

ZECOTEK MEDICAL SYSTEMS INC.
CONSOLIDATED FINANCIAL STATEMENTS

July 31, 2006 AND 2005

"Forging strong relationships. Providing clear business advice"



CHARTERED ACCOUNTANTS

AUDITORS' REPORT

To the Shareholders of
Zecotek Medical Systems Inc.

We have audited the consolidated balance sheet of Zecotek Medical Systems Inc. as at July 31, 2006 and the consolidated statements of loss and deficit and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at July 31, 2006 and the results of its operations and cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

The consolidated financial statements as at July 31, 2005 and for the year then ended were audited by other auditors who expressed an opinion without reservation in their report dated September 14, 2005 (except for note 2 to those financial statements which was as of February 13, 2006).

A handwritten signature in black ink that reads "Berris Mangan".

CHARTERED ACCOUNTANTS

Vancouver, B.C.
November 17, 2006

**ZECOTEK MEDICAL SYSTEMS INC.
CONSOLIDATED BALANCE SHEETS**

**As at July 31
(Expressed in Canadian Dollars)**

	2006	2005
ASSETS		
Current		
Cash and cash equivalents	\$ 249,014	\$ 122,598
Short term investments (note 4)	3,500,000	1,000,000
Accrued interest receivable	28,935	-
Goods and services tax recoverable	121,702	62,825
Prepaid expenses (note 13(d))	10,752	-
Total Current Assets	3,910,403	1,185,423
Due from related parties (note 5)	78,511	138,817
Restricted short term investments (note 4)	20,000	20,000
Deposits (note 16)	73,233	13,160
Property and equipment (note 6)	122,405	51,884
Patent costs (note 7)	71,348	-
Intangible assets and development costs (note 8)	1	1,788,293
Total Assets	\$ 4,275,901	\$ 3,197,577
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	\$ 219,032	\$ 45,649
Due to related party (note 5)	-	6,352
Liabilities of discontinued operations (note 12)	53,254	53,254
	272,286	105,255
Shareholders' Equity		
Share capital (note 9(b))	16,246,313	10,506,895
Contributed surplus (note 9(g))	1,558,457	363,917
Deficit	(13,801,155)	(7,778,490)
Total Shareholders' Equity	4,003,615	3,092,322
Nature of Business and Going Concern Uncertainty (note 1)		
Commitments (note 15)		
Contingent Liabilities (note 16)		
Subsequent Events (note 19)		
Total Liabilities and Shareholders' Equity	\$ 4,275,901	\$ 3,197,577

On behalf of the Board:

"Faouzi Zerrouk"
Director

"Erich Sager"
Director

See accompanying Notes to Consolidated Financial Statements

**ZECOTEK MEDICAL SYSTEMS INC.
CONSOLIDATED STATEMENTS OF LOSS AND DEFICIT**

**Years ended July 31,
(Expressed in Canadian Dollars)**

	2006	2005
REVENUE		
Interest Income	\$ 44,153	\$ 4,110
EXPENSES		
Impairment loss (<i>note 8</i>)	2,990,606	-
General and administrative (<i>note 11</i>)	2,174,562	581,694
Research and development (<i>notes 10, 13(a), (c) and (h)</i>)	595,787	755,325
Amortization	26,828	9,692
Foreign exchange	(8,965)	-
	5,778,818	1,346,711
Net loss for the year	(5,734,665)	(1,342,601)
Deficit, Beginning of Year	(7,778,490)	(6,435,889)
Excess of purchase price over carrying amount of intangible assets acquired (<i>notes 8(ii) and 9(b)(x)</i>)	(288,000)	-
Deficit, End of Year	\$(13,801,155)	\$(7,778,490)
Loss per common share – basic and diluted	\$(0.37)	\$(0.13)
Weighted average number of common shares outstanding – basic and diluted	15,495,522	10,199,700

See accompanying Notes to Consolidated Financial Statements

**ZECOTEK MEDICAL SYSTEMS INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS**

**Years ended July 31
(Expressed in Canadian Dollars)**

	2006	2005
Operating Activities:		
Net loss for the year	\$(5,734,665)	\$(1,342,601)
Adjustments for items not involving cash:		
Amortization – property and equipment	26,828	9,692
Stock-based compensation (<i>note 9(d)</i>)	1,074,620	72,917
Impairment loss (<i>note 8</i>)	2,990,606	-
	(1,642,611)	(1,259,992)
Changes in non-cash working capital:		
Accrued interest receivable	(28,935)	-
Goods and services tax recoverable	(58,877)	(61,850)
Prepaid expenses	(10,752)	-
Accounts payable and accrued liabilities	173,383	28,701
Net Cash Used in Operating Activities	(1,567,792)	(1,293,141)
Investing Activities:		
Increase in short term investments	(2,500,000)	(1,020,000)
Deposits paid	(60,073)	(13,160)
Decrease in loan receivable	-	10,000
Acquisition of property and equipment	(97,349)	(60,771)
Development costs incurred	(1,202,313)	(151,960)
Patent costs incurred	(71,348)	-
Acquisition of intangible assets	(288,000)	(210,034)
	(4,219,083)	(1,445,925)
Financing Activities:		
Proceeds from shares issued, net of issuance costs	5,859,337	2,965,375
Advances from related parties	60,306	2,965,375
Advances to related parties	(6,352)	(132,465)
	5,913,291	2,832,910
Increase in cash and cash equivalents	126,416	93,844
Cash and cash equivalents, Beginning of Year	122,598	28,754
Cash and cash equivalents, End of Year	\$ 249,014	\$ 122,598

See accompanying Notes to Consolidated Financial Statements

**ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Years ended July 31, 2006 and 2005
(Expressed in Canadian Dollars)**

1. NATURE OF BUSINESS AND GOING CONCERN UNCERTAINTY

Nature of Business

Zecotek Medical Systems Inc. (the "Company") is a development stage enterprise which was incorporated on November 25, 1983 under the laws of the Province of British Columbia, Canada. The Company was inactive until it purchased certain technologies on December 31, 2004 from Zecotek Holdings Inc., pursuant to an Amended and Restated Asset Purchase Agreement. The Company changed its name from Equicap Financial Corp. on February 10, 2005.

The activities of the Company are focused on the creation of advanced materials and integrated optoelectronic devices for high resolution medical imaging, optical precision surgery and biopharmaceutical research.

Effective May 12, 2006, the Company purchased certain additional technologies from Zecotek Holdings Singapore Pte. Ltd. pursuant to an Asset Purchase Agreement.

The Company has four wholly owned subsidiaries as follows:

<u>Subsidiary</u>	<u>Date of incorporation</u>	<u>Main current or planned activity</u>
Zecotek Crystals Inc.	August 6, 2004	Research and development and licensing of a scintillation material
Zecotek Lasers Inc.	June 7, 2005	Inactive
Zecotek 3D Inc.	October 18, 2005	Inactive
Zecotek Medical Systems Singapore Pte. Ltd.	April 4, 2006	Holding company for Singapore subsidiaries

The Company holds a 90% interest in the following subsidiaries which were incorporated in the 2006 year:

<u>Subsidiary</u>	<u>Main planned activity</u>
Zecotek Display Systems Pte. Ltd.	Research and development (and eventual exploitation) in 3D imaging technologies
Zecotek Imaging Systems Pte. Ltd.	Research and development (and eventual exploitation) of medical imaging technologies
Zecotek Laser Systems Pte. Ltd.	Research and development (and eventual exploitation) of medical laser technologies

Four other subsidiaries of the Company, O-TooZ Energie Group Inc., FilmIndustry.com, Inc., DJscene.com Media, Inc. and OnlineConsortium.com Inc., have been inactive since August of 2001 (see note 12).

**ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Years ended July 31, 2006 and 2005
(Expressed in Canadian Dollars)**

1. NATURE OF BUSINESS AND GOING CONCERN UNCERTAINTY - Continued

Going concern uncertainty

These financial statements have been prepared in accordance with generally accepted accounting principles on a going concern basis, which presumes that the Company will be able to realize assets and discharge liabilities in the normal course of business for the foreseeable future. The Company has incurred significant losses since its inception. To date, the Company has no products in commercial production or use and does not currently have any revenues other than interest earned on short-term investments. These factors, among others, raise uncertainty about the ability of the Company to continue as a going concern. The continued operations of the Company are dependent upon the ability of the Company to obtain further equity financing, the support of its principal shareholders, and successfully bring its technologies to market and achieving future profitable operations, the outcome of which cannot be predicted at this time.

These financial statements do not give effect to adjustments, if any, that would be necessary should the Company be unable to continue as a going concern and, therefore, be required to realize its assets and liquidate its liabilities in other than the normal course of business and at amounts which may differ from those shown in the financial statements.

2. SIGNIFICANT ACCOUNTING POLICIES

Basis of Consolidation

The consolidated financial statements of the Company are prepared in accordance with Canadian generally accepted accounting principles. The consolidated financial statements include the accounts of the Company and its wholly and majority owned subsidiaries as identified in Note 1. All significant inter-company accounts and transactions have been eliminated upon consolidation.

Use of Estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the period. Actual results may differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents consists of cash on hand, balances with banks and highly liquid market investments with original terms of maturity of less than ninety days at time of acquisition.

Short-Term Investments

Short-term investments, which consist of financial instruments purchased with an original maturity of greater than three months and less than one year, are recorded at the lower of cost and estimated market value.

Restricted Short-Term Investments

Restricted short-term investments are short-term investments pledged as security or otherwise subject to restricted liquidity, and are recorded at the lower of cost and estimated market value.

**ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Years ended July 31, 2006 and 2005
(Expressed in Canadian Dollars)**

2. SIGNIFICANT ACCOUNTING POLICIES - Continued

Property and Equipment

Equipment, furniture and leasehold improvements are recorded at cost less accumulated amortization. Amortization of equipment and furniture is provided on a declining balance basis over the expected useful lives at rates of 33.33% and 20% per annum, respectively, with a 50% reduction in the year during which the assets are acquired. Leasehold improvements are amortized over the duration of the lease term on a straight-line basis.

Intangible Assets

Intangible assets represent the purchase costs of the LFS crystal and biophotonic technologies.

The cost of intangible assets which are determined to have an indefinite life is not amortized, but is tested for impairment on an annual basis, based on a comparison of the fair value of the intangible asset with its carrying amount. The carrying amount is adjusted for impairment as necessary and any excess of the carrying amount over the fair value of the intangible asset is charged to earnings in the current period.

Intangible assets which are determined to have a finite useful life are amortized on a systematic basis over the estimated remaining useful life.

Research and Development Costs

Research costs are expensed in the year incurred.

Development costs include all expenditures considered directly attributable to efforts by the Company to develop, and bring to commercial production, a new product. Such amounts are charged as an expense in the period incurred except in circumstances where the market and technical feasibility of the product have been established, and recovery of development costs can reasonably be regarded as assured, in which case such costs are capitalized.

Product registration costs related to efforts by the Company to acquire legal protections for its proprietary products, such as trademarks and patents, are capitalized if the Company believes that obtaining the trademark or patent, and recovery of the costs from future related revenues is reasonably assured, otherwise the costs are expensed. Capitalized costs are amortized on a straight-line basis over the estimated useful life of the trademark or patent upon granting.

Impairment of Long-lived Assets

The Company reviews for the impairment of long-lived assets, including property and equipment and intangible assets with finite life, held for use, whenever changes in circumstances indicate that the carrying amount of an asset may not be recoverable from expected future cash flows. The assessment of recoverability is made based on projected undiscounted future net cash flows that are directly associated with the asset's use and eventual disposition. The amount of the impairment, if any, is measured as the difference between the carrying amount and the fair value of the impaired assets, and is presented as an impairment loss in the current period.

ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended July 31, 2006 and 2005
(Expressed in Canadian Dollars)

2. SIGNIFICANT ACCOUNTING POLICIES - Continued

Foreign Currency Translation

The Company follows the temporal method for consolidation of its foreign subsidiaries' operations. Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at the exchange rate in effect at each year-end date. Non-monetary assets and liabilities and related depreciation and amortization expenses are translated at the historical exchange rate. Revenue and expenses, other than depreciation and amortization, are translated at the average exchange rate for the year. The resulting exchange gain or losses on translation are included in operations for the year.

Stock-Based Compensation

The Company grants stock options to employees, directors, officers and consultants pursuant to the stock option plan described in note 9(d). Effective August 1, 2004, the Company adopted the recommendations of The Canadian Institute of Chartered Accountants Handbook Section 3870 (Stock-Based Compensation and Other Stock-Based Payments) requiring the use of the fair value method of accounting for stock-based compensation transactions. The fair value of stock options is estimated at the date of grant using the Black-Scholes Option Pricing Model and is amortized over the vesting terms of the options.

Warrants

Proceeds from issuances by the Company of units consisting of shares and warrants are allocated based on the residual method, whereby the carrying amount of the warrants is determined based on any difference between gross proceeds and the fair market value of the shares. If the proceeds from the offering are less than or equal to the estimated fair market value of shares issued, a nil carrying amount is assigned to the warrants.

Share issue costs

Professional, consulting and regulatory fees as well as other costs directly attributable to specific financing transactions are reported as deferred financing costs until the transactions are completed, if successful completion is considered reasonably assured. Share issue costs are charged to capital stock when the related shares are issued. Costs relating to financing transactions that are not completed are charged to net income.

Income Taxes

The Company accounts for income taxes using the liability method of tax allocation. Future income taxes are recognized for the future income tax consequences attributable to differences between the carrying amounts of assets and liabilities and their respective income tax bases. Future income tax assets and liabilities are measured using substantively enacted income 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 future income tax assets and liabilities of a change in rates is included in earnings in the period that includes the enactment date. Future income tax assets are recorded in the financial statements if realization is considered more likely than not.

ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended July 31, 2006 and 2005
(Expressed in Canadian Dollars)

2. SIGNIFICANT ACCOUNTING POLICIES - Continued

Loss per Share

Basic loss per share is calculated using the weighted average number of shares outstanding during the year. The Company uses the treasury stock method to compute the dilutive effect of options, warrants and similar instruments. Under this method the dilutive effect on loss per share is recognized based on the use of proceeds that could be obtained upon exercise of such options, warrants and similar instruments. It assumes that the proceeds would be used to purchase common shares at the average market price during the period. This calculation generally produces an anti-dilutive effect for loss years.

Tenant Inducements

Inducements received by the Company from landlords with respect to leased premises are deferred and recognized as a reduction of rent expense evenly over the term of the lease.

3. FINANCIAL INSTRUMENTS AND RISKS

The fair values of financial instruments are estimated at a specific point in time, based on relevant information about financial markets and specific financial instruments. As these estimates are subjective in nature, involving uncertainties and matters of significant judgment, they cannot be determined with precision. Changes in assumptions can significantly affect estimated fair values.

The carrying value of cash and cash equivalents, short-term and restricted short-term investments, accrued interest receivable, due from and to related parties, deposits, accounts payable and accrued liabilities and liabilities of discontinued operations approximate their fair value due to their short-term nature.

Financial instruments that potentially subject the Company to concentration of credit risks consist principally of cash and short-term investments, the balances of which are stated on the consolidated balance sheet. The Company places its cash in high credit quality financial institutions. Concentration of credit risks with respect to receivables is limited.

Financial risk is the risk to the Company's results of operations that arises from fluctuations in interest rates and foreign exchange rates and the degree of volatility of these rates, as well as credit risk associated with the financial stability of the issuers of the financial instruments. The Company has operations in Singapore, some of the transactions of which are transacted in Singapore dollars. The Company also incurs certain costs in US dollars. Accordingly, the Company is exposed to foreign exchange risk in respect to these currencies, and has not undertaken hedging activities to mitigate this risk.

The Company's short-term investments are invested in fixed rate securities.

4. SHORT-TERM INVESTMENTS

Short-term investments are comprised of guaranteed investment certificates ("GIC") with a weighted average interest rate of 3.75% (2005 – 2.24%) and maturities ranging to May, 2007. At July 31, 2006, the fair value of the short-term investments approximates the carrying amount, based on quoted market prices.

A GIC in the amount of \$20,000 has been pledged as collateral for the Company's corporate credit cards and is presented on the balance sheet as Restricted short term investments.

**ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Years ended July 31, 2006 and 2005
(Expressed in Canadian Dollars)**

5. AMOUNTS DUE TO AND FROM RELATED PARTIES

Details of amount due from related parties are as follows:

	2006	2005
Due from Dr. Faouzi Zerrouk	\$ 54,332	\$ 7,509
Due from Zecotek Laboratories Inc.	24,179	131,308
	\$ 78,511	\$ 138,817

Details of amount due to related parties are as follows:

	2006	2005
Zecotek Holdings Inc.	\$ -	\$ 6,352
	\$ -	\$ 6,352

Amounts due from Dr. Faouzi Zerrouk ("Dr. Zerrouk"), the Chairman of the Board of Directors, President and Chief Executive Officer, relate to travel and other advances.

Amounts due from Zecotek Laboratories Inc., a company controlled by Dr. Zerrouk, which is a subsidiary of a significant shareholder of the Company, Zecotek Holdings Inc., represent advances made pursuant to a Support Agreement (see note 13(a)).

The amounts due to and from related parties are non-interest bearing, unsecured and without fixed terms of repayment.

6. PROPERTY AND EQUIPMENT

	Cost	Accumulated Amortization	Net Book Value
2006			
Equipment	\$ 122,409	\$ 25,609	\$ 96,800
Furniture	22,732	5,630	17,102
Leasehold improvements	17,007	8,504	8,503
	\$ 162,148	\$ 39,743	\$ 122,405

	Cost	Accumulated Amortization	Net Book Value
2005			
Equipment	\$ 29,143	\$ 8,215	\$ 20,928
Furniture	18,649	1,865	16,784
Leasehold improvements	17,007	2,835	14,172
	\$ 64,799	\$ 12,915	\$ 51,884

ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended July 31, 2006 and 2005
(Expressed in Canadian Dollars)

7. PATENT COSTS

	Cost	Accumulated Amortization	Net Book Value
2006	\$ 71,348	\$ -	\$ 71,348
2005	\$ -	\$ -	\$ -

8. INTANGIBLE ASSETS AND DEVELOPMENT COSTS

	2006	2005
Balance, July 31, 2005	\$ 1,788,293	\$ -
Acquisition of intangible assets <i>(note 8(i))</i>	-	1,671,793
Acquisition of intangible assets <i>(note 8 (ii))</i>	1	-
Development costs incurred during year		
LFS crystal technology <i>(note 13(a))</i>	185,905	116,500
Biophotonic technology <i>(note 13(a))</i>	1,016,408	-
Impairment loss for year <i>(notes 8(i) and (ii))</i>	(2,990,606)	-
Balance, July 31, 2006	\$ 1	\$ 1,788,293

- i) On December 31, 2004, the Company's subsidiary, Zecotek Crystals Inc., completed an Asset Purchase Agreement for the purchase of a Lutetium Fine Silicate ("LFS") crystal technology from Zecotek Holdings Inc., for total consideration of \$1,636,333, consisting of cash of \$280,333 and common shares, warrants and stock options of the Company with a total assigned value of \$1,356,000 (see note 9(b)(iii)).

Legal expenses incurred in relation to the acquisition amounted to \$35,460.

Further development expenses of \$185,905 (2005 - \$116,500) representing salaries and fees paid to employees and consultants and other directly attributable costs for work undertaken to develop and commercialize the technology had been capitalized.

At July 31, 2006, the capitalized acquisition and development costs to that date, totalling \$1,974,198, were written-down to a nominal carrying amount of \$1. The technology has been licensed on a long term basis to a third party as described in Note 15(a). However, the ability of the Company to generate revenue from the technology under this agreement is unproven and uncertain. Therefore the Company does not have adequate assurance that the capitalized costs will be recovered in a reasonable period of time.

ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended July 31, 2006 and 2005
(Expressed in Canadian Dollars)

8. INTANGIBLE ASSETS AND DEVELOPMENT COSTS - Continued

- ii) Effective May 12, 2006, the Company and its Singapore subsidiaries, Zecotek Medical Systems Singapore Pte. Ltd., Zecotek Display Systems Pte. Ltd. ("ZMSS"), Zecotek Imaging Systems Pte. Ltd. and Zecotek Laser Systems Pte. Ltd. completed an asset purchase of certain biophotonics technology from Zecotek Holdings Singapore Pte. Ltd. of which Dr. Zerrouk is a majority shareholder. Consideration consisted of cash of \$338,000, the issuance of 11,750,000 common shares of the Company (estimated market value of \$0.90 per share) and preferred shares of all subsidiary companies of ZMSS which are convertible to 10% of the issued common shares of each subsidiary. The interest represented by the preferred shares will be recognized as a non-controlling interest on the balance sheet and statement of loss, as appropriate. The cash payment and common shares of the Company had been completed in May of 2006. The preferred shares have yet to be issued.

In conjunction with the asset purchase, the Company granted options to acquire 2,125,000 common shares of the Company at a price of \$1.76 which may be exercised for a period of five years to certain employees, directors, officers or consultants of the vendor and related companies.

Under the asset purchase agreement, the Company is responsible for any liabilities associated with the purchased assets, including any sales taxes arising as a result of the purchase and any contractual liabilities or liabilities associated with intellectual property rights.

The transaction was considered to be a Related Party transaction and consequently the purchased intangible assets were recorded at the nominal carrying amount of the related party vendor. Under this presentation, the shares issued as consideration for the purchase have also been recorded at a nominal amount. The cash portion of the consideration which was paid in the 2006 year (\$258,000) has been recorded as an increase of the deficit balance.

As at July 31, 2006, the Company had incurred development costs related to this technology, including that described in Note 15(b), incurred before and after the acquisition of the technology, totalling \$1,016,408, which had been capitalized. These costs have been written off as at July 31, 2006 as the Company is unable to establish reasonable assurance of future recovery of these costs based on projected cash flows derived from the technology.

ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended July 31, 2006 and 2005
(Expressed in Canadian Dollars)

9. SHARE CAPITAL

a) Authorized

The authorized share capital of the Company is an unlimited number of common voting shares with no par value.

b) Issued and outstanding common shares:

	Number of Shares #	Amount \$
Balance, July 31, 2004	6,151,841	\$ 6,376,520
Private placement (i)	200,000	100,000
Private placement (ii)	3,145,000	1,347,500
Acquisition of LFS crystal technology (iii)	3,142,000	1,065,000
Private placement (iv)	900,000	499,500
Exercise of warrants (v)	1,494,500	1,118,375
Balance, July 31, 2005	15,033,341	10,506,895
Exercise of warrants (vi)	202,500	101,250
Exercise of warrants (vii)	200,000	68,000
Exercise of warrants (viii)	987,500	493,750
Private placement (ix)	6,389,400	5,750,460
Acquisition of technologies (x)	11,750,000	1
Exercise of options (xi)	120,000	103,650
Exercise of options (xi)	10,000	10,483
Share issuance costs (ix)	-	(621,623)
Share issuance costs – agents' options (ix)	-	(166,553)
Balance, July 31, 2006	34,692,741	\$ 16,246,313

- i) On August 10, 2004, the Company completed a non-brokered private placement consisting of 200,000 units at a price of \$0.50 per unit and received cash consideration of \$100,000. Each unit consisted of one common share and one share purchase warrant. Each share purchase warrant entitled the holder to purchase one additional share for a period of one year at an exercise price of \$0.50 per share. The Company applied the residual approach and allocated total proceeds of \$100,000 to common shares and a nil value to the attached warrants.
- ii) On December 31, 2004, the Company completed an offering of 3,000,000 units at \$0.50 per unit for net cash proceeds of \$1,347,500 after issued expenses of \$152,500. Each unit consisted of one common share and one-half non-transferable share purchase warrant. Each whole warrant entitled the holder to purchase one additional common share for a period of six months at a price of \$0.75 per share. The Company applied the residual approach and allocated total proceeds of \$1,500,000 to common shares and a nil value to the attached warrants. The Company also issued 145,000 common shares at \$0.50 per share to the agent for corporate finance services rendered in relation to the transaction.

ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended July 31, 2006 and 2005
(Expressed in Canadian Dollars)

9. SHARE CAPITAL - Continued

b) Issued and outstanding common shares - continued

- iii) On December 31, 2004, pursuant to an Asset Purchase Agreement, as part consideration paid for the acquisition of the LFS crystal technology from Zecotek Holdings Inc., the Company issued 2,400,000 common shares at a discounted fair market value of \$700,000 as the common shares are subject to escrow for up to six years and settled an assumed debt of \$200,000 by the issuance of 400,000 units at \$0.50 per unit. Each unit consisted of one common share and one warrant to purchase one common share at \$0.50 for a period of 12 months. The Company also issued 202,000 common shares at \$0.47 per share (totalling \$95,000) as a finder's fee in respect to the transaction, and 140,000 common shares at \$0.50 per share (totalling \$70,000) pursuant to an Assignment Agreement dated July 5, 2004 to acquire the rights to the LSF scintillation material technology and issued stock options to purchase 800,000 common shares exercisable at \$0.50 per share for a period of five years. The options were valued at \$291,000 (\$0.36 per option share).
- iv) On February 8, 2005, the Company issued, by way of a private placement, 900,000 units at \$0.60 per unit for net proceeds of \$499,500 net of issuance expenses of \$40,500. Each unit consisted of one common share and one-half non-transferable share purchase warrant. Each whole warrant entitled the holder to purchase one additional common share for a period of six months at an exercise price of \$0.90 per share. The units were subject to a four month hold period from the closing date.
- v) During the year ended July 31 2005, 1,484,500 warrants were exercised at \$0.75 per share and 10,000 warrants were exercised at \$0.50 per share, for total cash proceeds of \$1,118,375.
- vi) In August, 2005, 202,500 warrants were exercised at \$0.50 per share for gross proceeds of \$101,250.
- vii) On November 1, 2005, 200,000 warrants were exercised at \$0.34 per share for gross proceeds of \$68,000.
- viii) In December, 2005, 987,500 warrants were exercised at \$0.50 per share for gross proceeds of \$493,750.
- ix) On May 12, 2006, the Company completed an offering of 6,389,400 units at \$0.90 per unit for net cash proceeds of \$5,128,837 after issuance expenses of \$621,623. Each unit consists of one common share and one-half non-transferable share purchase warrant. Each whole warrant entitles the holder to purchase one additional common share for a period of eighteen months at a price of \$1.30 per share. The Company applied the residual approach and allocated total proceeds of \$5,750,460 to common shares and a nil value to the attached warrants. The Company also issued 638,940 agents' options to agents for corporate finance services rendered in relation to the transaction. Each agent option consists of the right to acquire a unit with the same terms as described above. The estimated fair value of agents' options granted was determined to be \$166,553, using the Black-Scholes option pricing model (note 9(e)).

**ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Years ended July 31, 2006 and 2005
(Expressed in Canadian Dollars)**

9. SHARE CAPITAL - Continued

- x) On May 12, 2006, pursuant to the Asset Purchase Agreement described in Note 8(ii), as partial consideration paid for the acquisition of biophotonic technology, the Company issued 11,750,000 common shares. The common shares are subject to escrow and are to be released according to a pre-determined schedule over three years to May of 2009. The shares were recorded at the nominal carrying amount of the related party vendor. Share issuance costs of \$30,000 were incurred, which have been recorded as an increase of the deficit balance.
- xi) During the year ended July 31 2006, 120,000 options were exercised by a director and officer of the Company at \$0.50 per share, and 10,000 options at \$0.75 per share were exercised by an employee, for total cash proceeds of \$67,500. Contributed surplus amounts of \$43,650 and \$2,983 respectively related to these options were consequently transferred to the share capital account.

c) Common share purchase warrants

	Number of warrants	Weighted average exercise price
Balance, July 31, 2004	200,000	\$ 0.34
Warrants granted	3,240,000	0.68
Warrants exercised	(1,494,500)	0.75
Warrants expired	(15,500)	0.75
Balance, July 31, 2005	1,930,000	0.59
Warrants granted	3,194,700	1.30
Warrants exercised	(1,390,000)	0.48
Warrants expired	(540,000)	0.87
Balance, July 31, 2006	3,194,700	\$ 1.30

At July 31, 2006, the share purchase warrants outstanding and exercisable were as follows:

Number of common shares to be issued	Exercise price	Date of expiry
3,194,700	\$1.30	November 12, 2007

**ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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9. SHARE CAPITAL - Continued

d) Stock options

On December 28, 2005, the Board of Directors approved a new stock option plan. Under the plan, the Company may grant options to purchase common shares in the Company to employees, directors, officers, and consultants of the Company. The exercise price of the options is to be determined by the Board but generally will be equal to or greater than the market price of the shares at the grant date. Options will vest according to the following schedule:

- 25% - on grant date
- 25% - six months after grant date
- 25% - twelve months after grant date
- 25% - eighteen months after grant date

As of July 31, 2006, the Company has reserved 5,200,000 common shares for issuance of stock options to employees, directors, officers and consultants of the Company of which 365,000 were available for future issuance. Stock option transactions and the number outstanding are summarized below:

	Number of options	Weighted average exercise price
Balance, July 31, 2004	-	\$ -
Options granted in connection with Asset Purchase Agreement (<i>notes 8(i) and 13(c) and (d)</i>)	800,000	0.50
Options granted to employees, directors, officers and consultants (<i>note 13(c)</i>)	560,000	0.70
Balance, July 31, 2005	1,360,000	0.58
Options granted to employees, directors, officers and consultants (<i>notes 13(c) and (d)</i>)	3,605,000	1.43
Options exercised	(130,000)	0.52
Balance, July 31, 2006	4,835,000	\$ 1.22

At July 31, 2006, 2,306,250 options have vested, which have a weighted average exercise price of \$0.93.

The estimated fair value of options granted to employees, directors, officers and consultants is amortized to expense over the vesting period of the options, resulting in compensation expense and addition to contributed surplus of \$1,074,620 for the year ended July 31, 2006 (2005 – \$72,917).

The weighted average fair value of stock options granted during the 2006 year has been estimated at the date of grant using the Black-Scholes option pricing model as \$0.70 per share (2005 - \$0.31) using the following weighted average assumptions:

	2006	2005
Annualized stock volatility	55.2%	71.6%
Risk-free interest rate	4.3%	4.8%
Expected option life	4.8 years	3.6 years
Dividend payments	0.0%	0.0%

ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended July 31, 2006 and 2005
(Expressed in Canadian Dollars)

9. SHARE CAPITAL - Continued

d) Stock options - continued

The following summarizes options outstanding at July 31, 2006:

Exercise price	Number of options	Number of options Exercisable	Weighted average remaining life (years)
\$0.50	680,000	680,000	3.42
\$0.70	550,000	550,000	3.47
\$0.72	100,000	50,000	4.49
\$0.75	600,000	300,000	4.12
\$0.93	140,000	35,000	4.64
\$0.99	100,000	25,000	4.93
\$1.00	300,000	75,000	4.66
\$1.55	240,000	60,000	4.85
\$1.76	2,125,000	531,250	4.78
	4,835,000	2,306,250	4.33

The Black-Scholes model, used by the Company to calculate option values, was developed to estimate fair value of freely tradable, fully transferable options without vesting restrictions, which significantly differs from the Company's stock option awards. This model also requires highly subjective assumptions, including future stock price, volatility, and expected time until exercise, which greatly affect the calculated values.

e) Agents' Options

As at July 31, 2006, agents' options outstanding are as follows (see note 9(b)(ix)) :

Weighted average exercise price	Number of agents' options	Number of agents' options exercisable	Weighted average remaining life (years)
\$0.90	638,940	638,940	1.3

The fair value of agents' options has been estimated at the date of grant of options at \$166,553, using the Black-Scholes option pricing model using the following weighted average assumptions:

Annualized stock volatility	55.7%
Risk-free interest rate	4.1%
Expected option life	1.5 years
Dividend payments	0.0%

**ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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9. SHARE CAPITAL - Continued

f) Escrow Shares

As at July 31, 2006 a total of 12,724,378 (2005: 4,027,434) of the shares issued were held in escrow, the release of which is subject to a pre-determined schedule through January of 2011. Subsequent to July 31, 2006, 1,762,500 escrow shares were released.

g) Contributed Surplus

	2006	2005
Balance, beginning of year	\$ 363,917	\$ -
Options granted (note 9(d))	1,074,620	363,917
Agents' options granted (note 9(e))	166,553	-
Options exercised (note 9(b)(xi))	(46,633)	-
Balance, end of year	\$ 1,558,457	\$ 363,917

10. RESEARCH AND DEVELOPMENT EXPENSES

In the 2006 year, the Company incurred research and development expenses of \$595,787 (2005 - \$755,325) which it considered not directly attributable to specific product development, such as overhead, or not otherwise meeting the criteria for initial capitalization of such costs.

ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended July 31, 2006 and 2005
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11. GENERAL AND ADMINISTRATIVE

	2006	2005
Consulting and other professional (<i>notes 13(c), (d), (e), (i) and (j)</i>)	\$ 515,301	\$ 201,333
Filing fees	45,618	50,743
Legal	123,570	88,729
Marketing and promotion	7,680	6,134
Office and miscellaneous	53,735	29,803
Rent and storage	131,463	47,204
Salaries and benefits (<i>notes 13(f) and (g)</i>)	108,421	44,691
Stock-based compensation (<i>note 9(d)</i>)	1,074,620	72,917
Travel	114,154	40,140
Total	\$ 2,174,562	\$ 581,694

12. DISCONTINUED OPERATIONS

In the 2002 year, the Company's subsidiary, O-TooZ Energie Group Inc. ("O-TooZ"), disposed of its two healthy fast food outlets in Vancouver. The discontinued operation resulted in the default of lease agreement liabilities of approximately \$108,000.

In January of 2005, the Company abandoned O-TooZ along with its other inactive subsidiaries, Djscene.com Media Inc., Online Consortium.com Inc. and FilmIndustry.com Inc. The liabilities of these discontinued operations have been segregated in the consolidated balance sheet.

ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended July 31, 2006 and 2005
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13. RELATED PARTY TRANSACTIONS

- a) Pursuant to a Support Agreement dated January 1, 2005, which expired in May of 2006, the Company and its wholly-owned subsidiary, Zecotek Crystals Inc., paid fees during the 2006 year of \$1,089,226 (2005 - \$947,665) to Zecotek Laboratories Inc., a company controlled by Dr. Zerrouk, in respect to research and development services for the development of the Company's technologies.
- b) On May 12, 2006, the Company acquired biophotonic technologies from Zecotek Medical Systems Singapore Pte. Ltd., a company controlled by Dr. Zerrouk, as described in note 8(ii).
- c) The Company paid research and development expenses during the 2006 year of \$150,837 (2005 - \$180,000) and consulting fees of \$64,644 (2005 - \$nil) to Dr. Zerrouk. The research and development expenses paid included reimbursement of expenses incurred to relocate to Singapore of \$75,000. During the 2006 year, the Company granted options to Dr. Zerrouk exercisable to acquire 900,000 (2005 - 620,000) common shares of the Company at a price of \$1.76 per share until May 12, 2011 (2005 - 560,000 shares at \$0.50 per share, expiring December 31, 2009 and 60,000 shares at \$0.70 per share, expiring January 18, 2010).
- d) Included in consulting expense for the 2006 year is \$120,000 (2005 - \$120,000) and in prepaid expenses as at July 31, 2006 of \$10,752 (2005 - \$nil) representing payments to a director and officer of the Company. During the 2006 year, the Company granted options to the director and officer exercisable to acquire 300,000 (2005 - 240,000) common shares of the Company at a price of \$1.76 per share until May 12, 2011 (2005 - at \$0.50 per share, expiring December 31, 2009). During the 2006 year, 120,000 of the options were exercised (see note 9(b)(xi)).
- e) The Company paid consulting fees during the 2006 year of \$20,000 (2005 - \$nil) to a company controlled by the Chief Financial Officer of the Company.
- f) The Company paid salary during the 2006 year of \$55,000 (2005 - \$nil) to a director and officer of the Company.
- g) The Company paid salary during the 2006 year of \$29,975 (2005 - \$24,691) to a director of the Company.
- h) The Company paid research and development expenses during the 2006 year of \$21,123 (2005 - \$nil) to a director of the Company.
- i) The Company paid consulting fees during the 2006 year of \$106,630 (2005 - \$nil) to an officer of the Company.
- j) The Company paid consulting fees during the 2006 year of \$3,000 (2005 - \$nil) to a director of the Company.

Except where otherwise noted, these transactions are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

ZECOTEK MEDICAL SYSTEMS INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended July 31, 2006 and 2005
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14. INCOME TAXES

a) A reconciliation of the Canadian statutory tax rate to the effective rate for the Company is as follows:

	2006	2005
Statutory income tax rate	(34%)	(34%)
Tax losses not recognized	34%	34%
Effective tax rate	—	—

b) At July 31, 2006, the tax effects of temporary differences that give rise to the Company's future income tax assets are as follows:

	2006	2005
Non-capital losses subject to expiry	\$ 2,038,700	\$ 1,056,700
Intangible assets and development costs	522,400	217,800
Share issuance costs	257,000	77,600
Property and equipment	7,500	(700)
	2,825,600	1,351,400
Less: valuation allowance	(2,825,600)	(1,351,400)
	\$ -	\$ -

The valuation allowance reflects the Company's estimate that the benefit of the tax assets, more likely than not, will not be realized.

c) As at July 31, 2006, the Company and Zecotek Crystal Inc. have non-capital losses carried forward for Canadian tax purposes of approximately \$5,996,241, available to reduce taxable income of future years, subject to certain restrictions. These losses expire commencing in the 2007 year as follows:

2007	\$ 279,529
2008	1,406,327
2009	149,957
2010	99,190
2011	103,007
2015	1,478,231
2026	2,480,000
	<u>\$5,996,241</u>

ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended July 31, 2006 and 2005
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15. COMMITMENTS AND AGREEMENTS

- a) Effective February 27, 2006, the Company completed an exclusive license agreement with a third party for the use of the patents, technical data and know-how of its proprietary LFS scintillation crystal technology. Under the agreement, the Company is to receive a royalty of a fixed percentage of the gross selling price for each unit of licensed product delivered, sold, or leased to a third party during the twenty year term of the agreement. To date the Company has not yet received any revenue under the agreement.
- b) Effective June 27, 2006, Zecotek Medical Systems Singapore Pte. Ltd. ("ZMSS") entered into a Collaborative Research Agreement with the University of Washington ("UW") for joint development of a proprietary technology for use in medical imaging systems. Pursuant to the agreement, ZMSS is to pay a total of US\$2,368,222 to UW for the development project, as billed by UW. As at July 31, 2006 a total of US\$265,130 (\$300,843 Canadian dollars) had been paid. Subsequent to July 31, 2006, an additional amount of US\$106,130 (\$120,882 Canadian dollars) was paid.
- c) Effective May 1, 2006, ZMSS entered into an employment agreement with Dr. Zerrouk in respect to the positions of Chairman, President and Chief Executive Officer of the Company and its subsidiaries. The agreement provides for an annual remuneration package including salary and cost of living and relocation allowances totalling \$558,000 Singapore dollars (currently approximately \$399,700 Canadian dollars) and is for an indefinite term. In order to terminate the agreement, the Company must provide not less than twelve months notice, pay severance equal to twenty four month's salary and retain all stock options held by Dr. Zerrouk.
- d) Effective May 12, 2006, the Company granted Research Capital Corp. a right of first refusal to lead any future private or public equity or debt offering of the Company until May 12, 2007.
- e) The Company has entered into office leases for its Vancouver and Singapore offices. The Company also has entered into an apartment lease for certain employees in Singapore. Minimum required lease payments under these agreements are as follows:

2007	\$ 207,650
2008	245,580
2009	193,500
2010	80,630
	<hr/>
	\$ 727,360
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ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended July 31, 2006 and 2005
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16. CONTINGENT LIABILITIES

The landlord in respect to a tenancy agreement made by the Company for a residence to be used by Dr. Zerrouk initiated a legal claim against ZMSS in October of 2006 in respect to the termination of the agreement by ZMSS. The dispute relates to changes to the original agreement which ZMSS claims were promised by the landlord. ZMSS terminated the tenancy agreement and demanded return of deposits of \$45,000 Singapore dollars (approximately \$32,233 Canadian dollars) from the landlord. The landlord has claimed loss of rental income of \$360,000 Singapore dollars (approximately \$257,868 Canadian dollars) over the term of the agreement (August 1, 2006 to July 31, 2008) and costs incurred to remove certain chattels. Management of the Company is of the view that the landlord's claim does not have merit, that ZMSS is not liable for the claims for damages made by the landlord, and that it will be successful in recovering the deposit.

The outcome of this matter is uncertain. Any loss of the Company as a result of the claim will be recognized when that determination can reasonably be made.

17. NON-CASH FINANCING TRANSACTIONS

- a) On December 31, 2004, the Company issued 145,000 common shares at \$0.50 per share to an agent for corporate finance services rendered in respect to an offering of units of the Company (note 9(b)(ii)).
- b) On December 31, 2004, pursuant to an asset purchase agreement, the Company issued 2,400,000 common shares for \$700,000 as part consideration, settled an assumed debt of \$200,000 by issuance of 400,000 units at \$0.50 per unit, issued 202,000 common shares at \$0.47 per share as a finder's fee, and issued 140,000 common shares at \$0.50 per share, pursuant to an assignment agreement to acquire the rights to the LSF scintillation material technology (note 9(b)(iii)).
- c) On May 12, 2006, the Company issued 638,490 agents' options at an estimated fair value of \$166,553 for corporate finance services rendered by agents (note 9(b)(ix)).
- d) On May 12, 2006, the Company issued 11,750,000 common shares as partial consideration in acquiring technologies as described in notes 8(ii) and 9(b)(x).

18. GEOGRAPHIC INFORMATION

The Company has operations in Canada and Singapore. Geographic information by country as at July 31, 2006 and 2005 are as follows:

	2006	2005
Property and equipment		
Canada	\$ 41,832	\$ 51,884
Singapore	80,573	-
	\$ 122,405	\$ 51,884
	2006	2005
Revenue		
Canada	\$ 44,153	\$ 4,110
Singapore	-	-
	\$ 44,153	\$ 4,110

ZECOTEK MEDICAL SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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19. SUBSEQUENT EVENTS

- a) Effective August 22, 2006, Zecotek Medical Systems Singapore Pte. Ltd. entered into a tenancy agreement for a residence to be used by Dr. Zerrouk in Singapore. Monthly rent of \$12,000 Singapore dollars (currently approximately \$8,500 Canadian dollars) is to be paid from September 1, 2006 to August 31, 2008, totalling \$288,000 Singapore dollars (currently approximately \$204,600 Canadian dollars). A deposit of \$24,000 Singapore dollars (\$17,080 Canadian dollars) was paid in August, 2006.
- b) On August 9, 2006, 8,000 common shares of the Company were issued upon exercise of stock options at \$0.75 per share, for gross proceeds of \$6,000.
- c) Subsequent to July 31, 2006, 8,000 stock options entitling the holder to acquire the equivalent number of common shares of the Company at a price of \$0.75 per share expired.
- d) Effective August 24, 2006, the Company entered into a Collaborative Research Agreement with the University of British Columbia ("UBC") to jointly develop advanced light sources and optical systems for medical imaging products for the period from September 1, 2006 to December 31, 2009. Pursuant to the agreement, the Company is to pay research fees to UBC of \$98,600 upon execution of the agreement, and \$98,600 on each of September 1, 2007 and September 1, 2008, totalling \$295,800. The initial fee was paid in October of 2006.
- e) Subsequent to July 31, 2006, 1,762,500 common shares of the Company held in escrow were released.

20. COMPARATIVE FIGURES

Certain comparative figures for the 2005 year have been reclassified to conform to the presentation adopted for the 2006 year.