



**KELSO TECHNOLOGIES INC.**

Consolidated Financial Statements  
For the year ended December 31, 2013 and the four months ended December 31, 2012  
(Expressed in US Dollars)

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**INDEPENDENT AUDITORS' REPORT**

**TO THE SHAREHOLDERS OF KELSO TECHNOLOGIES INC.**

We have audited the accompanying consolidated financial statements of Kelso Technologies Inc., which comprise the consolidated statements of financial position as at December 31, 2013 and 2012, and the consolidated statements of operations and comprehensive income (loss), and cash flows for the year ended December 31, 2013, four months ended December 31, 2012, and years ended August 31, 2012 and 2011, and changes in equity for the year ended December 31, 2013, four months ended December 31, 2012 and year ended August 31, 2012, and a summary of significant accounting policies and other explanatory information.

*Management's Responsibility for the Consolidated Financial Statements*

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, as issued by the International Accounting Standards Board, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

*Auditors' Responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

*Opinion*

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Kelso Technologies Inc. as at December 31, 2013 and 2012, and its financial performance and its cash flows for the year ended December 31, 2013, four months ended December 31, 2012, and years ended August 31, 2012 and 2011, in accordance with International Financial Reporting Standards, as issued by the International Accounting Standards Board.

*Smythe Ratcliffe LLP*

Chartered Accountants

Vancouver, Canada  
March 28, 2014

**KELSO TECHNOLOGIES INC.**

## Consolidated Statements of Financial Position

December 31

(Expressed in US Dollars)

	2013	2012
<b>Assets</b>		
<b>Current</b>		
Cash and cash equivalents	\$ 4,462,531	\$ 1,421,053
Accounts receivable	1,259,340	1,055,778
Prepaid expenses	71,696	88,506
Inventory (Note 6)	2,139,750	1,188,467
	<b>7,933,317</b>	<b>3,753,804</b>
Intangible assets (Note 8)	57,939	93,464
Property and equipment (Note 7)	329,249	329,975
Deferred product costs	117,932	117,932
Deposit	12,780	24,307
Deferred income tax asset (Note 13)	832,171	-
	<b>\$ 9,283,388</b>	<b>\$ 4,319,482</b>
<b>Liabilities</b>		
<b>Current</b>		
Accounts payable and accrued liabilities (Notes 10, 11)	\$ 486,147	\$ 283,042
	<b>486,147</b>	<b>283,042</b>
<b>Shareholders' Equity</b>		
<b>Capital Stock</b> (Note 9)		
Common shares (Note 9 (a))	18,086,144	16,073,471
Subscriptions received (Note 9 (a))	16,816	353,846
<b>Share-Based Payments Reserve</b> (Note 9 (b))	<b>2,201,701</b>	<b>1,573,179</b>
<b>Deficit</b>	<b>(11,507,420)</b>	<b>(13,964,056)</b>
	<b>8,797,241</b>	<b>4,036,440</b>
	<b>\$ 9,283,388</b>	<b>\$ 4,319,482</b>

Approved on behalf of the Board:

"Peter Hughes" (signed)

Peter Hughes, Director

"James R. Bond" (signed)

James R. Bond, Director

See notes to consolidated financial statements

**KELSO TECHNOLOGIES INC.**

## Consolidated Statements of Changes in Equity

For the year ended December 31, 2013, four months ended December 31, 2012, and year ended August 31, 2012

(Expressed in US Dollars)

	Capital Stock		Share subscriptions	Share-based payments reserve	Deficit	Total
	Number of shares	Amount				
<b>Balance, August 31, 2011</b>	33,006,283	\$ 13,639,786	\$ 919	\$ 1,347,740	\$ (12,698,217)	\$ 2,290,228
Exercise of warrants	3,553,300	818,341	(919)	-	-	817,422
Exercise of options	100,000	36,967	-	(13,349)	-	23,618
Share-based payments	-	-	-	71,132	-	71,132
Loss for the year	-	-	-	-	(1,276,827)	(1,276,827)
<b>Balance, August 31, 2012</b>	36,659,583	14,495,094	-	1,405,523	(13,975,044)	1,925,573
Exercise of warrants	1,336,000	472,791	-	-	-	472,791
Private placement for cash	1,995,000	1,197,000	-	-	-	1,197,000
Share issue costs	-	(91,414)	-	-	-	(91,414)
Subscriptions received	-	-	353,846	-	-	353,846
Share-based payments	-	-	-	167,656	-	167,656
Net income for the period	-	-	-	-	10,988	10,988
<b>Balance, December 31, 2012</b>	39,990,583	16,073,471	353,846	1,573,179	(13,964,056)	4,036,440
Exercise of warrants	2,424,814	1,746,846	(353,846)	-	-	1,393,000
Exercise of options	604,929	265,827	-	(115,234)	-	150,593
Subscriptions received	-	-	16,816	-	-	16,816
Share-based payments	-	-	-	743,756	-	743,756
Net income for the year	-	-	-	-	2,456,636	2,456,636
<b>Balance, December 31, 2013</b>	<b>43,020,326</b>	<b>\$ 18,086,144</b>	<b>\$ 16,816</b>	<b>\$ 2,201,701</b>	<b>\$ (11,507,420)</b>	<b>\$ 8,797,241</b>

See notes to consolidated financial statements

**KELSO TECHNOLOGIES INC.**Consolidated Statements of Operations and Comprehensive Income  
(Expressed in US Dollars)

	Year ended December 31, 2013	Four months ended December 31, 2012	Year ended August 31, 2012	Year ended August 31, 2011
<b>Revenues</b>	<b>\$ 13,131,387</b>	<b>\$ 2,830,778</b>	<b>\$ 2,233,807</b>	<b>\$ 1,326,024</b>
<b>Cost of Goods Sold</b>	<b>7,826,180</b>	<b>1,937,607</b>	<b>1,673,434</b>	<b>1,006,062</b>
<b>Gross Profit</b>	<b>5,305,207</b>	<b>893,171</b>	<b>560,373</b>	<b>319,962</b>
<b>Expenses</b>				
Management compensation (Note 11)	809,392	146,727	392,490	258,193
Share-based payments (Note 9 (b))	743,756	167,656	71,132	611,052
Office and administration	635,412	231,360	505,113	456,437
Marketing	371,687	114,845	197,066	43,161
Consulting and investor relations	339,552	74,083	212,601	147,943
Research	253,308	36,802	155,073	110,922
Travel	223,019	41,006	100,163	60,290
Accounting and legal	167,929	66,414	97,708	143,466
Foreign exchange loss	76,982	2,282	75,587	(37,696)
Gain on settlement of debt	-	-	(14,764)	(25,362)
Amortization	3,025	1,008	45,031	15,425
	<b>3,624,062</b>	<b>882,183</b>	<b>1,837,200</b>	<b>1,783,831</b>
<b>Income (Loss) Before the Following:</b>	<b>1,681,145</b>	<b>10,988</b>	<b>(1,276,827)</b>	<b>(1,463,869)</b>
Write-off of property and equipment	(56,680)	-	-	-
<b>Income (Loss) Before Taxes:</b>	<b>1,624,465</b>	<b>10,988</b>	<b>(1,276,827)</b>	<b>(1,463,869)</b>
<b>Deferred Income Tax Recovery</b>	<b>832,171</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Net Income (Loss) and Comprehensive Income (Loss) for the Period</b>	<b>\$ 2,456,636</b>	<b>\$ 10,988</b>	<b>\$ (1,276,827)</b>	<b>\$ (1,463,869)</b>
<b>Basic Earnings (Loss) Per Share</b> (Note 15)				
<b>Diluted Earnings (Loss) Per Share</b> (Note 15)	<b>\$ 0.06</b>	<b>\$ 0.00</b>	<b>\$ (0.04)</b>	<b>\$ (0.05)</b>
	<b>\$ 0.06</b>	<b>\$ 0.00</b>	<b>\$ (0.04)</b>	<b>\$ (0.05)</b>
<b>Weighted Average Number of Common Shares Outstanding</b>				
Basic (Note 15)	41,712,969	38,562,337	34,379,896	28,072,327
Diluted (Note 15)	44,641,647	38,562,337	34,379,896	28,072,327

See notes to consolidated financial statements

**KELSO TECHNOLOGIES INC.**

## Consolidated Statements of Cash Flows

(Expressed in US Dollars)

	Year ended December 31, 2013	Four months ended December 31, 2012	Year ended August 31, 2012	Year ended August 31, 2011
<b>Operating Activities</b>				
Net income (loss)	\$ 2,456,636	\$ 10,988	\$ (1,276,827)	\$ (1,463,869)
Items not involving cash				
Deferred income tax recovery	(832,171)	-	-	-
Amortization of equipment and patent	71,731	15,515	45,031	15,425
Write-off of property and equipment	56,680	-	-	-
Gain on settlement of debt	-	-	(14,764)	(25,362)
Share-based payments	743,756	167,656	71,132	611,052
	<b>2,496,632</b>	<b>194,159</b>	<b>(1,175,428)</b>	<b>(862,754)</b>
Changes in non-cash working capital				
Accounts receivable	(203,562)	(151,675)	(473,990)	(269,064)
Prepaid expenses and deposit	28,337	(10,648)	(40,770)	(44,809)
Inventory	(946,195)	7,998	(945,294)	(251,171)
Accounts payable and accrued liabilities	203,105	(480,731)	509,600	6,723
	<b>(918,315)</b>	<b>(635,056)</b>	<b>(950,454)</b>	<b>(558,321)</b>
<b>Cash Provided by (Used in) Operating Activities</b>	<b>1,578,317</b>	<b>(440,897)</b>	<b>(2,125,882)</b>	<b>(1,421,075)</b>
<b>Investing Activities</b>				
Intangible assets	-	(65,000)	-	-
Deferred product costs	-	-	(36,680)	(81,252)
Property and equipment	(97,248)	(7,855)	(133,830)	(258,106)
<b>Cash Used in Investing Activities</b>	<b>(97,248)</b>	<b>(72,855)</b>	<b>(170,510)</b>	<b>(339,358)</b>
<b>Financing Activities</b>				
Issue of and subscription for common shares, net of share issue costs	1,543,593	1,578,377	841,040	3,022,215
Subscriptions received	16,816	353,846	-	-
Note payable	-	-	-	(70,320)
<b>Cash Provided by Financing Activities</b>	<b>1,560,409</b>	<b>1,932,223</b>	<b>841,040</b>	<b>2,951,895</b>
<b>Inflow (Outflow) of Cash and Cash Equivalents</b>	<b>3,041,478</b>	<b>1,418,471</b>	<b>(1,455,352)</b>	<b>1,191,462</b>
<b>Cash and Cash Equivalents, Beginning of Period</b>	<b>1,421,053</b>	<b>2,582</b>	<b>1,457,934</b>	<b>266,472</b>
<b>Cash and Cash Equivalents, End of Period</b>	<b>\$ 4,462,531</b>	<b>\$ 1,421,053</b>	<b>\$ 2,582</b>	<b>\$ 1,457,934</b>
<b>Cash and Cash Equivalents Consists of</b>				
Cash	\$ 1,641,931	\$ 1,421,053	\$ 2,582	\$ 1,457,934
Guaranteed investment certificates	2,820,600	-	-	-
	<b>\$ 4,462,531</b>	<b>\$ 1,421,053</b>	<b>\$ 2,582</b>	<b>\$ 1,457,934</b>

Supplemental Cash Flow Information (Note 14)

See notes to consolidated financial statements

## **KELSO TECHNOLOGIES INC.**

### Notes to Consolidated Financial Statements

For the year ended December 31, 2013, four months ended December 31, 2012, and years ended August 31, 2012 and 2011  
(Expressed in US Dollars)

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#### **1. NATURE OF OPERATIONS**

Kelso Technologies Inc. (the "Company") designs, engineers, markets, produces and distributes various proprietary pressure relief valves and manway securement systems designed to reduce the risk of environmental harm due to non-accidental events in the transportation of hazardous commodities via railroad tank cars. The Company trades on the TSX Venture Exchange ("TSX-V") under the symbol "KLS", and the US over-the-counter market ("OTCQX") under the symbol "KEOSF". The Company's head office is located at 7773 118A Street, Delta, British Columbia, V4C 6V1.

Effective December 31, 2012, the Company changed its fiscal year-end to December 31.

#### **2. BASIS OF PREPARATION**

##### **(a) Statement of compliance**

These consolidated financial statements are prepared in accordance with International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board.

These consolidated financial statements have been prepared under the historical cost basis, except for financial instruments classified as available-for-sale ("AFS") and fair value through profit or loss ("FVTPL"). These consolidated financial statements have been prepared using the accrual basis of accounting, except for cash flow information.

##### **(b) Basis of presentation and consolidation**

The consolidated financial statements include the accounts of the Company and its integrated wholly-owned subsidiaries, Kelso Technologies (USA) Inc. and Kelso Innovative Solutions Inc.; both are Nevada, USA, corporations. Intercompany transactions and balances have been eliminated.

##### **(c) Functional and presentation currency**

The functional and presentation currency of the Company and its subsidiaries is the US dollar ("USD").

##### **(d) Significant management judgment and estimation uncertainty**

The preparation of consolidated financial statements in conformity with IFRS requires the Company's management to undertake a number of judgments, estimates and assumptions that affect amounts reported in the consolidated financial statements and notes thereto. Actual amounts may ultimately differ from these estimates and assumptions. The Company reviews its estimates and underlying assumptions on an ongoing basis. Revisions are recognized in the period in which the estimates are revised and may impact future periods.

## **KELSO TECHNOLOGIES INC.**

### Notes to Consolidated Financial Statements

For the year ended December 31, 2013, four months ended December 31, 2012, and the years ended August 31, 2012 and 2011  
(Expressed in US Dollars)

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## **2. BASIS OF PREPARATION (Continued)**

### (d) Significant management judgment and estimation uncertainty (Continued)

#### *Significant management judgments*

The following are significant management judgments in applying the accounting policies of the Company that have the most significant effect on recognition and measurement of assets, liabilities, income and expenses:

#### (i) Recognition of deferred tax assets

The extent to which deferred tax assets can be recognized is based on an assessment of the probability of the Company's future taxable income against which the deferred tax assets can be utilized. In addition, significant judgment is required in assessing the impact of any legal or economic limits or uncertainties in various tax jurisdictions.

#### (ii) Functional currency

The functional currency for the Company's subsidiaries is the currency of the primary economic environment in which the entity operates. The Company has determined the functional currency of its subsidiary is the USD. Determination of functional currency may involve certain judgments to determine the primary economic environment and the Company reconsiders the functional currency of its entities if there is a change in events and conditions that determined the primary economic environment.

#### *Estimation uncertainty*

Information about estimates and assumptions that have the most significant effect on the recognition and measurement of assets, liabilities, income and expenses is provided below. Actual results may be substantially different.

#### (i) Impairment of long-lived assets

In assessing impairment, management estimates the recoverable amount of each asset or cash generating unit based on expected future cash flows and uses an interest rate to discount them. Estimation uncertainty relates to assumptions about future operating results and the determination of a suitable discount rate. To date, the Company has not recognized any impairment losses of long-lived assets.

#### (ii) Useful lives of depreciable assets

The Company reviews its estimate of the useful lives of depreciable assets at each reporting date, based on the expected utilization of the assets. Uncertainties in these estimates relate to technical obsolescence that may change the utilization of certain intangible assets and equipment.

## **KELSO TECHNOLOGIES INC.**

### Notes to Consolidated Financial Statements

For the year ended December 31, 2013, four months ended December 31, 2012, and the years ended August 31, 2012 and 2011  
(Expressed in US Dollars)

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## **2. BASIS OF PREPARATION (Continued)**

### (d) Significant management judgment and estimation uncertainty (Continued)

#### *Estimation uncertainty (Continued)*

#### (iii) Inventories

The Company estimates the net realizable values of inventories, taking into account the most reliable evidence available at each reporting date. The future realization of these inventories may be affected by future technology or other market-driven changes that may reduce future selling prices. A change to these assumptions could impact the Company's inventory valuation and impact gross margins.

#### (iv) Share-based payments

The Company measures the cost of equity-settled share-based transactions by reference to the fair value of the equity instruments at the date at which they are granted. Estimating fair value for share-based payment transactions requires determining the most appropriate valuation model, which is dependent on the terms and conditions of the grant. This estimate also requires determining the most appropriate inputs to the valuation model, including the expected life of the stock option, volatility and dividend yield, and assumptions.

#### (v) Allowance account for credit losses

The Company provides for bad debt by analyzing the historical default experience and current information available about customer's credit worthiness on an account by account basis. Uncertainty relates to the actual collectivity of customer balances that can vary from the Company's estimation.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

### (e) Approval of the consolidated financial statements

The consolidated financial statements of Kelso Technologies Inc. for the year ended December 31, 2013 were approved and authorized for issue by the Board of Directors on March 28, 2014.

## **KELSO TECHNOLOGIES INC.**

Notes to Consolidated Financial Statements

For the year ended December 31, 2013, four months ended December 31, 2012, and the years ended August 31, 2012 and 2011  
(Expressed in US Dollars)

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### **2. BASIS OF PREPARATION (Continued)**

(f) New accounting standards issued but not yet effective

*IFRS 9 Financial Instruments (2009)*

IFRS 9 introduces new requirements for classifying and measuring financial assets, as follows:

- Debt instruments meeting both a “business model” test and a “cash flow characteristics” test are measured at amortized cost (the use of fair value is optional in some limited circumstances)
- Investments in equity instruments can be designated as “fair value through other comprehensive income” with only dividends being recognized in profit or loss
- All other instruments (including all derivatives) are measured at fair value with changes recognized in profit or loss
- The concept of “embedded derivatives” does not apply to financial assets within the scope of the standard and the entire instrument must be classified and measured in accordance with the above guidelines.

The IASB has indefinitely postponed the mandatory adoption date of this standard.

*IFRS 9 Financial Instruments (2010)*

This is a revised version incorporating revised requirements for the classification and measurement of financial liabilities, and carrying over the existing de-recognition requirements from IAS 39 *Financial Instruments: Recognition and Measurement*.

The revised financial liability provisions maintain the existing amortized cost measurement basis for most liabilities. New requirements apply where an entity chooses to measure a liability at fair value through profit or loss; in these cases, the portion of the change in fair value related to changes in the entity's own credit risk is presented in other comprehensive income rather than within profit or loss.

The IASB has indefinitely postponed the mandatory adoption date of this standard.

## **KELSO TECHNOLOGIES INC.**

### Notes to Consolidated Financial Statements

For the year ended December 31, 2013, four months ended December 31, 2012, and the years ended August 31, 2012 and 2011  
(Expressed in US Dollars)

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## **2. BASIS OF PREPARATION (Continued)**

### (f) New accounting standards issued but not yet effective (Continued)

*IFRS 9 Financial Instruments* (Hedge Accounting and amendments to IFRS 9, IFRS 7 and IAS 39) (2013)

A revised version of IFRS 9 which:

- Introduces a new chapter to IFRS 9 on hedge accounting, putting in place a new hedge accounting model that is designed to be more closely aligned with how entities undertake risk management activities when hedging financial and non-financial risk exposures
- Permits an entity to apply only the requirements introduced in IFRS 9 (2010) for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss without applying the other requirements of IFRS 9, meaning the portion of the change in fair value related to changes in the entity's own credit risk can be presented in other comprehensive income rather than within profit or loss
- Removes the mandatory effective date of IFRS 9 (2010) and IFRS 9 (2009), leaving the effective date open pending the finalization of the impairment and classification and measurement requirements. Notwithstanding the removal of an effective date, each standard remains available for application.

This standard has no stated effective date.

*Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27)

Amends IFRS 10 *Consolidated Financial Statements*, IFRS 12 *Disclosure of Interests in Other Entities* and IAS 27 *Separate Financial Statements* to:

- provide "investment entities" (as defined) an exemption from the consolidation of particular subsidiaries and instead require that an investment entity measure the investment in each eligible subsidiary at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments* or IAS 39
- require additional disclosure about why the entity is considered an investment entity, details of the entity's unconsolidated subsidiaries, and the nature of relationship and certain transactions between the investment entity and its subsidiaries
- require an investment entity to account for its investment in a relevant subsidiary in the same way in its consolidated and separate financial statements (or to only provide separate financial statements if all subsidiaries are unconsolidated).

Applicable to annual periods beginning on or after January 1, 2014.

*Recoverable Amount Disclosures for Non-Financial Assets* (Amendments to IAS 36)

Amends IAS 36 *Impairment of Assets* to reduce the circumstances in which the recoverable amount of assets or cash-generating units is required to be disclosed, clarify the disclosures required, and to introduce an explicit requirement to disclose the discount rate used in determining impairment (or reversals) where recoverable amount (based on fair value less costs of disposal) is determined using a present value technique.

Applicable to annual periods beginning on or after January 1, 2014.

## **KELSO TECHNOLOGIES INC.**

### Notes to Consolidated Financial Statements

For the year ended December 31, 2013, four months ended December 31, 2012, and the years ended August 31, 2012 and 2011  
(Expressed in US Dollars)

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## **2. BASIS OF PREPARATION (Continued)**

### (f) New accounting standards issued but not yet effective (Continued)

#### *Annual Improvements 2010-2012 Cycle*

Makes amendments to the following standards:

- IFRS 2 — Amends the definitions of “vesting condition” and “market condition” and adds definitions for “performance condition” and “service condition”
- IFRS 3 — Require contingent consideration that is classified as an asset or a liability to be measured at fair value at each reporting date
- IFRS 8 — Requires disclosure of the judgments made by management in applying the aggregation criteria to operating segments, clarify reconciliations of segment assets only required if segment assets are reported regularly
- IFRS 13 — Clarify that issuing IFRS 13 and amending IFRS 9 and IAS 39 did not remove the ability to measure certain short-term receivables and payables on an undiscounted basis (amends basis for conclusions only)
- IAS 16 and IAS 38 — Clarify that the gross amount of property, plant and equipment is adjusted in a manner consistent with a revaluation of the carrying amount
- IAS 24 — Clarify how payments to entities providing management services are to be disclosed

Applicable to annual periods beginning on or after July 1, 2014.

#### *Annual Improvements 2011-2013 Cycle*

Makes amendments to the following standards:

- IFRS 1 — Clarify which versions of IFRSs can be used on initial adoption (amends basis for conclusions only)
- IFRS 3 — Clarify that IFRS 3 excludes from its scope the accounting for the formation of a joint arrangement in the financial statements of the joint arrangement itself
- IFRS 13 — Clarify the scope of the portfolio exception in paragraph 52
- IAS 40 — Clarifying the interrelationship of IFRS 3 and IAS 40 when classifying property as investment property or owner-occupied property

Applicable to annual periods beginning on or after July 1, 2014.

#### *Offsetting Financial Assets and Financial Liabilities (Amendments to IAS 32)*

Amends IAS 32 *Financial Instruments: Presentation* to clarify certain aspects because of diversity in application of the requirements on offsetting, focused on four main areas:

- the meaning of “currently has a legally enforceable right of set-off”
- the application of simultaneous realization and settlement
- the offsetting of collateral amounts
- the unit of account for applying the offsetting requirements.

Applicable to annual periods beginning on or after January 1, 2014.

## **KELSO TECHNOLOGIES INC.**

### Notes to Consolidated Financial Statements

For the year ended December 31, 2013, four months ended December 31, 2012, and the years ended August 31, 2012 and 2011  
(Expressed in US Dollars)

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### **3. SIGNIFICANT ACCOUNTING POLICIES**

The following is a summary of significant accounting policies.

(a) Cash equivalents

Cash equivalents include short-term liquid investments with maturities of 90 days or less, are readily convertible into known amounts of cash and which are subject to insignificant changes in value.

(b) Inventory

Inventory components include raw materials and supplies used to assemble valves and manway covers, as well as finished valves and manway covers. All inventories are recorded at the lower of cost and net realizable value on a weighted average basis. The stated value of all inventories includes raw materials and supplies purchase and assembly costs, and attributable overhead and amortization. A regular review is undertaken to determine the extent of any provision for obsolescence.

(c) Intangible assets

The Company's intangible assets include manway patents and education tube line rights with a finite useful life. The patents are capitalized and amortized on a straight-line basis over their thirteen-year protective term. The rights are capitalized and amortized on a straight-line basis over their two-year useful life. Intangible assets are tested for impairment on an annual basis or when events occur that may indicate impairment. If any such indications of impairment exist, the Company will estimate the recoverable amount of the asset and record any impairment on the carrying amount to profit or loss in the period.

(d) Property and equipment

Property and equipment are stated at cost less accumulated amortization. Leasehold improvements are amortized on a straight-line basis over the lease term. Amortization is calculated over the estimated useful life of the property and equipment on a declining-balance basis at the following rates:

Building	– 4%
Leasehold improvements	– 20%
Production equipment	– 20%
Vehicles	– 30%

(e) Research and development

Research costs are expensed as incurred. Product and technology development costs, which meet the criteria for deferral and are expected to provide future benefits with reasonable certainty are deferred and amortized over the estimated life of the products or technology. In 2011, the Company commenced deferring development costs associated with the manway securement systems. In the year of deferral of product costs, the Company does not record amortization.

## **KELSO TECHNOLOGIES INC.**

### Notes to Consolidated Financial Statements

For the year ended December 31, 2013, four months ended December 31, 2012, and the years ended August 31, 2012 and 2011  
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### **3. SIGNIFICANT ACCOUNTING POLICIES** (Continued)

(f) Revenue recognition

Revenues are recognized when the risks and rewards of ownership have passed to the customer based on the terms of the sale, collection of the relevant receivable is probable, evidence of an arrangement exists and the sales price is fixed or determinable. Risks and rewards of ownership pass to the customer upon shipment. Provisions for sales discounts, returns and miscellaneous claims from customers are made at the time of sale.

(g) Income taxes

Income tax expense, consisting of current and deferred tax expense, is recognized in the consolidated statements of operations. Current tax expense is the expected tax payable on the taxable income for the period, using tax rates enacted or substantively enacted at period-end, adjusted for amendments to tax payable with regard to previous years.

Deferred tax assets and liabilities and the related deferred income tax expense or recovery are recognized for deferred tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted or substantively enacted tax rates expected to apply when the asset is realized or the liability settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income (loss) in the period that substantive enactment occurs.

A deferred tax asset is recognized to the extent that it is probable that future taxable profits will be available against which the asset can be utilized. To the extent that the Company does not consider it probable that a deferred tax asset will be recovered, the deferred tax asset is reduced. Deferred tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current tax liabilities and when they relate to income taxes levied by the same taxation authority and the Company intends to settle its current tax assets and liabilities on a net basis.

(h) Foreign currency translation

The accounts of foreign operations are translated into USD as follows:

- (i) Monetary assets and liabilities, at the rate of exchange in effect at the consolidated statement of financial position date;
- (ii) Non-monetary assets and liabilities, at the exchange rates prevailing at the time of the acquisition of the assets or assumption of the liabilities; and
- (iii) Revenue and expense items (excluding amortization, which is translated at the same rate as the related asset), at the rate of exchange prevailing at the transaction date.

Gains and losses arising from translation of foreign currency are included in the determination of net income.

## **KELSO TECHNOLOGIES INC.**

### Notes to Consolidated Financial Statements

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#### **3. SIGNIFICANT ACCOUNTING POLICIES (Continued)**

(i) Earnings (loss) per share

The Company presents basic earnings (loss) per share data for its common shares, calculated by dividing the earnings/loss attributable to common shareholders of the Company by the weighted average number of shares outstanding during the period. The Company uses the treasury stock method for calculating diluted earnings (loss) per share. Under this method the dilutive effect on earnings per share is calculated on the use of the proceeds that could be obtained upon exercise of options, warrants and similar instruments. It assumes that the proceeds of such exercise would be used to purchase common shares at the average market price during the period. However, the calculation of diluted loss per share excludes the effects of various conversions and exercise of options and warrants that would be anti-dilutive.

(j) Share-based payments

The Company grants share options to acquire common shares of the Company to directors, officers, employees and consultants. The fair value of share-based payments to employees is measured at grant date, using the Black-Scholes option pricing model, and is recognized over the vesting period for employees using the graded vesting method. Fair value of share-based payments for non-employees is recognized and measured at the date the goods or services are received based on the fair value of the goods or services received. If it is determined that the fair value of goods and services received cannot be reliably measured, the share-based payment is measured at the fair value of the equity instruments issued using the Black-Scholes option pricing model.

For both employees and non-employees, the fair value of share-based payments is recognized as an expense with a corresponding increase in share-based payments reserve. The amount recognized as expense is adjusted to reflect the number of share options expected to vest. Consideration received on the exercise of stock options is recorded in capital stock and the related share-based payment in share-based payments reserve is transferred to capital stock.

(k) Capital stock

Proceeds from the exercise of stock options and warrants are recorded as capital stock in the amount for which the option or warrant enabled the holder to purchase a share in the Company. Any previously recorded share-based payment included in the share-based payments reserve is transferred to capital stock on exercise of options. Capital stock issued for non-monetary consideration is valued at the closing market price at the date of issuance. The proceeds from the issuance of units are allocated between common shares and warrants based on the residual value method. Under this method, the proceeds are allocated first to capital stock based on the fair value of the common shares at the time the units are priced and any residual value is allocated to the warrants reserve. Consideration received for the exercise of warrants is recorded in capital stock, and any related amount recorded in warrants reserve is transferred to capital stock.

## **KELSO TECHNOLOGIES INC.**

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### **3. SIGNIFICANT ACCOUNTING POLICIES (Continued)**

#### (l) Financial instruments

##### (i) Financial assets

The Company classifies its financial assets into one of the following categories, depending on the purpose for which the asset was acquired. The Company's accounting policy for each category is as follows:

##### *Fair value through profit or loss*

This category comprises derivatives, or assets acquired or incurred principally for the purpose of selling or repurchasing it in the near term. They are carried at fair value with changes in fair value recognized through profit or loss.

##### *Loans and receivables*

These assets are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They are carried at cost less any provision for impairment. Individually significant receivables are considered for impairment when they are past due or when other objective evidence is received that a specific counterparty will default.

##### *Held-to-maturity investments*

These assets are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Company's management has the positive intention and ability to hold to maturity. These assets are measured at amortized cost using the effective interest method. If there is objective evidence that the investment is impaired, determined by reference to external credit ratings and other relevant indicators, the financial asset is measured at the present value of estimated future cash flows. Any changes to the carrying amount of the investment, including impairment losses, are recognized through profit or loss.

##### *Available-for-sale*

Non-derivative financial assets not included in the above categories are classified as available-for-sale. They are carried at fair value with changes in fair value recognized directly in equity. Where a decline in the fair value of an available-for-sale financial asset constitutes objective evidence of impairment, the amount of the loss is removed from equity and recognized through profit or loss.

All financial assets, except for those at fair value through profit or loss, are subject to review for impairment at least at each reporting date. Financial assets are impaired when there is any objective evidence that a financial asset or a group of financial assets is impaired. Different criteria to determine impairment are applied for each category of financial assets, which are described above.

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### **3. SIGNIFICANT ACCOUNTING POLICIES** (Continued)

#### (I) Financial instruments (Continued)

##### (ii) Financial liabilities

The Company classifies its financial liabilities in the following categories: as FVTPL or other financial liabilities.

##### *Fair value through profit or loss*

Financial liabilities classified as FVTPL include financial liabilities held-for-trading and financial liabilities designated upon initial recognition as FVTPL. Fair value changes on financial liabilities classified as FVTPL are recognized in profit or loss.

##### *Other financial liabilities*

Other financial liabilities are non-derivatives and are recognized initially at fair value, net of transaction costs incurred, and are subsequently stated at amortized cost using the effective interest rate method. Any difference between the amounts originally received, net of transaction costs, and the redemption value is recognized in profit or loss over the period to maturity using the effective interest method. Other financial liabilities are classified as current or non-current based on their maturity date.

Other financial liabilities are classified as current or non-current based on their maturity date.

##### (iii) Fair value hierarchy

Fair value measurements of financial instruments are required to be classified using a fair value hierarchy that reflects the significance of inputs used in making the measurements. The levels of the fair value hierarchy are defined as follows:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3: Inputs for assets or liabilities that are not based on observable market data.

### **4. CAPITAL MANAGEMENT**

The Company considers its capital to be comprised of shareholders' equity.

The Company's objectives in managing its capital are to maintain its ability to continue as a going concern and to further develop its business. To effectively manage the Company's capital requirements, the Company has a planning and budgeting process in place to meet its strategic goals.

## **KELSO TECHNOLOGIES INC.**

### Notes to Consolidated Financial Statements

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#### **4. CAPITAL MANAGEMENT (Continued)**

In order to facilitate the management of its capital requirements, the Company prepares expenditure budgets that are updated as necessary depending on various factors, including successful capital deployment and general industry conditions. Management reviews the capital structure on a regular basis to ensure the above objectives are met. There have been no changes to the Company's approach to capital management during the year. There are no externally-imposed restrictions on the Company's capital.

#### **5. FINANCIAL INSTRUMENTS**

Financial instruments are agreements between two parties that result in promises to pay or receive cash or equity instruments. The Company classifies its financial instruments as follows: cash is classified as a financial asset at FVTPL, accounts receivable is classified as loans and receivables and accounts payable and accrued liabilities are classified as other financial liabilities, which are measured at amortized cost. The carrying value of these instruments approximates their fair values due to their short term to maturity.

The Company has exposure to the following risks from its use of financial instruments:

- Credit risk;
- Liquidity risk; and
- Market risk.

##### (a) Credit risk

Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. Cash and cash equivalents are placed with major Canadian and US financial institutions and the Company's concentration of credit risk for cash and cash equivalents and maximum exposure thereto is \$4,462,531 (2012 - \$1,421,053).

With respect to its accounts receivable, the Company assesses the credit rating of all customers and maintains provisions for potential credit losses, and any such losses to date have been within management's expectations. The Company's credit risk with respect to accounts receivable and maximum exposure thereto is \$1,259,340 (2012 - \$1,055,778). The Company's concentration of credit risk for accounts receivable with respect to Customer A is \$342,650 (2012 - \$465,802), while Customer B is \$638,777 (2012 - \$309,795) (note 16).

##### (b) Liquidity risk

Liquidity risk is the risk that the Company will be unable to meet its financial obligations as they fall due. The Company's approach to managing liquidity risk is to ensure, as far as possible, that it will have sufficient liquid funds to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Company's reputation. At December 31, 2013, the Company has \$4,462,531 (2012 - \$1,421,053) of cash and cash equivalents to settle current liabilities of \$486,147 with the following due dates: trade accounts payable of \$201,300 (2012 - \$270,795) are due within three months; management bonus payable of \$269,434 (2012 - \$Nil) are due within five and one half months and; due to related party balance of \$15,413 (2012 - \$12,247) is due on demand.

## KELSO TECHNOLOGIES INC.

### Notes to Consolidated Financial Statements

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#### 5. FINANCIAL INSTRUMENTS (Continued)

##### (c) Market risk

The significant market risks to which the Company is exposed are interest rate risk and currency risk.

##### (i) Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows will fluctuate as a result of changes in market interest rates. The Company's cash and cash equivalents consist of cash held in bank accounts and short-term liquid investments that earn interest at variable rates. Due to the short-term nature of these financial instruments, fluctuations in market rates of interest do not have a significant impact on the estimated fair value or future cash flows.

##### (ii) Currency risk

The Company is exposed to currency risk to the extent expenditures incurred or funds received and balances maintained by the Company are denominated in Canadian dollars ("CAD"). The Company does not manage currency risk through hedging or other currency management tools.

As at December 31, 2013 and 2012, the Company's net exposure to foreign currency risk is as follows (in USD):

	December 31, 2013	December 31, 2012
Net assets	\$ 3,319,501	\$ 824,251

Based on the above, assuming all other variables remain constant, a 10% weakening or strengthening of the USD against the CAD would result in approximately \$330,000 (2012 - \$13,000) foreign exchange loss or gain in the consolidated statements of operations and comprehensive income (loss).

##### (iii) Other price risk

Other price risk is the risk that the future cash flows of a financial instrument will fluctuate due to changes in market prices, other than those arising from interest rate risk or currency risk. The Company is not exposed to other price risk.

#### 6. INVENTORY

	December 31, 2013	December 31, 2012
Finished goods	\$ 1,211,968	\$ 476,871
Raw materials and supplies	927,782	711,596
	\$ 2,139,750	\$ 1,188,467

Included in cost of goods sold is \$6,658,316 (2012 - \$1,512,484) of direct material costs recognized as expense.

**KELSO TECHNOLOGIES INC.**

## Notes to Consolidated Financial Statements

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**7. PROPERTY AND EQUIPMENT**

	Land	Building	Leasehold improvements	Production equipment	Vehicles	Total
<b>Cost</b>						
Balance, August 31, 2012	\$ 12,558	\$ 163,092	\$ 32,610	\$ 155,676	\$ 27,674	\$ 391,610
Additions	-	-	-	7,855	-	7,855
Balance, December 31, 2012	12,558	163,092	32,610	163,531	27,674	399,465
Additions	-	47,569	9,187	39,985	507	97,248
Write-off	-	-	-	(98,375)	-	(98,375)
Balance, December 31, 2013	\$ 12,558	\$ 210,661	\$ 41,797	\$ 105,141	\$ 28,181	\$ 398,338
<b>Accumulated Amortization</b>						
Balance, August 31, 2012	\$ -	\$ 7,821	\$ 7,877	\$ 35,134	\$ 4,151	\$ 54,983
Amortization	-	2,070	1,648	8,436	2,353	14,507
Balance, December 31, 2012	-	9,891	9,525	43,570	6,504	69,490
Amortization	-	6,128	4,617	24,198	6,351	41,294
Write-off	-	-	-	(41,695)	-	(41,695)
Balance, December 31, 2013	\$ -	\$ 16,019	\$ 14,142	\$ 26,073	\$ 12,855	\$ 69,089
<b>Carrying Value</b>						
December 31, 2013	\$ 12,558	\$ 194,642	\$ 27,655	\$ 79,068	\$ 15,326	\$ 329,249
December 31, 2012	\$ 12,558	\$ 153,201	\$ 23,085	\$ 119,961	\$ 21,170	\$ 329,975

Included in cost of goods sold is \$36,206 (2012 - \$14,507) of amortization related to property and equipment.

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**8. INTANGIBLE ASSETS**

	Patent	Rights	Total
<b>Cost</b>			
Balance, August 31, 2012	\$ 40,840	\$ -	\$ 40,840
Additions	-	65,000	65,000
Balance, December 31, 2012	40,840	65,000	105,840
Additions	-	-	-
Balance, December 31, 2013	\$ 40,840	\$ 65,000	\$ 105,840
<b>Accumulated Amortization</b>			
Balance, August 31, 2012	\$ 11,368	\$ -	\$ 11,368
Amortization	1,008	-	1,008
Balance, December 31, 2012	12,376	-	12,376
Amortization	3,025	32,500	35,525
Balance, December 31, 2012	\$ 15,401	\$ 32,500	\$ 47,901
<b>Carrying Value</b>			
December 31, 2013	\$ 25,439	\$ 32,500	\$ 57,939
December 31, 2012	\$ 28,464	\$ 65,000	\$ 93,464

Included in cost of goods sold is \$32,500 (2012 - \$Nil) of amortization related to rights.

The Company is obligated to pay a 5% royalty from sales of their manway securement systems. During the year ended December 31, 2013, there were no revenues from sales of the manway securement systems. The Company also holds a number of other patents, which have been fully amortized as at December 31, 2013.

On November 28, 2012, the Company signed an agreement to acquire all proprietary manufacturing rights to an eduction tube line ("ETS") for \$65,000. The vendor entered into a consulting agreement with the Company for a period of twenty-four months for a fee of \$6,500 per month. The Company is obligated to pay a 7% royalty from sales on all ETS sold over the duration of the consulting contract. During the year ended December 31, 2013, there were revenues of \$64,975 (four months ended December 31, 2012 - \$Nil; year ended August 31, 2012 - \$Nil; year ended August 31, 2011 - \$Nil) from the sales of the ETS.

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### Notes to Consolidated Financial Statements

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#### **9. CAPITAL STOCK**

Authorized:

Unlimited Class A non-cumulative, preferred shares without par value, of which 5,000,000 are designated Class A, convertible, voting, preferred shares

Unlimited common shares without par value

Issued:

(a) Common shares

During the year ended December 31, 2013, the Company issued:

- (i) 2,424,814 shares pursuant to the exercise of share purchase warrants for proceeds of \$1,746,846, of which \$353,846 relating to the exercise of 999,000 warrants was raised during the year ended December 31, 2012.
- (ii) 604,929 shares pursuant to the exercise of 604,929 share purchase options for proceeds of \$150,593. Fair value previously recognized on options exercised of \$115,234 was reclassified from share-based payments reserve to capital stock.
- (iii) In addition, the Company received share subscriptions for the exercise of an additional 5,000 warrants and 19,717 options for gross proceeds of \$16,816. These shares were issued subsequent to December 31, 2013.

During the four months ended December 31, 2012, the Company issued:

- (i) 1,995,000 units pursuant to a private placement for gross proceeds of \$1,197,000. Each unit consists of one common share and one-half of one share purchase warrant. One whole warrant will entitle the holder thereof to purchase one additional common share at a price of \$0.80USD until September 28, 2014. The Company paid \$91,414 in finder's fees and other costs.
- (ii) The Company issued 1,336,000 shares for warrants exercised for gross proceeds of \$472,791.

During the year ended August 31, 2012, the Company raised:

- (i) 100,000 shares pursuant to the exercise of 100,000 share purchase options for proceeds of \$23,618. Fair value previously recognized on options exercised of \$13,349 was reclassified from share-based payments reserve to capital stock.
- (ii) 3,553,300 shares pursuant the exercise of share purchase warrants for proceeds of \$818,341, of which \$919 was raised during the year ended August 31, 2011.

**KELSO TECHNOLOGIES INC.**

## Notes to Consolidated Financial Statements

For the year ended December 31, 2013, four months ended December 31, 2012, and the years ended August 31, 2012 and 2011  
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**9. CAPITAL STOCK (Continued)**

## (b) Stock options

The Company has a stock option plan (the "Plan") available to employees, directors, officers and consultants with grants under the Plan approved from time to time by the Board of Directors. Under the Plan, the Company is authorized to issue options to purchase an aggregate of up to 10% of the Company's issued and outstanding common shares. Each option can be exercised to acquire one common share of the Company. The exercise price for an option granted under the Plan may not be less than the market price at the date of grant less a specified discount dependent on the market price.

Options to purchase common shares have been granted to directors, employees and consultants as follows:

Exercise Price (CAD)	Expiry Date	Year ended December 31, 2013	Four months ended December 31, 2012	Year ended August 31, 2012
\$ 0.70	November 8, 2012	-	-	58,213
\$ 0.70	May 26, 2013	-	10,929	10,929
\$ 0.24	December 7, 2013	-	250,000	250,000
\$ 0.55	February 9, 2014	150,000	150,000	150,000
\$ 0.65	November 25, 2014	150,000	150,000	150,000
\$ 0.24	June 2, 2015	530,000	600,000	600,000
\$ 0.24	October 4, 2015	300,000	554,000	554,000
\$ 0.58	July 22, 2016	400,000	420,000	420,000
\$ 0.58	August 25, 2016	100,000	100,000	100,000
\$ 0.65	October 30, 2017	310,000	310,000	-
\$ 0.70	October 7, 2019	28,571	28,571	28,571
\$ 1.45 (USD)	March 31, 2017	870,000	-	-
Total outstanding		2,838,571	2,573,500	2,321,713
Total exercisable		2,838,571	2,536,000	2,246,713

**KELSO TECHNOLOGIES INC.**

## Notes to Consolidated Financial Statements

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**9. CAPITAL STOCK (Continued)**

## (b) Stock options (Continued)

A summary of the Company's stock options as at December 31, 2013, December 31, 2012 and August 31, 2012, and changes for the periods then ended are as follows:

	Number	Weighted Average Exercise Price (CAD)
Outstanding, August 31, 2011	3,028,999	\$ 0.38
Granted	150,000	\$ 0.65
Expired	(757,286)	\$ 0.42
Exercised	(100,000)	\$0.24
Outstanding, August 31, 2012	2,321,713	\$ 0.38
Granted	310,000	\$ 0.65
Expired	(58,213)	\$ 0.70
Outstanding, December 31, 2012	2,573,500	\$ 0.41
Granted	870,000	\$ 1.45 USD
Exercised	(604,929)	\$ 0.26
Outstanding, December 31, 2013	2,838,571	\$ 0.78

The weighted average contractual life for the remaining options at December 31, 2013 is 2.43 (December 31, 2012 - 2.8; August 31, 2012 - 2.8) years.

*Share-based payments*

Share-based payments of \$743,756 (four months ended December 31, 2012 - \$167,656; year ended August 31, 2012 - \$71,132; year ended August 31, 2011 - \$611,052) were recognized in the year ended December 31, 2013 for stock options granted, and the vesting of options granted in the prior year.

The fair value of stock options is determined using the Black-Scholes option pricing model with assumptions as follows:

	Year ended December 31, 2013	Four months ended December 31, 2012	Year ended August 31, 2012
Risk-free interest rate (average)	1.62%	1.09%	1.09%
Estimated volatility (average)	88%	154%	115%
Expected life in years	3.65	5	2.35
Expected dividend yield	0.00%	0.00%	0.00%
Estimated forfeitures	0.00%	0.00%	0.00%
Grant date fair value per option	\$ 0.85	\$ 0.54	\$ 0.39

Option pricing models require the use of highly subjective estimates and assumptions including the expected stock price volatility. Changes in the underlying assumptions can materially affect the fair value estimates.

**KELSO TECHNOLOGIES INC.**

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**9. CAPITAL STOCK (Continued)**

## (c) Share purchase warrants

As at December 31, 2013 and 2012, the Company has share purchase warrants outstanding entitling the holders to acquire common shares as follows:

Exercise Price (CAD)	Expiry Date	Outstanding December 31, 2012	Issued	Exercised	Expired	Outstanding December 31, 2013
\$ 5.25*	October 31, 2014	1,059,029	-	304,979	-	754,050
USD\$ 0.80	September 18, 2014	997,500	-	120,835	-	876,665
\$ 0.70	July 25, 2013	1,000,000	-	1,000,000	-	-
		3,056,529	-	1,425,814	-	1,630,715

Exercise Price (CAD)	Expiry Date	Outstanding August 31, 2012	Issued	Exercised	Expired	Outstanding December 31, 2012
USD\$ 0.80	September 18, 2014	-	997,500	-	-	997,500
\$ 2.10*	October 31, 2014	1,059,029	-	-	-	1,059,029
\$ 0.35	December 22, 2012	2,370,000	-	2,335,000	35,000	-
\$ 0.70	July 25, 2013	1,000,000	-	-	-	1,000,000
		4,429,029	997,500	2,335,000	35,000	3,056,529

Exercise Price (CAD)	Expiry Date	Outstanding August 31, 2011	Issued	Exercised	Expired	Outstanding August 31, 2012
\$1.05 *	October 31, 2014	1,059,029	-	-	-	1,059,029
\$0.18	May 25, 2012	2,182,500	-	2,182,500	-	-
\$0.25	August 31, 2012	496,800	-	496,800	-	-
\$0.35	December 22, 2012	3,244,000	-	874,000	-	2,370,000
\$0.70	July 25, 2013	1,000,000	-	-	-	1,000,000
		7,982,329	-	3,553,300	-	4,429,029

\* Exercisable at \$1.05 from October 31, 2011 until October 30, 2012, at \$2.10 from October 31, 2012 until October 30, 2013, and at \$5.25 from October 31, 2013 until October 30, 2014.

**10. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES**

	December 31, 2013	December 31, 2012
Trade accounts payable	\$ 151,300	\$ 235,795
Accrued liability	50,000	35,000
Related party payables (Note 11)	284,847	12,247
	\$ 486,147	\$ 283,042

**KELSO TECHNOLOGIES INC.**

## Notes to Consolidated Financial Statements

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**11. RELATED PARTY TRANSACTIONS**

Related party transactions not otherwise described in these consolidated financial statements are shown below. These amounts of key management compensation are included in the amounts shown on the consolidated statements of operations:

	Year ended December 31, 2013	Four months ended December 31, 2012	Year ended August 31, 2012	Year ended August 31, 2011
Management fees	\$ 539,958	\$ 146,727	\$ 392,490	\$ 258,193
Management bonus*	\$ 269,434	\$ -	\$ -	\$ -
Share-based payments**	\$ 340,000	\$ -	\$ 17,071	\$ 332,525

\* The Company has management bonus agreements whereby 10% of the annual net income before taxes and share-based payments is equally distributed to management.

\*\* Share-based payments consists of the key management portion of the fair value of options granted calculated using the Black-Scholes option pricing model and does not include any cash compensation.

As at December 31, 2013, amounts due to a related party, which is unsecured and has no interest or specified terms of payments, is \$15,413 (2012 - \$12,247) for reimbursement of expenses to a director of the Company. These amounts are due on demand.

**12. COMMITMENTS**

The Company is committed to making the following payments for base rent on its office in Downers Grove, Illinois:

2014	\$ 25,890
2015	26,640
2016	27,390
2017	28,140
2018 and thereafter	28,890
	<b>\$ 136,950</b>

**13. INCOME TAXES**

As at December 31, 2013, the Company has accumulated non-capital losses for tax purposes in Canada of approximately \$3,269,000 that may be carried forward to apply against future years' income for income tax purposes. The losses expire as follows:

2028	\$ 589,000
2029	631,000
2030	123,000
2031	831,000
2032	1,095,000
	<b>\$ 3,269,000</b>

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## Notes to Consolidated Financial Statements

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**13. INCOME TAXES (Continued)**

The Company has approximately \$14,000 in non-capital losses in the US that may be applied against future taxable income (expiring in 2025 or later).

The tax effected items that give rise to significant portions of the deferred income tax assets and deferred income tax liabilities at December 31, 2013 and 2012 are as follows:

	December 31, 2013	December 31, 2012
Deferred income tax assets		
Non-capital losses carried forward		
Canada	\$ 830,235	\$ 40,828
Excess of undepreciated capital cost over carrying value of property and equipment	2,979	-
Share issue costs	38,485	-
Total deferred income tax assets	871,699	40,828
Deferred income tax liabilities		
Deferred product costs	(30,662)	(29,483)
Cumulative eligible capital	(8,866)	(11,345)
Total deferred income tax liabilities	(39,528)	(40,828)
Net deferred income tax assets	\$ 832,171	\$ -

Deferred tax assets were not recognized as at December 31, 2012, as management believed it was not probable that these assets would be realized. The Company has begun using its deferred tax assets in the year ended December 31, 2013, and believes that it will do so in the future. As such, it has recognized the above deferred tax assets as at December 31, 2013.

Significant unrecognized tax benefits and unused tax losses for which no deferred tax asset is recognized as of December 31, 2013 and 2012 are as follows:

	December 31, 2013	December 31, 2012
Non-capital losses carried forward		
Canada	\$ -	\$ 5,377,804
United States	-	13,639
Excess of undepreciated capital cost over carrying value of property and equipment	-	78,220
Excess of accumulated exploration expenditures over carrying value of mineral properties	134,377	144,352
Capital losses (Canada)	-	74,696
Share issue costs	-	177,208
Unrecognized deductible temporary differences	\$ 134,377	\$ 5,865,919

Income tax expense differs from the amount that would be computed by applying the Canadian statutory income tax rate of 25.75% (2012 - 25.00%) to income (loss) before income taxes.

**KELSO TECHNOLOGIES INC.**

## Notes to Consolidated Financial Statements

For the year ended December 31, 2013, four months ended December 31, 2012, and the years ended August 31, 2012 and 2011  
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**13. INCOME TAXES (Continued)**

A reconciliation of income taxes at statutory rates with reported taxes is as follows:

	Year ended December 31, 2013	Four months ended December 31, 2012	Year ended August 31, 2012	Year ended August 31, 2011
Net income (loss) for period	\$ 1,624,465	\$ 10,988	\$ (1,276,827)	\$ (1,463,869)
Statutory income tax rate	25.75%	25.00%	26.50%	27.17%
Income tax (benefit) liability computed at statutory tax rate	418,300	2,747	(338,359)	(397,733)
Items not deductible for income tax purposes	191,517	41,914	18,850	166,920
Change in timing differences	(82,645)	(17,980)	22,455	(49,878)
Impact on foreign exchange on tax assets and liabilities	116,104	17,471	8,476	(85,031)
Effect of change in tax rate	(47,315)	-	17,615	22,086
Unused tax losses and tax offsets not recognized	(1,428,132)	(44,152)	270,963	343,636
Deferred income tax recovery	\$ (832,171)	\$ -	\$ -	\$ -
Represented by:				
Current income tax	\$ 613,017	\$ 28,634	\$ -	\$ -
Deferred income tax	(1,445,188)	(28,634)	-	-
Deferred income tax expense (recovery)	\$ (832,171)	\$ -	\$ -	\$ -

Effective April 1, 2013, the British Columbia corporate tax rate increased from 10.00% to 11.00%, while the federal rate remained unchanged at 15.00%. The overall increase in tax rates has resulted in an increase in the Company's statutory tax rate from 25.00% to 25.75%.

**14. SUPPLEMENTAL CASH FLOW INFORMATION**

	Year ended December 31, 2013	Four months ended December 31, 2012	Year ended August 31, 2012	Year ended August 31, 2011
Non-cash financing activities	\$ -	\$ -	\$ -	\$ 2,397
Amortization of property and equipment allocated to cost of goods sold	\$ 41,294	\$ 14,507	\$ -	\$ 167
Amortization of property and equipment allocated to inventory	\$ 5,088	\$ -	\$ 2,792	\$ -
Interest paid	\$ -	\$ -	\$ -	\$ -
Income taxes paid	\$ -	\$ -	\$ -	\$ -

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## Notes to Consolidated Financial Statements

For the year ended December 31, 2013, four months ended December 31, 2012, and the years ended August 31, 2012 and 2011  
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**15. EARNINGS (LOSS) PER SHARE**

The calculation of basic and diluted earnings (loss) per share for the relevant periods is based on the following:

	Year ended December 31, 2013	Four months ended December 31, 2012	Year ended August 31, 2012	Year ended August 31, 2011
Net income (loss) for the period attributable to common shareholders	\$ 2,456,636	\$ 10,988	\$ (1,276,827)	\$ (1,463,869)
Basic weighted average number of common shares outstanding	41,712,969	38,562,337	34,379,896	28,072,327
Effect of dilutive securities:				
Options	2,170,120	-	-	-
Warrants	758,558	-	-	-
Diluted weighted average number of common shares outstanding	44,641,647	38,562,337	34,379,896	28,072,327
Basic earnings (loss) per share	\$ 0.06	\$ 0.00	\$ (0.04)	\$ (0.05)
Diluted earnings (loss) per share	\$ 0.06	\$ 0.00	\$ (0.04)	\$ (0.05)

For diluted earnings per share for the year ended December 31, 2013 and four months ended December 31, 2012, dilution is calculated based on the net number of common shares issued should assuming "in the money" options and warrants would have been exercised and the proceeds used to repurchase common shares at the average market price in the period. For the years ended August 31, 2012 and 2011, basic loss per share equals diluted loss per share.

**16. SIGNIFICANT CUSTOMERS**

The following table represents sales to individual customers exceeding 10% of the Company's annual revenues:

	Year ended December 31, 2013	Four months ended December 31, 2012	Year ended August 31, 2012
Customer A	\$ 8,782,478	\$ 872,778	\$ 1,281,314
Customer B	\$ 3,409,289	\$ 1,558,429	\$ Nil

Both Customers A and B are major US corporations, who have displayed a pattern of consistent timely payment of accounts owing.

## **KELSO TECHNOLOGIES INC.**

### Notes to Consolidated Financial Statements

For the year ended December 31, 2013, four months ended December 31, 2012, and the years ended August 31, 2012 and 2011  
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#### **17. COMPARATIVE FIGURES**

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

#### **18. SEGMENTED INFORMATION**

The Company operates primarily in one business segment, the design, production and distribution of various proprietary pressure relief valves, with operations located in the United States.

#### **19. EVENTS AFTER THE REPORTING PERIOD**

Subsequent to year-end:

- (a) The Company issued 24,717 common shares in settlement of 5,000 warrants and 19,717 options exercised for gross proceeds of \$16,816 received prior to December 31, 2013.
- (b) The Company issued 575,000 common shares in settlement of 195,000 warrants and 380,000 options exercised for gross proceeds of \$292,827.