005, down from \$152,075 at May 31, 2005). Tighter credit granting controls and increased emphasis on account collection will continue to be required to reduce accounts receivable

exposure and shorten the cash flow cycle. In addition, Seair is has now successfully facilitated a financing transaction between the Export Development Corporation (“EDC”) and a customer residing outside of Canada and the United States. The use of EDC can significantly reduce the time and risk associated with collecting on overseas sales.

The company has a limited number of personnel which reduces the capacity to implement and enforce internal controls.

Dependence on Third Parties

Seair’s business model involves partnering with third parties to establish sales and distribution channels in specific target markets. Seair has limited ability to control the nature, extent and pace of market development and investment by these third parties and, therefore, limited influence on how rapidly and effectively specific sales opportunities are addressed.