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A N N U A L R E P O R T
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SMARTIRE AT A GLANCE



SMARTIRE

SmartTire Systems Inc. develops and markets proprietary tire monitoring systems for the transportation industry worldwide. SmartTire is a public company with offices in North America and Europe.

Incorporated 1987

OTCBB listed public company

Stock Symbol: SMTR

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P R E S I D E N T ' S R E P O R T



SMARTIRE



SmarTire achieved a number of positive milestones in 2004 while experiencing several significant challenges. As a company totally focused on Tire Pressure Monitoring Systems (TPMS), SmarTire was forced to endure another year of delays regarding the roll-out of TPMS legislation in the United States and the subsequent delays on the part of automakers in placing TPMS orders.

The TREAD Act originally brought forward by the U.S. government in 2000 mandated the use of TPMS in all passenger cars over a three-year period beginning in 2001. Delayed by legal action and fine tuning by the National Highway Traffic Safety Administration (NHTSA), the TREAD Act was finally implemented in October of 2004. U.S. automakers must be 100% compliant with the terms and conditions of the TREAD Act by the fall of 2007.

This ground breaking legislation is not only the driving force behind the installation of TPMS in U.S. passenger cars, it is being seen as the template for similar legislation in the other world markets. In addition, industry sources are anticipating that the TREAD Act will be expanded in scope to include a wider range of vehicles such as motorcycles, trucks, buses and recreational vehicles.

With the TREAD Act now a reality, passenger car manufacturers are finalizing their TPMS requirements and selecting their suppliers. European and Asian car manufacturers are also preparing for TREAD Act compliance to ensure their vehicles can be exported into the U.S. The long awaited emergence of the TPMS industry is finally taking place. As the company that pioneered TPMS with a heavy investment in time and money, SmarTire is now ideally positioned to exploit the TPMS market opportunity.

Although competitors have entered the marketplace in pursuit of the \$1.0 billion annual opportunity created by the TREAD Act, their single target is the new passenger car market. Being the least challenging in terms of technical difficulty and the most attainable from the standpoint of existing supplier relationships, the passenger car TPMS market represents the obvious market of choice for our competitors.

SmarTire will continue to aggressively compete in the new car market. We have scored initial successes such as the contract with Aston Martin, the prestigious flagship division of Ford Motor Company. We are actively pursuing TPMS supply contracts in North America, Europe and Asia. With approximately 50 million new vehicles manufactured each year on a global basis, the passenger car and light vehicle market represents a massive opportunity with relatively few qualified suppliers competing for a share of the business.

Despite the magnitude of this marketing opportunity, SmarTire is placing equal emphasis on other TPMS applications including commercial vehicles, buses, recreational vehicles and motorcycles. During 2004, SmarTire made significant progress in penetrating these markets. New products specifically designed for these applications were introduced and comprehensive marketing programs were developed for each segment. We have minimal competition in these markets as well as a distinct advantage in technology based on years of advanced product research.

With the possibility that the TREAD Act will be expanded to include these other applications, product acceptance of TPMS is steadily increasing. We have introduced new systems to these receptive markets on a global basis offering the highest standards of performance and reliability. Successful introduction and marketing of a new TPMS product is a multi-stage process. Initial product testing by the customer is required prior to placing any substantial orders. Test programs can last from a few weeks to several months.

One of our major objectives in 2004 was to establish distribution networks in each market segment. This involved contracting leading distributors with extensive dealer networks. Securing the top distributors in each sector not only ensures sales and marketing success but it also creates major barriers to entry for competitors. We are heavily focused on the quality of our distributors as well as their commitment to our TPMS program.



Based on existing market conditions at the time, we had anticipated a significant increase in revenue during this past fiscal year. However due to the continued delay of the TREAD Act, major orders for passenger car TPMS did not materialize. In addition, considerable time was required to establish product acceptance and distribution of TPMS in other market segments. As a result, SmarTire generated slightly less revenue in 2004 than in 2003.

This past year also presented us with a daunting challenge from the standpoint of public market performance. A necessary change of financial advisors and funding sources early in 2004 triggered a series of events that resulted in serious downward pressure on our share price. This was further compounded by the company's cash requirement to retire debt, develop new products, build inventory and satisfy operating expenses. We successfully resolved these difficult financial issues as they arose but the cost to our shareholders in terms of dilution was substantial.

We are committed to re-build SmarTire's shareholder value. We have both the opportunity and the ability to achieve this objective. From a timing standpoint, the TREAD Act is finally and firmly in place. Product awareness has been building, product acceptance is now a reality and we have established TPMS distribution in the primary world markets. Our talented engineers with years of specialized expertise have developed a wide range of TPMS solutions. Finally, our new financial advisors have arranged the funding necessary to finance our aggressive business plan and to ensure that SmarTire will have the funding required to secure and service long-term supply contracts.

On behalf of the Directors, the management and staff of SmarTire, I wish to express our sincere appreciation to all of our stakeholders who have provided their support during 2004.

Sincerely,

Robert V. Rudman, CA
President and Chief Executive Officer



SMARTIRE

SmarTire develops and markets innovative tire pressure monitoring systems (TPMS) for the world's automotive and transportation industries. Leveraging its substantial investment in leading edge TPMS technology, SmarTire brought to market several technically enhanced products in 2004 including SmarTire for Motorcycles and SmarTire for Recreational Vehicles, Commercial Vehicles and Buses. These new products are the culmination of years of hands-on experience gained through previous generations of products and have been extremely well received in their respective markets.

A D V A N C E D , T E S T E D A N D P R O V E N T E C H N O L O G Y

Application Specific Integrated Sensor: SmarTire's core technology includes a custom Application Specific Integrated Sensor (ASIS) contained in a single chip that detects pressure and temperature within the harsh environment of a tire. This single chip design is extremely robust yet energy efficient, enabling long battery life. Further miniaturization enables the entire SmarTire radio frequency technology to be packaged on small circuit board for more efficient manufacturing and a smaller overall transmitter size.

Radio Frequency Transmission: Transmitting critical data reliably through a rotating, steel-encased tire pushes radio frequency technology to its limit. SmarTire's 17 years experience in radio frequency technology has enabled the company to deliver products that are proven to be among the most advanced and reliable in the entire automotive and transportation industry. SmarTire continues to invest in ongoing research and development to ensure that its RF technology remains at the forefront of the industry and able to meet the demands of these technically challenging markets.

Tire Data Display Options: To be useful to the driver of the vehicle, tire data and alerts must be displayed in a way that is easily readable and immediately captures their attention. SmarTire offers a number of innovative display options for both its OEM and aftermarket products depending on the type of vehicle or application. In addition, SmarTire has developed TPMS systems for the commercial OEM market that are designed to integrate with the existing onboard data displays.

Battery-less TPMS: As the world becomes more ecologically minded, there is increasing demand for a TPMS system that operates without batteries. SmarTire has invested significant technical resources to battery-less research including a license for surface acoustic wave technology. The company has also successfully completed the initial test phase of a new battery-less tire pressure monitoring system. The new SmarTire battery-less system involves a passive sensor inside each tire that is energized by an antenna located within each wheel arch.

S M A R T I R E P R O D U C T S

SmarTire markets direct measurement TPMS for both the aftermarket and original equipment manufacturer (OEM) applications. All SmarTire systems use a sensor mounted inside the tire that directly monitors the air pressure and temperature, ensuring the tire is operating optimally and safely. If a tire loses pressure or if a tire's temperature rises abnormally, the SmarTire system instantly alerts the driver or rider to the condition so appropriate action can be taken.

A new product naming strategy was launched this year to differentiate the SmarTire products in the various target markets and to build brand equity in the SmarTire name. For example, SmarTire for Passenger Vehicles, SmarTire for Motorcycles and all other products will include the target application as part of the product name. This naming strategy conveys the message that SmarTire builds products designed to meet the needs of specific markets and customers.



SMARTIRE FOR PASSENGER VEHICLES

SmarTire for Passenger Vehicles is a proven product that uses sophisticated sensors, state-of-the-art wireless technology and offers a number of display options for both aftermarket and OEM applications. SmarTire for Passenger Vehicles is installed on tens of thousands of vehicles worldwide including passenger cars, light trucks, sport utility vehicles and multi-purpose vans. Some of the world's most prestigious automobile manufacturers such as Bentley, Aston Martin, Morgan, and Holden use SmarTire products on their vehicles.

SmarTire sells its passenger vehicle product worldwide with a particular focus on North American, European and Pacific Rim countries. The Chinese market has become increasingly important and SmarTire's master distributor, Beijing Boom Technologies, has been very successful in introducing SmarTire's aftermarket product in this growing market. SmarTire is continually seeking strategic business opportunities with vehicle manufacturers, aftermarket parts and accessory providers and automotive service centers to expand its distribution and customer base.

The final rule of the Transportation Recall Enhancement Accountability and Documentation (TREAD) Act, prepared by the National Highway Transportation Safety Administration (NHTSA) has drawn worldwide attention to tire pressure monitoring and its contribution to improved vehicle safety. Countries without current legislation are watching the US closely for the impact of the TREAD Act and specifically tire pressure monitoring. SmarTire expects more countries to adopt similar legislation in the future.

SMARTIRE FOR MOTORCYCLES

SmarTire launched its second generation SmarTire for Motorcycles product in 2004 and this product has generated considerable attention and accolades from motorcycle riders, dealers and the worldwide motorcycle press. SmarTire for Motorcycles is the only product of its kind on the market and is designed to give motorcyclists continuous information on the condition of their tires and an early warning of a tire problem. SmarTire for Motorcycles features a compact and lightweight integrated receiver and display that can be easily mounted in view of the rider.

SmarTire for Motorcycles is distributed in North America by National Cycle and by Nichols Motorcycle Supply. The product is distributed by Motohaus in the U.K. and by Seehauser in Europe. SmarTire is continually seeking strategic relationships with

distributors, dealers and motorcycle manufacturers to make this important technology available to as many motorcyclists as possible. SmarTire for Motorcycles has received extremely positive media coverage with a number of reviews and product features in several leading magazines.

SMARTIRE FOR RECREATIONAL VEHICLES

SmarTire for Recreational Vehicles was launched this year to a receptive market of RV owners and enthusiasts. SmarTire's second generation product is a significant enhancement of its previous successful product. The system allows the RV owner to not only monitor the tires of the coach but also the tires of a towed vehicle or trailer. This is critically important as it is almost impossible to be aware of a problem with the tires of a towed vehicle or trailer until it is too late. SmarTire for Recreational Vehicles can monitor up to 20 wheel positions on up to six axles, making it compatible with the wide array of RV/Trailer/Tow Behind configurations.

SmarTire is marketing its recreational vehicle products to both the aftermarket and OEM manufacturers. Bob Dickman Tire Center of Junction City, Oregon is an important distributor of SmarTire products and has taken the lead in supplying such prestigious companies as Country Coach and Monaco Coach as both standard and optional equipment on their lines of recreational vehicles. More distributors are being added to provide total coverage across the US and Canada.

SmarTire expects the recreational vehicle market to become increasingly important to the company in the coming year. Industry figures show a sustained growth in the RV lifestyle and with tire monitoring increasing in awareness and acceptance, SmarTire is positioning itself to become the leading provider of this important technology to the RV market.

SMARTIRE FOR BUSES

The new SmarTire for Buses product utilizes the company's next generation high pressure transmitters and warns the driver if a tire is under-inflated, loses pressure while driving or if the tire temperature rises abnormally. This tire information is critical for the safe operation of the bus and helps maximize tire life, fuel economy and safety as well as reduce the risk of downtime due to a tire failure. The SmarTire for Buses system can also alert the driver to other serious problems such as a brake dragging which causes the tire to increase in temperature potentially leading to a devastating tire fire.



International tour bus companies and bus manufacturers are currently testing the product in pilot projects. In addition, SmarTire has received orders from tour bus operators in Asia and will aggressively pursue other opportunities worldwide for this innovative product. The global tour and transit bus market will become an extremely important business opportunity for the company in the coming year.

SMARTIRE FOR COMMERCIAL VEHICLES

SmarTire is targeting both the OEM and the aftermarket for its SmarTire for Commercial Vehicles product. Tire monitoring for commercial vehicles provides bottom-line cost savings in terms of maximized fuel economy, extended tire life and reduced downtime as well as significant safety benefits for both the driver and cargo. Commercial vehicle owners and fleet managers are both interested in tire monitoring technology as a way to improve their operations.

SmarTire, in conjunction with Vansco Ltd., has developed a J1939 controller area network (CAN), chassis-mounted receiver designed specially for the commercial OEM market. The J1939 CAN is the most widely used communication standard in commercial vehicles today. When combined with SmarTire's high pressure sensors, this CAN receiver allows tire data to be sent directly to the vehicle's on board display system. This innovative system is designed to meet the stringent OEM requirements of commercial truck, bus, agricultural, construction and recreational vehicle manufacturers.

To reach the commercial trailer OEM and aftermarket, the company has entered into a joint development program with Haldex Brake Products Ltd. to integrate TPMS with Haldex's industry leading brake systems. This collaboration will result in a commercial TPMS for marketing and resale by Haldex to its worldwide customer base.

SMARTIRE FOR INDUSTRIAL AND OTHER APPLICATIONS

The off-road, industrial vehicle sector was the original proving ground for SmarTire's TPMS technology. The benefits of TPMS in these challenging environments remain the same with increased tire life, reduced downtime and improved safety for the driver. SmarTire anticipates that the development work completed for the commercial vehicle market will open the door to new opportunities in the industrial and off-road sector.

SmarTire's TPMS technology has also been utilized in other interesting applications such as monorails and people movers. These rail systems rely on rubber tires and to

ensure their safe and efficient operation, SmarTire's technology has been installed on such high profile projects as the Kuala Lumpur and Las Vegas monorails.

T H E T R E A D A C T

In November 2000, a U.S. federal transportation law was enacted to prevent the re-occurrence of the tragedies experienced with Firestone equipped Ford sport utility vehicles. The Transportation, Recall, Enhancement, Accountability, and Documentation (TREAD) Act empowered the National Highway Traffic Safety Administration (NHTSA) to improve vehicle safety through various initiatives including a regulation that requires the installation of warning systems in new vehicles to indicate when tires are significantly under-inflated.

The original NHTSA rulemaking allowed for the use of either 'Direct' or 'Indirect' (ABS based) approaches to tire pressure monitoring. The direct measurement approach was determined to be technically superior but represented a greater cost solution. In August 2003, auto safety advocates scored a major victory when the U.S. Court of Appeals ordered NHTSA to rewrite the rulemaking and to disallow the use of indirect systems on the basis that they are too ineffective and placed drivers at risk. The new NHTSA rulemaking sets requirements that can currently only be met through the use of direct measurement systems.

The U.S. Court of Appeals decision resolved the dispute over indirect systems but effectively delayed the TPMS phase-in schedule by one year as NHTSA addressed the rewriting of the rulemaking. However, the new mandate is structured to prevent any further delay by requiring auto manufacturers to achieve 50% compliance for model year 2006, 90% for model year 2007 and total compliance for model year 2008. SmarTire applauds this new rulemaking and compliance schedule.

S M A R T I R E I N 2 0 0 5

Building on its many years of technology and product development, its market successes to-date and its new product launches of 2004, SmarTire will aggressively pursue and seize TPMS opportunities in all target markets on a global basis throughout 2005. With a family of products that addresses the entire spectrum of vehicles on the road today, SmarTire is well positioned to satisfy the TPMS requirements of the passenger car, motorcycle, recreational, commercial and industrial vehicle markets. The SmarTire team is fully committed to the company's goals and objectives designed to build a successful business and increase shareholder value.



MANAGEMENT'S DISCUSSION & ANALYSIS

The following discussion of our financial condition, changes in financial condition and results of operations for the fiscal years ended July 31, 2004, 2003 and 2002, should be read in conjunction with the audited annual financial statements and the notes thereto.

Our consolidated financial statements are stated in United States Dollars and are prepared in accordance with United States Generally Accepted Accounting Principles.

RESULTS OF OPERATIONS

Fiscal Year Ended July 31, 2004 vs. Fiscal Year Ended July 31, 2003

Revenue

Gross revenue for the fiscal year ended July 31, 2004 decreased to \$1,658,279 from \$1,802,596 for our fiscal year ended July 31, 2003. This decrease in revenue was a result of the following:

- Sales of aftermarket passenger car tire monitoring systems (TMS) decreased to \$1,087,395 for fiscal 2004 from \$1,141,210 for fiscal 2003.
- Sales of original equipment manufacturer ("OEM") passenger car systems decreased to \$166,202 for fiscal 2004 from \$174,880 for fiscal 2003.
- Sales of aftermarket motorcycle systems decreased to \$37,744 for fiscal 2004 compared to \$183,589 for fiscal 2003.

We recently introduced a substantially improved second generation motorcycle tire pressure monitoring system (TPMS) at the Indy Motorcycle Dealers Show, held in Indianapolis, Indiana in mid-February 2004. During May 2004 this product became commercially available and we began shipping it to our customers. In August 2004, we discovered that the sensor/transmitter may break during installation on the subset of motorcycle rims with curved rim surfaces when the strap is torqued to its required value. On September 14, 2004 we contacted the National Highway Transportation Safety Administration (NHTSA) to determine if a Safety Defect and Non Compliance Report was required and was advised that this was necessary. SmarTire's remedy for the defect was to recall 100% of affected sensor/transmitter items from the field and replace both recalled and inventory sensor/transmitters with sensor/transmitters previously manufactured by a different supplier that have been tested and known to use plastics that provide the required mechanical properties. Additionally, to ensure that transmitters are used only on rims with flat drop center wells (as originally designed for) and not curved, the additional precautionary steps were taken:

- Adding improved warnings and instruction sheet to new product as well as product in inventory at dealers and distributors that clarify flat rim drop center well application only
- Removal of tire pressure monitoring system (TPMS) on motorcycles with rims with curved drop center wells

We anticipate the cost of this recall will be approximately US\$67,000. In addition, we are currently working on a solution to enable us to sell our tire pressure monitoring system (TPMS) on motorcycles with rims with curved drop center wells. To date, the response to the recall by our customers has been very positive. Although interest in the motorcycle product by existing and potential customers remains positive, it is difficult for us to predict what the volume of sales will be, as this will depend primarily on market acceptance.

- Sales of aftermarket recreational vehicle systems were \$118,357 for fiscal 2004 compared to \$26,383 for fiscal 2003. These sales include sales of our high pressure transmitters that were released in our fourth quarter and sales of low pressure sensors to monitor the wheels of a towed vehicle or trailer that was introduced during our first quarter ended October 31, 2003.
- Sales of OEM recreational vehicle systems were \$64,454 for fiscal 2004. The majority of these sales occurred in the fourth quarter after the release our high pressure transmitters. Although it is difficult for us to predict what the volume of sales will be, we anticipate a substantial increase in sales during the next fiscal year.
- Sales of aftermarket high pressure monitoring systems for use on buses were \$42,406 for fiscal 2004. All of these sales occurred in our fourth quarter after the release our high pressure transmitters. Although it is difficult for us to predict what the volume of sales will be, we anticipate a substantial increase in sales during the next fiscal year.
- Sales of aftermarket high pressure monitoring systems for use on commercial vehicles were \$22,733 for fiscal 2004. Our customers purchased these systems in the fourth quarter after the release our high pressure transmitters. The majority of these systems are currently being used for test purposes. Although it is difficult for us to predict what the volume of sales will be, we anticipate a substantial increase in sales during the next fiscal year.

- Sales of off-the-road (OTR) tire monitoring systems were \$1,088 for fiscal 2004 compared to \$58,395 for fiscal 2003. Our off-the-road (OTR) tire pressure monitoring system (TPMS) utilizes a high-pressure transmitter and is designed primarily for off-the-road (OTR) heavy industrial applications and commercial applications. The system may potentially be used not only on large mining trucks, but also heavy mobile equipment (such as tractors, wheeled loaders, graders and the like). Sales of our off-the-road (OTR) tire monitoring systems to date have been limited to those systems which are designed for use on large mining trucks. We anticipate that an increase in sales of this product in fiscal 2005 now that we have successfully completed commercializing the wireless gateway receiver that has been developed with Vansco.
- Revenue of \$94,800 was recorded for engineering changes to modify our products pursuant to our Manufacturing, Co-Marketing and Development Agreement with Hyundai Autonet Co. Ltd. for fiscal 2004 compared to \$173,400 for the fiscal 2003. Revenue is determined by the percentage of completion method.
- Sales of the motorsport tire monitoring systems (TMS) decreased to \$nil for fiscal 2004 from \$44,739 for fiscal 2003. As indicated above, we do not anticipate further sales of our motorsport tire monitoring systems (TMS) as our exclusive motorsport distributor, Pi Research of Cambridge, England, now manufactures and markets their own system. Accordingly, we have discontinued production of our motorsport tire monitoring systems (TMS).
- Sales of miscellaneous products were \$23,100 for fiscal 2004 compared to \$nil for fiscal 2003.

The miscellaneous products that accounted for \$23,100 during fiscal 2004 consisted primarily of dataloggers, which are used to facilitate testing by our OEM customers.

On September 10, 2004 the NHTSA's (National Highway Traffic Safety Administration) issued a Notice of Proposed Rulemaking (NPRM) document defining their current position. Comments on the proposed Rulemaking must be received on or before 60 days after date of publication (of the NPRM) in the Federal Register. NHTSA is proposing a new FMVSS (Federal Motor Vehicle Safety Standards) requirement for four tire, 25-percent under-inflation detection. The rule proposes requirements for covered vehicles manufactured on or after September 1, 2005. NHTSA is proposing the following phase in schedule:

- 50 percent of a vehicle manufacturer's light vehicles would be required to comply with the standard during the first year (September 1, 2005 to August 31, 2006);
- 90 percent during the second year (September 1, 2006 to August 31, 2007);
- all light vehicles thereafter.

NHTSA is also proposing the following:

- to require vehicle manufacturers to assure compliance with FMVSS 138 with the tires installed on the vehicle at the time of the initial sale;
- to require the TPMS to be equipped with a telltale that would alert the driver of a TPMS malfunction. The malfunction warning be provided either through a separate, dedicated telltale or through a distinctive warning delivered by the low pressure telltale
- the use of a specific test course (i.e., the Southern loop of the tread wear test course, San Angelo, Texas) which is both objective and representative of a range of driving conditions;
- the TPMS would be required to warn the driver when the tire pressure in one or more of the vehicle's tires, up to a total of four tires, is 25 percent or more below the vehicle manufacturer's recommended cold inflation pressure for the tire, or a minimum level of pressure specified in the standard, whichever pressure is higher;
- vehicle manufacturers would be required to certify vehicle compliance under the standard with the tires installed on the vehicle at the time of the initial vehicle sale;
- the TPMS would be required to include a low tire pressure warning telltale (Yellow) that must remain illuminated as long as any of the vehicle's tires remains significantly under inflated and the vehicle's ignition locking system is in the "On" ("Run") position. The telltale must be extinguished when all of the vehicle's tires cease to be significantly under inflated. The TPMS's low tire pressure warning telltale would be required to perform a bulb-check at vehicle startup;
- the TPMS also would be required to include a malfunction indicator to alert the driver when the system is non-operational, and thus unable to provide the required low pressure warning. NHTSA is proposing that the malfunction would be indicated by either (1) separate dedicated telltale (Yellow) or (2) designing the low pressure telltale so that it flashes for one minute when a malfunction is detected after which the telltale will remain illuminated as long as the ignition locking system is in the "On" ("Run") position. This flashing and illumination sequence would be repeated upon each subsequent vehicle start up until the situation has been corrected;



- the TPMS would not be required to monitor the spare tire (if provided) either when it is stowed or when it is installed on the vehicle;
- For vehicle's certified under the standard, vehicle manufacturers would be required to provide in the owners manual an explanation of the purpose of the low tire pressure warning telltale, the potential consequences of significantly under-inflated tires, the meaning of the telltale when it is illuminated, and what action the driver should take when the telltale is illuminated.

To encourage early compliance, NHTSA is proposing to permit carry-forward credits for vehicles that are certified as complying with the standard and that are manufactured on or after the effective date of the final rule. However, beginning September 1, 2007 all covered vehicles would be required to comply with the standard, without regard to any earlier carry forward credits. It will not be permissible for dealers to install tires on a new vehicle that would take the vehicle out of compliance with the TPMS standard. NHTSA is proposing to permit vehicle manufacturers to incorporate a second, red light to accompany the continuously illuminated yellow TPMS telltale, which would be illuminated when pressure in one or more tires becomes dangerously under-inflated, as determined by the manufacturer. It will be permissible to incorporate the TPMS telltale as part of a reconfigurable display, provided that the illumination of the yellow telltale is continuous while one or more tires are under-inflated. NHTSA will retain their discretion regarding how they will structure phase in requirements for small volume manufacturers (5000 vehicles or less for North American Market) and will make such determination on a case by case basis. OEM's are free to select a low pressure alert level at a higher level than the 25 percent below placard.

Our direct measurement tire monitoring systems (TMS) products meet the standard for tire pressure monitoring established by NHTSA. Accordingly, we believe the auto manufacturers must accelerate their implementation plans in order to meet these new NHTSA rules which will create additional opportunities to market our products to OEMs in the automobile industry. In addition, although the TREAD Act only applies to passenger automobiles, we believe that other motor vehicles, including medium and heavy trucks, buses and motorcycles will be impacted by this legislation in subsequent years. We also believe that compliance with the TREAD Act by European, Japanese, Chinese and other automakers will accelerate the adoption of tire monitoring systems (TMS) globally.

It is difficult to predict the magnitude of the expected sales increase or the exact timing of the increase since our products will continue to face competition from other tire monitoring systems (TMS) manufactured by our competitors, and the timing of additional legislative initiatives on tire safety, if any, in the United States and abroad remains uncertain. Our management expects that, as tire monitoring systems (TMS) becomes standard equipment for new passenger vehicles, demand for tire monitoring systems (TMS) as dealer installed options and aftermarket products will gradually decline.

Our current strategy involves generating revenue from products available to meet today's demand for dealer installed options and aftermarket products combined with the pursuit of OEM business. However, the pursuit of OEM business will involve new challenges for management, including overcoming existing relationships that certain of our competitors currently enjoy with automakers.

Gross Margin

Gross margin on product sales decreased to 12.8% for fiscal 2004 from 23% for fiscal 2003. The decrease occurred due to the following factors:

- 1) our product mix of systems sold in the fiscal 2004 had lower gross margins than the product mix of systems sold in the fiscal 2003;
- 2) our provision for our motorcycle recall (discussed above) in the amount of \$66,801 decreased our fiscal 2004 margin by 4%;

During our third quarter, we shifted the majority of our production to Hyundai Autonet, and as we expected, our gross margin increased in our third and fourth quarters, after excluding the cost of our motorcycle recall. Although we expect that our gross margin will continue to increase in fiscal 2005, this is dependent on the cost of components and the sales contracts that we enter into.

Expenses

Expenses increased to \$7,186,287 for fiscal 2004 from \$6,802,391 for fiscal 2003, as increases in marketing, engineering, research and development expenses and depreciation and amortization were partially offset by a decrease in general and administration expenses.

Engineering, research and development expenses increased to \$1,654,690 for fiscal 2004 from \$1,177,935 for fiscal 2003. This increase was primarily attributed to an increase in prototype development expenses, an increase in product testing on products that we have released in the current fiscal year, an increase in the number of patents and approval applications, and an increase in the number of engineering employees and engineering-related wages.

Marketing expenses increased to \$1,821,122 for fiscal 2004 from \$1,448,326 for fiscal 2003. The increase was primarily a result of an increase in travel and higher marketing-related wages, which increased as a result of the recruitment of a V.P. of Sales and Marketing. This increase was partially offset by lower tradeshow expenditures. Trade show expenses in fiscal 2003 included the cost of attending the Automechanika show, which is held in Europe every two years. Fiscal 2003 also included expenses of \$130,000 in connection with the termination of a management agreement; 50% of this amount or \$65,000 was booked as marketing expenses and 50% was booked as general and administrative expenses.

General and administrative expenses decreased to \$2,338,758 for fiscal 2004 from \$2,939,260 for fiscal 2003. The decrease was primarily attributed to lower professional fees, investor relation costs and administration wages. Professional fees for fiscal 2003 included an expense of \$315,044 to settle certain potential unquantified claims threatened by certain offshore investors against our Company. Administrative wages decreased as there were less administrative employees during fiscal 2004 and as explained above, our general and administrative expenses for year ended July 31, 2003 include \$65,000 that was incurred in connection with the termination of a management contract. The decrease was partially offset by an increase in insurance costs.

Depreciation and amortization expense increased to \$1,371,717 for fiscal 2004 from \$1,236,870 for fiscal 2003. Depreciation and amortization expense is expected to remain at approximately its current level for the foreseeable future.

Interest and finance charges increased to \$4,031,820 for fiscal 2004 from \$3,722,505 for fiscal 2003. The charges for fiscal 2004 included \$3,302,272 in interest and finance charges on our 7% and 8% convertible debentures, and our discounted convertible debentures, \$262,965 related to the issuance of our \$15M equity line of credit with Talisman Management Limited which we do not plan to use, \$179,917 related to the issuance of promissory notes totaling \$1,500,000, plus a payment in November 2003 of \$75,355 paid to Palisades Master Fund, L.P. as an early participation bonus. As discussed below under the heading "Liquidity and Capital Resources," on October 27, 2003, in order to encourage early exercise of certain outstanding warrants by Palisades Master Fund and three additional warrant holders, we offered to reduce the exercise price of a total of 10,769,231 outstanding warrants from \$0.2645 per share to \$0.20 per share. Palisades Master Fund elected to accept our offer, but on November 6, 2003, in order to encourage early exercise of the warrants by the remaining three warrant holders, we offered to reduce the exercise price of the remaining 7,478,635 warrants from \$0.2645 per share to \$0.1771 per share. As a result, we agreed to pay the \$75,355 early participation bonus to Palisades Master Fund, being an amount equal to the difference between the aggregate exercise price that Palisades Master Fund paid upon the exercise of 3,290,596 outstanding warrants at \$0.20 per share and the aggregate exercise price that Palisades Master Fund would have paid if it had the benefit of the reduced exercise price of \$0.1771 per share. The fair value of the early participation bonus is included in interest expense.

Interest and finance charges of \$3,722,505 were incurred during fiscal 2003, including \$3,720,250 in interest and finance charges on 10%, 5%, 7% and 8% redeemable convertible debentures, a 12% promissory note and a \$5 million equity line of credit issued during fiscal 2003. The \$5 million equity line of credit was terminated on July 22, 2004.

Interest Income

Interest income of \$5,873 was earned for fiscal 2004 as compared to \$2,835 for fiscal 2003. This increase was due to slightly higher average cash balances maintained during fiscal 2004.

Foreign exchange gain

A foreign exchange gain of \$12,492 was earned for fiscal 2004 as compared to \$192,201 for fiscal 2003. Foreign exchange gains or losses are due to fluctuations in currency exchange rates and are impossible to predict.

Fiscal Year Ended July 31, 2003 vs. Fiscal Year Ended July 31, 2002**R E V E N U E**

Gross revenue for the fiscal year ended July 31, 2003 increased to \$1,802,596 from \$1,012,344 for the fiscal year ended July 31, 2002. This increase in revenue was a result of the following:

- Sales of aftermarket passenger car tire monitoring systems (TMS) increased to \$1,141,210 for fiscal 2003 from \$791,217 for fiscal 2002.
- Sales of original equipment manufacturer ("OEM") - passenger car systems increased to \$174,880 for fiscal 2003 from \$164,588 for fiscal 2002. Fiscal 2002 included sales under the Lincoln Continental program of our first generation product that was discontinued by Ford Motor Company at the end of December 31, 2001. Without the sales of \$43,711 under the Lincoln Continental program for fiscal 2002, sales for fiscal 2002 would have been \$120,847.
- Sales of motorcycle tire monitoring systems (TMS) were \$183,589 for fiscal 2003 compared to \$nil for fiscal 2002.
- Sales of "off-the-road" tire monitoring systems (TMS) designed for mining vehicle applications were \$58,395 for fiscal 2003 compared to \$nil for fiscal 2002. These tire monitoring systems (TMS) are currently undergoing on-vehicle validation.
- Revenue of \$173,400 was recorded for engineering changes to modify our products pursuant to our Manufacturing, Co-Marketing and Development Agreement with Hyundai Autonet Co. Ltd. for fiscal 2003 compared to \$nil for the fiscal 2002. Revenue is determined by the percentage of completion method.
- Sales of the motorsport tire monitoring systems (TMS) decreased to \$44,739 for fiscal 2003 from \$56,539 for fiscal 2002. As indicated above, we do not anticipate further sales of our motorsport tire monitoring systems (TMS) as our exclusive motorsport distributor, Pi Research of Cambridge, England, now manufactures and markets their own system. Accordingly, we have discontinued production of our motorsport tire monitoring systems (TMS).
- Sales of recreational vehicle products were \$26,383 for fiscal 2003 compared to \$nil for fiscal 2002.

G R O S S M A R G I N

Gross margin on product sales decreased to 23% for fiscal 2003 from 31% for fiscal 2002. The decrease occurred as the product mix of systems sold in fiscal 2003 had lower gross margins than the product mix of systems sold in fiscal 2002. The gross margins continued to be affected by the reduction in carrying value of first generation product inventory in the 1999 fiscal year.

E X P E N S E S

Expenses decreased to \$6,802,391 for fiscal 2003 from \$7,038,843 for fiscal 2002, as a result of decreases in engineering, research and development expenses and marketing expenses. Reductions in these expenses (discussed in greater detail below) were partially offset by higher general and administration expenses and depreciation and amortization expenses.

Engineering, research and development expenses decreased to \$1,177,935 for fiscal 2003 from \$1,727,606 for fiscal 2002. The higher engineering, research and development expenses for fiscal 2002 were attributable primarily to a \$500,000 expenditure for non-recoverable development costs incurred with a key component supplier for future product development activities in that fiscal year. This expenditure was a one-time expense with this supplier. The nature of our activities could result in other future non-recurring engineering, research and development expenditures. A decrease in prototype development expenses, lower travel costs and lower expenditures on patents and approvals also contributed to the decrease in engineering, research and development expenses between fiscal 2002 and fiscal 2003, although these cost savings were partially offset by an increase in engineering-related-wages due to an increase in the number of engineering employees.

Marketing expenses decreased to \$1,448,326 for fiscal 2003 from \$1,527,644 for fiscal 2002. This decrease was mainly due to lower advertising and promotion costs, as well as lower travel costs. This decrease was partially offset by higher marketing-related wages and tradeshow expenditures. Wages were higher as we incurred expenses of \$130,000 in connection with the termination of a management agreement; 50% of this amount, or \$65,000, is included in the marketing expenses for fiscal 2003, and 50% was included in general and administrative expenses for the year. The balance of the increase in our marketing expenses was a result of trade show expenses, including the cost of attending the Automechanika show, which is held in Europe every two years.

General and administrative expenses increased to \$2,939,260 for fiscal 2003 from \$2,631,215 for fiscal 2002. The increase is attributable to an increase in professional fees, filing fees, insurance premiums and an expense of \$315,044 to settle certain potential unquantified

claims threatened by certain offshore investors against our Company. Professional fees increased as a result of filing registration statements with the Securities and Exchange Commission. As explained above, general and administrative expenses include \$65,000 that was incurred in connection with the termination of a management contract. The increase was partially offset by lower travel and capital expenses.

Depreciation and amortization expense increased to \$1,236,870 for fiscal 2003 from \$1,152,378 for fiscal 2002. Depreciation and amortization expense is expected to remain at approximately its current level for the foreseeable future.

Interest and finance charges of \$3,722,505 were incurred during fiscal 2003, including \$3,720,250 in interest and finance charges on 10%, 5%, 7% and 8% redeemable convertible debentures, a 12% promissory note and a \$5 million equity line of credit issued during fiscal 2003.

Interest Income

Interest income of \$2,835 was earned for fiscal 2003 as compared to \$18,735 for fiscal 2002. This decrease was due to lower average cash balances maintained and lower interest rates during fiscal 2003.

Foreign exchange gain

A foreign exchange gain of \$192,201 was earned for fiscal 2003 as compared to \$24,015 for fiscal 2002. The increase was primarily due to the decrease in the value of the US dollar against the Canadian dollar during the year, which resulted in foreign exchange gains on the settlement of US dollar liabilities outstanding at July 31, 2002 during fiscal 2003.

L I Q U I D I T Y A N D C A P I T A L R E S O U R C E S

Current Position

We have continued to finance our activities primarily through the issuance and sale of securities. We have incurred losses from operations in each year since inception. As at July 31, 2004, we had an accumulated deficit of \$59,018,256. Our net loss for fiscal 2004 was \$10,987,026 compared to \$9,914,629 for fiscal 2003. As of July 31, 2004, our stockholders' equity was \$3,466,216 and we had working capital of \$732,405.

Our cash position at July 31, 2004 was \$112,951 as compared to \$1,843,694 at July 31, 2003. This decrease was due to the net decrease from our operating, financing and investing activities as described below.

Our net loss of \$10,987,026 for fiscal 2004 includes non-cash charges of \$1,371,717 for depreciation and amortization, \$3,842,107 for interest and finance expense and \$98,175 for shares and warrants issued for services received. Decreases in non-cash working capital during this period amounted to \$1,860,812. Non-cash working capital changes included increases in inventory and prepaid expenses and a decrease in receivables and accounts payable and accrued liabilities. An increase in inventory of \$2,391,749 accounted for the most significant use of cash for working capital. This increase was primarily due to the procurement of components for production builds at Hyundai Autonet.

During fiscal 2004, we realized aggregate gross cash proceeds of \$7,170,265 from financing activities as follows:

On October 27, 2003, in order to encourage early exercise of a total of 10,769,231 warrants issued to the purchasers of our 7% convertible debentures, we offered to reduce the exercise price of the warrants from \$0.2645 per share to \$0.20 per share. The offer was open for acceptance by the warrant holders until November 4, 2003. In consideration of the warrant holders' agreement to immediately exercise their respective warrants, we offered to issue to the participating warrant holders one additional warrant for each warrant that was exercised. One of the warrant holders, Palisades Master Fund, L.P. accepted our offer and exercised a total of 3,290,596 outstanding warrants at the reduced exercise price of \$0.20 per share. On October 27, 2003, we issued a total of 3,290,596 five-year warrants to Palisades Master Fund, exercisable at an exercise price of \$0.20 per share, resulting in gross proceeds of \$658,119. The additional warrants were to be exercisable for a period of five years at an exercise price of \$0.20 per share.

On October 27, 2003, our former investment banker HPC Capital Management, also agreed to immediately exercise 194,000 outstanding common stock purchase warrants dated May 16, 2003, in consideration of receiving one additional five-year warrant with an exercise price of \$0.20 per share for each warrant so exercised. Of the 194,000 warrants exercised by HPC Capital Management under this arrangement, 180,000 were exercised at an exercise price of US\$0.13 per share and 14,000 were exercised at an exercise price of US\$0.10 per share, resulting in gross proceeds of \$24,800.

On November 6, 2003, in order to encourage early exercise of the warrants by the remaining three warrant holders, we offered to reduce the exercise price of the remaining 7,478,635 warrants from \$0.2645 per share to \$0.1771 per share. The offer was open for acceptance by the warrant holders until November 19, 2003. In consideration of the warrant holders' agreement to immediately exercise their respective warrants, we offered to issue to the participating warrant holders one additional warrant for each warrant that is exercised. The additional warrants are exercisable for a period of five years at an exercise price of \$0.1771 per share.

On November 10, 2003, all of the remaining warrant holders, Crescent International Ltd., Alpha Capital AG and Goldplate Investment Partners, accepted our offer and exercised a total of 7,478,635 outstanding warrants at the reduced exercise price of \$0.1771 per share. On December 24, 2003 we closed a private placement of discounted unsecured convertible debentures in the aggregate principal amount of \$3,493,590. We issued the convertible debentures at a 22% original issue discount from the face principal amount (based on a notional interest rate of 11% per annum for each year of the two-year term of the debentures), resulting in gross proceeds of \$2,725,000, before the deduction of a \$218,000 cash placement fee subsequently paid to HPC Capital Management and other expenses of the offering. The discounted convertible debentures do not otherwise bear interest, and will mature on April 1, 2006. The outstanding principal amount of each debenture may be converted at any time into shares of our common stock, in whole or in part, at the option of the holder of the debenture at a set price of \$0.22 per share. The discounted convertible debentures are subject to mandatory redemption in equal monthly payments, payable in cash. We may elect to make the monthly redemption payments in shares of our common stock at a conversion price equal to the lesser of:

(a) the set price of \$0.22 per share (subject to adjustment pursuant to the anti-dilution provisions contained in the debentures), and

(b) 85% of the average of the closing prices of the Company's common stock for twenty days immediately preceding the applicable monthly redemption date, provided that certain conditions are met, including the condition that the underlying shares of common stock shall have been registered under the Securities Act of 1933, as amended.

On February 5, 2004, we notified the holders of the discounted convertible debentures that we had elected to effect the first monthly redemption payment in shares, and that the election should continue for subsequent redemption periods until revised. One of the holders of the discounted convertible debentures exercised its right to receive its first monthly redemption payment, in the amount of \$14,583, in cash.

On April 28, 2004, the Company irrevocably notified the debenture holders that it would make the monthly redemption payments in cash commencing June 1, 2004 until otherwise notified.

On October 14, 2003, an employee exercised 79,400 employee stock options at \$0.20 per stock option.

On April 15, 2004, the Company received gross proceeds of \$750,000 upon the issuance of an unsecured short-term promissory note to an accredited investor. The note bears interest at a rate of 8% per annum and is repayable within 120 days of issuance with accrued interest. As a commitment fee to loan the Company money, the holder of the note received \$75,000.

On April 30, 2004, 500,000 warrants were exercised at \$0.104. Pursuant to the anti-dilution provisions contained in certain warrants, the exercise price of 25,290,153 warrants outstanding were reduced to \$0.104 per share, which was the deemed price per share of the common stock that was issued to effect the April 1, 2004 redemption payment of the Company's discounted convertible debentures maturing April 1, 2006.

On May 19, 2004, we received gross proceeds of \$750,000 upon the issuance of an unsecured short-term promissory note to an accredited investor. The note bears interest at a rate of 8% per annum and is repayable within 120 days of issuance with accrued interest. As a commitment fee to loan the Company money, the holder of the note received \$75,000.

On May 19, 2004 we received gross proceeds of \$750,000 upon the issuance of an unsecured short-term promissory note to an accredited investor. The note bears interest at a rate of 8% per annum and is repayable within 120 days of issuance with accrued interest. As a commitment fee to loan the Company money, the holder of the note received \$75,000.

On May 19, 2004, we entered into a Standby Equity Distribution Agreement with Cornell Capital Partners, LP, an accredited investor, in connection with a 24-month, \$15.0 million equity line of credit facility. The agreement contemplates the potential future issuance and sale of up to \$15.0 million of our common stock to Cornell Capital Partners, LP, subject to certain restrictions and other obligations. As the underlying shares have been registered with the Securities and Exchange Commission, we are able to request advances. To July 31, 2004 we have drawn down \$750,000. We may continue to request advances until Cornell Capital Partners has advanced \$15,000,000 or two years after the effective date of the registration statement, whichever occurs first. Cornell Capital Partners is a private limited partnership whose business operations are conducted through its general partner, Yorkville Advisors, LLC.

Pursuant to the equity line of credit, we may, at our discretion, periodically sell to Cornell Capital Partners during the effectiveness of the related registration statement, shares of common stock for a total purchase price of up to \$15.0 million. Each such periodic sale of shares is known as an advance or drawdown. We may request an advance every 7 trading days. The maximum amount of each advance is \$500,000. Each advance will close 6 trading days after we give written notice of such advance, at which time we will deliver the appropriate number of shares of our common stock to Cornell Capital Partners, L.P. against payment of the advance amount. For each share of common stock purchased under the equity line of credit, Cornell Capital Partners will pay 98% of the lowest closing bid price on the OTC Bulletin Board, or such other principal market on which our common stock may then be traded, for the 5 days immediately following the notice date. Further, Cornell Capital Partners will retain 5% of each advance as a fee.

The amount of capital available under the equity line of credit will not be dependent on the price or volume of our common stock. Cornell Capital Partners may not own more than 9.9% of our outstanding common stock at any time. Because Cornell Capital Partners can repeatedly acquire and sell shares, this limitation does not limit the potential dilutive effect or the total number of shares that Cornell Capital Partners may receive under the equity line of credit.

We have issued to Cornell Capital Partners 14,370,835 shares of common stock of which 10,861,220 were pursuant to three draw downs of \$250,000 and 3,509,615 shares of common stock as a commitment fee under the equity line of credit. In addition, we have also issued, as a placement fee, 96,154 shares of our common stock to Newbridge Securities Corporation.

The net proceeds realized or to be realized by us from these transactions have and are to be used for debt repayment, working capital and the purchase of capital assets.

During fiscal 2004, we also purchased certain capital assets at an aggregate cost of \$446,780. The majority of these capital assets were sent to Hyundai Autonet in Korea to facilitate production of our aftermarket tire pressure monitoring systems (TPMS) for passenger cars and motorcycles.

Our management projects that we will require a minimum of \$6.3-\$8.5 million to fund our debt repayment, ongoing operating expenses and working capital requirements through July 31, 2005.

Between August 1, 2004 and October 15, 2004, the Company realized gross cash proceeds of \$2,746,788 from draw downs totalling \$2.2 Million from our \$15 Million equity line of credit and \$546,788 from the exercise of warrants.

However, due to the uncertainty of our ability to meet our current operating and capital expenses, in their report on the annual consolidated financial statements for fiscal 2004, our independent auditors included additional comments in their Auditors' report indicating concerns about our ability to continue as a going concern. Our consolidated financial statements contain additional note disclosures describing the circumstances that led to this disclosure by our independent auditors. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As the continuation of our business is dependent upon obtaining further financing, successful and sufficient market acceptance of our current products and any new products that we may introduce, the continuing successful development of our products and related technologies, and, finally, achieving a profitable level of operations. The issuance of additional equity securities by us could result in a significant dilution in the equity interests of our current stockholders. Obtaining commercial loans, assuming those loans would be available, will increase our liabilities and future cash commitments.

We plan to raise any additional capital required to meet the balance of our estimated funding requirements for the next twelve months, primarily through the private placement of our securities (including shares issuable under our \$15.0 Million standby equity distribution agreement with Cornell Capital, assuming that we will meet all conditions to effect drawdowns under equity line of credit facility). We may also realize cash proceeds upon the exercise of our outstanding warrants, which cannot be assured.

FUTURE OPERATIONS

Presently, our revenues are not sufficient to meet operating and capital expenses. We have incurred operating losses since inception, and this is likely to continue for the foreseeable future.



Our management projects that we will require a minimum of \$6.3-\$8.5 million to fund our debt repayment, ongoing operating expenses and working capital requirements through July 31, 2005 as follows:

	2004	2003
Marketing	\$ 1,500,000	\$ 2,000,000
Engineering, research and development	1,200,000	1,700,000
General and administrative	2,200,000	2,500,000
Capital Purchases	150,000	400,000
Debt repayment	1,500,000	2,518,962 ⁽¹⁾
General Working Capital	(250,000)	(618,962)
TOTAL	\$ 6,300,000	\$ 8,500,000

(1) Assumes monthly repayments on the discounted convertible debentures of \$145,566 in cash commencing January 1, 2004. The amount of cash used to redeem the discounted convertible debentures may be less than the September 30, 2004 balance outstanding of \$1,612,798 as per the forbearance and escrow agreement dated September 24, 2004, the debenture holders have the option, after December 31, 2004, of converting the convertible debenture in whole or in part into shares of our common our common stock at \$0.03 per share (subject to adjustment pursuant to the anti-dilution provisions contained in the debentures).

Our working capital requirements are impacted by our inventory requirements. Therefore, any increase in sales of our products will be accompanied not only by an increase in revenues, but also by an increase in our working capital requirements. Our new products, the market acceptance of which will impact on our inventory needs and therefore will impact on our working capital requirements, include the following:

Our motorcycle tire pressure monitoring system (TPMS) was introduced for sale into the aftermarket in September 2002. We introduced a substantially improved second generation motorcycle tire pressure monitoring system (TPMS) in mid-February 2004 and began delivery of this system to our distributors in May 2004. We had a recall in September and are currently working on a solution for curved rims that we plan to introduce into the market in January 2005.

During our fiscal year, we introduced low pressure tire monitoring systems (TPMS) for the recreational vehicle market. Marketed as "RoadVoice™" and "TrailerVoice™", they represent the first tire monitoring systems targeted specifically at the recreational vehicle, towed vehicle and trailer markets.

During our fiscal year, we introduced high pressure tire monitoring systems (TPMS) for the recreational vehicle market, bus and commercial market.

In May 2004, we completed the development of a new wireless gateway receiver to facilitate the manufacture of pressure monitoring systems (TPMS) for commercial vehicles, which we expect to commence in fiscal 2005.

The continuation of our business is dependent upon obtaining further financing, market acceptance of our current products and any new products that we may introduce, the continuing successful development of our products and related technologies, and, finally, achieving a profitable level of operations.

As discussed above under the heading "Liquidity and Capital Resources, we plan to raise any additional capital required to meet the balance of our estimated funding requirements through July 31, 2005, primarily through the private placement of our securities (including the registration of additional shares of our common stock for issuance upon use of our \$15M standby equity distribution agreement entered into on May 19, 2004).

The issuance of additional equity securities by us could result in a significant dilution in the equity interests of our current stockholders. Obtaining commercial loans, assuming those loans would be available, will increase our liabilities and future cash commitments.

A P P L I C A T I O N O F C R I T I C A L A C C O U N T I N G P O L I C I E S

Our consolidated financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles in the United States. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by management's application of accounting policies. We believe that understanding the basis and nature of the estimates and assumptions involved with the following aspects of our consolidated financial statements is critical to an understanding of our financials.

GOING CONCERN

As at July 31, 2004, we had an accumulated deficit of \$59,018,256. Our net loss for the year was \$10,987,026 compared to \$9,914,629 for fiscal 2003. As of July 31, 2004, our stockholders' equity was \$3,466,216 and we had working capital of \$732,405.

We require additional financing to fund our operations. During fiscal 2004, we used \$7,535,839 cash in operating activities and \$446,780 to purchase capital assets. Accordingly, during fiscal 2004, we raised gross cash proceeds of \$7,154,385 from the exercise of warrants of \$2,179,385, \$2,725,000 from the issuance of 22% discounted convertible debentures, \$1,500,000 from the issuance of two unsecured promissory notes, \$750,000 from the draw down on our \$15 Million Equity line of credit and \$15,880 from the exercise of employee stock options.

Between August 1, 2004 and October 15, 2004, the Company realized gross cash proceeds of \$ 2,346,788 from draw downs totalling \$1.8 Million from our \$15 Million equity line of credit and \$546,788 from the exercise of warrants.

Although we have successfully registered the \$15.0 million standby equity distribution agreement, we only have 7,751,070 registered shares remaining under the agreement and there can be no assurance that we will be able to register additional shares, which, as discussed elsewhere in this annual report, is subject to various conditions and limitations, there can be no assurance that additional financing will be available to us when needed or, if available, that it can be obtained on commercially reasonable terms. Our consolidated financial statements have been prepared on the going concern basis, which assumes that adequate sources of financing will be obtained as required and that our assets will be realized, and liabilities settled in the ordinary course of business. Accordingly, our consolidated financial statements do not include any adjustments related to the recoverability of assets and classification of assets and liabilities that might be necessary should we be unable to continue as a going concern.

INVENTORY

Inventory is carried at the lower of cost, determined on a weighted average cost method, and net realizable value. The determination of net realizable value is based on several assumptions and estimates. We provide an allowance that we consider to be reasonable for non-moving or slow moving inventory items and for items with expected future realizable value lower than cost. These assumptions and estimates may be inaccurate and may be revised.

The markets in which we compete are rapidly changing due to technological developments and increasing focus on automotive safety. Other companies offer products similar to those offered by us, and target the same customers as we do. Many of these companies have substantially greater financial, marketing and technical resources. We also anticipate that the competition within these markets will increase as demand for the products escalates. It is possible that new competitors or alliances among existing competitors may emerge and such competitors may rapidly acquire significant market share and make it difficult for us to sell our current inventory. All of these elements could reduce the net realizable value of our inventory.

WARRANTY OBLIGATIONS

On an ongoing basis, we record our best estimate of our warranty obligations and product returns related to products sold. These estimates are made after the consideration of contractual warranty obligations and historical experience. Unforeseen events, including increased technological difficulties with products, could occur that have not been anticipated in estimating the warranty provision. Additional costs or estimates will be recognized as determinable.

REVENUE RECOGNITION

Our Company recognizes revenue when there is persuasive evidence of an arrangement, goods are shipped and title passes, collection is probable, and the fee is fixed or determinable. Customer acceptance is used as the criterion for revenue recognition when the product sold does not have an established sales history to allow management to reasonably estimate returns and future provisions. Provisions are established for estimated product returns and warranty costs at the time the revenue is recognized. Our Company records deferred revenue when cash is received in advance of the revenue recognition criteria being met. Revenue from engineering services is recognized on services as they are rendered and pre-defined milestones are achieved. Engineering services revenue for the year were \$94,800 (2003-\$173,400 and 2002 – nil).

OTHER ASSETS

Other assets are recorded at cost and are being amortized over five years on a straight line basis. Other assets are comprised of licenses to manufacture and sell tire monitoring systems (TMS) to the original equipment manufacturers. On an ongoing basis, management assesses whether the expected net recoverable amount of the licenses exceeds the book value of the licenses. The net recoverable amount is determined on a projected cash flow basis, discounted at an appropriate rate. In making our cash flow estimates, we consider recent market trends and transactions, as well as reasonable estimates of future events based on current economic characteristics. Although we expect to generate cash flow from sales to the original equipment manufacturer marketplace, it is possible that we will not generate cash flow from sales to the original equipment manufacturer marketplace in excess of net book value, or that we will generate cash flow from sales to the original equipment manufacturer market in future years after the other assets have been fully amortized.



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders of SmarTire Systems Inc.

We have audited the consolidated balance sheets of SmarTire Systems Inc. as at July 31, 2004 and 2003 and the consolidated statements of operations, stockholders' equity and comprehensive income (loss) and cash flows for each of the years in the three year period ended July 31, 2004. 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 and 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 financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as at July 31, 2004 and 2003 and the results of its operations and its cash flows for each of the years in the three year period ended July 31, 2004 in accordance with U.S. generally accepted accounting principles.

On September 10, 2004, except for note 16 which is as of October 5, 2004, we reported separately to the shareholders of the Company on the consolidated balance sheets as at July 31, 2004 and 2003 and the consolidated statements of operations and deficit and cash flows for the years then ended, which consolidated financial statements were prepared in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants

Vancouver, Canada

September 10, 2004, except for note 16 which is as of October 5, 2004

COMMENTS BY AUDITOR FOR U.S. READERS ON CANADA — U.S. REPORTING DIFFERENCE

In the United States, reporting standards for auditors require the addition of an explanatory paragraph (following the opinion paragraph) when the financial statements are affected by conditions and events that cast substantial doubt on the Company's ability to continue as a going concern, such as those described in note 2 to the financial statements. Our report to the shareholders dated September 10, 2004, except for note 16 which is as of October 5, 2004, is expressed in accordance with Canadian reporting standards which do not permit a reference to such events and conditions in the report of independent registered public accounting firm when these are adequately disclosed in the financial statements.

KPMG LLP

Chartered Accountants

Vancouver, Canada

September 10, 2004, except for note 16 which is as of October 5, 2004



CONSOLIDATED BALANCE SHEETS

(Prepared in accordance with U.S. generally accepted accounting principles)

July 31, 2004 and 2003

	2004	2003
A S S E T S		
Current assets:		
Cash and cash equivalents	\$ 112,951	\$ 1,843,694
Receivables, net of allowance for doubtful accounts of nil (2003 —nil)	259,508	405,885
Inventory (note 4)	3,245,807	806,846
Prepaid expenses	189,477	165,792
	3,807,743	3,222,217
Capital assets (note 5)	824,616	550,458
Deferred financing costs (note 10)	157,020	183,259
Other assets (note 6)	2,147,749	3,129,658
	\$ 6,937,128	\$ 7,085,592

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Accounts payable and accrued liabilities	\$ 1,293,251	\$ 788,267
Deferred revenue	10,830	10,018
Promissory notes payable (note 7)	1,500,000	—
Current portion of convertible debentures	271,257	—
	3,075,338	798,285
Convertible debentures, net of equity portion of \$1,525,253 (2003 – \$1,966,664) (note 8)	395,574	3
Stockholders' equity:		
Share capital (note 9):		
Preferred shares, par value \$1,000 Cdn per share:		
100,000 shares authorized		
Issued and outstanding; none		
Common shares, without par value:		
300,000,000 shares authorized (July 31, 2003 —200,000,000)		
103,130,761 shares issued and outstanding at		
July 31, 2004 (July 31, 2003 —55,039,065)	58,368,020	48,204,995
Additional paid – in capital	4,417,323	6,681,893
Deficit	(59,018,256)	(48,031,230)
Accumulated other comprehensive loss	(300,871)	(568,354)
	3,466,216	6,287,304
	\$ 6,937,128	\$ 7,085,592

Going concern (note 2)

Commitments and contingencies (note 14)

Subsequent events (note 16)

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board:

Robert V. Rudman

DIRECTOR

Bill Cronin

DIRECTOR



CONSOLIDATED STATEMENTS OF OPERATIONS

(Prepared in accordance with U.S. generally accepted accounting principles)

Years ended July 31, 2004, 2003 and 2002

	2004	2003	2002
R E V E N U E	\$ 1,658,279	\$ 1,802,596	\$ 1,012,344
C O S T O F G O O D S S O L D	1,445,563	1,387,365	699,955
	212,716	415,231	312,389
E X P E N S E S :			
Depreciation and amortization	1,371,717	1,236,870	1,152,378
Engineering, research and development	1,654,690	1,177,935	1,727,606
General and administrative	2,338,758	2,939,260	2,631,215
Marketing	1,821,122	1,448,326	1,527,644
	7,186,287	6,802,391	7,038,843
L O S S F R O M O P E R A T I O N S	(6,973,571)	(6,387,160)	(6,726,454)
O T H E R E A R N I N G S (E X P E N S E S) :			
Interest income	5,873	2,835	18,735
Net interest and financing expenses	(4,031,820)	(3,722,505)	(145,472)
Foreign exchange gain	12,492	192,201	24,015
	(4,013,455)	(3,527,469)	(102,722)
L O S S F O R T H E Y E A R	\$ (10,987,026)	\$ (9,914,629)	\$ (6,829,176)
Basic and diluted loss per share	\$ (0.13)	\$ (0.37)	\$ (0.41)
Weighted average number of common shares used in the computation of basic and diluted loss per share (note 13)	83,356,095	26,771,427	16,743,977

See accompanying notes to consolidated financial statements.



CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME (LOSS)

(Prepared in accordance with U.S. generally accepted accounting principles)

Years ended July 31, 2004, 2003 and 2002

	Common shares		Additional paid-in capital	Deferred stock compensation	Deficit	Accumulated other comprehensive loss	Stockholders' equity	Comprehensive income (loss)
	Shares	Amount						
BALANCE AT JULY 31, 2001	15,159,369	37,566,083	683,462	(40,773)	(31,287,425)	(806,198)	6,115,149	(5,779,943)
Issuance of common shares for cash upon private placements, net of issuance costs of \$551,569	3,352,000	4,650,289	—	—	—	—	4,650,289	—
Exercise of warrants for cash, net of issuance costs of \$10,890	200,000	298,110	—	—	—	—	298,110	—
Fair value of warrants issued on private placement	—	—	206,340	—	—	—	206,340	—
Forfeiture of stock options	—	—	(4,341)	4,341	—	—	—	—
Compensation expense	—	—	—	19,427	—	—	19,427	—
Loss for the period	—	—	—	—	(6,829,176)	—	(6,829,176)	(6,829,176)
Translation adjustment	—	—	—	—	—	(171,093)	(171,093)	(171,093)
BALANCE AT JULY 31, 2002	18,711,369	42,514,482	885,461	(17,005)	(38,116,601)	(977,291)	4,289,046	(7,000,269)
Issuance of common shares for cash upon private placements, net of issuance costs of \$289,172 (note 9(a))	6,964,286	1,810,828	—	—	—	—	1,810,828	—
Intrinsic value of beneficial conversion feature of convertible debentures plus fair value of warrants issued (note 8)	—	—	5,157,521	—	—	—	5,157,521	—
Conversion of convertible debenture and accrued interest to common shares net of issuance costs of \$628,526 (note 8)	24,381,133	3,024,395	—	—	—	—	3,024,395	—
Exercise of warrants for cash, net of issuance costs of \$61,060 (note 9(b))	3,300,000	298,940	—	—	—	—	298,940	—
Issuance of shares as fees on equity line of credit (note 9(c))	478,412	300,000	—	—	—	—	300,000	—
Fair value of agent's warrants issued on private placements and convertible debentures (notes 8 and 9)	—	—	502,367	—	—	—	502,367	—
Debt settlement through issuance of common shares (note 9(d))	353,865	77,850	—	—	—	—	77,850	—
Issuance of shares and repricing of warrants to settle a potential claim (note 9(e))	850,000	178,500	136,544	—	—	—	315,044	—
Compensation expense	—	—	—	17,005	—	—	17,005	—
Loss for the period	—	—	—	—	(9,914,629)	—	(9,914,629)	(9,914,629)
Translation adjustment	—	—	—	—	—	408,937	408,937	408,937
BALANCE AT JULY 31, 2003	55,039,065	48,204,995	6,681,893	—	(48,031,230)	(568,354)	6,287,304	(9,505,692)
Exercise of stock options for cash (note 9 (j))	79,400	15,880	—	—	—	—	15,880	—
Intrinsic value of beneficial conversion feature of convertible debentures plus fair value of warrants issued (note 8)	—	—	2,457,023	—	—	—	2,457,023	—
Conversion of convertible debentures and accrued interest to common shares allocated pro-rata between additional paid-in-capital and common shares, net of issuance costs of \$156,133 (note 8)	20,882,076	5,344,961	(2,788,277)	—	—	—	2,556,684	—
Exercise of warrants for cash, net of issuance costs of \$78,370 (note 9(f))	12,463,231	3,702,985	(1,601,970)	—	—	—	2,101,015	—
Issuance of shares and warrants as fees for services received (note 9(g))	200,000	34,800	63,375	—	—	—	98,175	—
Fair value of agent's warrants issued on private placement of convertible debentures (note 8(d))	—	—	15,699	—	—	—	15,699	—
Issuance of shares as fees on equity line of credit (note 9(h))	3,605,769	375,000	(375,000)	—	—	—	—	—
Cash cost incurred for equity line (note 9(h))	—	—	(35,420)	—	—	—	(35,420)	—
Shares issued upon draw downs on equity line of credit, net of issuance cost of \$60,601 (note 9(h))	10,861,220	689,399	—	—	—	—	689,399	—
Loss for the period	—	—	—	—	(10,987,026)	—	(10,987,026)	(10,987,026)
Translation adjustment	—	—	—	—	—	267,483	267,483	267,483
BALANCE AT JULY 31, 2004	103,130,761	58,368,020	4,417,323	—	(59,018,256)	(300,871)	3,466,216	(10,719,543)

See accompanying notes to consolidated financial statements.



CONSOLIDATED STATEMENTS OF CASH FLOWS

(Prepared in accordance with U.S. generally accepted accounting principles)

Years ended July 31, 2004, 2003 and 2002

	2004	2003	2002
CASH PROVIDED BY (USED FOR):			
Operating activities:			
Loss for the year	\$ (10,987,026)	\$ (9,914,629)	\$ (6,829,176)
Items not affecting cash:			
Depreciation and amortization	1,371,717	1,236,870	1,152,378
Stock-based compensation	—	17,005	19,427
Non-cash interest and finance charges	3,842,107	3,694,914	—
Issuance of shares and warrants for services received	98,175	—	—
Issuance of shares and repricing of warrants to settle a potential claim (note 9(c))	—	315,044	—
Change in non-cash working capital:			
Receivables	170,127	(182,366)	(5,266)
Deferred revenue	—	9,423	—
Deferred financing expense	—	(5,000)	—
Inventory	(2,391,749)	594,333	151,249
Prepaid expenses	(13,984)	240,861	(294,769)
Accounts payable and accrued liabilities	374,794	(434,556)	346,652
Net cash used in operating activities	(7,535,839)	(4,428,101)	(5,459,505)
Investing activities:			
Purchase of capital assets	(446,780)	(62,978)	(164,886)
Purchase of other asset	—	—	(500,000)
Net cash used in investing activities	(446,780)	(62,978)	(664,886)
Financing activities:			
Cash received on exercise of stock options	15,880	—	—
Issuance of common shares	—	2,100,000	5,173,500
Cash received on exercise of warrants (note 9 (f))	2,179,385	360,000	309,000
Proceeds from convertible debentures (note 8)	2,725,000	5,618,000	—
Proceeds from promissory note (note 7)	1,500,000	250,000	—
Proceeds from equity line of credit (note 9)	750,000	—	—
Financing costs	(626,696)	(886,799)	(316,871)
Repayment of promissory notes (notes 6 and 7)	(305,715)	(1,600,000)	(1,450,000)
Net cash provided by financing activities	6,237,854	5,841,201	3,715,629
Effect of exchange rate differences on cash and cash equivalents	14,022	(32,396)	4,473
Net increase (decrease) in cash and cash equivalents	(1,730,743)	1,317,726	(2,404,289)
Cash and cash equivalents, beginning of year	1,843,694	525,968	2,930,257
Cash and cash equivalents, end of year	\$ 112,951	\$ 1,843,694	\$ 525,968
SUPPLEMENTARY INFORMATION:			
Interest and finance charges paid	\$ 189,713	\$ 27,591	\$ 92,093
NON-CASH INVESTING AND FINANCING ACTIVITIES:			
Purchase of other asset through issuance of promissory note	—	—	2,800,000
Fair value of agents warrants issued in conjunction with financings	15,699	502,367	206,340
Shares issued for financing services on private placement	—	—	28,358
Settlement of debt through issuance of common shares (note 9(d))	—	77,850	—
Conversion of convertible debentures to common shares	2,556,684	3,024,395	—
Issuance of shares as consideration for equity line of credit	375,000	300,000	—
Financing costs included in accounts payable	52,859	30,000	—

See accompanying notes to consolidated financial statements.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Prepared in accordance with U.S. generally accepted accounting principles)

Years ended July 31, 2004, 2003 and 2002

1. OPERATIONS :

The Company and its subsidiaries develop and market products incorporating wireless data transmission and processing technologies, primarily for the automotive markets. The Company's primary product is a wireless tire monitoring system which it currently markets for use on passenger vehicles, motorcycles, recreational vehicles, trucks, buses and other pneumatic tire applications. All sales of its product are made in this industry segment.

2. GOING CONCERN :

The Company requires additional financing to fund its operations. The Company has incurred recurring operating losses and has a deficit of \$59,018,256 and working capital of \$732,405 as at July 31, 2004. During the year ended July 31, 2004, the Company used cash of \$7,982,619 in operating and investing activities.

The Company is pursuing various alternatives to meet its immediate and long-term financial requirements. During fiscal 2004, the Company realized gross cash proceeds of \$7,170,265 from financing activities (2003-\$8,328,000) and arranged a \$15.0 million equity line of credit (note 9(h)) to fund its operations. Subsequent to the year-end, the Company raised gross proceeds of \$2,746,788 (note 16). There can be no assurance that the Company can draw down amounts under the equity line of credit when required and that additional financing will be available to the Company when needed or, if available, that it can be obtained on commercially reasonable terms. These consolidated financial statements have been prepared on the going concern basis which assumes that adequate sources of financing will be obtained as required and that the Company's assets will be realized and liabilities settled in the ordinary course of business. Accordingly, these consolidated financial statements do not include any adjustments related to the recoverability of assets and classification of assets and liabilities that might be necessary should the Company be unable to continue as a going concern.

3. SIGNIFICANT ACCOUNTING POLICIES :

(a) Basis of presentation:

These consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, SmarTire USA Inc., SmarTire Europe Limited, and SmarTire Technologies Inc. All intercompany balances and transactions have been eliminated.

(b) Research and development costs:

Research and development costs are expensed as incurred. Equipment used in research and development is capitalized only if it has an alternative future use.

(c) Cash and cash equivalents:

Cash and cash equivalents includes investments in short-term investments with a term to maturity when acquired of 90 days or less.

(d) Inventory:

Inventory of raw materials are recorded at the lower of cost, determined on a first-in, first-out basis, and net realizable value. Inventory of finished goods and work-in progress are recorded at the lower of average cost and net realizable value. Average cost is determined using the weighted-average method and includes invoice cost, duties and freight where applicable plus direct labour applied to the product and an applicable share of manufacturing overhead. A provision for obsolescence for slow moving inventory items is estimated by management based on historical and expected future sales and is included in cost of goods sold.

(e) Capital assets:

Capital assets are recorded at cost. Depreciation of computer hardware and software and office and shop equipment is provided for on the declining balance basis at 30% per annum. Leasehold improvements are depreciated over the lesser of their useful lives or the term of the lease.

(f) Other assets:

Other assets include the license to manufacture and sell tire monitoring systems to the original equipment vehicle manufacturers (note 6). Other assets are recorded at cost and are being amortized over five years on a straight-line basis.

(g) Impairment of long-lived assets:

The Company monitors the recoverability of long-lived assets, based on estimates using factors such as expected future asset utilization, business climate and future undiscounted cash flows expected to result from the use of the related assets or to be realized on sale. The Company recognizes an impairment loss if the projected undiscounted future cash flows is less than the carrying amount. The amount of the impairment charge, if any, is measured equal to the excess of the carrying value over the expected future cash flows discounted using the Company's average cost of funds.

(Prepared in accordance with U.S. generally accepted accounting principles)

(h) Revenue recognition:

The Company recognizes revenue when there is persuasive evidence of an arrangement, goods are shipped and title passes, collection is probable, and the fee is fixed or determinable. Customer acceptance is used as the criterion for revenue recognition when the product sold does not have an established sales history to allow management to reasonably estimate returns and future provisions. Provisions are established for estimated product returns and warranty costs at the time the revenue is recognized. The Company records deferred revenue when cash is received in advance of the revenue recognition criteria being met. Revenue from engineering services is recognized on services as they are rendered and pre-defined milestones are achieved. Engineering services revenue for the year were \$94,800 (2003-\$173,400 and 2002 – nil).

(i) Loss per share:

Basic loss per share computations are based on the weighted average number of shares outstanding during the year. If in a period the Company has outstanding dilutive stock options and warrants, diluted loss per share is calculated using the treasury stock method.

(j) Income taxes:

The Company accounts for income taxes in accordance with the asset and liability method. Under this method, deferred income taxes are recognized for the future income tax consequences attributable to differences between the financial statement carrying amounts and their respective income tax bases and for loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. The effect on deferred income tax assets and liabilities of a change in tax rates is recognized in income in the period of enactment. Deferred income tax assets are evaluated and if their realization is not considered to be “more likely than not”, a valuation allowance is provided.

(k) Warranty costs:

The Company accrues warranty costs upon the recognition of related revenue, based on its best estimates, with reference to past experience. See note 14(c).

(l) Foreign currency translation:

The Company’s functional or primary operating currency is the Canadian dollar. The Company’s financial statements are prepared in Canadian dollars before translation to the US dollar reporting currency. The Company translates transactions in currencies other than the Canadian dollar at the exchange rate in effect on the transaction date. Monetary assets and liabilities denominated in a currency other than the Canadian dollar are translated at the exchange rates in effect at the balance sheet date. The resulting exchange gains and losses are recognized in earnings.

Amounts reported in Canadian dollars have been translated into US dollars as follows: assets and liabilities are translated into US dollars at the rate of exchange in effect at the balance sheet date and revenue and expense items are translated at the average rates for the period. Unrealized gains and losses resulting from the translation into the reporting currency are accumulated in accumulated other comprehensive loss, a separate component of stockholders’ equity.

(m) Use of estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management at the date of the financial statements to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts to revenues and expenses during the reporting period. Significant areas requiring the use of estimates include estimating the net realizable value of inventory, the future cash flows for assessing the net recoverable amount of long-lived assets and warranty reserve. Actual results may differ from those estimates.

(n) Stock-based compensation:

The Company has elected under FAS 123, Accounting for Stock-based Compensation, to account for employee stock options using the intrinsic value method. This method is described in Accounting Principles Board (“APB”) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. As the Company grants stock options with an exercise price not less than the market value of the underlying common shares on the date of grant, no compensation expense is required to be recognized under APB 25. FAS 123 uses the fair value method of calculating the cost of stock option grants. Had compensation cost for employee stock options been determined by this method, net loss and net loss per share would have been as follows:

	2004	2003	2002
Net loss:			
As reported	\$ (10,987,026)	\$ (9,914,629)	\$ (6,829,176)
Stock-based compensation expense recognized using intrinsic value method	—	17,005	19,427
Stock-based compensation expense determined under fair value based method for all awards	(1,291,736)	(738,339)	(1,076,749)
Pro forma	\$ (12,278,762)	\$ (10,635,963)	\$ (7,886,498)
Basic and diluted loss per share:			
As reported	(0.13)	(0.37)	(0.41)
Pro forma	(0.15)	(0.40)	(0.47)

The Company recognizes compensation expense on a straight-line basis over the vesting period beginning on the date the stock option is granted.

The fair value of each option and warrant granted is estimated on the date of grant using the Black-Scholes option valuation model with the following range of weighted average assumptions.

	2004	2003	2002
Expected dividend yield	0%	0%	0%
Expected stock price volatility	139 – 152%	128 – 155%	129%
Risk-free interest rate	3.28 – 4.08%	3.6 – 4.3%	4.35%
Expected life of options and warrants	3 – 5 years	2 – 5 years	1 – 2 years

Weighted-average fair values of options granted during the year are as follows:

	2004	2003	2002
Options whose exercise price at date of grant:			
Equals the market price of stock	\$ 0.07	\$ 0.72	—
Exceeds the market price of stock	0.16	0.94	2.07
Is less than the market price of stock	—	—	—

The Company recognizes compensation expense for stock options, common stock and other instruments issued to non-employees for services received based upon the fair value of the equity instruments issued as the services are performed and the instrument is earned.

If the exercise price of employee stock option award is not fixed in the functional currency of the Company or in the currency the employee is paid, the award is accounted for as a variable award until the award is exercised, forfeited, or expires unexercised. The Company measures compensation as the amount by which the quoted market value of the common shares of the Company's stock covered by the grant exceeds the option price, with changes in the market price included in the measurement of loss.

(o) Comprehensive income:

Under SFAS 130, Reporting Comprehensive Income, the Company is required to report comprehensive income, which includes net loss as well as changes in equity from non-owner sources. The other changes in equity included in comprehensive income for the periods presented comprise the foreign currency cumulative translation adjustments. Accumulated other comprehensive loss is presented in the consolidated statements of stockholders' equity and comprehensive income (loss).

(p) Recent accounting pronouncements:

In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities, which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. FIN 46R replaces FASB Interpretation No. 46, Consolidation of Variable Interest Entities, which was issued in January 2003. The Company will be required to apply FIN 46R to variable interest in VIEs created after December 31, 2003. For variable interests in VIEs created before January 1, 2004, the Interpretation will be applied beginning on July 31, 2004. For any VIEs that must be consolidated under FIN 46R that were created before January 1, 2004, the assets, liabilities and noncontrolling interests of the VIE initially would be measured at their carrying amounts with any difference between the net amount added to the balance sheet and any previously recognized interest being recognized as the cumulative effect of an accounting charge. If determining the carrying amounts is not practicable, fair value at the date FIN 46R first applies may be used to measure the assets, liabilities and noncontrolling interest of the VIE. The Company currently has no variable interest entities, hence there is no impact of FIN 46R on these consolidated financial statements.

In April 2003, the FASB issued FAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities" ("FAS No. 149"), which amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under FAS No. 133. FAS No. 149 is to be applied prospectively for certain contracts entered into or modified after June 30, 2003. The Company has adopted FAS No. 149, which had no effect on our consolidated financial statements.



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Prepared in accordance with U.S. generally accepted accounting principles)

FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, was issued in May 2003. This Statement establishes standards for the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The Statement also includes required disclosures for financial instruments within its scope. For the Company, the Statement was effective for instruments entered into or modified after May 31, 2003 and otherwise will be effective as of August 1, 2004, except for mandatorily redeemable financial instruments. For certain mandatorily redeemable financial instruments, the Statement will be effective for the Company on August 1, 2005. The effective date has been deferred indefinitely for certain other types of mandatorily redeemable financial instruments. The Company has adopted FAS No. 150, which had no impact on these consolidated financial statements.

4. INVENTORY:

	2004	2003
Raw materials	\$ 1,515,438	\$ 318,512
Work in progress	554,421	59,599
Finished goods	1,175,948	428,735
	\$ 3,245,807	\$ 806,846

5. CAPITAL ASSETS:

2004	Cost	Accumulated amortization	Net book value
Computer hardware and software	\$ 697,178	\$ 509,980	\$ 187,198
Office and shop equipment	1,336,068	786,049	550,019
Leasehold improvements	207,327	119,928	87,399
	\$ 2,240,573	\$ 1,415,957	\$ 824,616

2003	Cost	Accumulated amortization	Net book value
Computer hardware and software	\$ 600,781	\$ 415,801	\$ 184,980
Office and shop equipment	886,748	609,095	277,653
Leasehold improvements	192,515	104,690	87,825
	\$ 1,680,044	\$ 1,129,586	\$ 550,458

6. OTHER ASSETS:

On December 13, 2000, the Company entered into an Assignment and Amendment Agreement with TRW Inc. ("TRW") that transferred to the Company the license to manufacture and sell tire monitoring systems to the original equipment vehicle manufacturers of most medium and heavy duty trucks. Consideration consisted of 490,072 shares of common stock valued at \$1,337,500, based on the market value of the Company's stock at the date of purchase, plus cash of \$400,000.

On August 31, 2001, the Company and TRW entered into an agreement to restructure their strategic alliance. Under the terms of restructuring, the Company and TRW agreed to terminate a number of agreements. The Company has the right to manufacture and sell tire monitoring systems to the original equipment vehicle manufacturers market ("OEM"). Consideration consisted of a promissory note of \$2.8 million, carrying an interest rate of 6% per annum plus cash of \$500,000. The balance of principal in the amount of \$1,350,000 owed at July 31, 2002 was repaid during fiscal 2003 and interest of \$97,542 on this balance was forgiven by TRW.

The rights are being amortized over five years on a straight-line basis.

2004	Cost	Accumulated amortization	Net book value
OEM – most medium and heavy duty trucks	\$ 1,737,500	\$ 1,190,402	\$ 547,098
OEM – all other vehicles	3,300,000	1,699,349	1,600,651
	\$ 5,037,500	\$ 2,889,751	\$ 2,147,749
2003	Cost	Accumulated amortization	Net book value
OEM – most medium and heavy duty trucks	\$ 1,737,500	\$ 845,850	\$ 891,650
OEM – all other vehicles	3,300,000	1,061,992	2,238,008
	\$ 5,037,500	\$ 1,907,842	\$ 3,129,658

Management believes that the net book value of its other assets of \$2,147,749 as at July 31, 2004 is recoverable based on expectations of future cash flows from the Company's future sales of tire monitoring systems. Management's belief is based on an undiscounted cash flow analysis of management's current best estimate of projected annual sales to the passenger vehicle and light truck OEM market plus management's projected sales to the heavy truck OEM market.

7 . P R O M I S S O R Y N O T E S :

During the year, the Company received total gross proceeds of \$1,500,000 upon the issuance of two unsecured short-term promissory notes of \$750,000 each, to an accredited investor. Each note bears interest at a rate of 8% per annum and was repayable on August 13, 2004 and September 16, 2004 respectively (see note 16 for subsequent events). As a commitment fee, the holder of the notes received a total of \$150,000.

8 . C O N V E R T I B L E D E B E N T U R E S :

	Face value of debt	Debt component	Balance to be accreted to operations
Balance as at July 31, 2002	\$ —	\$ —	\$ —
10% redeemable convertible debentures with cash financing cost of \$76,177 (a)	750,000	66,000	684,000
5% redeemable convertible debentures with cash financing cost of \$94,000 and discount of \$32,000 (b)	400,000	257,143	142,857
7% and 8% convertible debentures with cash financing cost of \$483,022 (c)	4,500,000	3	4,499,997
Initial allocation	5,650,000	323,146	5,326,854
Accretion of deemed debt discount to interest	—	3,329,778	(3,329,778)
Conversion of 10%, 5% and \$2,533,333 of 7% convertible debentures to common Shares (a, b, c)	(3,683,333)	(3,652,921)	(30,412)
Balance as at July 31, 2003	1,966,667	3	1,966,664
Issuance of 11% discounted convertible debenture with cash finance cost of \$264,894 and discount of \$768,590 (d)	3,493,590	1,036,567	2,457,023
Accretion of deemed debt discount to interest expense	—	3,236,921	(3,236,921)
Discount in convertible debentures (d)	—	(768,590)	768,590
Conversion of 7%, 8% and \$840,681 of discounted convertible debentures to common shares (c, d)	(2,532,355)	(2,532,355)	—
Cash payment on discounted convertible debentures (d)	(305,715)	(305,715)	—
Balance as at July 31, 2004	2,622,187	666,831	1,955,356
Less Current portion of convertible debentures	1,714,284	271,257	1,443,027
Balance as at July 31, 2004	\$ 907,903	\$ 395,574	\$ 512,329

(a) In the first private placement during the year ended July 31, 2003, the Company realized gross cash proceeds of \$500,000 and \$250,000, respectively, from the issuance of 10% redeemable convertible notes of the Company plus 150,000 share purchase warrants on the completion of a private placement effected pursuant to Regulation S under the Securities Act of 1933. The agreements were signed on September 20, 2002 and the notes were to mature on December 20, 2002.

On November 4, 2002, the holders converted these convertible notes into 1,500,000 units. Each unit consisted of one common share and one share purchase warrant. Each warrant entitles the holder to purchase one additional common share at an exercise price of \$0.50 per share until November 4, 2005. On conversion of these senior convertible notes, the carrying value of debt and accrued interest was reclassified to common shares included in stockholders' equity. Interest accretion of \$684,000 was charged to the statement of operations as interest expense during the year ended July 31, 2003.

Each warrant initially entitled the holder to purchase one of the Company's common shares and is exercisable at a price of \$1.25 on or before September 20, 2005, on which date the warrant will expire. These warrants were subsequently repriced to \$0.10 on May 6, 2003 as described in note 9(e).

For accounting purposes, the Company calculated the fair value of warrants issued using the Black-Scholes model using the weighted average assumptions as disclosed in note 3(n) and the intrinsic value of the beneficial conversion feature, which in aggregate totals \$684,000, and initially recorded these values as additional paid-in capital. The intrinsic value is the amount by which the fair value of the underlying common shares at the date of the agreement exceeds the conversion price.

Advisors to the private placement received a cash commission of \$60,000 or 8% on the face value of the notes and 120,000 share purchase warrants exercisable at a price equal to the lesser of conversion price of the convertible notes into common shares or \$0.50. The Company also incurred an additional cash cost of \$16,177 to secure the funding. The warrants are exercisable over five years and expire on November 4, 2007. The fair value of these warrants at the date of grant was \$51,393. The fair value of the warrants was estimated on the date of issuance using the Black-Scholes option valuation model.

(b) In the second private placement during fiscal 2003, the Company issued senior subordinated redeemable convertible debentures to a private investment company bearing interest at 5% per annum. The Company closed the first tranche on November 21, 2002 and the second tranche on January 31, 2003. In each tranche, the Company received proceeds of \$184,000 for the issuance of a debenture in the principal amount of \$200,000. Total net cash proceeds after finance charges were \$274,000. Each debenture was issued at an 8% discount from the face principal amount. Advisors to the placement received a cash commission of \$64,000 and 68,325 warrants. Additional expenses of \$30,000 were incurred for this transaction. The fair value of these warrants at the date of grant was estimated at \$15,626. The fair value of these warrants was estimated on the date of issuance using the Black-Scholes option valuation model.

(Prepared in accordance with U.S. generally accepted accounting principles)

8. CONVERTIBLE DEBENTURES (continued):

(b) Continued:

For accounting purposes, the Company calculated the intrinsic value of the beneficial conversion feature which amounted to \$142,857 and initially recorded its value as additional paid-in capital. The remaining balance of \$257,143 was recorded as liability.

The commission and fair value of the warrant were recorded as financing costs. These debentures were converted to common shares between February 10, 2003 and May 16, 2003 at conversion prices ranging from \$0.064 to \$0.28. Interest accretion of \$142,857 was charged to the statement of operations as interest expense during the year ended July 31, 2003.

- (c) On June 17, 2003, the Company closed a private placement of 7% convertible debentures in three tranches pursuant to Rule 506 of Regulation D under the Securities Act of 1933, for gross proceeds of \$2,800,000. On July 17, 2003, the Company closed another private placement of 8% convertible debentures pursuant to Rule 506 of Regulation D under the Securities Act of 1933, for gross proceeds of \$1,700,000. Net cash proceeds from the convertible debentures were \$4,016,978.

In connection with the offering of the convertible debentures, the Company issued 23,846,153 common share purchase warrants which expire between July 17, 2008 and November 10, 2008. Advisors to the transactions received a cash commission of \$360,000 and 180,000 share purchase warrants: 112,000 share purchase warrants for a period of five years, and 68,000 share purchase warrants for a period of three years. At July 31, 2004 the warrants entitle the holders to purchase common shares of the Company at \$0.059 per share (subject to adjustment pursuant to the anti-dilution provisions contained in the warrants). The fair value of these warrants at the date of grant was estimated at \$77,640 using the Black-Scholes option valuation model using weighted average assumptions as disclosed in note 3(n). Additional expenses related to this offering were \$123,022 plus 100,000 share purchase warrants exercisable at a price of \$0.135 per share for a period of five years. The financing cost will be amortized over the lesser of the life of the convertible debentures or the date of redemption or conversion into common shares.

Interest on the debentures is payable quarterly on March 1, June 1, September 1 and December 1, and at maturity, in cash or, at the Company's option, in shares of the Company's common stock at an interest conversion price equal to 90% of the lesser of the average closing bid price during the 20 trading days immediately preceding the interest payment date, or the average closing bid price during the 20 trading days immediately preceding the date on which the shares are issued if such shares are issued and delivered after the interest payment date. The Company's right to elect to pay accrued interest in shares of its common stock is subject to certain conditions, including the requirement that there shall be an effective registration statement qualifying the resale of the common stock to be issued to the holders of the convertible debentures in lieu of a cash interest payment. All overdue accrued and unpaid interest under the convertible debentures will be subject to a late fee at the rate of 18% per annum.

The Company may not prepay any portion of the principal amount on any convertible debenture without the prior written consent of the holder of the debenture.

The Company will be considered in default of the convertible debentures if certain events occur. Once an event of default occurs, the holder of a convertible debenture can elect the Company to immediately repay a mandatory prepayment amount as outlined in the agreement.

If an event of default occurs, the holder of a convertible debenture can elect to require the Company to immediately repay a mandatory prepayment amount equal to the greater of:

- (i) 120% of the principal amount of the debenture, plus all accrued and unpaid interest and any other amounts outstanding in respect of the debenture; or
- (ii) 120% of the principal amount of the debenture, plus all accrued and unpaid interest and any other amounts outstanding in respect of the debenture, divided by the conversion price of the debenture, and multiplied by the greater of:
 - A. the last reported closing bid price for our common stock on the date on which the payment is due, or
 - B. the last reported closing bid price for our common stock on the date on which the payment actually paid.

For accounting purposes, the proceeds from the issuance of these convertible debentures were primarily allocated to fair value of warrants issued and the intrinsic value of the beneficial conversion feature, which amounts to \$2,799,997 and \$1,700,000 respectively. The fair value of the warrants was calculated using the Black Scholes option model using assumptions as disclosed in note 3(n). The remaining value of the proceeds of \$3 was allocated to debt and is being accreted to the redemption value of the convertible debentures over the period from the date of issuance to the initial maturity dates of May 19, 2005 and July 16, 2006.

During the year ended July 31, 2003, \$2,533,333 of principal and \$12,846 of interest were converted into common shares resulting in the issuance of 19,564,102 common shares. Interest accretion of \$2,533,322 was charged to the statement of operations as interest expense upon conversion of convertible debentures.

During the year ended July 31, 2004, \$1,691,667 of principal and \$41,270 of interest were converted into common shares resulting in the issuance of 13,601,799 common shares. Interest accretion of \$1,732,935 was charged in the statement of operations as interest expense upon conversion of convertible debentures.

As at July 31, 2004, \$275,000 of the convertible debenture remained outstanding.

(d) On December 24, 2003, the Company closed a private placement of discounted unsecured convertible debentures in the aggregate principal amount of \$3,493,590. The Company also issued 7,939,978 warrants exercisable at \$0.25 (subject to adjustment pursuant to the anti-dilution provisions contained in the warrants) with an expiry period of 5 years. The Company issued the convertible debentures at a 22% original issue discount from the face principal amount (based on a notional interest rate of 11% per annum for each year of the two-year term of the debentures), resulting in gross proceeds of \$2,725,000. The discount represented prepaid interest for this convertible debentures. The discount of \$768,590 has been netted against the value of debentures and is being amortized over the maturity period. Advisors to the transaction received a cash commission of \$218,000 and 109,000 three year share purchase warrants exercisable at a price of \$0.25 each (subject to adjustment pursuant to the anti-dilution provisions contained in the warrants). The fair value of these warrants at the date of grant was estimated at \$15,699. The fair value of these warrants was estimated on the date of issuance using the Black-Scholes option valuation model using the volatility 141%, risk free interest rate 3.28%, expected life of warrants 3 years. In addition, expenses of \$46,894 for professional fees related to this transaction were incurred. The discounted convertible debentures do not otherwise bear interest, and will mature on April 1, 2006. The outstanding principal amount of each debenture may be converted at any time into shares of the Company's common stock, in whole or in part, at the option of the holder of the debenture at a set price of \$0.22 per share (subject to adjustment pursuant to the anti-dilution provisions contained in the debentures). The Company will make the monthly redemption payments of \$145,566 over two years in cash unless during the twenty trading day prior notice period immediately prior to the applicable monthly redemption date the Company irrevocably notifies the holder that it will issue underlying shares in lieu of cash at a conversion price equal to the lesser of:

- (i) the set price of \$0.22 per share (subject to adjustment pursuant to the anti-dilution provisions contained in the debentures), and
- (ii) 85% of the average of the closing prices of the Company's common stock for twenty days immediately preceding the applicable monthly redemption date, provided that certain conditions are met, including the condition that the underlying shares of common stock shall have been registered under the Securities Act of 1933, as amended.

For accounting purposes, the proceeds from the issuance of these convertible debentures were allocated to the fair value of the warrants issued and the intrinsic value of the beneficial conversion feature which amounts to \$861,351 and \$1,595,672, respectively. The fair value of the warrants was calculated using the Black-Scholes option valuation model using assumptions consistent with those disclosed in note 3(n). The remaining proceeds of \$1,036,567 was allocated to debt and is being accreted to the redemption value of the convertible debentures over the maturity period. Monthly redemption payments for February, March, April and May 2004 were made in shares of the Company, except for one cash payment of \$14,583. Monthly redemption payments of \$145,566 for each of June and July were made in cash. During the year, holders of discounted convertible debentures also converted \$273,000 of convertible debentures into common shares. This resulted in additional interest accretion of \$240,085. During the year ended July 31, 2004, interest accretion of \$1,206,762 was charged to the statement of operations as interest expense.

9 . S H A R E C A P I T A L :

- (a) During the year ended July 31, 2003, the Company issued 6,964,286 units in five separate private placements for gross cash proceeds of \$2,100,000, each effected pursuant to Regulation S under the Securities Act of 1933. 6,964,286 units consist of 6,964,286 common shares and 5,714,286 share purchase warrants. Each warrant entitles the holder to purchase one additional common share at an exercise price ranging from \$0.10 to \$0.85. Warrants begin to expire in November 4, 2005. These warrants were repriced to have an exercise price of \$0.10 per share on May 6, 2003 (note 9(e)). Advisors to the private placement were paid a commission of \$168,000 and were issued 291,143 share purchase warrants exercisable at a price ranging from \$0.10 to \$0.85. The fair value of these warrants at the date of grant was estimated at \$121,172. The fair value of these warrants is estimated on the date of issuance using the Black-Scholes option valuation model using the weighted average assumptions as disclosed in note 3(n). The fair value of the warrants issued to the advisors and commission paid is recorded as share issue cost.
- (b) The Company also realized gross cash proceeds of \$360,000 and net cash proceeds of \$334,400 from the exercise of 3,300,000 warrants. Advisors to the transactions received a cash commission of \$25,600 and 224,000 share purchase warrants exercisable at a price of \$0.10. The fair value of these warrants at the date of grant was estimated at \$35,460 by the Black-Scholes option valuation using the weighted average assumptions as disclosed in note 3(n). The fair value of the warrants were recorded as share issue costs.
- (c) The Company also arranged a \$15.0 million and \$5.0 million equity line of credit facilities from separate private investment companies during 2003. Neither facility has been used nor registered with the Securities and Exchange Commission. The \$5.0 million equity line of credit facility was cancelled on July 22, 2004. During the year ended July 31, 2004, the Company decided not to use the \$15.0 million equity line of credit facility as it entered into a new equity line of credit facility (note 9(h)).
 - (i) The Company issued 1,250,000 warrants exercisable at a price of \$0.1955 per share for three years as consideration for the \$15.0 million equity line of credit. The fair value of these warrants at the date of grant is estimated at \$178,259 using the Black-Scholes option valuation using the weighted average assumptions as disclosed in note 3(n). The fair value of the warrant was expensed as an interest and finance cost during fiscal 2004.
 - (ii) On the date of execution of the \$5.0 million equity line of credit facility, the Company issued shares worth \$290,000 based on the trading price of the stock of the Company on that day. Shares worth \$10,000 were issued to the placement agent on February 26, 2003. The Company has recorded the fair value of the common shares as an interest and financing expense.

(Prepared in accordance with U.S. generally accepted accounting principles)

9. SHARE CAPITAL (continued):

- (d) On April 3, 2003, the Company issued to the former managing director of SmarTire Europe Limited a total of 353,865 common shares at a deemed price of \$0.22 per share, in partial payment and settlement of the Company's obligation to pay him a termination allowance in connection with the termination of his management agreement, without cause, on October 15, 2002.
- (e) On May 6, 2003, the Company issued 850,000 shares at a deemed price of \$0.21 per share to an accredited investor and repriced 1,000,000 warrants previously issued to the investor on December 20, 2002, thereby reducing the exercise price of the warrant from \$0.70 per share to \$0.10 per share. An aggregate of 3,614,286 additional warrants previously issued to other investors were also repriced to an exercise price of \$0.10 per share. These transactions were all effected pursuant to Regulation S under the Securities Act of 1933, and were effected in consideration of certain releases provided by the investors to the Company in respect of certain potential unquantified claims threatened by the investors against the Company. The fair value of the shares is \$178,500 based on the deemed price of \$0.21 and the incremental fair value of the warrants is \$136,544. The fair value of the warrant is estimated on the date of issuance by the Black-Scholes option valuation model using the weighted average assumptions as disclosed in note 3(n). The incremental fair value of these warrants and the value of shares issued were recorded as an administrative expense.
- (f) For the year ended July 31, 2004, the Company realized gross cash proceeds of \$2,179,385 and net cash proceeds of \$2,101,015 from the exercise of warrants as follows:
- (i) On April 30, 2004, 500,000 warrants were exercised at \$0.104 resulting in gross cash proceeds of \$52,000 and net cash proceeds of \$49,920.
 - (ii) On October 27, 2003, the Company offered warrant holders who were issued warrants with an exercise price of \$0.2645 on May 15, 2003 in connection with the convertible debenture a reduction in their exercise price to \$0.20 plus one additional warrant at \$0.20 if they exercised their warrants. A total of 3,290,596 warrants were exercised. In addition, the Company granted 194,000 additional warrants exercisable at a price of \$0.20 per share for five years to a shareholder who also exercised their warrants. On November 6, 2003, the exercise price of the 7,478,635 warrants initially granted at \$0.2645 were reduced to \$0.1771 and were exercised for gross proceeds of \$1,324,466.
During October and November 2003, the fair value of the 10,963,231 warrants of \$1,601,970 initially recorded as additional paid in capital was reclassified to share capital on exercise of the warrants.
 - (iii) On May 20, 2004, the Company realized gross cash proceeds of \$120,000 from the exercise of 1,000,000 warrants at an exercise price of \$0.12 per share.
- (g) During the year ended July 31, 2004, 200,000 common shares with a fair market value of \$0.174 per share, 300,000 share purchase warrants with an exercise price of \$0.17 per share and 250,000 share purchase warrants with an exercise price of \$0.20 per share were issued for services received. The fair value of these warrants at the date of grant was estimated at \$63,375. The fair value of these warrants was estimated on the date of issuance using the Black-Scholes option valuation model using the weighted average assumptions consistent with those as described in note 3(n). Fair value of common shares and warrants of \$98,175 has been exercised.
- (h) On May 19, 2004, the Company arranged a \$15 million Standby Equity Distribution Agreement from a private investment company. The Company may, at its discretion, draw down \$500,000 every seven business days, subject to an effective registration statement. In consideration for each draw down, the Company will sell shares of common stock at a 2% discount to the lowest closing bid prices for the 5 trading days after an advance notice is given by the Company. In addition, 5% of each advance will be retained by the private investment company as a commission.
On June 1, 2004, the Company filed a registration statement with the Securities and Exchange Commission to register the \$15 million equity line of credit that was declared effective on June 14, 2004. On June 1, 2004, the Company issued 3,605,769 shares at an effective price of \$0.104 per share as payment for the \$365,000 commitment fee and \$10,000 placement agency fee related to the Standby Equity Distribution Agreement. The Company also incurred additional costs of \$35,420 in fees to prepare and file the registration statement. During the year ended July 31, 2004, the Company effected three draw downs of \$250,000 each at prices of \$.090, \$.065 and \$.059, which resulted in the issuance of 10,861,220 common shares and net proceeds of \$689,399. In addition, the Company incurred an additional \$60,000 as a financing expense to advisors of the Standby Equity Distribution Agreement of which \$30,000 is payable as at July 31, 2004.
- (i) On December 15, 2003, the Company's authorized common share capital was increased to 300,000,000 pursuant to a special resolution of the shareholders adopted at the annual and special annual meeting of the Company held on December 11, 2003.
- (j) Stock-based compensation plans:
At July 31, 2004, the Company had eight stock-based compensation plans that are described below:
- (i) Under the "1998 US Stock Incentive Plan" the Company may grant options to its employees for up to 300,000 common shares.
Under the "1998 Stock Incentive Plan" the Company may grant options to its employees for up to 600,000 common shares.
 - (ii) Under the "2000 US Stock Incentive Plan" the Company may grant options to its employees for up to 200,000 common shares.
Under the "2000 Stock Incentive Plan" the Company may grant options to its employees for up to 800,000 common shares.
 - (iii) Under the "2002 US Stock Incentive Plan" the Company may grant options to its employees for up to 100,000 common shares.
Under the "2002 Stock Incentive Plan" the Company may grant options to its employees for up to 900,000 common shares.

(iv) Under the "2003 US Stock Incentive Plan" the Company may grant options to its employees for up to 2,000,000 common shares.

Under the "2003 Stock Incentive Plan" the Company may grant options to its employees for up to 8,000,000 common shares.

The options currently outstanding under the "2003 US Stock Incentive Plan" and the "2003 Stock Incentive Plan" vest immediately. The options currently outstanding under the "1998 US Stock Incentive Plan" and the "2000 and 2002 Stock Incentive Plan" generally vest from two to four years, with the first 20% to 33% vesting at the date of grant and the balance vesting annually at each anniversary date of the grant thereafter. The exercise price of each option is based on the fair value of the common stock at the date of grant. These options have a five year term.

	2004		2003		2002	
	Shares	Weighted average exercise price	Shares	Weighted average exercise price	Shares	Weighted average exercise price
Outstanding, beginning of year	1,714,400	\$ 2.54	1,677,250	\$ 3.08	1,458,750	\$ 3.20
Options granted	9,169,600	0.20	778,300	1.42	484,700	2.88
Options exercised	(79,400)	(0.20)	—	—	—	(2.00)
Options forfeited	(2,334,800)	(0.38)	(741,150)	(2.80)	(266,200)	(3.40)
Outstanding, end of year	8,469,800	\$ 0.63	1,714,400	\$ 2.54	1,677,250	\$ 3.08

Range of exercise prices	Options outstanding			Options exercisable		
	Number of shares	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price	
\$0.085 – 0.20	6,900,200	4.07	\$ 0.20	6,900,200	\$ 0.20	
\$0.37 – 1.00	136,134	3.46	0.52	136,134	0.52	
\$1.16 – 6.76	1,433,466	2.07	2.71	1,222,337	2.78	
\$0.85 – 6.76	8,469,800	3.72	\$ 0.63	8,258,671	\$ 0.59	

The Company normally issues options to directors at fixed exercise prices. 75,000 options issued to directors and outstanding as at July 31, 2004 (2002 – 75,000) vested immediately, but if not exercised each year, there is an annual 20% increase in the exercise price until the options expire. For accounting purposes these options are considered to be variable in nature and compensation expense is recorded to the extent of increases in the market value of the underlying common shares as compared to the exercise price at each reporting period.

Where options issued after January 18, 2001 have an exercise price in a currency that is not either the (a) functional currency of the Company, or (b) the currency in which the employee is paid, the options are to be accounted for as variable plan options and compensation expense will be recorded equal to changes in the market value of the underlying common shares at each reporting period. The Company normally grants options in U.S. dollars when the functional currency of the Company is the Canadian dollar. Most employees of the Company are paid in either Canadian dollars or British pounds sterling. Accordingly, these employee options are considered to be variable options.

The compensation expense for these variable options for the year ended July 31, 2004 is nil (2003 – nil). In addition, compensation expense is recognized to the extent that options are granted having an exercise price less than the market price of the underlying common stock on the date of grant.

(k) Warrants:

As at July 31, 2004, warrants outstanding were exercisable for 37,483,485 (2003 – 32,154,507) common shares of the Company. The warrants entitle the holders to purchase common shares of the Company at prices ranging from \$0.059 to \$2.80 per share and expire on various dates until June 30, 2009.

The exercise price of warrants issued were not less than the market price of the Company's common shares at the date of issuance.

(Prepared in accordance with U.S. generally accepted accounting principles)

10. DEFERRED FINANCING COSTS:

	2004	2003
Equity line of credit		
Fair value of agents warrants (note 9(c))	\$ —	\$ 178,259
Professional fees	—	5,000
	—	183,259
Convertible debenture (note 8)		
Commission	218,000	—
Fair value of agents warrants	15,699	—
Professional fees	46,894	—
	280,593	—
Amortization	(123,573)	—
	157,020	—
	\$ 157,020	\$ 183,259

The deferred charges related to the discounted convertible debenture are being amortized over the maturity period. During the year, \$123,573 was amortized and charged to interest expense.

11. FINANCIAL INSTRUMENTS:

(a) Fair value of financial instruments:

The carrying values of cash and cash equivalents, receivables, accounts payable and accrued liabilities, promissory notes payable and convertible debentures approximate their fair values due to being in a ready cash form or the short-term maturity of these instruments.

(b) Credit risk:

The majority of the Company's activities are concentrated in the automotive industry and sales are primarily to a few major customers (note 15). To reduce credit risk, management performs ongoing credit evaluations of its customers' financial condition. The Company maintains reserves for potential credit losses based on a risk assessment of its customers.

(c) Foreign currency risk:

The Company operates internationally which gives rise to the risk that cash flows may be adversely impacted by exchange rate fluctuations. To July 31, 2004, the Company has not entered into derivatives or other hedging instruments to mitigate its foreign exchange risk.

12. INCOME TAXES:

(a) Effective tax rate:

The effective income tax rates differ from the Canadian statutory rates for the following reasons:

	2004	2003	2002
Canadian statutory tax rate	36.4%	38.5%	41.7%
Computed tax expense	\$ (3,999,277)	\$ (3,817,132)	\$ (2,847,766)
Foreign losses tax affected at lower rates	5,162	192,027	128,066
Reduction in effective tax rates	(339,481)	—	483,059
Permanent and other differences	1,352,012	387,870	975,676
Change in valuation allowance	2,981,584	3,237,235	1,260,965
	\$ —	\$ —	\$ —

(b) Deferred tax assets and liabilities:

	2004	2003	2002
Deferred tax assets:			
Fixed and other assets, accounting depreciation in excess of tax	\$ 1,220,775	\$ 861,607	\$ 519,987
Loss carryforwards	16,534,418	14,148,423	11,472,671
Scientific research and development expenses	382,971	359,733	319,525
Share issue costs	549,499	373,523	192,718
(b) Deferred tax assets and liabilities (continued):			
Others	37,207	—	1,150
Total gross deferred tax assets	18,724,870	15,743,286	12,506,051
Valuation allowance	(18,724,870)	(15,743,286)	(12,506,051)
Net deferred tax assets	\$ —	\$ —	\$ —

In assessing the realizability of future tax assets, Management considers whether it is more likely than not that some portion or all of the future tax assets will be realized. The ultimate realization of the future tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible.

For Canadian tax purposes, the Company has approximately \$31,500,000 of non-capital losses for income tax purposes available at July 31, 2004 to reduce taxable income of future years. These losses will expire as follows:

2005	\$	3,200,000
2006		7,600,000
2007		200,000
2008		4,400,000
2009		5,600,000
2010		4,900,000
2011		5,600,000
	\$	<u>31,500,000</u>

Additionally, for Canadian tax purposes, the Company has scientific research and development expenditures of \$1,080,000 available to reduce future taxable income indefinitely.

For United States tax purposes, the Company has approximately \$6,100,000 of net operating losses for income tax purposes available at July 31, 2004 to reduce taxable income of future years. These losses will expire as follows:

2012	\$	100,000
2013		1,000,000
2019		1,800,000
2020		1,300,000
2021		400,000
2022		800,000
2023		300,000
2024		400,000
	\$	<u>6,100,000</u>

For United Kingdom tax purposes, the Company has approximately \$9,600,000 of non-capital losses for income tax purposes available at July 31, 2004 to reduce taxable income of future years. These losses may be carried forward indefinitely.

13. EARNINGS (LOSS) PER SHARE :

The weighted average number of shares outstanding used in the computation of earnings (loss) per share were as follows:

	2004	2003	2002
Weighted-average shares used in computation of basic earnings (loss) per share	83,356,095	26,771,427	16,743,977
Weighted average shares from assumed conversion of dilutive warrants and options	—	—	—
Fully diluted weighted average number of common shares	<u>83,356,095</u>	<u>26,771,427</u>	<u>16,743,977</u>

14. COMMITMENTS AND CONTINGENCIES :

(a) The Company is committed to the following payments under operating leases, and service agreements for premises and certain equipment and consultants:

2005	\$	1,372,953
2006		218,325
2007		182,176
2008		143,303
2009		142,570
2010		<u>139,907</u>



(Prepared in accordance with U.S. generally accepted accounting principles)

14. COMMITMENTS AND CONTINGENCIES (continued):

(b) Cash and short-term investments are used to secure credit card advances in the amount of \$15,000 (2003 - \$25,000).

(c) Product warranties:

The Company provides for estimated warranty costs at the time of product sale. Warranty expense accruals are based on best estimate with reference to historical claims experience. As warranty estimates are based on forecasts, actual claim costs may differ from amounts provided. An analysis of changes in liability for product warranties follows:

Balance, August 1, 2002	\$	9,114
Provision increase		29,946
Expenditures		(18,622)
<hr/>		
Balance, July 31, 2003		20,438
Provision increase		85,934
Expenditures		(16,512)
<hr/>		
Balance, July 31, 2004	\$	89,860

15. SEGMENTED INFORMATION:

The Company operates in the wireless tire monitoring technology industry. Management of the Company makes decisions about allocating resources based on this one operating segment. Geographic information is as follows:

Revenue from external customers:

	Revenue from external customers		
	2004	2003	2002
United States	\$ 651,089	\$ 509,228	\$ 524,516
United Kingdom	225,517	261,905	266,638
Italy	—	391,169	12,629
China	514,365	243,866	—
Other	267,308	396,428	208,561
	<hr/>	<hr/>	<hr/>
	\$ 1,658,279	\$ 1,802,596	\$ 1,012,344

As at July 31, 2004, 53% (July 31, 2003-73%) of the Company's fixed assets were in Canada, 17% (July 31, 2003-27%) were in Europe and 30% were in Korea (July 31, 2003-nil).

Major customers, representing 10% or more of total sales, include:

	2004	2003	2002
Customer A	\$ 484,433	\$ —	\$ —
Customer B	—	391,169	12,629
Customer C	28,472	125,413	143,487
Customer D	113,888	109,270	187,314

16. SUBSEQUENT EVENTS:

(a) Between August 9, 2004 and October 5, 2004, the Company issued 60,673,423 shares at effective prices ranging from \$0.03 to \$0.05 per share pursuant to the Standby Equity Distribution Agreement for gross proceeds of \$2,200,000 and net proceeds of \$2,086,500. The issuance of these shares reduced the set price that the holders of the convertible debentures can convert the convertible debentures into common stock and the exercise price of 14,612,907 warrants outstanding to \$0.037.

(b) Subsequent to year end, the Company defaulted on payments to holders of its discounted convertible debentures. In response to the default, certain debenture holders filed legal actions against the Company. On September 24, 2004, the Company and holders of the discounted convertible debentures signed an agreement which provided for: withdrawal of legal action; an immediate exercise of 18,226,274 warrants at \$0.03 for gross proceeds of \$546,788; conversion of \$734,389 of debentures into 24,479,630 common shares and a lock-up provision that establishes a daily limit on the number of shares that can be traded by the debenture holders.

(c) Between August 1, 2004 and October 5, 2004, the Company repaid \$651,837 of principal and \$49,663 in accrued interest on its promissory notes. The Company obtained an extension to November 30, 2004 to repay the balance due on the promissory notes.

17. COMPARATIVE FIGURES:

Certain figures have been reclassified to conform to the financial statement presentation adopted for the current year.



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Al Kozak
William Cronin
Martin Gannon
Johnny Christiansen

OFFICERS FOR SMARTIRE SYSTEMS INC.

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President and Chief Executive Officer

Al Kozak
Chief Operating Officer

Jeff Finkelstein
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ANNUAL MEETING

December 10th, 2004 at 9 AM
Westin Bayshore Hotel
President's Room
1601 Bayshore Drive
Vancouver, British Columbia
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Statements contained in this annual report that are not based on historical facts are forward-looking statements, including any statements concerning management's plans and objectives for future operations and expectations or beliefs regarding the future. All such forward-looking statements are, by necessity, only estimates of future results and actual results may differ materially from these statements due to a number of factors, including: (i) market acceptance of the company's technology and products; (ii) the competitive environment and impact of technological change; (iii) the Company's ability to obtain timely patent and other intellectual property protection for its products; and (iv) the availability of components and raw materials and the reliance on contract manufacturers. The Company assumes no obligations to update these forward-looking statements to reflect annual results, changes in assumptions or changes in other factors affecting such statements.



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