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# 2005

## HIGHPOINTS

### JANUARY

An additional strategic advantage for business development and for the commercial launch of the 125L Ozone Sterilizer in the United States:

*Michael Ward, a professional with an extensive background in sales who has been very successful in the field of sterilization, joins our team as Sales Director – U.S. market.*

### APRIL

British government subsidizes testing on the capacity of the 125L Ozone Sterilizer from TSO<sub>3</sub> to inactivate prions:

*The Health Protection Agency (HPA) in the United Kingdom is testing the 125L Ozone Sterilizer for the inactivation of the prion, an infectious protein responsible for Creutzfeldt-Jakob disease. The project will extend over a period of about three years.*

### MAY

Dr. Paul S. Malchesky, a renowned researcher, puts his expertise to work for the TSO<sub>3</sub> Scientific Committee:

*Specialized notably in the development of innovative technologies, Dr. Malchesky was formerly Vice President, Research and Development, Scientific Services and Investigational Studies, at STERIS Corporation – the biggest sterilization company in North America.*

Added value for the promotion of the 125L Ozone Sterilizer thanks to the compatibility endorsements from two leading American manufacturers:

*The Richard Wolf Company, the leader in the development and production of high quality optics, and Volk Optical, a recognized leader in aspheric optics, support and suggest the ozone sterilization of their products.*

### JULY

Securing of TSO<sub>3</sub> financial position with the closing of a \$10 million private placement:

*Made through a syndicate of underwriters, this financing is a sign of the interest and confidence in TSO<sub>3</sub> by the investment community and secures the financial position of the Company.*

The field of utilization for the 125L Ozone Sterilizer broadens:

*TSO<sub>3</sub> extends its product claim by increasing its capacity to sterilize a greater variety of instruments that include instruments for micro-invasive surgery.*

### OCTOBER

First sale of the 125L Ozone Sterilizer is full of promise:

*Responding to a request for a quotation, TSO<sub>3</sub> completes the first firm sale with a North American hospital after the sterilizer was submitted to a rigorous evaluation process. During this evaluation, the 125L had to meet several performance criteria and compared favourably to the competition.*

### DECEMBER

The sales team is reinforced with four new experienced resources:

*The opening of four new positions for regional sales managers supports the commercialization efforts for the 125L Ozone Sterilizer.*

Positive reports on the 125L Ozone Sterilizer from two U.S. referral sites:

*"Economical," "Simple," "Reliable" and "Safe for hospitals" are among the conclusions in the written reports from users and managers in hospital settings.*

# PROFILE

Founded in 1998, TSO<sub>3</sub> has made its mission the development and commercialization of innovative and comprehensive solutions for sterilization.

The Company has developed a unique sterilization process that uses ozone as the sterilizing agent. Efficacious, fast, economical and environment friendly, this process is safe for both the users and the patients, and responds perfectly to the new needs in sterilization.

The first product resulting from this technological platform is the *125L Ozone Sterilizer* (named for its 125-litre/4-cubic-foot capacity), a large-capacity sterilizer developed for general usage and designed for all hospital settings. This reliable and easy-to-use device allows the efficacious sterilization of surgical and diagnostic instruments sensitive to heat and moisture.

The *125L Ozone Sterilizer* is cleared for commercialization by Health Canada and by the UNITED STATES Food and Drug Administration (FDA).

TSO<sub>3</sub> currently has 54 employees, including 16 on the sales and marketing team. TSO<sub>3</sub> became a publicly owned company on August 30, 2001, with an Initial Public Offering of \$5 million. An additional \$35 million was raised through subsequent rounds of financing. Shares are now traded on the Toronto TSX under the symbol TOS.

# MESSAGE FROM THE MANAGEMENT

## A STIMULATING BANNER YEAR



GERMAIN CARRIÈRE  
Chairman of the Board of Directors

JOCELYN VÉZINA  
President and Chief Executive Officer

**IN 2005**  
THE EFFORTS OF THE PAST YEARS WERE CONSOLIDATED, IN ORDER TO PUT IN PLACE ALL THE ELEMENTS NECESSARY FOR THE COMMERCIALIZATION OF OUR FIRST PRODUCT: THE 125L OZONE STERILIZER.

The very first sales of the ozone sterilizers, initially foreseen for the second quarter of 2005, were realized at the end of the year and in January 2006. The introduction of a new sterilization process in hospitals is a complex sales process. The acquisition cycle for a capitalized device in the healthcare sector is at least six to 12 months. That is the minimal cycle that we can expect for a brand-new technology.

Several of the first users are in their acquisition process, having evaluated our device and seen its effectiveness for themselves. That is why, throughout the year 2005, we worked with them in their adaptation to this new technology.

In terms of financing, compatibility and the organizing of the sales team, TSO<sub>3</sub> received much support and made great progress, including, notably, the first firm sale of a 125L Ozone Sterilizer to a North American hospital. This success is very motivating as we have been impatiently waiting for the moment.

## SEVERAL EXPRESSIONS OF CONFIDENCE AND POSITIVE REPORTS

More good news came with the closing of the \$10 million private placement, financing that was accomplished under excellent conditions for the shareholders and secures our financial underpinnings.

This latest fiscal year was also positive in terms of the endorsements and comments received from certain referral sites. TSO<sub>3</sub> obtained compatibility endorsements for the 125L Ozone Sterilizer from two leading manufacturers in the field of medical instrumentation, and from three more manufacturers early in 2006.

In addition, two U.S. referral sites have sent us extremely positive reports that confirm our 125L Ozone Sterilizer is economical, easy to use and safe for the patients, the users and the environment.

## THE RANGE OF USES KEEPS GROWING

The continued efforts aimed at increasing the number of instruments on our compatibility list were also rewarded with the addition of numerous lumened surgical instruments, thereby confirming the superior capacity of ozone to penetrate the very narrow internal channels of these instruments. The inclusion of these such micro-invasive surgical instruments lengthens considerably the list of instruments compatible with our process and sets us apart even more from our competition, which, we believe, will attract and convince future buyers of our product.

## AN EXPERIENCED SALES TEAM

As for our team, TSO<sub>3</sub> has focused mainly on reinforcing the sales sector. In addition to hiring an experienced sales director, we have since filled five new positions as regional sales managers in the United States. Their experience represents a major advantage for the commercial launch of the 125L Ozone Sterilizer.

The visibility that our distributor offered us allowed us to develop a list of prospective customers. However, we realized during 2005 that our distributor was not going to reach the sales objectives we had set. To remedy this situation, we decided to utilize our own sales force to commercialize our products. With a team of eight professionals, we decided, along with our distributor, to rework the agreement so we would take the leadership in sales starting in 2006.

## A PROMISING FUTURE

We are extremely encouraged by all of our accomplishments in 2005 and we foresee a very promising future for TSO<sub>3</sub>. Our team is working unceasingly to meet each of the challenges we encounter while respecting the deep values that guide us – rigour, transparency and the determination to succeed. These values constitute our strength and represent a guarantee of quality offered to our future customers. We look forward to the next fiscal year with great enthusiasm.

## FINANCIAL RESULTS

For the fiscal year ended December 31, 2005, the Company posted a net loss of \$6.4 million or \$0.19 per share, compared to a net loss of \$5.9 million or also \$0.19 per share for the fiscal year 2004.

This slight increase in the net loss is explained by the intensification of the Company's commercial launch efforts, as well as by the increase of R&D expenses, mainly used for compatibility validation and other necessary activities to support the commercial launch.

# 120 MANUFACTURERS SUPPORT US

Through the cooperation of numerous players in the field of surgical instrumentation, we have obtained convincing results in terms of compatibility. In only a few months we were able to validate a huge number of instruments among the lines most used in surgery today. The number of manufacturers and suppliers of raw materials participating in our Manufacturers Testing Program (MTP) doubled from 60 to 120 in 2005. The numbers are revealing – and very promising.

## **INSTRUMENT MANUFACTURERS: A GROWING COLLABORATION**

Thanks to the collaboration of numerous key players in the field of surgical instrumentation, we have obtained convincing results regarding compatibility.

In 2004, we delayed activities related to the commercialization of the sterilizer in order to pursue the research on compatibility, and we successfully met this challenge within the time allocated.

Although the compatibility research began when the Company was founded and we had always devoted every effort possible, a major boost was given to this research in 2005. We were able to validate a huge number of instruments among the lines most used in surgery today. The number of manufacturers and suppliers of raw materials participating in our Manufacturers Testing Program (MTP) doubled from 60 to 120 this year. The numbers are revealing – and very promising.

In fact, our MTP has multiple positive repercussions, because not only do the manufacturers provide us access to their instruments, they do not hesitate to give us their time, notably by sharing their expertise. One of the outcomes of this program is a collaboration that generates such a level of confidence in our sterilization process that several manufacturers are spontaneously showing their interest in offering us their endorsement.

In our area of activity, mainly when a new product is being launched in the market, endorsements are written and signed acknowledgements from manufacturers, who are clarifying their intention to promote the compatibility of their instruments with our sterilization process to our mutual customers.

### **TSO<sub>3</sub> OBTAINS CLEARANCE FOR NEW CLAIMS FROM HEALTH CANADA**

Instruments used in urology, cardiology, ophthalmology and various micro-invasive surgeries are among the instruments whose compatibility has been validated, and they represent only a part of what can currently be sterilized with ozone.

### **OUR COMPATIBILITY RATE IS SIMILAR TO, AND IN CERTAIN CASES EXCEEDS, THAT OF THE CLOSEST COMPETITOR.**

We must point out the supplementary trials successfully carried out in 2005 regarding the fine tubing that is part of the new instruments utilized in micro-invasive surgery. Further testing confirmed the superior capacity of ozone to penetrate in the long, thin tubes of these instruments, which allows the diversity and the volume of the instruments that can be sterilized with the 125L Ozone Sterilizer to be increased. These new claims were approved by Health Canada and a similar request has been filed for the United States.

This planned new usage is the broadest for any low-temperature gaseous sterilization process on the market, which allows us to get ahead of the competition by including in the list of instruments that can be sterilized with ozone, the high-demand surgical instruments with lumens that have smaller diameters and longer lengths.

This is particularly important for the ever-thinner instruments used in micro-invasive surgery as the number of these procedures being conducted continues to increase exponentially. In addition, new lumened devices are being developed for neurological and specialty procedures that will expand the market for the 125L Ozone Sterilizer even further. With the soaring market for such devices, this news is excellent for the future of TSO<sub>3</sub>.

### **THE MANUFACTURERS TESTING PROGRAM HAS LED TO COLLABORATION THAT GENERATES GREAT CONFIDENCE IN OUR STERILIZATION PROCESS. THAT MEANS THAT SEVERAL MANUFACTURERS ARE SHOWING INTEREST IN OFFERING THEIR ENDORSEMENT.**

## TECHNOLOGICAL SHOWCASES PROVIDE CONCLUSIVE RESULTS

Our commercialization strategy includes gaining recognition for our product in the market through agreements with North American hospitals that act as technological showcases for our new ozone sterilization process.

The [Canadian hospitals](#) that are acting as pilot sites have allowed us to test the device and related accessories in real-life operation situations. Through this, several improvements were made to our product before we crossed the border to the United States in early 2005. Among these pilot sites, several have begun the requisition process in order to purchase the device in 2006.

The American sites, called "[referral sites](#)," are trying out our sterilization process with the aim of reporting on its efficaciousness. The users and professionals working in these hospitals are in a position to see for themselves the numerous advantages of the 125L Ozone Sterilizer, including the lower costs.

**THE FIRST SATISFACTION REPORTS FROM TWO U.S. REFERRAL SITES IN DECEMBER 2005 SUPPORT OUR POSITION TO THE EFFECT THAT THE 125L IS A SAFE, SIMPLE AND ECONOMICAL DEVICE FOR HOSPITALS.**

A true trial program, this allows TSO<sub>3</sub> to directly obtain user reports, observations, comments and referrals that feed our customer sales approach. The first satisfaction reports submitted by two U.S. referral sites in December 2005 clearly indicate that the users are very satisfied and confirm that the 125L is safe, simple and economical for hospitals.

## POSITIVE REPORTS

One sterilization manager summarized the experience by saying, "The 125L is certainly simple to operate, with only one choice of cycle, and no need to purchase or handle chemical sterilants. For us, though, the simplicity is not as important as the issue of safety for staff and patients, and the advantages of saving so much money as compared with our old EtO sterilizer". He added, "The 125L has been very reliable. It has been a strong complementary addition to our options for sterilization of heat-sensitive devices".

"The impact for us was significant", says a Urology Nurse Manager. "Because of the faster instrument turnaround time, we noticed that our instruments are more readily available in the OR storage area when we need them. From a standpoint of the devices themselves, we noticed they looked shinier and more like new than they did when they were sterilized in ethylene oxide".

**AT THE TIME OF THE WRITING OF THE SATISFACTION REPORTS, MORE THAN 300 STERILIZATION CYCLES HAD BEEN RUN IN EACH 125L OZONE STERILIZER AT THESE HOSPITALS; THE NUMBER OF PATIENTS WHOSE INSTRUMENTS HAVE BEEN STERILIZED IN OZONE HAS EXCEEDED 2,000. BIOLOGICAL INDICATORS WERE RUN WITH EVERY CYCLE, AND ALL CONFIRMED THAT ALL MICROORGANISMS HAD BEEN COMPLETELY KILLED.**

With a cost of well under US\$1.00 per cycle for the water, oxygen and electricity used to make the sterilant, the cost of operation for a 125L will be less than US\$1,000 annually. Savings from reduced sterilant purchases are expected to be significant.

## **A NEW REALITY WITH A GREAT FUTURE**

Since the beginning of operations, TSO<sub>3</sub> has implemented a sales strategy that utilizes a double-pronged approach – a recognized and competent distributor and the internal implementation of an effective sales team. We therefore decided to choose the best distributor for our product, while negotiating a distribution agreement with sufficient safeguards and objectives to maintain a close rein over the sales process. Our sales team supported our distributor.

This strategy allowed us to obtain both great credibility for our product among users and great visibility at trade shows. This also gave us the opportunity to develop a list of several hundred prospective customers for our device, at minimal cost. The advantages were therefore numerous. However, we had to admit that our distribution network was not fully achieving the sales objectives that were set.

The team at the distribution company has vast experience in the sale of commodity products that are already well known and target mainly ORs. But as the *125L Ozone Sterilizer* is a new, innovative product that targets central sterilization departments, the customer approach requires different expertise and the sales team must be completely dedicated to the product.

These learnings in 2005 led us to reconsider the organization of our sales and marketing department, and we made the decision to consolidate our team internally. We therefore met with our distributor to negotiate a transition contract for 2006, which will allow us to both profit from any sales to accounts that were already visited by our distributor, and to assume the leadership in our sales efforts to new customers, now and in the future.

Our current team of sales professionals are dedicating 100% of their efforts to selling the *125L Ozone Sterilizer*. This new approach allows us to save the equivalent of the discount to the distributor and, thereby, to substantially increase our margins and reach profitability faster.

## **ADDITIONAL RESOURCES: A STRONG AND ACTIVE TEAM**

The sales and marketing department was greatly reinforced in 2005, doubling the number of employees from eight to 16. The team was added a person in charge of business development, two clinical specialists, a sales director for the U.S. market and four U.S. regional sales managers.

The team in place can now profit from the contribution of eight sales professionals who have extensive experience working with capital equipment sales, for both operating rooms and central sterilization departments in hospitals. These professionals were meticulously selected for having already successfully introduced a new sterilization process in hospitals.

Thanks to this team and new approach, we are better equipped to meet our sales objectives in 2006.

## **SECURING OUR FINANCIAL POSITION WITH A \$10 MILLION PRIVATE PLACEMENT**

In 2005, TSO<sub>3</sub> displayed prudent management by obtaining \$10 million in financing to ensure the Company has the necessary financial resources for its activities.

As part of this financing on a firm underwritten basis, the syndicate of underwriters led by Canaccord Adams and completed by Dundee Securities and Clarus Securities, formally agreed to acquire the entire issue at a predetermined price. The syndicate was therefore very confident in the institutional interest and their involvement in the transaction, because it thereby assumed the risks of the market.

As the demand was strong during this financing, the units were placed in the hands of excellent institutional investors, a large portion of which are outside Québec, thereby allowing the advantageous solidification and diversification of the TSO<sub>3</sub> shareholders base.

We also have the possibility of obtaining an additional \$6.25 million that would be generated by the exercise of the warrants issued with this private placement. Each warrant can be exercised at \$2.50 any time until July 7, 2007.

## **A FURTHER SIGN OF CONFIDENCE FROM THE FINANCIAL COMMUNITY.**

### **MAJOR SUPPORT**

In 2005, the Health Protection Agency (HPA) in the United Kingdom decided to award a grant in the amount of CAN\$710k (£327k) to study the effectiveness of the 125L Ozone Sterilizer for the inactivation of prions, the infectious proteins that cause Creutzfeldt-Jakob disease (CJD). This program will extend over a period of about three years. We are also working with international regulatory authorities to ensure the recognition of the protocols that have been set up.

The British interest in our technology confirms both the need for a sterilization method that will inactivate prions and ozone's potential for being the solution.

This project is one of the most exciting that we have undertaken until now and confirms, yet again, the very great efficaciousness of ozone sterilization.

"The potential transmission of CJD from patient to patient via contaminated surgical instruments has been a concern worldwide for a number of years", said Dr. Neil Raven, research project manager at the HPA. "The data from the preliminary tests conducted by TSO<sub>3</sub> lead us to believe that the ozone sterilizer could be a significant part of the solution to the problem of variant CJD (vCJD), the human form of mad cow disease".

## **A SOLID FOUNDATION ON WHICH TO BUILD A PROMISING FUTURE**

After having devoted the past few years to building the collaborations necessary to our success tomorrow and deepening our understanding and knowledge of the end-users, we are now in a position to offer the market the low-temperature solution it has been waiting for.

Our solution to sterilization problems and our expertise give us the opportunity to accompany hospitals in their transition towards ozone sterilization. To this offer, it is important to add that it is not only the proven effectiveness of the 125L Ozone Sterilizer that makes our product so attractive – the fact that we are the only firm to put on the market a sterilization device that will be self-financing through the savings generated by its utilization, must also be considered.

It is also important to mention that increasingly strict Canadian regulations oblige hospitals to reduce ethylene oxide emissions by 99% starting in January 2007. Ethylene oxide is the gas most used for low-temperature sterilization in hospitals, a gas that is highly toxic and carcinogenic.

These regulations support the arrival of an environment-friendly technology such as the one we have developed, and the numerous ethylene oxide sterilizers that are still in operation in hospitals all represent sales opportunities for ozone sterilizers.

### **2006 WILL BE A YEAR FOCUSED MAINLY ON SALES**

The whole of our operations in 2005, as well as the sales team we have in place, were geared to generating the expected sales and build on a solid base in terms of development during fiscal 2006. Moreover, we will continue to build our list of potential customers and hire talented new resources for our team. The outlook for 2006 is very promising, particularly as it will be a very active year in terms of sales of 125L Ozone Sterilizers.

### **MORE SIGNS OF CONFIDENCE TO REAP**

We also have the firm intention to maintain the pace and multiply the list of our collaborations for compatibility and endorsements.

TSO<sub>3</sub> has brought together all the ingredients necessary to be the master of its destiny and make 2006 a memorable year.

## **ACKNOWLEDGEMENTS**

**Notably, fiscal 2005 allowed TSO<sub>3</sub> to increase its visibility among the clientele, to realize major advances and to consolidate its sales force. The outlook is very stimulating for the whole team who give their utmost every day to build this business. We want to thank the whole team for their determination and competence in the service of TSO<sub>3</sub>.**

**We thank all of our partners in North America and overseas, as well as the referral sites that have accepted to share their enthusiasm for the performance of our device for the benefit of future users.**

**We also thank all the members of our Board of Directors who let TSO<sub>3</sub> benefit from their vast experience, as well as the members of our Scientific Committee for their outstanding contributions.**

**Thanks also to our shareholders who believe in the immense potential of TSO<sub>3</sub> and have confidence in the future.**

Germain Carrière



Chairman of the Board

Jocelyn Vézina



Chief Executive Officer

# ANALYSIS OF FINANCIAL SITUATION

## AND OPERATING RESULTS

This management analysis presents information on TSO<sub>3</sub> Inc. activities, and compares the operating results and financial situation for the years ended December 31, 2005 and December 31, 2004. The following information must be read in conjunction with the [audited financial statements](#) and unless advised otherwise, all figures are in Canadian dollars.

### Overview

Founded in June 1998, TSO<sub>3</sub> Inc. - hereafter referred to as the Company - has developed a unique new sterilization process that uses ozone as the sterilizing agent. The first device to be produced from this technological platform, the 125L Ozone Sterilizer, designed to allow the sterilization of the new generation of surgical and diagnostic instruments made from heat-sensitive polymers. The Company received clearance from Health Canada on May 3, 2002 to sell the 125L in Canada. This event was followed on September 3, 2003 by clearance from the United States Food and Drug Administration (FDA) to sell the 125L Ozone Sterilizer and the accompanying Chemical Indicator.

The Company is conducting the commercial launch of its technology, which involves compatibility testing of the process with various commercially available surgical instruments, and pursue his work in several Canadian pilot sites and U.S. referral sites.

### Internal Sales Force

In 2003, TSO<sub>3</sub> signed an exclusive distribution agreement with an American partner, SKYTRON. The Company began negotiating a new agreement in late 2005 and signed in early 2006, under which TSO<sub>3</sub> and SKYTRON agree to a transition period that will let TSO<sub>3</sub> profit from any sales to accounts already contacted by this distributor, and using the Company's own sales force, immediately assume the responsibility for managing all sales with new customers, now and in the future. The original agreement with the distributor included arrangements whereby TSO<sub>3</sub> would transfer the product to the distributor with a 25% discount on the suggested retail price. For fiscal 2006 – the transition period – the Company will pay a 20% commission to the distributor during the first quarter, 15% in the second, 10% in the third and 5% in the fourth. For 2007 and beyond, no commission will be paid. The Company believes the additional revenues generated by this new commercialization strategy will be greater than the additional costs, thus creating more value for our shareholders.

The sales and marketing department was greatly reinforced in 2005, doubling the number of employees from eight to 16. The team in place can now profit from the contribution of eight sales professionals who have extensive experience working with capital equipment sales, for both operating rooms and central sterilization departments in hospitals.

### Compatibility program

No sterilization process is compatible with every instrument. For this reason, TSO<sub>3</sub> has implemented a Manufacturers' Testing Program (MTP). The Company intends to constantly validate the medical instruments of both today and tomorrow through this program, to ensure optimal compatibility with the ozone sterilization process. Although the compatibility research began when the Company was founded, a major boost was given to this research in 2004 and 2005. The Company was able to validate a large number of instruments among the categories most used in surgery today. The referral sites where the 125L was tested have confirmed that the Company has reached the level of compatibility required for the utilization of these units on a regular basis. As well, the number of manufacturers and suppliers of raw materials participating in the Company's compatibility validation program (the MTP) doubled from 60 to 120 during fiscal 2005.

### Canadian Pilot Sites

TSO<sub>3</sub> entered into agreements in 2002 and 2003 with the following hospital centres:

- McGill University Hospital Centre - Montréal Neurological Hospital;
- Sacré-Coeur Hospital of Montréal;
- *Centre hospitalier universitaire de Québec - Saint-François d'Assise* Hospital;
- *Centre hospitalier de l'Université de Montréal - Notre-Dame* Hospital;
- Vancouver General Hospital;
- Sunnybrook and Women's College Health Sciences Centre in Toronto.

These hospitals have agreed to make their sterilization department facilities, personnel and equipment available for the project. These tests aim to validate the compatibility of additional instruments and packaging, and also to demonstrate to hospitals how the 125L Ozone Sterilizer can considerably reduce direct and indirect operating costs. The Company anticipates concluding evaluations at these pilot sites by the end of the fiscal year 2006.

### American Referral Sites

The Company plans to obtain market recognition for its innovative technology by promoting the use of its 125L Ozone Sterilizer in several prestigious hospitals in the United States. In-use evaluations are ongoing. At the end of the evaluation period, the users agree to write a testimonial and to act as a showcase for the technology for future clients, in exchange for a discount on the selling price of the 125L Ozone Sterilizer.

The Company signed agreements, in October and December of 2003 respectively, with the Cleveland Clinic Foundation and Spectrum Health, two renowned U.S. hospital networks. On May 5, 2004, the Company announced the signing of additional agreements with referral sites in the United States.

At the end of the fiscal year 2005, all the American referral sites were in place; two of them had written positive testimonials. The Company anticipates concluding the evaluations during the fiscal year 2006.

## CRITICAL ACCOUNTING POLICIES

The Company financial statements are prepared in accordance with Generally Accepted Accounting Principles in Canada (GAAP). The Company's critical accounting policies include the use of estimates, the determination of the useful life or fair value of goodwill and intangible assets and the revenues recognition policy. Some of our critical accounting policies require the use of judgment in their application or require estimates of inherently uncertain matters. Discussed below are those policies that we believe are critical and require the use of complex judgment in their application:

### Intangible Assets

Intangible assets refer to the acquisition cost of a patent licence and the acquisition cost of a technology including all the related rights. The licence, stated at acquisition cost, is amortized according to the straight-line method over the licence's useful life, 16 years. An amortization of \$61,942 was recorded during the fiscal year 2005.

Beginning January 1, 2005, the technology is amortized using the straight-line method over the estimated useful life of 20 years. During the fiscal year 2005, an amount of \$148,944 was recorded for the amortization of the technology.

Intangible assets are periodically tested for impairment based on an estimate of undiscounted cash flows for the remaining amortization period. Any impairment loss revealed by this test will be carried to earnings for the period during which the loss occurred.

## Revenues Recognition

The Company follows the new Canadian accounting standards regarding recognition of its revenues.

Accordingly, the revenues will not be recognized until the major inherent risks to ownership and future obligations regarding the delivered product are transferred. Revenues from the sale of these products will also be recognized after deduction for sales discounts. Amounts received from clients or from our distribution partner before revenues are recognized will be posted as Deferred Revenue.

## CHANGES IN ACCOUNTING POLICIES

### Production Costs

Since the beginning of 2004, the Company has allocated direct labour and direct production costs to the cost of units in inventories in order to better reflect the sterilizer production cost. For the fiscal year 2005, an amount of \$16,081 was allocated to the cost of the inventory.

### Compensation and other Stock-based Payments

Commencing January 1, 2004, the Company now records stock-based compensation and other stock-based payments according to the fair value method as required by the new Canadian Institute of Chartered Accountants (CICA) regulations. The compensation expense associated with this method of stock-based payment is therefore recognized as earnings. The adoption of this new regulation resulted in an increase of \$416,672 in compensation expenses for 2005. As of December 31, 2005, this event will result in additional expenses of \$362,730 in 2006, \$140,551 in 2007 and \$40,745 in 2008. These costs constitute non-cash operations.

## SUMMARY OF OPERATING RESULTS

Fiscal years ended December 31

	2005	2004	2003 (restated)
<hr style="border-top: 1px dotted black;"/>			
(in thousands of dollars except loss/share)			
Sales	\$ 172	\$ -	\$ -
Operating Expenses	\$ 994	\$ 567	\$ 736
Research and Development (before tax credits)	\$ 1,878	\$ 1,573	\$ 1,758
Marketing	\$ 1,924	\$ 1,722	\$ 1,204
Administrative	\$ 2,327	\$ 2,784	\$ 2,446
Financial Fees	\$ 14	\$ 13	\$ 26
Other Revenues	\$ (530)	\$ (726)	\$ (1,154)
Income Tax	\$ -	\$ 12	\$ -
Net Loss	\$ 6,435	\$ 5,946	\$ 5,026
Net Loss Per Share	\$ 0.19	\$ 0.19	\$ 0.18
<hr/>			
Weighted Average Number of Shares Outstanding After Dilution (in thousands)	34,315	31,509	28,828

[Download chart in  
Excel format.](#)

## Sales

For the fiscal year ended December 31, 2005, sales stood at \$171,766 compared to none in 2004. During this fiscal year, the Company realized the first sale of a 125L Ozone Sterilizer and its accessories.

## Operations

Operating costs for the fiscal year ended December 31, 2005 totaled \$993,642 compared to \$567,263 in 2004. These costs were mainly incurred by Production and After-Sales Service Department operations. The difference between the two periods is mainly due to an increase in the warranty fees and in the number of employees. In 2005, the Company hired a new employee for the production department. The increase between the two periods is also due to the amortization of the technology which began on January 1, 2005.

## Research and Development Activities

For the fiscal year ended December 31, 2005, the Company continued its research and development efforts as per its budget. R&D expenses before tax credits amounted to \$1,878,310 compared to \$1,573,603 in 2004. The increase between the two periods is due to the purchase of material and instruments needed to pursue the testing of instrument compatibility. The Company intensified its research program in the United Kingdom with the beginning of the work on the inactivation of prions. R&D activities in addition to the compatibility program included improving existing products and diversifying products emanating from the Company's technological platform.

## Marketing

Sales and marketing expenses totalled \$1,923,980 for the fiscal year ended December 31, 2005, compared to an amount of \$1,721,777 in 2004. This increase is due to more intensive marketing activities, including promotional materials and sales representation. The sales and marketing team also increased at the end of 2005 from eight to 16 professionals. The increase in marketing expenses is also due to the implementation of the US referral sites at the beginning of 2005.

## Administration

Administration expenses amounted to \$2,327,232 for the fiscal year ended December 31, 2005, compared to an amount of \$2,784,407 in 2004. The decrease is due by the diminution of the accounting item: *Share-based compensation and professional fees*. The decrease between the two periods is also due to a reduction in bonuses to the management. On the other hand, the amount paid in insurance increased in 2005.

## Other Revenues

The financial statements of the Company indicate revenues for the fiscal year ended December 31, 2005, of \$530,213 compared to \$726,377 for the same period in 2004. Despite an increase in investment income, this decrease is mainly due to a reduction in government grants and to the delay in the disbursement of the Immigrant Investors Program financial contribution.

## Net Loss

The Company recorded a net loss of \$6,434,885 or \$0.19 per share, for the fiscal year ended December 31, 2005, compared to a restated net loss of \$5,946,139, also \$0.19 per share in 2004.

Download chart in  
Excel format.

## FINANCIAL POSITION

As at December 31

	2005	2004	2003 (restated)
(in thousands of dollars)			
Liquid Assets (Cash & Temporary Investments)	\$14,595	\$10,679	\$15,640
Accounts Receivable	\$ 344	\$ 332	\$ 1,453
Inventories	\$ 3,303	\$ 2,845	\$ 2,349
Property, Plant and Equipment	\$ 416	\$ 498	\$ 509
Intangible Assets	\$ 3,832	\$ 3,908	\$ 3,970
Short & Long Term Debt	\$ -	\$ 69	\$ 3,689
Deferred Revenues	\$ 962	\$ 36	\$ -
Share Capital and Contributed Surplus	\$50,657	\$39,866	\$39,288
Shareholders' Equity	\$20,610	\$17,431	\$22,799

### Liquid Assets and Financial Situation

As of December 31, 2005, cash, temporary investments and accounts receivable amounted to \$14,939,305 compared to \$11,010,894 as of December 31, 2004.

### Inventories

As of December 31, 2005, short term assets showed inventory valued at \$3,303,258 compared to \$2,845,586 as of December 31, 2004. This amount was attributable to the cost of producing sterilizers for the commercial launch.

### Deferred Revenues

Deferred Revenues as of September 30, 2005 totalled \$961,826 compared to \$36,060 for the same period last year. These deferred revenues reflect amounts received for a certain number of sterilizers during the evaluation period phase for which the ownership has not yet been transferred. Sales will be posted to our financial results when the evaluation period is completed and the transfer of property has been confirmed. In effect, the referral sites agreement assumes the acquisition of the sterilizer only when TSO<sub>3</sub> has confirmation that expectations are fully met.

### Required Capital Payments and Contractual Commitments

The required capital payments and the various contractual commitments in the coming fiscal year are as follows:

	2006	2007
R&D Contract	\$92,907	\$ -
Rent	\$10,160	\$7,714
Referral and Pilot Sites	\$84,109	\$

Download chart in  
Excel format.

## SUMMARY OF QUARTERLY RESULTS

	2005				2004			
	T4	T3	T2	T1	T4	T3	T2	T1
(000\$ except loss/share)								
Sales	11	161	-	-	-	-	-	-
Other Revenues	197	157	75	101	82	133	335	176
Net Loss	1,835	1,401	1,637	1,562	1,406	1,419	1,579	1,542
Net Loss per Share (Basic and Diluted)	0.05	0.04	0.05	0.05	0.05	0.04	0.05	0.05

For the third quarter of 2005, the Company recorded the first sales of a sterilizer and its accessories totalling \$161,345 and sold accessories during the last quarter representing \$10,421. The item *Other Revenues* have come solely from investment incomes, income tax credits and government grants. Taken together, these items vary considerably from one quarter to the next. The item *Net Loss per Share* has been relatively stable and constant for the past two years.

## CAPITAL RESOURCES

Historically, the Company has funded its activities from several rounds of public and private financing, as well as from various government subsidies. Since its inception in June 1998, the Company has raised \$47 million from the sale of its equity.

Even though for the fiscal year 2005 the monthly burn-rate was \$430,000, the Company anticipates that, following the increase in gross expenses resulting from the commercial launch of the *125L*, the burn-rate could reach \$700,000 range.

Besides, the Company closed on July 7, 2005 a private placement of \$10 million from the sale of 5,000,000 units. Each unit is composed of one common share and one-half warrant. Each whole warrant entitles its holder to purchase one additional common share of the Company at a price of \$2.50 at any time until July 7, 2007. As additional consideration for services rendered as part of the July share issue, the Company granted 350,000 warrants to the underwriters. Each warrant entitles them to purchase one common share at a price of \$2.18 per share, until January 7, 2007.

The Company believes that its current liquid assets and the amounts that would be generated by the exercising of the warrants would allow it to reach the break-even point.

The Company has a line of credit with which it can obtain advances up to a maximum of \$100,000. Amounts drawn on this line of credit, renewable on an annual basis, bear interest at the prime rate plus 1.5%. The Company's accounts receivable and inventories are pledged as security against the line of credit, and the Company must satisfy certain financial ratios commonly founds in this type of loan. As of December 31, 2005, this line of credit was undrawn.

The Company has entered into a non-refundable financial contribution agreement with *IQ Immigrants Investisseurs Inc.* Under this agreement and upon reaching specific objectives, the Company may receive a contribution totalling \$1,000,000. This contribution is payable in four annual instalments of \$250,000 beginning in 2002. In 2002 and 2003, the Company received the first two instalments totalling \$500,000. The third and fourth instalments are expected in 2006, when the established sales objective has been reached.

The Company has also applied to the National Research Council of Canada with its "Process Optimization Bench". This project will allow the Company, once certain objectives are met, to receive a financial contribution of up to \$150,000. This amount was available until December 31, 2005. The Company has received, as of December 31, 2005, a cumulative amount of \$147,543 through this project. An additional amount of \$2,457 is posted in the Company's accounts receivable.

## OFF-BALANCE SHEET TRANSACTION

The Company made no off-balance sheet transaction.

## TRANSACTIONS WITH RELATED PARTIES

The Company leases its premises from a company owned by the Company's shareholders.

Over the last three complete fiscal years, the Company has made the following related transactions, assessed at fair market value:

	2005	2004	2003
Rent	\$ 56,560	\$ 55,560	\$ 55,560
Other Rent-Related Expenses	73,462	60,650	83,034
	<b>\$130,022</b>	\$116,210	\$138,594

[Download chart in Excel format.](#)

## RISK FACTORS

### Risks Related to Operating Activities

The Company's activities entail certain risks and uncertainties inherent to the industry in which it operates. However, management has implemented a risk-reduction strategy that addresses:

### Risks Associated with International Operations

TSO<sub>3</sub> must carry out the majority of its sales outside of Québec and Canada, either in the United States or in Europe. The necessity to market on an international scale will put the Company in a position of direct competition with firms that possess networks and resources greater than its own. Nothing can guarantee that the marketing campaigns planned by the Company for international markets, alone or with strategic alliances, will be successful. The operations of TSO<sub>3</sub> at an international level could be affected negatively by factors such as the policies of Canada and the United States in regard to foreign trade, investments and taxes, foreign exchange rate controls and fluctuations, political instability and increased payment periods. One or more of these factors could have a significantly negative effect on the financial situation and results of the Company.

### Compatibility and Biocompatibility

All sterilization processes can affect medical instruments or alter their key properties over a period of time. Taking into consideration the nature of the devices to be sterilized and the oxidative effects on devices in contact with ozone, TSO<sub>3</sub> limits to a minimum the frequency and duration of ozone exposure to the devices. Nevertheless, oxidation can produce several effects, depending on the material. In order to fully establish the true commercial value of its sterilization process, the Company must demonstrate the compatibility of its technology with a wide range of medical instruments. Even though the tests and studies undertaken to date by TSO<sub>3</sub> have shown that its ozone sterilization process is compatible with the majority of medical instruments currently used in the hospital environment, the Company must maintain ongoing studies in this respect.

### **Dependency on Key Personnel and Growth**

The Company believes that its success will continue to depend on its ability to attract and retain qualified managers and other key personnel. Losing a key employee could have a major negative impact on TSO<sub>3</sub>. Achieving its short-term objectives could launch the Company into a phase of significant and rapid growth and force it to considerably increase its personnel, the number of partners, cash flow and operating capacity. Such growth could be extremely trying on management. Also, the Company has to attract competent employees and motivate its managers. Moreover, any shortcoming in effectively managing the Company's growth could adversely affect its financial position and operating results.

### **Intellectual Property and Counterfeiting Risks**

The success of TSO<sub>3</sub> is based on its unique technology. TSO<sub>3</sub> relies on a combination of patents, trade secrets, non-disclosure agreements and various contractual provisions in order to protect its technology. Nothing can guarantee that these measures will be sufficient to protect any illegal appropriation or infringement of its technology by a third party.

### **Product Liability Issues**

In the health sector, lawsuits, often claiming substantial damages, are becoming increasingly common. In particular, in the United States, lawsuits are filed by patients, employees or beneficiaries against healthcare providers, as well as authorities operating and managing hospitals in the private and public sectors. During these proceedings, claimants could allege and blame the non-sterility of certain instruments or defective functioning of products sold, installed or derived from TSO<sub>3</sub>'s technology. To address the problems associated with such lawsuits, the Company is of the opinion that it has the necessary insurance coverage.

## **LIQUIDITY AND FINANCIAL RESOURCES**

Management believes that it will be able to raise the necessary long-term capital to achieve the Company's corporate objectives. However, the availability of these financial resources cannot be guaranteed.

## **VOLATILITY OF SHARE PRICE**

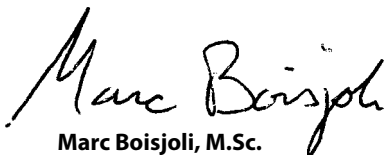
Company share prices are subject to volatility. Financial and scientific results that differ from analysts' projections may lead to significant variations in the price of Company shares.

## **DISCLOSURE CONTROLS AND PROCEDURES**

The Chief Executive Officer and the Chief Financial Officer of the Company are responsible for establishing and maintaining the Company's controls and disclosure procedures. They are assisted in this responsibility by the Company's Communication Committee, which is composed of members of Senior Management, by the Director of Communications and IR, as well as by the Company's legal advisor. As required by Securities Legislation, the CEO and the CFO have conducted an evaluation of the controls and procedures regarding information disclosure and have concluded that these controls and procedures are effective.

## **PROSPECTIVE STATEMENT**

This document contains certain prospective statements that reflect the Company's current expectations for future activities. The prospective statements include risks and uncertainties. The real results can differ considerably from the results described on page 19 and those expected by the Company. Investors are advised to consult the Company's quarterly and annual reports, as well as the filing of the Company's annual information form for more details on the risks and uncertainties related to these prospective statements. The reader must not unduly rely upon the Company's prospective statements. The Company is not obliged to update these prospective statements.



**Marc Boisjoli, M.Sc.**

Vice President, Finances and Chief Financial Officer

February 28, 2006

# MANAGEMENT REPORT

## Responsibility of the Financial Statements

The financial statements of TSO<sub>3</sub> Inc., which have been approved by the Board of Directors were prepared by Management in accordance with Canadian Generally Accepted Accounting Principles and contain certain amounts based on best judgment and estimates as their final determination is dependent upon subsequent events. It is the opinion of Management that the accounting policies utilized are appropriate in the circumstances and are adequate to reflect the financial position and the results of operations within reasonable limits of materiality. The financial information presented elsewhere in this annual report is consistent with the information contained in the financial statements.

In order to carry out its responsibilities with regard to the financial statements, Management maintains internal control systems that aim to provide a reasonable degree of certainty that transactions are duly authorized, that the assets are well protected, and that adequate records are kept.

The Board of Directors' Audit Committee, comprised solely of board members who are neither managers nor employees of the Company, ensures that Management assumes its responsibility in terms of financial statements.

The functions of the Audit Committee are to:

- Review the financial statements and recommend them for approval by the Board of Directors;
- Review the systems of internal control and security;
- Recommend the appointment of the external auditors and their fee arrangements to the Board of Directors;
- Review other accounting, financial, and security matters as required.

This committee meets regularly with Management and the external auditors. The latter may, as they see fit, meet with the Audit Committee, with or without Management, to discuss matters affecting the audit and financial information.

The external auditors are appointed to report to the shareholders regarding the fairness of presentation of the Company's financial statements. The auditors fulfil this responsibility by carrying out an independent examination of these statements in accordance with Canadian generally accepted auditing standards.

On behalf of Management,



**Jocelyn Vézina**  
Chief Executive Officer



**Marc Boisjoli**  
Vice President, Finances and Chief  
Financial Officer

February 28, 2006

# Auditors' Report

To the Shareholders of TSO<sub>3</sub>,

We have audited the balance sheets of TSO<sub>3</sub> Inc., as at December 31, 2005 and 2004 and the statements of earnings, contributed surplus, deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of TSO<sub>3</sub> Inc., as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*Samsan Bélain*  
*Deloitte + Touche S.E.M.C.L.*

**Chartered Accountants**

Québec City, February 10, 2006

## Statements of Earnings

Years ended December 31

Download chart in  
Excel format.

	2005	2004
<b>SALES</b>	\$ 171,766	\$ -
<b>EXPENSES</b>		
Operating	993,642	567,263
Research and development	1,878,310	1,573,603
Marketing	1,923,980	1,721,777
Administrative	2,327,232	2,784,407
Financial	13,700	13,243
	<b>7,136,864</b>	6,660,293
<b>OPERATING LOSS</b>	<b>6,965,098</b>	6,660,293
<b>OTHER REVENUES</b> (Note 18)	<b>530,213</b>	726,377
<b>INCOME TAXES</b>	-	12,223
<b>NET LOSS</b>	<b>\$ 6,434,885</b>	\$ 5,946,139
Basic and diluted net loss per share (Note 17)	\$ 0.19	\$ 0.19
References:		
Amortization of deferred financing costs and depreciation and amortization of property, plant and equipment and of intangible assets (Notes 2, 7 and 8)		
Interest (Note 10)		
Income taxes (Note 14)		
Research and development tax credits (Note 15)		

## Statements of Contributed Surplus

Years ended December 31

	2005	2004
Balance beginning of year	\$ 2,213,699	\$ 1,322,017
Changes in accounting policies	-	314,283
	<b>2,213,699</b>	1,636,300
Warrants (Note 11)	1,639,871	-
Compensation options (Note 11)	350,350	-
Stock-based compensation (Note 11)	416,672	577,399
Balance end of year	<b>\$ 4,620,592</b>	\$ 2,213,699

## Statements of Deficit

Years ended December 31

	2005	2004
Balance beginning of year	\$22,434,946	\$16,174,524
Changes in accounting policies	-	314,283
	<b>22,434,946</b>	16,488,807
Share issue expenses	827,023	-
Compensation options (Note 11)	350,350	-
Net loss	6,434,885	5,946,139
Balance end of year	<b>\$30,047,204</b>	\$22,434,946

# Balance Sheets

As at December 31

Download chart in  
Excel format.

	<b>2005</b>	2004
<b>CURRENT ASSETS</b>		
Cash	\$ 294,101	\$ 438,229
Temporary investments (Note 4)	14,300,902	10,240,334
Accounts receivable (Note 5)	344,302	332,331
Inventories (Note 6)	3,303,258	2,845,586
Prepaid expenses	95,894	48,871
	<b>18,338,457</b>	13,905,351
<b>PROPERTY, PLANT AND EQUIPMENT</b> (Note 7)	<b>416,327</b>	497,573
<b>INTANGIBLE ASSETS</b> (Note 8)	<b>3,832,250</b>	3,907,995
	<b>\$22,587,034</b>	\$18,310,919
<b>CURRENT LIABILITIES</b>		
Accounts payable and accrued liabilities	\$ 1,015,491	\$ 775,686
Deferred revenue	961,826	36,060
Current portion of long-term debt (Note 10)	-	68,500
	<b>1,977,317</b>	880,246
<b>LONG-TERM DEBT</b> (Note 10)	-	-
	<b>1,977,317</b>	880,246
<b>SHAREHOLDERS' EQUITY</b>		
Share capital (Note 11)	46,036,329	37,651,920
Contributed surplus	4,620,592	2,213,699
Deficit	(30,047,204)	(22,434,946)
	<b>20,609,717</b>	17,430,673
	<b>\$22,587,034</b>	\$18,310,919

On behalf of the Board,



**Jocelyn Vézina**  
Director



**Simon Robitaille**  
Director

# Statements of Cash Flows

Years ended December 31

Download chart in  
Excel format.

	<b>2005</b>	2004
<b>OPERATING ACTIVITIES</b>		
Net loss	\$(6,434,885)	\$(5,946,139)
Adjustments for:		
Depreciation and amortization of property, plant and equipment	157,744	193,914
Amortization of intangible assets	214,350	61,942
Amortization of deferred financing costs	-	84,822
Stock-based compensation	416,672	577,399
Loss on disposal of property, plant and equipment	1,698	-
	<b>(5,644,421)</b>	(5,028,062)
Changes in non-cash operating working capital items (Note 12)	648,905	(443,813)
Cash flows used in operating activities	<b>(4,995,516)</b>	(5,471,875)
<b>INVESTING ACTIVITIES</b>		
Temporary investments	(5,421,424)	7,699,378
Acquisition of property, plant and equipment	(87,496)	(182,578)
Acquisition of intangible assets	(138,605)	-
Increase in value of investments		
Immigrant Investors Program	-	(109,533)
Realization of investment	-	3,475,049
Disposal of property, plant and equipment	9,300	-
Cash flows (used in) from investing activities	<b>(5,638,225)</b>	10,882,316
<b>FINANCING ACTIVITIES</b>		
Reimbursement of long-term debt	(68,500)	(3,620,978)
Share issue	10,024,280	948,241
Share issue expenses	(827,023)	-
Cash flows from (used in) financing activities	<b>9,128,757</b>	(2,672,737)
<b>INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>(1,504,984)</b>	2,737,704
CASH AND CASH EQUIVALENTS AT BEGINNING	8,801,619	6,063,915
<b>CASH AND CASH EQUIVALENTS AT END</b> (Note 12)	<b>\$7,296,635</b>	\$ 8,801,619

# Notes to the Financial Statements

Years ended December 31, 2005 and 2004

## 1. DESCRIPTION OF BUSINESS

The Company was incorporated on June 10, 1998 under Part 1A of the *Companies Act* (Québec). Its activities consist of developing and marketing a sterilization process for heat-sensitive medical instruments using ozone as a sterilizing agent.

## 2. ACCOUNTING POLICIES

The financial statements are prepared in accordance with Canadian generally accepted accounting principles and include the following significant accounting policies:

### Use of estimates

The preparation of financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Since the process for presenting financial information presupposes the use of estimates, actual results could differ from the information presented.

### Cash and cash equivalents

Cash and cash equivalents include cash and highly liquid temporary investments with maturities of three months or less that are held for the purpose of meeting short-term cash commitments.

### Temporary investments

Temporary investments are recorded at the lower of cost and market value.

### Inventories

Inventories are valued at the lower of cost and replacement cost for raw materials, and at the lower of cost and net realizable value for work in process and finished goods. The cost of inventories is determined substantially according to the first in, first out method. The cost of work in process and finished goods consists of the cost of raw materials and an applicable share of the cost of labour and manufacturing overhead.

### Property, plant and equipment

Property, plant and equipment are recorded at cost. Depreciation and amortization are calculated under the declining balance method, except for software, Web site and leasehold improvements, which are depreciated under the straight-line method, using the following annual rates, term or useful life:

<i>Office furniture, stand, equipment and tools</i>	<i>20%</i>
<i>Computer equipment, vehicles and lift truck</i>	<i>30%</i>
<i>Software and Web site</i>	<i>3 years</i>
<i>Leasehold Improvements</i>	<i>Lease term</i>

# Notes to the Financial Statements

Years ended December 31, 2005 and 2004 *(cont'd)*

## 2. ACCOUNTING POLICIES *(cont'd)*

### **Intangible assets**

Intangible assets include the patent cost of a licence, the cost of a technology including all the related rights, and the patent costs. The licence and patents are amortized using the straight-line method over the licence's useful life of 16 years and over the patents' useful lives of 20 years.

During the previous year, the Company estimated the useful life of the technology. The technology is therefore amortized, beginning this year, using the straight-line method over the estimated useful life of 20 years.

### **Impairment of long-lived assets**

Long-lived assets are reviewed for impairment upon the occurrence of events or changes in circumstances indicating that the carrying value of the assets may not be recoverable. Impairment is recognized when the carrying amount of a long-lived asset exceeds the undiscounted cash flows expected to result from its use and disposal. The recognized impairment is measured as the excess of the carrying amount over its fair value.

### **Deferred financing costs**

Deferred financing costs are mainly costs incurred to obtain loans under the Immigrant Investors Program. These costs were amortized using the straight-line method over the terms of the loans, through September 2004.

There was no amortization of deferred financing costs in 2005 (\$84,822 in 2004).

### **Foreign currency transactions**

Foreign currency transactions are translated into Canadian dollars as follows: monetary assets and liabilities are translated at the exchange rates in effect at the balance sheet date, and revenues and expenses are translated at the exchange rates in effect at the time of the transaction. Non-monetary assets and liabilities are translated at historical rates. The gains or losses resulting from translation are carried to earnings.

### **Government assistance and research and development tax credits**

Government assistance is recorded in the financial statements when there is reasonable assurance that the Company has complied with, and will continue to comply with all of the conditions necessary to obtain the assistance.

The Company incurs research and development expenditures, which are eligible for tax credits. The recorded tax credits are based on management's estimates of amounts expected to be recovered and are subject to audit by taxation authorities.

Government assistance, including investment tax credits for research and development, is reflected as a reduction in the cost of the assets to which it relates or in other revenues.

### **Income taxes**

The Company follows the liability method of accounting for income taxes. Under this method, future income taxes are recognized based on the expected future tax consequences of differences between the carrying amount of balance sheet items and their corresponding tax basis, using the enacted and substantively enacted income tax rates for the years in which the differences are expected to reverse. Future income tax assets are recognized in the earnings only if their realization is considered more likely than not.

# Notes to the Financial Statements

Years ended December 31, 2005 and 2004 (cont'd)

## 2. ACCOUNTING POLICIES (cont'd)

### Revenue recognition

The Company generates revenue mainly from the sale of ozone sterilization units, parts and instruments related to these units and contracts for the support and maintenance of these units. The Company is generally committed under revenue arrangements with multiple deliverables that include delivery of units, installation, maintenance, and consulting and support services. The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the price to the buyer is fixed or determinable and collection is reasonably assured. Revenue from revenue arrangements with multiple deliverables are divided into separate units of accounting when the Company has reliable evidence. When revenue cannot be determined, it is deferred and calculated using the straight-line method over the term of the contract.

Revenue related to units sold, parts and instruments related to those units, installation and consulting services are recognized once the services are provided and the client accepts the services received. Maintenance and support contracts are calculated using the straight-line method over the term of the contract.

## 3. CHANGES IN ACCOUNTING POLICIES

### Adopted during the previous year

#### Stock-based compensation and other stock-based payments

Starting January 1, 2004, the Company records stock-based compensation and other stock-based payments using the fair value method as required by the newly issued standard of the Canadian Institute of Chartered Accountants (CICA). The compensation expense associated with this method of stock-based payment is recognized to operations.

The impact of the change on the earnings is an increase of \$416,672 in administrative expenses for the year ended December 31, 2005 (\$577,399 in 2004, representing \$0.01 per share).

#### Generally accepted accounting principles

On January 1, 2004, the Company adopted CICA Handbook Section 1100 "Generally Accepted Accounting Principles (GAAP)". This section establishes the standards for financial reporting in accordance with GAAP, and provides guidance on sources to consult when selecting accounting policies and determining appropriate disclosures. The Company has completed the evaluation of the impact of this new guideline and has determined that it has no effect on the financial statements.

#### Consolidation of variable interest entities

The Company adopted, CICA Accounting Guideline 15 (AcG-15) "Consolidation of Variable Interest Entities (VIEs)" on a prospective basis. VIEs are entities in which equity investors do not have a controlling financial interest or that the equity investment at risk is not sufficient to permit the entity to finance its activities without additional support from other parties. Under this Guideline, a VIE must be consolidated by its primary beneficiary, i.e., the party that receives the majority of the expected residual returns and/or absorbs the majority of the expected losses. This accounting guideline applies to annual and interim periods beginning on or after November 1, 2004. The Company has completed the evaluation of the impact of this new guideline and has determined that it has no effect on its financial statements.

# Notes to the Financial Statements

Years ended December 31, 2005 and 2004 (cont'd)

## 4. TEMPORARY INVESTMENTS

	2005	2004
Commercial paper and bonds, maturing at various dates through October 2009, average yield of 2.99% (market value of \$8,596,232)	\$ 8,554,882	\$ 6,069,747
Deposit certificates (US\$500,000), maturing in March 2006, average yield of 3.06% (equivalent market value)	581,500	-
Money market fund (market value of \$4,170,694)	4,066,926	3,081,577
Strategic yield fund (market value of \$1,133,314)	1,097,594	1,089,010
	<b>\$14,300,902</b>	<b>\$10,240,334</b>

Temporary investments related to cash and cash equivalents amount to \$7,002,534 as of December 31, 2005 (\$8,363,390 in 2004).

## 5. ACCOUNTS RECEIVABLE

	2005	2004
Accounts receivable	\$ 8,033	\$ 6,947
Grants receivable	2,457	14,141
Tax credits receivable	249,000	231,000
Other	84,812	80,243
	<b>\$ 344,302</b>	<b>\$ 332,331</b>

## 6. INVENTORIES

	2005	2004
Raw materials	\$ 851,554	\$ 479,598
Work in progress	306,949	188,588
Finished goods	1,231,324	1,816,133
Finished goods on consignment	913,431	361,267
	<b>\$ 3,303,258</b>	<b>\$ 2,845,586</b>

Download chart in  
Excel format.

# Notes to the Financial Statements

Years ended December 31, 2005 and 2004 (cont'd)

Download chart in  
Excel format.

## 7. PROPERTY, PLANT AND EQUIPMENT

	Cost	Accumulated Amortization	Net Book Value	
			2005	2004
Equipment and tools	\$ 447,376	\$ 269,276	\$ 178,100	\$ 201,662
Computer equipment	318,952	198,457	120,495	134,792
Software	258,997	218,807	40,190	77,548
Office furniture	99,168	49,296	49,872	53,360
Lift truck	14,115	10,000	4,115	16,877
Web site	44,077	31,250	12,827	1,395
Stand	8,170	5,158	3,012	3,765
Leasehold improvements	165,474	157,758	7,716	8,174
	\$1,356,329	\$ 940,002	\$ 416,327	\$ 497,573

Depreciation and amortization for the year amount to \$157,744 (\$193,914 in 2004).

## 8. INTANGIBLE ASSETS

	Cost	Accumulated Amortization	Net Book Value	
			2005	2004
Technology (prototype)	\$2,978,874	\$ 148,944	\$2,829,930	\$2,978,874
Licence	991,063	123,883	867,180	929,121
Patent	138,605	3,465	135,140	-
	\$4,108,542	\$ 276,292	\$3,832,250	\$3,907,995

Amortization for the year amounts to \$214,350 (\$61,942 in 2004).

## 9. CREDIT FACILITIES

The Company has a line of credit with which it can obtain advances up to a maximum of \$100,000. This line of credit, which is renewable on an annual basis, bears interest at the prime rate plus 1.5%. The Company's accounts receivable and inventories are pledged as security on this line of credit, and the Company must comply with certain financial ratios usually found in this type of loan. This line of credit was undrawn as at December 31, 2005 and 2004.

# Notes to the Financial Statements

Years ended December 31, 2005 and 2004 (cont'd)

## 10. LONG-TERM DEBT

	2005	2004
Note payable under the IDEA-SME financial assistance program, without interest, payable by a final instalment of \$68,500 in April 2005	\$ -	\$ 68,500
Current portion	-	68,500
	\$ -	\$ -

No interest on the debt in 2005 (\$3,943 in 2004).

[Download chart in Excel format.](#)

## 11. SHARE CAPITAL

Authorized

An unlimited number of shares

Common, voting, participating, without par value

Class A, voting, participating, with a par value of \$1.00 each

Class B, voting, participating, without par value

	2005	2004
Issued		
36,413,695 common shares (31,400,295 in 2004)	\$46,036,329	\$37,651,920

On July 7, 2005, the Company issued 5,000,000 units at a price of \$2.00/unit. Each unit is comprised of one common share and a half warrant. Each full warrant entitles its owner to purchase one common share of the Company at a price of \$2.50 at all times until July 7, 2007.

The proceeds from this issuance of units was divided proportionally between capital assets and contributed surplus using the respective fair values of the shares and the warrants issued.

During the year, holders exercised their stock options and subscribed to a total of 13,400 shares in consideration of \$24,280.

### Stock options

The Company's Board of Directors adopted a stock option plan solely for directors, executives, employees and service providers of the Company, which was approved by its shareholders. The total number of common shares from the Company's share capital that can be issued under this plan is 2,355,022 shares. The total number of common shares reserved for the exercise of stock options in favour of a holder cannot, at any time, represent more than 5% of the Company's common shares issued and outstanding at the time of granting less the total number of options already exercised by this person from any other stock options. The options granted pursuant to this plan, which vest over a three-year period, may be exercised within a maximum of 10 years of the grant date.

# Notes to the Financial Statements

Years ended December 31, 2005 and 2004 *(cont'd)*

## 11. SHARE CAPITAL *(cont'd)*

### Stock options *(cont'd)*

During 2005, the Company awarded 352,710 stock options to its employees at a weighted average exercise price of \$2.15. The weighted average fair value of these stock options is \$1.56 per option.

During 2004, the Company awarded 399,000 stock options to its employees at a weighted average exercise price of \$1.79. The weighted average fair value of these stock options is \$1.28 per option.

The stock-based compensation expense pertaining to the options granted has been amortized using the graded vesting method and resulted in a compensation expense of \$416,672 as at December 31, 2005 (\$577,399 in 2004). Stock options awarded during 2003, 2004 and 2005 will also involve additional compensation expenses of \$362,730 in 2006, \$140,551 in 2007, and \$40,745 in 2008.

The fair value of the stock options granted is estimated using the Black-Scholes option pricing model under the following weighted average assumptions:

	2005	2004
<i>Risk free interest rate</i>	<b>4.13%</b>	4.84%
<i>Expected volatility</i>	<b>60%</b>	55%
<i>Life</i>	<b>10 years</b>	10 years
<i>Expected dividend yield</i>	<b>0%</b>	0%

The Black-Scholes options pricing model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable, a practice significantly different from how stock options are granted by the Company. In addition, option pricing models require the input of highly subjective assumptions including the expected stock price volatility. Any changes in the assumptions can materially affect the fair value estimate.

[Download chart in Excel format.](#)

# Notes to the Financial Statements

Years ended December 31, 2005 and 2004 *(cont'd)*

## 11. SHARE CAPITAL *(cont'd)*

The following table summarizes the stock option activity:

	2005		2004	
	Number	Weighted average exercise price	Number	Weighted average exercise price
Outstanding beginning of year	1,734,516	\$1.96	1,469,668	\$1.98
Granted	352,710	2.15	399,000	1.79
Exercised	(13,400)	1.81	-	-
Forfeited	(71,000)	1.95	(134,152)	1.71
Outstanding end of year	2,002,826	\$1.99	1,734,516	\$1.96
Exercisable end of year	1,281,967	\$1.95	1,025,951	\$1.92

The following table summarizes certain information regarding the stock options of the Company as at December 31, 2005:

Exercise price	Outstanding options		Exercisable options	
	Number	Weighted average remaining contractual life (years)	Number	Weighted average remaining contractual life (years)
\$1.35 to \$1.85	1,577,826	6.4	1,152,633	5.7
\$2.30 to \$2.99	266,000	9.4	23,333	6.8
\$3.34 to \$3.45	159,000	7.8	106,001	7.8
	2,002,826	6.9	1,281,967	5.9

Download chart in Excel format.

# Notes to the Financial Statements

Years ended December 31, 2005 and 2004 *(cont'd)*

## 11. SHARE CAPITAL *(cont'd)*

### Warrants and other options

Upon issuance of the 5,000,000 units on July 7, 2005, 2,500,000 warrants were granted. Each warrant can be used to purchase one common share of the Company at a price of \$2.50 through July 7, 2007.

Also, as additional consideration for services rendered for the issuance of these units, the Company granted 350,000 warrants to the underwriter. Each warrant can be used to subscribe to one common share of the Company at a price of \$2.18 each before January 7, 2007.

The fair value of the stock options granted is estimated using the Black-Scholes option pricing model under the following weighted average assumptions:

	2005
<i>Risk-free interest rate</i>	<b>2.95%</b>
<i>Expected volatility</i>	<b>67%</b>
<i>Life</i>	<b>1.9 year</b>
<i>Expected dividend yield</i>	<b>0%</b>

The weighted average fair value of warrants granted in 2005 is \$0.97 per option.

Warrants and other options varied as follows:

	2005		2004	
	Number	Weighted average exercise price	Number	Weighted average exercise price
Outstanding beginning of year	<b>460,476</b>	<b>\$2.12</b>	624,202	\$2.09
Granted	<b>2,850,000</b>	<b>2.46</b>	-	-
Exercised	-	-	-	-
Cancelled	-	-	(163,726)	2.00
Outstanding end of year	<b>3,310,476</b>	<b>\$2.41</b>	460,476	\$2.12
Exercisable end of year	<b>3,310,476</b>	<b>\$2.41</b>	321,586	\$2.11

Download chart in Excel format.

# Notes to the Financial Statements

Years ended December 31, 2005 and 2004 (cont'd)

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## 11. SHARE CAPITAL (cont'd)

The following table summarizes certain information regarding the stock options of the Company as at December 31, 2005:

Exercise price	Number	Outstanding warrants and other options	
		Weighted average remaining contractual life (years)	Number
\$1.85	43,806	0.5	43,806
\$2.15	416,670	1.0	416,670
\$2.18	350,000	1.0	350,000
\$2.50	2,500,000	1.5	2,500,000
	3,310,476	1.4	3,310,476

## 12. ADDITIONAL INFORMATION TO THE STATEMENTS OF CASH FLOWS

	2005	2004
<i>Changes in non-cash operating working capital items</i>		
Decrease (increase) in current assets		
Accounts receivable	\$ 6,029	\$ 202,899
Income tax credits receivable	(18,000)	(31,000)
Inventories	(457,672)	(496,539)
Prepaid expenses	(47,023)	(13,648)
Increase (decrease) in current liabilities		
Accounts payable and accrued liabilities	239,805	(141,585)
Deferred revenues	925,766	36,060
	\$ 648,905	\$ (443,813)
<i>Cash and cash equivalents</i>		
Cash	\$ 294,101	\$ 438,229
Temporary investments, with maturities of three months or less	7,002,534	8,363,390
	\$7,296,635	\$8,801,619
<i>Interest</i>		
Received	\$ 217,198	\$ 275,236
Paid	\$ -	\$ 3,943
<i>Research and development tax credits</i>		
Received	\$ 201,533	\$ 257,160

# Notes to the Financial Statements

Years ended December 31, 2005 and 2004 (cont'd)

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## 13. RELATED PARTY TRANSACTIONS

During 2005, the Company carried out the following transactions, measured at fair value, with a company held by certain shareholders of the Company:

	2005	2004
Rent	\$ 56,560	\$ 55,560
Other rent-related expenses	73,462	60,650
	<b>\$130,022</b>	<b>\$116,210</b>

## 14. INCOME TAXES

For tax purposes, the operations of each year result in a loss that can be applied against future taxable income. The income tax expense for the current year relates to taxes pertaining to the Company's capital.

As at December 31, 2005, the accumulated tax losses that can be carried forward are as follows:

Expiry date	Deferred losses	
	Federal	Provincial
2015	\$ 5,178,000	\$ 5,122,000
2014	4,601,000	4,380,000
2010	4,188,000	4,018,000
2009	2,793,000	2,610,000
2008	1,571,000	1,571,000
2007	649,000	649,000
2006	404,000	404,000
	<b>\$19,384,000</b>	<b>\$18,754,000</b>

As at December 31, 2005, in addition to its tax losses carried forward, the Company has unclaimed research and development expenses (\$5,275,000 at the federal level and \$6,260,000 at the provincial level) and \$1,126,000 in financing costs that can be carried forward to reduce future taxable income. The unrealized tax benefit, estimated at \$6,670,000, and related to these losses carried forward and undeducted expenses, has not been recorded.

In addition, as at December 31, 2005, the Company has \$991,000 in additional tax credits, representing the outstanding and unrecorded portion of the federal tax credit receivable.

Furthermore, the cost of intangible assets for tax purposes is \$578,000 (net book value of \$2,904,402) resulting from the Company taking advantage of provisions in the federal and provincial income tax laws with respect to rollovers. Future income taxes estimated at \$760,000 and resulting from the difference between the carrying value and the tax value of intangible assets have not been recorded.

Future income tax assets related to tax losses and undeducted expenses will be recorded in the financial statements, resulting in an increase in earnings and shareholders' equity, once the Company concludes that these losses likely will be realized. At the same time, the future income tax liability related to the cost of the intangible assets for tax purposes will be recorded, and the amount of intangible assets will be increased accordingly.

# Notes to the Financial Statements

Years ended December 31, 2005 and 2004 (cont'd)

## 15. RESEARCH AND DEVELOPMENT TAX CREDITS

For tax credit purposes, research and development expenditures incurred during 2005 amount to \$1,900,727 (\$1,510,946 in 2004); of these research and development expenses, \$22,470 as at December 31, 2005 (\$49,670 in 2004) relate to property, plant and equipment.

Some of these expenses qualify for refundable scientific research tax credits resulting in a balance receivable of \$249,000 as at December 31, 2005 (\$231,000 in 2004).

The tax credits related to 2005 have not been reviewed by the tax authorities. Consequently, the amount of tax credits awarded could differ from the one already recorded.

## 16. FINANCIAL INSTRUMENTS

### Interest rate risk

Long-term debt does not bear interest and the Company expects to reimburse this debt fully upon maturity. As a result, no interest rate risk is associated with this debt.

### Foreign exchange risk

The majority of the Company's sales are made in Canada, and therefore its exposure to foreign currency fluctuations is limited. Consequently, the Company does not use financial instruments to manage its foreign exchange risk.

### Fair value

The fair value of cash, temporary investments, accounts receivable, accounts payable and accrued liabilities, and long-term debt approximates their carrying values due to the short-term maturities of these items.

## 17. EARNINGS PER SHARE

The following table reconciles the basic and the diluted earnings per share:

Download chart in  
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	2005	2004
Net loss		
Basic and diluted	\$6,434,885	\$5,946,139
Number of shares		
Weighted average number of outstanding shares	33,824,100	31,400,295
Diluted impact of stock options <sup>(1)</sup> (Note 11)	321,676	86,206
Diluted impact of warrants <sup>(1)</sup> (Note 11)	169,376	22,490
Weighted average number of outstanding shares on a diluted basis	34,315,152	31,508,991
Loss per share		
Basic	\$ 0.19	\$ 0.19
Diluted	\$ 0.19	\$ 0.19

(1) The calculation of the diluted impact excludes all anti-dilutive stock options and warrants. These are stock options and warrants that would not be exercised because their exercise price is higher than the average market value of the common share of the Company for each of the years shown in the table. The number of excluded stock options was 560,879 for the year ended December 31, 2005 (1,183,306 in 2004). The number of excluded warrants was 844,287 for the year ended December 31, 2005 (402,812 in 2004).

# Notes to the Financial Statements

Years ended December 31, 2005 and 2004 *(cont'd)*

Download chart in  
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## 18. OTHER REVENUES

	2005	2004
Investment income	\$221,633	\$206,817
Research and development tax credits	242,563	248,160
Government grants	34,999	204,773
Immigrant Investors Program:		
Interest and financial contribution	-	138,121
Amortization of deferred financing costs	-	(84,822)
Foreign exchange gain	30,397	8,042
Loss on disposal of assets	(1,698)	-
Other	2,319	5,286
	<b>\$530,213</b>	<b>\$726,377</b>

The Company entered into a non-refundable financial contribution agreement with *IQ Immigrants Investisseurs Inc.*, under which, the Company can receive a contribution totalling \$1,000,000, receivable in four annual instalments of \$250,000, beginning in 2002. During the previous years, the Company received the first two instalments, i.e., \$500,000. As at December 31, 2005, the Company is eligible for the remaining amount of \$500,000 upon attaining specific objectives.

The Company also qualified for the National Research Council of Canada's "Process Optimization Bench" project that, upon attaining specific objectives, will allow the Company to obtain a financial contribution of up to \$150,000 until December 31, 2005. As at December 31, 2005, the Company had received an amount of \$147,543. The balance receivable totals \$2,457.

## 19. COMMITMENTS AND GUARANTEES

The Company is committed to pay an amount of \$30,000 per Canadian Referral Site and \$23,260 (US\$20,000) per U.S. Referral Site. As at December 31, 2005, the Company signed agreements for Referral Sites for a total commitment of \$381,374. In 2005, an amount of \$196,242 (\$71,824 in 2004) was paid for these sites.

Under its operating leases, the Company is committed to make payments totalling \$10,160 in 2006, \$7,714 in 2007, \$3,131 in 2008, \$839 in 2009 and \$839 in 2010.

The Company is committed under a research contract to pay a total sum of \$103,230 (75,000 €). As at December 31, 2005, \$10,323 (7,500 €) was paid. The Company expects to make a payment of \$92,907 (67,500 €) in 2006.

The Company issued an irrevocable letter of credit totalling \$380,000 in favour of a potential client. This letter of credit is secured by the Company's temporary investments.

# Notes to the Financial Statements

Years ended December 31, 2005 and 2004 *(cont'd)*

## 20. SUBSEQUENT EVENTS

During January 2006, shareholders exercised certain stock options and subscribed to 25,200 shares for a total of \$55,125.

## 21. COMPARATIVE FIGURES

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

## Directors

**Jocelyn Vézina**  
Chief Executive Officer  
TSO<sub>3</sub> Inc.

**Simon Robitaille**  
Vice President, Operations  
and Director of Research  
TSO<sub>3</sub> Inc.

**André Boulanger**  
Engineer  
Project Manager

**Germain Carrière**  
President and Chief  
Operating Officer  
Desjardins Securities

**André de Villers**  
President CEMA

**Régis Labeaume**  
Chief Executive Officer  
of the *Fondation de  
l'Entrepreneurship*

**Serge Lapointe**  
Senior Investment Advisor  
Life and Sciences  
*Fonds de solidarité FTQ*

**Jacques Marcotte**  
President  
Feminica Industries Inc.

## Scientific Advisory Board

**Charles O. Hancock, RAC**  
(Regulatory Affairs  
Professionals)  
Regulatory Affairs Consultant

**Bernard Legube, Ph.D.**  
Professor  
Environmental Chemistry  
*Université de Poitiers, France*

**Richard Marchand, M.D.**  
Microbiologist and  
Infections Specialist  
Consultant

**Paul S. Malchesky, D. Eng.**  
Chief Scientific Officer  
EnviroSystems, Inc.  
California

**James W. Tatalick**  
Consultant

## Investors' Information

**Ticker Symbol: TOS**

**Listing: TSX**

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**Intellectual Property  
Solicitors**

Borden Ladner Gervais LLP  
Ottawa

**Corporate Solicitors**

Lavery, De Billy LLP

**Bank**

National Bank of Canada

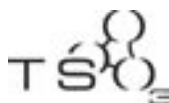
**Annual Shareholder  
Meeting**

Wednesday, May 3, 2006,  
at 10:30 a.m.  
*Musée national  
des beaux-arts du Québec  
Salon Paul-Rainville  
1, avenue Wolfe-Montcalm  
Québec (Québec)*

**Communications  
and Investor Relations**

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