HLB **Cinnamon Jang Willoughby & Company**

Chartered Accountants
A Partnership of Incorporated Professionals

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

FLEXIBLE SOLUTIONS INTERNATIONAL, INC.:

We have audited the accompanying consolidated balance sheets of Flexible Solutions International, Inc. (the "Company") as of December 31, 2007 and 2006 and the related consolidated statements of operations, stockholders' equity and cash flows for each of the two years in the period ended December 31, 2007. The 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform an audit to obtain reasonable assurance whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. 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. We believe that our audits provide a reasonable basis for our opinion.

In our opinion the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Flexible Solutions International, Inc. as at December 31, 2007 and 2006 and the consolidated results of its operations and its cash flows for each of the two years in the period ended December 31, 2007 in conformity with generally accepted accounting principles in the United States of America.

"Cinnamon Jang Willoughby & Company"

Chartered Accountants

Burnaby, Canada
March 21, 2008

FLEXIBLE SOLUTIONS INTERNATIONAL, INC.
Consolidated Balance Sheet
December 31, 2007 and 2006
(U.S. Dollars)

	December 31, 2007	December 31, 2006
Assets		
Current		
Cash and cash equivalents	$ 3,355,854	$ 450,759
Accounts receivable (Note 3)	1,051,056	1,319,575
Inventories (see Note 4)	2,361,270	1,904,315
Prepaid expenses	115,353	124,360
	6,883,533	3,799,009
Property, equipment and leaseholds, net (see Note 5)	4,612,571	4,100,553
Patents (see Note 6)	230,438	169,758
Investment (see Note 7)	-	369,000
Long term deposits (see Note 8)	48,034	47,220
Total Assets	$11,774,576	$ 8,485,540
Liabilities		
Current		
Accounts payable and accrued liabilities	$ 385,792	$ 423,030
Deferred revenue	9,870	20,559
	395,662	443,589
Mortgage (Note 15)	452,018	-
	847,680	443, 589
Stockholders' Equity		
Capital stock (Note 14)		
Authorized		
50,000,000 common shares with a par value of $0.001 each		
1,000,000 preferred shares with a par value of $0.01 each		
Issued and outstanding:		
14,057,567 (2006: 13,058,427) common shares	14,058	13,058
Capital in excess of par value	15,914,303	12,370,418
Other comprehensive income (see Note 9)	394,289	131,002
Accumulated Deficit	(5,395,754)	(4,472,527)
Total Stockholders' Equity	10,926,895	8,041,951
Total Liabilities and Stockholders' Equity	$11,774,576	$ 8,485,540
Commitments, Contingencies and Subsequent events	**(See Notes 16, 17 & 18)**	

See Notes to Consolidated Financial Statements.

FLEXIBLE SOLUTIONS INTERNATIONAL, INC.
Consolidated Statements of Operations
For the Years Ended December 31, 2007 and 2006
(U.S. Dollars)

	Years Ended December 31, 2007	2006
Sales	$7,431,791	$ 8,373,597
Cost of sales	4,738,143	5,401,350
Gross profit	2,693,648	2,972,247
Operating Expenses		
Wages	1,094,799	1,069,736
Administrative salaries and benefits	447,516	666,542
Advertising and promotion	63,126	45,215
Investor relations and transfer agent fee	302,401	258,072
Office and miscellaneous	201,810	157,755
Insurance	230,656	209,864
Interest expense	10,605	3,136
Rent	227,431	232,820
Consulting	338,728	383,965
Professional fees	233,701	324,359
Travel	134,011	136,049
Telecommunications	38,163	34,041
Shipping	67,834	41,517
Research	120,817	123,254
Commissions	119,790	171,380
Bad debt expense	2,310	90,747
Currency exchange	43,568	(23,417)
Utilities	25,996	18,064
	3,703,262	3,940,099
Loss before other items and income tax	(1,009,614)	(967,852)
Registration rights penalty	-	(326,710)
Write down of investment	(98,000)	
Other expenses	(15,051)	
Other income	195,442	
Interest income	3,996	3,114
Loss before income tax	(923,227)	(1,291,448)
Income tax (recovery)	-	(127,049)
Loss for the year	$ (923,227)	$ (1,164,369)
Net loss per share (basic and diluted)	$ (0.07)	$ (0.09)
Weighted average number of common shares (basic and diluted)	13,823,654	12,994,430

See Notes to Consolidated Financial Statements.

FLEXIBLE SOLUTIONS INTERNATIONAL, INC.
Consolidated Statements of Cash Flows
For Years Ended December 31, 2007 and 2006
(U.S. Dollars)

	Years Ended December 31,			
		2007		2006
Operating activities				
Net loss	$	(923,227)	$	(1,164,369)
Adjustments to reconcile net loss to net cash				
Stock compensation expense		651,405		858,585
Shares issued for services		-		74,306
Depreciation		526,127		597,170
Write down of investment		98,000		-
		352,305		365,692
Changes in non-cash working capital items:				
(Increase) Decrease in accounts receivable		300,065		(553,174)
(Increase) Decrease in inventories		(337,532)		410,664
(Increase) Decrease in prepaid expenses		16,852		12,955
Increase (Decrease) in accounts payable		(78,550)		(268,075)
Increase (Decrease) deferred revenue		(10,689)		20,559
Increase (Decrease) in income taxes		-		28,918
Cash provided by (used in) operating activities		242,451		17,539
Investing activities				
(Increase) Decrease in long term deposits		1,981		(2,147)
(Increase) Decrease in loan receivable		-		35,228
(Increase) Decrease in development of patents		(60,680)		(29,116)
(Increase) Decrease in acquisition of equipment		(586,127)		(37,160)
Cash provided by (used in) investing activities		(644,826)		(33,195)
Financing activities				
Proceeds from issuance of common stock		3,164,481		15,285
Cash provided by financing activities		3,164,481		15,285
Effect of exchange rate changes on cash		142,990		(22,152)
Inflow (outflow) of cash		2,905,096		(22,523)
Cash and cash equivalents, beginning		450,759		473,282
Cash and cash equivalents, ending	$	3,355,854	$	450,759
Supplemental disclosure of cash flow information:				
Registration rights penalty	$	-	$	(326,710)
Interest paid		10,605		3,136
Non Cash Investing Activities:				
Mortgage assumed for acquisition of property	$	452,018	$	-

See Notes to Consolidated Financial Statements.

FLEXIBLE SOLUTIONS INTERNATIONAL, INC.
Consolidated Statements of Stockholders' Equity
For the Years Ended December 31, 2007 and 2006
(U.S. Dollars)

	Shares	Par Value	Capital in Excess of Par Value	Accumulated Earnings (Deficiency)	Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balance December 31, 2005	**12,981,316**	**$ 12,981**	**$ 11,422,218**	**$ (3,308,158)**	**$ 153,254**	**$ 8,280,295**
Translation adjustment	—	—	—	—	(22,495)	(22,495)
Net loss	—	—	—	(1,164,369)	—	(1,164,369)
Comprehensive income	—	—	—	—	—	(1,210,081)
Shares issued:						
Exercise of stock options	46,000	46	64,354	—	—	64,400
Issue of stock for services	31,111	31	74,306	—	—	74,337
Private placement	—	—	(49,046)	—	—	(49,046)
Stock option compensation	—	—	858,585	—	—	882,015
Balance December 31, 2006	**13,058,427**	**$ 13,058**	**$ 12,370,417**	**$ (4,472,527)**	**$ 131,002**	**$ 8,041,950**
Translation adjustment	—	—	—	—	263,288	263,288
Net loss	—	—	—	(923,227)	—	(923,227)
Comprehensive income	—	—	—	—	—	(659,939)
Shares issued:						
Exercise of stock options	163,000	163	288,837	—	—	289,000
Cancellation of stock	(100,000)	(100)	(270,900)	—	—	(271,000)
Private placement	936,140	936	2,874,546	—	—	2,875,482
Stock option compensation	—	—	651,405	—	—	651,405
Balance December 31, 2007	**14,057,567**	**$ 14,058**	**$ 15,914,303**	**$ (5,395,754)**	**$ 394,289**	**$ 10,926,895**

See Notes to Consolidated Financial Statements.

1. BASIS OF PRESENTATION.

These consolidated financial statements include the accounts of Flexible Solutions International, Inc. (the "Company"), and its wholly-owned subsidiaries Flexible Solutions, Ltd. ("Flexible Ltd."), NanoChem Solutions Inc., WaterSavr Global Solutions Inc., NanoDetect Technologies Inc. and Seahorse Systems Inc. All inter-company balances and transactions have been eliminated. The parent company was incorporated May 12, 1998 in the State of Nevada and had no operations until June 30, 1998 as described further below.

Flexible Solutions International, Inc. and its subsidiaries develops, manufactures and markets specialty chemicals which slow down the evaporation of water. The companies primary product, HEAT$AVR®, is marketed for use in swimming pools and spas where its use, by slowing the evaporation of water, allows the water to retain a higher temperature for a longer period of time and thereby reduces the energy required to maintain the desired temperature of the water in the pool. Another product, WATER$AVR®, is marketed for water conservation in irrigation canals, aquaculture, and reservoirs where its use slows down water loss due to evaporation. In addition to the water conservation products, the Company also manufacturers and markets water-soluble chemicals utilizing thermal polyaspartate biopolymers (hereinafter referred to as "TPAs"), which are beta-proteins manufactured from the common biological amino acid, L-aspartic. TPAs can be formulated to prevent corrosion and scaling in water piping within the petroleum, chemical, utility and mining industries. TPAs are also used as proteins to enhance fertilizers in improving crop yields and as additives for household laundry detergents, consumer care products and pesticides.

On June 30, 1998, the Company completed the acquisition of all of the shares of Flexible Ltd. The acquisition was effected through the issuance of 7,000,000 shares of common stock by the Company with former shareholders of the subsidiary receiving all of the total shares then issued and outstanding. The transaction has been accounted for as a reverse-takeover. Flexible Ltd. is accounted for as the acquiring party and the surviving entity. As Flexible Ltd. is the accounting survivor, the consolidated financial statements presented for all periods are those of Flexible Ltd. The shares issued by the Company pursuant to the 1998 acquisition have been accounted for as if those shares had been issued upon the organization of Flexible Ltd.

On May 2, 2002, the Company established WaterSavr Global Solutions Inc. through the issuance of 100 shares of common stock from WaterSavr Global Solutions Inc. to the Company.

On February 7, 2005, the Company established Nano Detect Technologies Inc. through the issuance of 1,000 shares of common stock from Nano Detect Technologies Inc. to the Company.

On June 21, 2005, the Company established Seahorse Systems Inc. through the issuance of 1,000 shares of common stock from Seahorse Systems Inc. to the Company.

Pursuant to a purchase agreement dated May 26, 2004, the Company acquired the assets of Donlar Corporation ("Donlar") on June 9, 2004 and created a new company, NanoChem Solutions Inc. as the operating entity for such assets. The purchase price of the transaction was $6,150,000 with consideration being a combination of cash and debt. Under the purchase agreement and as part of the consideration, the Company issued a promissory note bearing interest at 4% to Donlar's largest creditor to satisfy $3,150,000 of the purchase price. This note was due June 2, 2005 and upon payment, all former Donlar assets that were pledged as security were released from their mortgage. The remainder of the consideration given was cash.

(U.S. Dollars)

The following table summarizes the estimated fair value of the assets acquired at the date of acquisition (at June 9, 2004):

Current assets	$ 1,126,805
Property and equipment	5,023,195
	$ 6,150,000
Acquisition costs assigned to property and equipment	314,724
Total assets acquired	$ 6,464,724

There was no goodwill or other intangible assets accept certain patents recorded at nil fair value, acquired as a result of the acquisition. The acquisition costs assigned to property and equipment include all direct costs incurred by the Company to purchase the Donlar assets. These costs include due diligence fees paid to outside parties investigating and identifying the assets, legal costs directly attributable to the purchase of the assets, plus applicable transfer taxes. These costs have been assigned to the individual assets based on their proportional fair values and will be amortized based on the rates associated with the related assets.

2. SIGNIFICANT ACCOUNTING POLICIES.

These consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States applicable to a going concern and reflect the policies outlined below.

(a) *Cash and Cash Equivalents*.

The Company considers all highly liquid investments purchased with an original or remaining maturity of less than three months at the date of purchase to be cash equivalents. Cash and cash equivalents are maintained with several financial institutions.

(b) *Inventories and Cost of Sales*

The Company has four major classes of inventory: finished goods, works in progress, raw materials and supplies. In all classes, inventory is valued at the lower of cost and market. Cost is determined on a first-in, first-out basis. Cost of sales includes all expenditures incurred in bringing the goods to the point of sale. Inventorial costs and costs of sales include direct costs of the raw material, inbound freight charges, warehousing costs, handling costs (receiving and purchasing) and utilities and overhead expenses related to the Company's manufacturing and processing facilities.

In 2004, the FASB issued SFAS No. 151, "Inventory Costs", to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. This standard requires that such items be recognized as current-period charges. The standard also establishes the concept of "normal capacity" and requires the allocation of fixed production overhead to inventory based on the normal capacity of the production facilities. Any unallocated overhead must be recognized as an expense in the period incurred. This standard is effective for inventory costs incurred starting January 1, 2006. The adoption of this standard did not have a material impact on its financial position, results of operations or cash flows for 2006 or 2007.

(c) *Allowance for Doubtful Accounts*

The Company provides an allowance for doubtful accounts when management estimates collectibility to uncertain. Accounts receivable are continually reviewed to determine which, if any, accounts are doubtful of collection. In making the determination of the appropriate allowance amount, the Company considers current economic and industry conditions, relationships with each significant customer, overall customer credit-worthiness and historical experience.

(d) *Property, Equipment and Leaseholds*.

The following assets are recorded at cost and depreciated using the following methods using the following annual rates:

Computer hardware	30% Declining balance
Furniture and fixtures	20% Declining balance
Manufacturing equipment	20% Declining balance
Office equipment	20% Declining balance
Building	10% Declining balance
Leasehold improvements	Straight-line over lease term

Depreciation is recorded at half for the year the assets are first purchase. Property and equipment are written down to net realizable value when management determines there has been a change in circumstances which indicates its carrying amount may not be recoverable. No write-downs have been necessary to date.

(e) *Impairment of Long-Lived Assets*.

In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", the Company reviews long-lived assets, including, but not limited to, property and equipment, patents and other assets, for impairment annually or whenever events or changes in circumstances indicate the carrying amounts of assets may not be recoverable. The carrying value of long-lived assets is assessed for impairment by evaluating operating performance and future undiscounted cash flows of the underlying assets. If the sum of the expected future cash flows of an asset, is less than its carrying value, an impairment measurement is indicated. Impairment charges are recorded to the extent that an asset's carrying value exceeds its fair value. Accordingly, actual results could vary significantly from such estimates. There were no impairment charges during the periods presented.

(f) *Investments.*

Investment in corporations subject to significant influence and investments in partnerships are recorded using the equity method of accounting. On this basis, the Company's share of income and losses of the corporations and partnerships is included in earnings and the Company's investment therein adjusted by a like amount. Dividends received from these entities reduce the investment accounts. Portfolio investments not subject to significant influence are recorded using the cost method.

The fair value of a cost method investment is not estimated if there are no identified events or changes in circumstances that may have a significant adverse effect on the fair value of the investment.

The Company currently does not have any investments that require use of the equity method of accounting.

(g) *Foreign Currency*.

The functional currency of one of the subsidiaries is the Canadian Dollar. The translation of the Canadian Dollar to the reporting currency of the U.S. Dollar is performed for assets and liabilities using exchange rates in effect at the balance sheet date. Revenue and expense transactions are translated using average exchange rates prevailing during the year. Translation adjustments arising on conversion of the financial statements from the Company's functional currency, Canadian Dollars, into the reporting currency, U.S. Dollars, are excluded from the determination of loss and are disclosed as other comprehensive income (loss) in stockholders' equity.

Foreign exchange gains and losses relating to transactions not denominated in the applicable local currency are included in the operating loss if realized during the year and in comprehensive income if they remain unrealized at the end of the year.

(h) *Revenue Recognition*.

Revenue from product sales is recognized at the time the product is shipped since title and risk of loss is transferred to the purchaser upon delivery to the carrier. Shipments are made F.O.B. shipping point. The Company recognizes revenue when there is persuasive evidence of an arrangement, delivery has occurred, the fee is fixed or determinable, collectibility is reasonably assured and there are no significant remaining performance obligations. When significant post-delivery obligations exist, revenue is deferred until such obligations are fulfilled. To date there have been no such significant post-delivery obligations.

Provisions are made at the time the related revenue is recognized for estimated product returns. Since the Company's inception, product returns have been insignificant; therefore no provision has been established for estimated product returns.

(i) *Stock Issued in Exchange for Services*.

The valuation of the Company's common stock issued in exchange for services is valued at an estimated fair market value as determined by officers and directors of the Company based upon trading prices of the Company's common stock on the dates of the stock transactions. The corresponding expense of the services rendered are recognized over the period that the services are performed.

(j) *Stock-based Compensation*.

In December 2004, the Financial Accounting Standards Board ("FASB") issued revised SFAS No. 123(R), *Share-Based Payment*, which replaces SFAS No. 123, "*Accounting for Stock-Based Compensation*", which superseded APB Opinion No. 25, "*Accounting for Stock Issued to Employees*". FAS No. 123(R) requires the cost of all share-based payment transactions to be recognized in an entity's financial statements, establishes fair value as the measurement objective and requires entities to apply a fair-value-based measurement method in accounting for share-based payment transactions. SFAS No. 123(R) applies to all awards granted, modified, repurchased or cancelled after July 1, 2005, and unvested portions of previously issued and outstanding awards. The Company adopted this statement for its first quarter starting January 1, 2006 and will continue to evaluate the impact of adopting this statement.

Prior to 2006, the Company adopted the disclosure provisions of SFAS No. 123 for stock options granted to employees and directors. The Company disclosed on a supplemental basis, the pro-forma effect of accounting for stock options awarded to employees and directors, as if the fair value based method had been applied, using the Black-Scholes option-pricing model. The Company has always recognized the fair value of options granted to consultants.

(k) *Comprehensive Income*.

Other comprehensive income refers to revenues, expenses, gains and losses that under generally accepted accounting principles are included in comprehensive income, but are excluded from net income as these amounts are recorded directly as an adjustment to stockholders' equity. The Company's other comprehensive income is primarily comprised of unrealized foreign exchange gains and losses.

(l) *Loss Per Share*.

Basic loss per share data is computed by dividing the net loss applicable to common stock by the weighted average number of common shares outstanding during the year. Diluted earnings per share, which includes the dilutive effect of the exercise of options and warrants has not been presented because, due to the net losses recorded by the Company for all periods presented, their inclusion would be anti-dilutive.

(m) *Use of Estimates*.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Significant areas requiring the use of management estimates relate to the determination of allowance for doubtful accounts, assumptions used in determining stock-based compensation, future income tax valuation allowances, impairment of long lived assets, and rates for amortization of property, plant and equipment. Actual results could differ from those estimates and would impact the results of operations and cash flows.

(n) *Financial Instruments*.

The fair market value of the Company's financial instruments comprising cash, accounts receivable, accounts payable and accrued liabilities were estimated to approximate their carrying values due to immediate or short-term maturity of these financial instruments. The Company maintains cash balances at financial institutions which at times, exceed federally insured amounts. The Company has not experienced any material losses in such accounts.

The Company is exposed to foreign exchange and interest rate risk to the extent that market value rate fluctuations materially differ from financial assets and liabilities, subject to fixed long-term rates.

The Company is exposed to credit-related losses in the event of non-performance by counterparties to the financial instruments. Credit exposure is minimized by dealing with only credit worthy counterparties. Accounts receivable for the three primary customers totals $630,296 (60%) as at December 31, 2007 (2006 - $483,682 or 37%).

(o) *Contingencies*

Certain conditions may exist as of the date the financial statements are issued, which may result in a loss to the Company but which will only be resolved when one or more future events occur or fail to occur. The Company's management and its legal counsel assess such contingent liabilities, and such assessment inherently involves an exercise of judgment. In assessing loss contingencies related to legal proceedings that are pending against the Company or unasserted claims that may result in such proceedings, the Company's legal counsel evaluates the perceived merits of any legal proceedings or unasserted claims as well as the perceived merits of the amount of relief sought or expected to be sought therein.

If the assessment of a contingency indicates that it is probable that a material loss has been incurred and the amount of the liability can be estimated, the estimated liability would be accrued in the Company's financial statements. If the assessment indicates that a potentially material loss contingency is not probable but is reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss if determinable and material, would be disclosed.

Loss contingencies considered remote are generally not disclosed unless they involve guarantees, in which case the guarantees would be disclosed.

(p) *Income Taxes*

Potential benefits of income tax losses are not recognized in the accounts until realization is more likely than not. The Company has adopted SFAS No. 109 as of its inception. Pursuant to SFAS No. 109 the Company is required to compute tax asset benefits for net operating losses carried forward. Potential benefits of net operating losses have not been recognized in these financial statements because the Company cannot be assured that it is more likely than not that it will utilize the net operating losses carried forward in future years; and accordingly is offset by a valuation allowance

(q) *Recent Accounting Pronouncements*

Fair value measurement

In September 2006, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 157, "Fair Value Measurement" ("SFAS 157"). The Statement provides guidance for using fair value to measure assets and liabilities. The Statement also expands disclosures about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurement on earnings. This Statement applies under other accounting pronouncements that require or permit fair value measurements. This Statement does not expand the use of fair value measurements in any new circumstances. Under this Statement, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the entity transacts. SFAS 157 is effective for the Company for fair value measurements and disclosures made by the Company in its fiscal year beginning on January 1, 2008. The Company is currently reviewing the impact of this statement.

Employers accounting for defined benefit pension and other postretirement plans

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106 and 132(R)" (SFAS 158"). SFAS 158 requires an employer that sponsors one or more single-employer defined benefit plans to (a) recognize the overfunded or underfunded status of a benefit plan in its statement of financial position, (b) recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to SFAS 87, "Employers' Accounting for Pensions", or SFAS 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions", (c) measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end, and (d) disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. SFAS 158 is effective for the Company's fiscal year ending December 31, 2007. The adoption of SFAS No. 158 is not expected to have a material impact on the Company's financial position, results of operations or cash flows.

Accounting for servicing of financial assets

In March 2006, the FASB issued SFAS No. 156, "*Accounting for Servicing of Financial Assets*", which amends SFAS No. 140 "*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*". SFAS No. 156 may be adopted as early as 1 January 2006, for calendar year-end entities, provided that no interim financial statements have been issued. Those not choosing to early adopt are required to apply the provisions as of the beginning of the first fiscal year that begins after 15 September 2006 (e.g. 1 January 2007, for calendar year-end entities). The intention of the new statement is to simplify accounting for separately recognized servicing assets and liabilities, such as those common with mortgage securitization activities, as well as to simplify efforts to obtain hedge-like accounting.

Specifically, the FASB said SFAS No. 156 permits a service using derivative financial instruments to report both the derivative financial instrument and related servicing asset or liability by using a consistent measurement attribute, or fair value. The adoption of SFAS No. 156 is not expected to have a material impact on the Company's financial position, results of operations or cash flows.

Accounting for certain hybrid instruments

In February 2006, the FASB issued SFAS No. 155, "*Accounting for Certain Hybrid Financial Instruments*", which amends SFAS No. 133, "*Accounting for Derivative Instruments and Hedging Activities*" and SFAS No. 140. SFAS No. 155 permits fair value measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or hybrid financial instruments containing embedded derivatives. The adoption of SFAS No. 155 is not expected to have a material impact on the Company's financial position, results of operations or cash flows.

The Fair Value Option for Financial Assets

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115." SFAS No. 159 permits entities to measure eligible assets and liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently investigating the impact of this pronouncement and has not yet determined the impact on the consolidated financial statements.

(U.S. Dollars)

Business Combinations

In December 2007, the FASB issued Statement No. 141(Revised 2007), "Business Combinations" (SFAS No. 141(R)). SFAS No. 141(R) requires an acquiring entity to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS No. 141(R) also changes the accounting treatment for certain specific items. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the first annual reporting period beginning on or after December 15, 2008. The Company is currently investigating the impact of this pronouncement and has not yet determined the impact on the consolidated financial statements.

Noncontrolling Interests in Consolidated Financial Statements

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements – An Amendment of ARB No. 51." SFAS No. 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This statement requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. SFAS No. 160 is effective for fiscal years and interim periods within those fiscal years beginning on or after December 15, 2008. The Company does not expect adoption of this pronouncement to have a material impact on the consolidated financial statements.

Accounting for Collaborative Arrangements Related to the Development and Commercialization of Intellectual Property

In December 2007, the FASB ratified the consensus reached on EITF 07-1, "Accounting for Collaborative Arrangements Related to the Development and Commercialization of Intellectual Property." EITF 07-1 defines collaborative arrangements and establishes reporting requirements for transactions between participants in a collaborative arrangement and between participants in the arrangement and third parties. EITF 07-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. The Company does not expect adoption of this pronouncement to have a material impact on the consolidated financial statements

3. ACCOUNTS RECEIVABLE

	2007	2006
Accounts receivable	$1,052,316	$ 1,344,155
Allowance for doubtful accounts	(1,260)	(24,580)
	$ 1,051,056	$ 1,319,575

(U.S. Dollars)

4. INVENTORIES

	2007	2006
Completed goods	$ 1,664,777	$ 970,780
Works in progress	198,172	397,995
Raw materials	498,321	535,540
	$ 2,361,270	$ 1,904,315

5. PROPERTY, PLANT AND EQUIPMENT

	2007 Cost	Accumulated Depreciation	2007 Net
Buildings	$4,011,826	$ 970,854	$ 3,040,972
Computer hardware	75,458	48,284	27,174
Furniture and fixtures	21,788	12,154	9,634
Office equipment	32,905	22,035	10,870
Manufacturing equipment	2,313,363	1,280,943	1,032,420
Trailer	3,854	1,863	1,990
Leasehold improvements	46,304	36,480	9,825
Trade show booth	8,766	6,212	2,554
Land	477,133	—	477,133
	$6,991,397	$ 2,378,829	$ 4,612,571

	2006 Cost	Accumulated Depreciation	2006 Net
Buildings	$3,144,259	$ 724,752	$ 2,419,507
Computer hardware	60,576	34,200	26,376
Furniture and fixtures	18,576	8,608	9,968
Office equipment	29,533	17,488	12,045
Manufacturing equipment	2,207,781	990,959	1,216,822
Trailer	1,991	1,411	580
Leasehold improvements	39,517	25,551	13,966
Trade show booth	7,456	4,353	3,103
Land	398,186	—	398,186
	$5,907,875	$ 1,807,322	$ 4,100,553

(U.S. Dollars)

6. PATENTS

In fiscal 2005, the Company started the patent process for additional WATER$AVR® products. Patents associated with these costs were granted in 2006 and they have been amortized over their legal life of 17 years.

	2007 Cost	Accumulated Amortization	2007 Net
Patents	$ 243,853	$ 13,415	230,438

	2006 Cost	Accumulated Amortization	2006 Net
Patents	$ 172,938	$ 3,180	169,758

7. INVESTMENTS.

	2007	2006
Tatko Inc.	$ -	$ 271,000
Air-Water Interface Delivery and Detection Inc.	-	98,000
	$ -	$369,000

On May 31, 2003, the Company acquired an option to purchase a 20% interest in the outstanding shares of Tatko Inc. ("Tatko") for consideration of the issuance of 100,000 shares of the Company's common stock. The option to purchase the shares of Tatko expires on May 31, 2008. The cost of the investment has been accounted for based on the fair market value of the Company's common stock on May 31, 2003. For further information on this option, see Contingencies (Note 16) below.

In 2005, NanoDetect purchased 32.7 shares of equity in Air Water Interface Delivery and Detection Inc. ("AWD") for a total cost of $98,000. This investment represents only 3.3% of the issued and outstanding shares of AWD and, accordingly, will be accounted for under the cost method. While the technology to be developed by AWD still has enormous potential and may be commerialized in the future, management consideres that those events are sufficiently far in the future and not certain enough to maintain the investment in the venture at the invested cost. Therefore, the investment in AWD will be written down to zero.

8. LONG TERM DEPOSITS

The Company has reclassified certain security deposits to better reflect there long term nature. Long term deposits consist of damage deposits held by landlords and security deposits held by various vendors.

	2007	2006
Long term deposits	$ 48,034	$ 47,220

(U.S. Dollars)

9. COMPREHENSIVE INCOME

	2007	2006
Net loss	$ (923,227)	$ (1,164,369)
Other comprehensive income	263,287	(22,495)
Comprehensive income	$ (659,940)	$ (1,186,864)
Basic and diluted comprehensive loss per share	(0.05)	(0.09)

10. INCOME TAX

The income tax expense (recovery) is compromised of the following:

	2007	2006
Current tax, domestic	-	-
Current tax, foreign	-	$ (127,079)
Current tax, total	-	$ (127.079)

Income taxes vary from the amount that would be computed by applying the estimated combined statutory income tax rate (35%) for the following reasons:

	2007	2006
Income before taxes, domestic	$ (49,668)	$ (427,661)
Income before taxes, foreign	(873,559)	(863,787)
Income before taxes, total	$ (923,227)	$ (1,291,448)
Expense (recovery) for income taxes at statutory rate (35%)	$ (323,129)	$ (452,007)
Permanent difference – stock based compensation	227,992	326,523
Depreciation	112,200	104,543
Miscellaneous	37,492	-
Tax refund from application of losses to prior periods	-	(127,079)
Application of losses from prior periods	(198,858)	(139,308)
Losses carried forward	144,287	160,249
Income tax expense (recovery)	$ -	$ (127,079)

(U.S. Dollars)

Deferred income taxes reflect the 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. The Company's deferred tax liability calculated at a 35% tax rate consists of the following:

	2007	2006
Non-capital loss carry forwards	$ 1,245,397	$ 950,037
Book over tax value of property and equipment	404,850	220,502
Valuation allowance	(1,650,248)	(1,170,539)
Net deferred tax asset (liability)	-	-

The Company's carried losses for income tax purposes are $3,486,657 (2006 - $2,714,390), which may be carried forward to apply against future income tax, expiring between 2013 and 2026. The future tax benefit of these loss carry-forwards has been offset with a full valuation allowance. These losses expire as follows:

2013	$ 107,685
2014	451,507
2016	926,433
2017	412,249
2022	125,722
2023	256,119
2024	813,503
2025	195,485
2027	135,146

11. LOSS PER SHARE.

	Net loss	Shares (denominator)	Per share amount
2007 Basic net loss	$ (923,227)	13,823,654	$ (0.07)
2006 Basic net loss	$ (1,164,369)	12,994,430	$ (0.09)

Options to purchase 1,912,440 shares of the Company's common stock at prices ranging from $3.00 to $4.60 per share were outstanding during the year ended December 31, 2007 (2006: options to purchase 2,126,410 shares of the Company's common stock at prices ranging from $1.40 to $4.60 per share), but were excluded from the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of the Company's common stock and were anti-dilutive. There were no preferred shares issued and outstanding for the years ended December 31, 2007 or 2006.

12. STOCK OPTIONS.

(U.S. Dollars)

The Company adopted a stock option plan ("Plan"). The purpose of this Plan is to provide additional incentives to key employees, officers, directors and consultants of the Company and its subsidiaries in order to help attract and retain the best available personnel for positions of responsibility and otherwise promoting the success of the business activities. It is intended that options issued under this Plan constitute non-qualified stock options. The general terms of awards under the option plan are that 100% of the options granted will vest the year following the grant. The maximum term of options granted is 5 years.

The Company may issue stock options and stock bonuses for shares of its common stock to provide incentives to directors, key employees and other persons who contribute to the success of the Company. The exercise price of all incentive options are issued for not less than fair market value at the date of grant.

The following table summarizes the Company's stock option activity for the years ended December 31, 2007 and 2006:

	Number of shares	Exercise price per share	Weighted average exercise price
Balance, December 31, 2005	1,060,740	$1.40 - $4.60	$3.44
Granted	1,191,000	$3.25 - $3.60	$3.25
Exercised	(46,000)	$1.40	$1.40
Cancelled or expired	(79,000)	$1.40 - $4.25	$2.46
Balance, December 31, 2006	2,126,740	$1.40 - $4.60	$3.44
Granted	235,700	$1.50 - $3.60	$2.35
Exercised	(163,000)	$1.50 - $3.25	$1.77
Cancelled or expired	(287,000)	$3.00 - $4.40	$3.93
Balance, December 31, 2007	1,912,440	$3.00 – 4.60	$3.38

In December 2004, the Financial Accounting Standards Board ("FASB") issued revised FAS No. 123(R), *Share-Based Payment*, which replaces FAS No. 123, *Accounting for Stock-Based Compensation*, which superseded APB Opinion No. 25, *Accounting for Stock Issued to Employees*. FAS No. 123(R) requires the cost of all share-based payment transactions to be recognized in an entity's financial statements, establishes fair value as the measurement objective and requires entities to apply a fair-value-based measurement method in accounting for share-based payment transactions. FAS No. 123(R) applies to all awards granted, modified, repurchased or cancelled after July 1, 2005, and unvested portions of previously issued and outstanding awards. The Company adopted this statement for its first quarter starting January 1, 2006 and will continue to evaluate the impact of adopting this statement.

The fair value of each option grant is calculated using the following weighted average assumptions:

	2007	2006
Expected life – years	1.0 - 5.0	5.0
Interest rate	4.18 – 5.18%	4.50%
Volatility	86.0 – 115.0%	52.0%
Dividend yield	—%	—%

Weighted average fair value of options granted	$ 1.37 - 2.67	$ 1.49

During the year ended December 31, 2007, the Company granted 200,700 (2006 – 410,000) stock options to consultants and has applied FAS No. 123 using the Black-Scholes option-pricing model, which resulted in additional expenses of $129,882 (2006 - $362,005). During the year ended December 31, 2007, employees were granted 35,000 (2006 – 781,000) stock options, which resulted in additional expenses of $20,069 (2006 – 496,580).

13. WARRANTS

On April 14, 2005, the Company announced that it had raised $3,375,000 pursuant to a private placement of up to 1,800,000 shares of its common stock. The investors collectively purchased 900,000 shares of the Company's common stock at a per share purchase price of $3.75, together with warrants to purchase up to 900,000 additional shares of the Company's common stock. The warrants have a four-year term and are immediately exercisable at a price of $4.50 per share.

On June 8, 2005, the Company announced that it had raised an additional $327,750 pursuant to a private placement of up to 174,800 shares of its common stock. An investor purchased 87,400 shares of the Company's common stock at a per share price of $3.75, together with a warrant to purchase up to 87,400 additional shares of the Company's common stock. The warrant has a four-year term and is immediately exercisable at a price of $4.50 per share.

In May 2007 the Company closed a $3,042,455 private placement with select institutional investors. The terms are 936,140 units with each unit consisting of one share at $3.25 and one half warrant with a three year term and a strike price of $4.50 per share for total of 468,070 warrants. The Company also issued 16,154 warrants with the same terms for investment banking services related to this transaction.

The following table summarizes the Company's warrant option activity for the year ended December 31, 2007 (no prior or subsequent activity):

	Number of shares	Exercise price per share	Weighted average exercise price
Balance, December 31, 2005	987,400	$4.50	$4.50
Granted	—	—	—
Exercised	—	—	—
Cancelled	—	—	—
Balance, December 31, 2006	987,400	$4.50	$4.50
Granted	484,244	$4.50	$4.50
Exercised	—	—	—
Cancelled	—	—	—
Balance, December 31, 2007	1,471,644	$4.50	$4.50

14. CAPITAL STOCK.

The $326,710 registration rights penalty recorded in the quarter ended September 30, 2006 is a one time occurrence that management believes should have been recorded directly against the corresponding capital, which was raised in 2005. However, at the date of issuance of the capital, it was deemed to be very unlikely that any obligation would arise and as such, we were not able to make a reasonable estimate of a potential liability. Given these circumstances, GAAP measures require we record the payment as an other item on our income statement. All contractual obligations related to the equity raised in 2005 are now complete and no more amounts will become due.

(U.S. Dollars)

During the year ended December 31, 2006 the Company issued 46,000 shares of common stock at $1.40 per share upon exercise of stock options.

During the year ended December 31, 2006 the Company issued 31,111 shares of common stock for services, recognizing an expense of $74,337.

During the year ended December 31, 2007 the Company issued 163,000 shares of common stock upon the exercise of stock options. The strike price varied from $1.50 – 3.25 per share.

In May 2007 the Company closed a $3,042,455 private placement with select institutional investors. The terms are 936,140 units with each unit consisting of one share at $3.25 and one half warrant with a three year term and a strike price of $4.50 per share. The proceeds will be used to build a biomass conversion facility that will use renewable agriculture crops to produce aspartic acid.

15. MORTGAGE

Pursuant to the acquisition of the plant and property in Taber, Alberta, the Company agreed to assume a mortgage of $651,298 ($645,167 CAD) to the vendor to satisfy the balance of the purchase price. The debt bears no interest, is secured by a first charge over the plant and property acquired, and is repayable by November 2012.

The debt has been discounted for financial reporting purposes to its fair value. The rate used to discount the debt to its fair value was 7% which was based on the cost of borrowing of similar companies for the same purpose

Repayments of mortgage principal over the next five years are as follows:

2008	$ -
2009	-
2010	-
2011	-
2012	651,298

16. SEGMENTED, SIGNIFICANT CUSTOMER INFORMATION AND ECONOMIC DEPENDENCY.

The Company operates in two segments:

(a) Development and marketing of two lines of energy and water conservation products (as shown under the column heading “EWCP” below), which consists of a (i) liquid swimming pool blanket which saves energy and water by inhibiting evaporation from the pool surface, and (ii) food-safe powdered form of the active ingredient within the liquid blanket and which is designed to be used in still or slow moving drinking water sources.

(U.S. Dollars)

(b) Manufacture of biodegradable polymers and chemical additives used within the petroleum, chemical, utility and mining industries to prevent corrosion and scaling in water piping (as shown under the column heading "BPCA" below). These chemical additives are also manufactured for use in laundry and dish detergents, as well as in products to reduce levels of insecticides, herbicides and fungicides.

The Company's traditional operating activities related to the production and sale of its energy conversation product line. Upon acquiring the Donlar assets, the Company formed NanoChem, which was formed as its wholly-owned subsidiary in exchange for the capital contribution necessary to purchase the Donlar assets. The assets the Company acquired from Donlar include domestic and international patents and business processes relating to the production of TPAs and other environmental products and technologies, as well as a manufacturing plant. These assets are currently used by NanoChem for its revenue-producing activities.

The accounting policies of the segments are the same as those described in Note 2 to the Company's consolidated financial statements, *Significant Accounting Policies*. The Company evaluates performance based on profit or loss from operations before income taxes, not including nonrecurring gains and losses and foreign exchange gains and losses.

The Company's reportable segments are strategic business units that offer different, but synergistic products and services. They are managed separately because each business requires different technology and marketing strategies.

	EWCP	BPCA	Total
Revenue	$ 1,217,365	$ 6,214,425	$ 7,431,791
Interest revenue	3,142	907	4,049
Interest expense	7,412	3,193	10,605
Depreciation and amortization	62,832	463,295	526,127
Segment profit (loss)	(1,868,458)	945,231	(923,227)
Segment assets	1,340,812	3,271,759	4,612,571
Expenditures for segment assets	1,004,938	33,204	1,038,142

The sales generated in the United States and Canada are as follows:

	2007	2006
Canada	$ 934,757	$ 202,763
United States and abroad	6,497,034	8,171,399
Total	$ 7,431,791	$ 8,374,162

The Company's long-lived assets are located in Canada and the United States as follows:

	2007	2006
Canada	$ 1,331,166	$ 364,487
United States	3,511,843	3,905,824
Total	$ 4,843,009	$ 4,270,311

Two customers account for $3,544,123 (48%) of sales made in the year (2006 - $4,727,042).

(U.S. Dollars)

17. COMMITMENTS.

We are committed to minimum rental payments for property and premises aggregating approximately $355,022 over the term of three leases, the last expiring on December 31, 2011.

Commitments in each of the next five years are approximately as follows:

2008	186,906
2009	134,192
2010	16,962
2011	16,962

18. CONTINGENCIES.

On May 1, 2003, the Company filed a lawsuit in the Supreme Court of British Columbia, Canada, against John Wells and Equity Trust, S.A. seeking the return of 100,000 shares of the Company's common stock and the repayment of a $25,000 loan, which were provided to defendants for investment banking services consisting of securing a $5 million loan and a $25 million stock offering. Such services were not performed and in the proceeding the Company seeks return of such shares after defendant's failure to both return the shares voluntarily and repay the note. On May 7, 2003, the Company obtained an injunction freezing the transfer of the shares. On May 24, 2004, there was a hearing on defendant's motion to set aside the injunction, which motion was denied by the trial court on May 29, 2004. On the date of issuance, the share transaction was recorded as shares issued for services at fair market value, a value of $0.80 per share. No amounts have been recorded as receivable in the Company's consolidated financial statements as the outcome of this claim is not determinable.

As of January 3, 2007 all litigation between FSI and Patrick Grant has been settled. As part of the settlement FSI permited Mr. Grant to exercise an option to purchase 100,000 shares of FSI's common stock at a price of $1.50 per share and to exercise a second option to purchase 50,000 shares of FSI's common stock at a price of $2.00 per share. FSI also forgave a loan to Mr. Grant and related parties in the amount of approximately $46,177. This amount has been recorded as a bad debt expense in 2006. FSI, its subsidiaries and officers face no further liability in regard to the Grant lawsuit.

On July 23, 2004, we filed a lawsuit in the Circuit Court of Cook County, Illinois against Tatko Biotech Inc. ("Tatko"). The action arose from our Joint Product Development Agreement with Tatko in which we agreed to invest $10,000 toward the product development venture and granted to Tatko 100,000 shares of our restricted common stock. In return, Tatko granted us a five-year option to purchase 20% of Tatko's outstanding capital stock. Tatko refused to collaborate on the agreement and, therefore, we filed the lawsuit to have the court declare that Tatko is not entitled to the 100,000 shares of our restricted common stock. On January 4, 2008, the lawsuit was dismissed pursuant to an agreement by Tatko to treat the Joint Product Development Agreement as void. As a result of the dismissal of the lawsuit and the agreement of the parties, the 100,000 shares of restricted stock will be returned or cancelled.

19. SUBSEQUENT EVENTS.

Subsequent to the year ended December 31, 2007:

The Company obtained a loan for $1 million Canadian at zero percent of interest from an unrelated third party. The repayment term of the loan is 5 years beginning in 2012.

The Company has approved to grant incentive options for total of 83,000 shares to various employees with a strike price of $3.60 and vesting on December 31st, 2008. The estimated value of the options granted is $11,832.

20. COMPARATIVE FIGURES.

Certain of the comparative figures have been reclassified to conform with the current year's presentation.