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FLEXIBLE SOLUTIONS INTERNATIONAL INC
Form 10KSB
March 10, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-KSB

(Mark one)

Annual Report Under Section 13 or 15(d) of the Securities Exchange Act
of 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005.

Transition Report Under Section 13 or 15(d) of the Securities Exchange
Act of 1934

For the transition period from _____ to _____.

Commission File Number 000-29649

FLEXIBLE SOLUTIONS INTERNATIONAL, INC.
(Name of Small Business Issuer in Its Charter)

NEVADA
(State of Incorporation)

91-1922863
(IRS Employer Identification No.)

615 DISCOVERY STREET
VICTORIA, BRITISH COLUMBIA, CANADA
(Address of Principal Executive Offices)

V8T 5G4
(Zip Code)

(250) 477-9969
(Issuer's Telephone Number)

NONE
(Securities registered under Section 12(b) of the Exchange Act)

COMMON STOCK, \$0.001 PAR VALUE
(Securities registered under Section 12(g) of the Exchange Act)

Check whether the issuer is not required to file reports pursuant to
Section 13 or 15(d) of the Exchange Act.

Check whether the issuer (1) filed all reports required to be filed by
Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such
shorter period that the registrant was required to file such reports), and (2)
has been subject to such filing requirements for the past 90 days. Yes No

Check if there is no disclosure of delinquent filers in response to
Item 405 of Regulation S-B contained in this form, and no disclosure will be

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contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

State issuer's revenues for its most recent fiscal year: \$6,709,394.

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was sold, or the average bid and asked price of such common equity, as of a specified date within the past 60 days: As of March 2, 2006, the aggregate market value of the Company's common stock held by non-affiliates was approximately \$16,086,877 based on the closing price for shares of the registrant's common stock on the American Stock Exchange for that date.

State the number of shares outstanding of each of the issuer's class of common equity, as of the latest practicable date: As of March 2, 2006, there were 12,981,316 shares of the Company's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

No documents are incorporated by reference.

Transitional Small Business Disclosure Format (check one): Yes No

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FLEXIBLE SOLUTIONS INTERNATIONAL, INC.
INDEX TO ANNUAL REPORT ON FORM 10-KSB
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005

| | PAGE | |
|------------|--|----|
| | ---- | |
| PART I | | |
| Item 1. | Description of Business. | 1 |
| Item 2. | Description of Property. | 9 |
| Item 3. | Legal Proceedings. | 10 |
| Item 4. | Submission of Matters to a Vote of Security Holders. | 11 |
| PART II | | |
| Item 5. | Market for Common Equity and Related Stockholder Matters. | 11 |
| Item 6. | Management's Discussion and Analysis or Plan of Operation. | 14 |
| Item 7. | Financial Statements. | 27 |
| Item 8. | Changes in and Disagreements with Accountants on Accounting and Financial Disclosure. | 28 |
| Item 8A. | Controls and Procedures. | 28 |
| Item 8B. | Other Information. | 28 |
| PART III | | |
| Item 9. | Directors, Executive Officers, Promoters and Control Persons; Compliance With Section 16(a) of the Exchange Act. | 29 |
| Item 10. | Executive Compensation. | 31 |
| Item 11. | Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters. | 33 |
| Item 12. | Certain Relationships and Related Transactions. | 34 |
| Item 13. | Exhibits. | 34 |
| Item 14. | Principal Accountant Fees and Services. | 34 |
| SIGNATURES | | 36 |

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-KSB for the year ended December 31, 2005 ("Annual Report"), including the Notes to Unaudited Consolidated Financial Statements, contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, without limitation, those statements relating to development of new products, our financial condition, our ability to increase distribution of our products, integration of businesses we acquire and disposition of any of our current business. Forward-looking statements can be identified by the use of forward-looking terminology, such as "may," "will," "should," "expect," "anticipate," "estimate," "continue," "plans," "intends," or other similar terminology. These forward-looking statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is anticipated or forecasted in these forward-looking statements due to numerous factors, including, but not limited to, our ability to generate or obtain sufficient working capital to continue our operations, changes in demand for our products, the timing of customer orders and deliveries and the impact of competitive products and pricing. In addition, such statements could be affected by general industry and market conditions and growth rates, and general domestic and international economic conditions.

Although we believe that the expectations reflected in these forward-looking statements are reasonable and achievable, such statements involve risks and uncertainties and no assurance can be given that our actual results will be consistent with these forward-looking statements. Except as otherwise required by applicable securities laws, we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, changed circumstances or any other reason, after the date of this Annual Report.

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ITEM 1. DESCRIPTION OF BUSINESS.

OUR COMPANY

Flexible Solutions International, Inc.

Flexible Solutions International, Inc. ("we," "us," and "our") develops, manufactures and markets specialty chemicals which slow down the evaporation of water. Our primary product, HEAT\$AVR(R), is marketed for use in swimming pools and spas where its use, by slowing the evaporation of water, allows the water to retain a higher temperature for a longer period of time and thereby reduces the energy required to maintain the desired temperature of the water in the pool. Another product, WATER\$AVR(R), is marketed for water conservation in irrigation canals, aquaculture, and reservoirs where its use slows down water loss due to evaporation. We also make and sell dispensers which automate the deployment of our chemical products.

We were incorporated as Flexible Solutions, Ltd. (referred to hereinafter as "Flexible Ltd."), a British Columbia corporation, on January 26, 1991. On May 12, 1998, we merged Flexible Ltd. with and into Flexible Solutions International, Inc., a Nevada corporation, and, in exchange for all of the outstanding shares of Flexible Ltd., we issued 7,000,000 shares of common stock, which represented all of our then-issued and then-outstanding shares, to the former shareholders of Flexible Ltd. Flexible Ltd. is now our wholly-owned subsidiary. For further information on Flexible Ltd., see "Our Subsidiaries--Flexible Solutions, Ltd." below. At the time of our merger with Flexible Ltd., we had no other business and were incorporated solely in order to acquire Flexible Ltd. This merger facilitated the establishment of a public trading market for our common stock. Trading in our common stock commenced on October 12, 1999, through the OTC Bulletin Board under the trading symbol "FXSO". Since November 2002, our common stock has traded on the American Stock Exchange under the trading symbol "FSI".

OUR SUBSIDIARIES

We are the parent holding company for Flexible Ltd., WaterSavr Global Solutions Inc. (hereinafter referred to as "WaterSavr"), NanoChem Solutions Inc. (hereinafter referred to as "NanoChem"), Nano Detect Technologies Inc. (hereinafter referred to as "Nano Detect"), and Seahorse Systems Inc. (hereinafter referred to as "Seahorse").

Flexible Solutions, Ltd.

Flexible Solutions Ltd., a British Columbia corporation inter-provincially registered in Alberta, was organized to develop and market swimming pool chemical products designed to reduce heat loss. HEAT\$AVR(R) and ECO\$AVR(R) are Flexible Ltd.'s principal products. For further information on these products, see "Our Products--HEAT\$AVR(R) and ECO\$AVR(R)" below.

WaterSavr Global Solutions Inc.

In 2002, we established WaterSavr Global Solutions Inc. to concentrate on the marketing of our WATER\$AVR(R) product. Since February 7, 2005, WaterSavr has been organized as a Nevada corporation. WATER\$AVR(R) is a patented powder that, when deployed onto a water surface of any size, will significantly reduce evaporation. For further information on our WaterSavr products, see "Our Products--WATER\$AVR(R)" below.

NanoChem Solutions Inc.

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On May 25, 2004, we formed NanoChem Solutions Inc. in order to acquire certain of the assets of Donlar Corporation, which owned a broad portfolio of environmentally friendly technologies and products. In June 2004, NanoChem purchased these assets from the bankruptcy estate of Donlar Corporation ("Donlar") for \$6.15 million. In exchange for the capital contribution necessary to purchase the Donlar assets, we were issued all of the outstanding shares of NanoChem, making it our wholly-owned subsidiary. The newly acquired assets include 52 U.S. and 139 International patents relating to environmental products and technologies, as well as a 56,780 sq. ft. manufacturing plant on 40 acres of property in an area outside of Chicago, Illinois. As part of the asset acquisition from Donlar, we also acquired leaseholds to corporate offices and a laboratory in Bedford Park, Illinois that are now occupied by NanoChem. The principal products that we acquired from Donlar via our wholly-owned subsidiary, NanoChem, consist of water-soluble chemicals utilizing thermal polyaspartate biopolymers (hereinafter referred to as "TPAs"), which are beta-proteins manufactured from the common biological amino acid, L-aspartic. TPAs can be formulated to prevent corrosion and scaling in water piping within the petroleum, chemical, utility and mining industries. TPAs are also used as proteins to enhance fertilizers in improving crop yields and as additives for household laundry detergents, consumer care products and pesticides. For further information on these products, see "Our Products--Biopolymer Products (TPAs)" below.

Nano Detect Technologies Inc.

On January 7, 2005, we formed Nano Detect Technologies Inc. to engage in new product research based on our thin film spreading technology.

Seahorse Systems Inc.

On June 21, 2005, we formed Seahorse Systems Inc. in order to research alternative uses for our patented ECOSAVR(R) chemical dispensing device.

OUR PRODUCTS

HEAT\$AVR(R) and ECO\$AVR(TM)

Our principal products consist of the HEAT\$AVR(R) and ECO\$AVR(R) branded chemical solutions. HEAT\$AVR(R) is a chemical product for use in swimming pools and personal spas that forms a thin, transparent layer on the water's surface that reduces water evaporation and heat loss. We market the HEAT\$AVR(R) product as a cost-effective and convenient way to save on the cost of energy required to heat pools and spas. Our studies indicate that approximately 70% of the energy lost from a swimming pool occurs through water evaporation. By using our HEAT\$AVR(R) product, we can minimize that heat loss and save our customers money on their pool and spa energy needs. For example, we have received reports from our commercial customers documenting energy savings of between \$2,400 to \$6,000 per year when using our HEAT\$AVR(R) product.

We completed the development of our HEAT\$AVR(R) product and introduced it to the commercial marketplace in 1998, achieving initial sales of \$84,252 that year. Since that time, we have expanded our marketing of the HEAT\$AVR(R) product to include the residential marketplace. We found that by designing the HEAT\$AVR(R) product to be "residential-friendly," we could increase sales. As a result, we created a patented, fish-shaped dispensing unit for the HEAT\$AVR(R) residential market and have designated the dispensing unit as the ECO\$AVR(R). Since that time, we have increased sales and market share on our HEAT\$AVR(R) and ECO\$AVR(R) products.

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Each ECO\$AVR(R) dispenser is made of molded plastic in the form of a ten-inch long colorful ECO\$AVR(R) fish that is filled with enough HEAT\$AVR(R) solution to cover the surface of a 400 sq. ft. swimming pool for about one month. The ECO\$AVR(R) is deployed by cutting off the dorsal fin and tossing the fish into the pool where it submerges to the bottom. Differential pressure causes the HEAT\$AVR(R) solution inside the ECO\$AVR(R) to escape into the water where it rises to the surface and forms a transparent layer on the water's surface. Once the ECO\$AVR(R) is empty, the dispenser is removed and replaced. We also make and sell automatic metering system dispensers for automatically dispensing HEAT\$AVR(R) into a swimming pool or spa. These dispensers contain a reservoir holding a one-gallon supply of HEAT\$AVR(R). The unit is programmed to inject the appropriate amount of HEAT\$AVR(R) product into the pool at the rate of one ounce per 400 sq. ft. of pool surface per day.

The ECO\$AVR(R) product has a suggested retail price of between \$11.95 and \$14.95 in the United States. HEAT\$AVR(R) retails for between \$200 and \$300 per four gallon case in the United States. In outdoor swimming pools, our HEAT\$AVR(R) product can provide savings on pool heating costs and provides convenience of use when compared to pool blankets. Pool blankets are plastic covers, which are cut to the size and shape of the surface of the pool or spa. They float on the surface and perform the same function as our HEAT\$AVR(R) product: reducing energy cost by inhibiting water evaporation. Pool personnel often find it inconvenient to use conventional pool blankets because a pool blanket must be removed and stored prior to entering the pool and provides no energy savings when not on the pool. Conversely, our HEAT\$AVR(R) product eliminates the necessity of installing, removing and storing the blanket and works 24 hours a day. We believe that the ease of use provided by HEAT\$AVR(R) results in more consistent pool and spa usage. In addition, the use of HEAT\$AVR(R) in an indoor pool results in even greater energy savings. Indoor pool locations use energy not only to heat the pool water, but also to air condition the pool environment. By slowing the transfer of heat and water vapor from the pool to the atmosphere of the pool enclosure, less energy is required to maintain a pool at the desired temperature and there is a reduced load on the air-conditioning system because less heat is transferred from the pool water to the surrounding air and less water vapor will have to be removed from the air to maintain the required comfort level.

We market our HEAT\$AVR(R) and ECO\$AVR(R) products to both residential and commercial markets, consisting of individual homeowners with swimming pools and personal spas and commercial consumers consisting of operators of swimming pools and personal spas located in hotels, motels, schools, and municipal and private recreational facilities.

Traditionally, we sold our HEAT\$AVR(R) and ECO\$AVR(R) products directly to a wholesale network. However, in February 2004, we reorganized the distribution of our HEAT\$AVR(R) and ECO\$AVR(R) products so that we now handle distribution of the products from our sales and marketing office in Richmond, British Columbia. By bringing our product distribution in-house, we believe we can fully integrate our manufacturing and distribution processes such that we can increase our revenue per unit by 100%. While we now maintain greater control over our distribution process, we also still maintain non-exclusive distributorships in Canada and the United States for the sale of bulk HEAT\$AVR(R) (without the ECO\$AVR(R) dispenser) and exclusive distributorships in Australia, Chile, Japan, Korea, Spain, South Africa, Switzerland and Great Britain. We support our distributors and seek additional market opportunities by annually attending the major pool industry trade shows in the United States. We also advertise in trade magazines, maintain a semi-annual newsletter that is sent to buyer associations, customers and potential customers, and maintain an internet presence containing information about our products.

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WATER\$AVR(R)

We introduced our WATER\$AVR(R) product in June 2002. This product utilizes our core technology to reduce water evaporation. We market it as a water conservation product for use where water is standing or gently flowing and the need for water conservation can justify the cost of purchase and deployment of the product. We believe that our WATER\$AVR(R) product may find a market for use in the following markets: reservoirs, potable water storage, aqueducts and canals, agricultural irrigation, flood water crops, lawn and turf care, potted and bedding plants, stock watering ponds, and mining.

WATER\$AVR(R) is sold in granulated form and can be provided in shaker containers holding 3/4 lbs. or in 50 lbs. weatherproof bags. WATER\$AVR(R) can be applied in various ways from hand dispersal to fully automated scheduled metering, and we also offer an automatic dispenser for WATER\$AVR(R) to automate deployment of the product.

In May 2004, the Metropolitan Water District of Southern California awarded us a \$30,000 grant under that agency's Innovation Supply Program for an evaporation control project to start in June 2004. In September and October 2004, we achieved positive results from our evaporation control testing conducted at Owens Lake, California. The evaporation control results were as follows:

- o Evaporation reduction for 2- and 3-day application cycles over September and October were 37% and 30%, respectively; and
- o Evaporation savings were as high as 54% and as low as 22% on individual days depending on environmental factors.

We also ordered a simultaneous toxicity study to be performed by McGuire Environmental Consultants Inc. of Denver, Colorado to determine if any water quality change occurred as a result of the application of WATER\$AVR(R) to a body of water. With respect to the environmental impact testing performed in Colorado, the results were as follows:

- o No effect on odor;
- o No effect on invertebrates;
- o No effect on vertebrates;
- o No anticipated effect on any current drinking water treatment processes; and
- o Biodegradability reconfirmed independently.

We anticipate our initial market for WATER\$AVR(R) will be in Spain, Australia and the United States. We have provided quantities of the product for testing in these countries and, if successful, we anticipate that substantial orders may be received. We also anticipate marketing WATER\$AVR(R) to both developed and drought stricken countries to address water conservation concerns. In this regard, we are seeking to establish strategic relationships with companies in the water processing industry who have marketing and manufacturing operations in countries with water conservation concerns. We have two full-time employees and two other employees more than 50% assigned to establishing sales channels throughout the world for WATER\$AVR(R).

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Over the last three years, our continued research and development has resulted in a patent pending modification of the original WATER\$AVR(R) that combines evaporation control with control of mosquito larvae. The result is our new WATER\$AVR--BTI(TM) product. The BTI portion of the product is a recognized and approved, environmentally friendly method of killing mosquito larvae during the first, second and third stages of larvae development. Combined with our original WATER\$AVR(R) product, WATER\$AVR--BTI(TM) can be effectively and quickly spread across large and small water surfaces evenly and can be constrained to the water/air interface where larvae must go to obtain air.

In November 2004, after announcing positive test results from independent trials conducted at Louisiana State University on the efficacy of the WATER\$AVR--BTI(TM) product, we filed an application with the U.S. Environmental Protection Agency ("EPA") to obtain product registration. Included in our application were the results of the field tests on the performance of WATER\$AVR--BTI(TM), carried out by the Entomology Department at the Louisiana State University Agricultural Center. The results of the field testing at Louisiana State University were as follows: WATER\$AVR--BTI(TM) has been shown to correspond to a reduction in the density of mosquito larvae present in a body of water. These field tests back up our internal laboratory tests, showing that the use of WATER\$AVR--BTI(TM) resulted in a 100% kill rate of mosquito larvae in contact with the product.

In November 2005, we received approval from the EPA for the registration of WATER\$AVR--BTI(TM), which has now been approved by the EPA for commercial sale in the United States as of November 30, 2005. We will begin marketing the product commercially in fiscal 2006. While EPA approval applies only to registration of the product in the United States, we believe EPA approval may expedite product registration and approval processes in other parts of the world.

Biopolymer Products (TPAs)

Our subsidiary, NanoChem, produces TPAs used in industrial and consumer products. TPAs have a wide range of molecular weights. The ideal weight depends on the application, formulation and required performance characteristics in specific processes. This allows for customization of the products to correspond to particular product applications.

TPAs for Oilfields. TPAs are used to reduce scale and corrosion in various "topside" water systems. They are chosen over traditional phosphate and other products when biodegradability is required by environmental regulation. In this regard, we create products that can be used by our NanoChem sales force to market to oil service company technicians on a oil well-by-oil well basis according to the specific water conditions involved.

TPAs for the Agricultural Industry. TPAs have the ability to reduce fertilizer crystallization before, during and after application and can also prevent crystal formation between fertilizer and minerals present in the soil. Once crystallized, fertilizer and soil minerals are not bio-available to provide plant nourishment. As a result, in select conditions the use of TPAs either blended with fertilizer or applied directly to crops can increase yield values significantly beyond the cost of the TPA used. We conduct sales of these TPA-specific products by distribution through agricultural input companies, with a current emphasis on the Western United States. These proteins are designated for crop nutrient management programs and should not be confused with crop protection and pesticides or other agricultural chemical application. Depending on the application, these TPA products are marketed under a variety of brands including Amisorb, LYNX, MAGNET, AmGro and VOLT. Markets of significance include potatoes, sugar beets, cotton, tomatoes, almonds and other high value per acre crops.

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TPAs for Irrigation. The crystallization prevention ability of TPAs can also be useful in select irrigation conditions. By reducing calcium carbonate scale propagation, TPAs can prevent early plugging of drip irrigation ports and reduce maintenance costs and lengthen equipment lifetimes. These TPAs can replace and compete with acid type scale removers, but have the competitive advantages of a positive yield effect on the plant, as well as an easier deployment formulation with liquid fertilizers when used as part of a "fertigation" program. Our TPAs for drip irrigation scale prevention are at an early stage of commercialization and will be marketed and sold through the same channels as our TPAs for the agricultural industry.

TPAs for Detergent. In detergents, TPAs are a biodegradable substitute for poly-acrylic acid. In select markets, the use of this substitute outweighs the added cost of TPAs, which has allowed for the continued growth of this TPA product line. However, to increase penetration of this market beyond specialty detergent manufacturers, we will have to find ways to decrease the cost of goods sold or wait for legislative intervention regarding biodegradability of detergent components. In the meantime, we are researching various methods of reducing production costs.

TPAs for Personal Care Products. TPAs can also be used in shampoo and cosmetic products for increased hydration that improves the feel of the core product to consumers. It may also be used as an additive to toothpaste with the documented effect of reducing decay bacteria adhesion to tooth enamel and presumed reduction in total decay. We do not currently sell TPAs for personal care products into these markets.

COMPETITION

HEAT\$AVR(R) and ECO\$AVR(TM)

We are aware of only one other company that manufactures a chemical evaporation reduction product that competes with our HEAT\$AVR(R) product. This other product has had limited sales to date and does not have the important convenience factor of our ECO\$AVR(R) product. In addition to this existing competitor, our previous distributor, Sun Solar Energy Technologies Inc. (hereinafter referred to as "Sun Solar"), has recently begun selling a product called Turbo-Tropical Fish that directly competes with our ECO\$AVR(R) product. This product, while having a higher price point and no sales history to date, must be taken seriously because of the expertise Sun Solar derived from working with us for six years as our exclusive North American distributor of ECO\$AVR(R), which relationship ended in February 2004. We also believe that Sun Solar is infringing our trademark rights by using the name "Turbo Tropical Fish" and we are actively litigating the issue.

As mentioned above, HEAT\$AVR(R) also competes against plastic pool blanket products. We compete against pool blankets on the basis of convenience of use of HEAT\$AVR(R) versus the inconvenience of deploying and storing pool blankets. Pool owners and operators may also decide that evaporation control products are not needed for their pools.

WATER\$AVR(R)

Aegis Chemical Industries Ltd. of India directly competes with our WATER\$AVR(R) product. We believe our WATER\$AVR(R) product is superior for the following reasons:

- o Easier Application. WATER\$AVR(R) may be deployed directly to the water surface by hand or machine. Our competition requires premixing to dilute the product to usable strength, followed by extensive pumping.

- o Cost. In order to achieve comparable water savings levels, other products would cost more than the WATER\$AVR(R) product.

Water conservation is an important priority throughout the world, and numerous researchers in industry and academia are seeking to develop solutions that may compete with, or be superior to our products. Climate changes that relieve water shortage conditions or a technological breakthrough in water desalination could reduce the need for water conservation products.

WATER\$AVR--BTI(TM)

We are not aware of any direct competition to our WATER\$AVR--BTI(TM) product; however, the business of pest control is very large and very well funded. There are a multitude of methods and materials that can be used for mosquito control and all of them are competition for our product. We believe that we will be able to compete by:

- o Providing an environmentally sensitive alternative;
- o Increasing effectiveness per unit cost; and
- o Reducing cost of application respective to similar products.

Biopolymers (TPAs)

Our TPA products have direct competition with Lanxess AG (recently spun out of Bayer AG), a German TPA manufacture of similar quality operating pursuant to a different patented process from that used by NanoChem. NanoChem and Lanxess have cross-licensed each other's processes and either company can use either process for the term of the patents involved. It is believed that Lanxess has approximately the same production capacity as NanoChem and it must be presumed that their cost of goods sold is competitive. We believe that we can compete effectively with Lanxess by offering excellent customer service in oilfield sales, superior distributor support in the agricultural marketplace and the advantage of flexibility because of the relative size of our company. In addition, we intend to continue to seek market niches that are not the primary targets of Lanxess, such that we can attempt to avoid confusion.

Our TPA products face indirect competition from other chemicals in every market in which we are active. In irrigation scale control, acid washes can be utilized. In detergent, poly-acrylic acid is most often used due to price advantage. For crop enhancement, increased fertilizer levels or reduced concentrations can serve as a substitute for TPAs. Likewise, in oilfield scale prevention, phosphonates, phosphates and molibdonates provide the same effect. Notwithstanding the above, we believe our competitive advantages include:

- o Biodegradability compared to poly-acrylic acid for detergents;
- o Biodegradability compared to competing oil field chemicals;
- o Cost-effectiveness for crop enhancement compared to increased fertilizer use; and
- o Environmental considerations, ease of formulation and increased crop yield opportunities in irrigation scale control markets.

MANUFACTURING

Our HEAT\$AVR(R) and ECO\$AVR(R) products and dispensers are made from chemicals, plastic and other materials and parts that are readily available from multiple suppliers. We have never experienced any shortage in the availability of raw materials and parts for our products and we do not have any long term supply contracts for any such items. We manufacture our products in an approximately 11,000 sq. ft. plant in Calgary, Alberta, Canada.

Our WATER\$AVR(R) products are manufactured under contract with Ondo Nalco Company ("Ondo") under a five-year agreement effective as of April 2002, with a five-year extension available. We are not required to purchase any minimum quantity of such product.

Our 56,780 sq. ft. manufacturing facility in Peru, Illinois presently satisfies our TPA needs for our NanoChem subsidiary. Precursor chemicals for TPA production are sourced from various manufacturers throughout the world and we believe they are available in sufficient quantities for any expected increase in sales. The precursor chemicals are, however, derived from crude oil and are subject to price fluctuations related to world oil prices.

GOVERNMENTAL REGULATIONS

HEAT\$AVR(R) and ECO\$AVR(R)

Chemical products for use in swimming pools are covered by a variety of governmental regulations in the countries where we sell our products. These regulations cover such matters as packaging, labeling, and product safety. We believe our products are in compliance with such regulations.

WATER\$AVR(R)

Our WATER\$AVR(R) product is subject to additional regulation in most countries, particularly for agricultural and drinking water uses. As we continue to develop this product, and prior to its full-scale commercial roll-out, we will address these issues on a country-by-country basis. We do not anticipate that governmental regulations will be an impediment to marketing our WATER\$AVR(R) product because the ingredients have historically been used in agriculture for many years for other purposes. Nevertheless, we will need to obtain approval to sell WATER\$AVR(R) in the United States for agricultural users. To date, we have already applied for and received National Sanitation Foundation approval for drinking water in the United States.

WATER\$AVR--BTI(TM)

As a new pesticide formulation, WATER\$AVR--BTI(TM) must be approved by the EPA and equivalent bodies in countries throughout the world where we will sell the product. An application for product approval was filed with the EPA in November 2004 and permission was granted November 30, 2005 to begin selling the product. Our subsidiary, WaterSavr, will proceed to apply for certification in any country where significant markets are identified and will begin marketing the product commercially in fiscal 2006.

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Biopolymer Products (TPAs)

In the oil field and agricultural markets, NanoChem has applied for and received government approval in all areas of current use. As new markets are accessed, we will seek additional certification for such markets. We believe our NanoChem employees are experienced and skilled in the successful prosecution of these certifications.

In the detergent market, there are currently no regulatory requirements for use of TPAs in detergent formulations. For personal care products such as shampoo and toothpaste, there are various regulatory bodies, including the National Sanitation Foundation and the United States Food and Drug Administration, that regulate TPA use. If we begin to market our TPA products to these industries, we will need to satisfy the regulatory approval requirements therefor.

PROPRIETARY RIGHTS

Our success and ability to compete is dependent, in part, upon our proprietary technology. We rely on a combination of patent, copyright and trade secret laws and nondisclosure agreements to protect our proprietary technology. We currently hold 56 U.S. patents and 139 International patents, the duration of which range from 5 to 17 years. We also have three U.S. patent applications pending and have applied to extend these pending patents to certain other countries where we operate. There can be no assurance that our pending patent applications will be granted or that any issued patent will be upheld as valid or prevent the development of competitive products, which may be equivalent to or superior to our products. We have not received any claims alleging infringement of the intellectual property rights of others, but there can be no assurance that we may not be subject to such claims in the future.

RESEARCH AND DEVELOPMENT

We have spent approximately \$57,806 for the year ended December 31, 2005 and \$58,552 for the year ended December 31, 2004, on research and development activities. This work relates primarily to the development of our water and energy conservation products, as well as new research in connection with our TPA products.

EMPLOYEES

As of December 31, 2005, we had 23 employees, including one officer, sixteen sales and customer support personnel, and six manufacturing personnel. None of our employees is represented by a labor union and we have experienced no work stoppages to date.

ITEM 2. DESCRIPTION OF PROPERTY.

Our Chief Executive Officer provides use of space in his residence to conduct some of his administrative duties and we do not reimburse him for such use. We lease total space of 4,300 sq. ft. in Victoria, British Columbia for administration and sales and research at \$4,684 per month. This lease is effective through June 2009. We lease an 11,000 sq. ft. building in Calgary, Alberta for \$6,932 per month for manufacture of our swimming pool products. This lease is effective through September 2006. We lease 1,900 sq. ft. in Richmond, British Columbia as additional space for sales and customer support at a cost of \$2,128 per month. This lease is effective through January 2007. NanoChem leases 7,000 sq. ft. in Bedford Park, Illinois as offices and laboratories at a cost of \$6,548 per month. This lease is effective through November 2006. NanoChem also owns 56,780 sq. ft. of offices and factory in Peru, Illinois.

ITEM 3. LEGAL PROCEEDINGS.

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

On November 13, 2003, an ex-employee, Patrick Grant, filed a lawsuit in the Circuit Court of Cook County, Illinois against us, WaterSavr, and our Chief Executive Officer, Daniel B. O'Brien. The plaintiff claims damages for breach of contract, tortious interference with an agreement and various wrongful discharge claims. Mr. Grant seeks monetary damages in excess of \$1,020,000 for the breach of contract and tortious interference claims and unspecified compensatory and punitive damages in the wrongful discharge claims. We consider the case to be without merit and are vigorously disputing the claims. In addition, we intend to file counterclaims against the plaintiff for failure to repay financial obligations owed to us, as well as unspecified damages arising out of plaintiff's disclosure of confidential information to a client during his employment at WaterSavr. No amounts have been recorded as receivable and no accrual has been made for any loss in our consolidated financial statements as the outcome of the claim filed by Mr. Grant is not yet determinable.

On July 23, 2004, we filed a breach of contract suit in the Circuit Court of Cook County, Illinois against Tatko Biotech Inc. ("Tatko"). The action arises out of our joint product development agreement with Tatko in which we agreed to invest \$10,000 toward the product development venture and granted to Tatko 100,000 shares of our restricted common stock. In return, Tatko granted us a five-year option to purchase 20% of Tatko's outstanding capital stock. Tatko has since refused to collaborate on the agreement and we have sought declaratory relief stating that Tatko is not entitled to the 100,000 shares of our restricted common stock. The litigation is still pending at this time. In addition, Tatko filed its own suit on September 24, 2004 in the Circuit Court of Cook County, Illinois seeking declaratory relief of its entitlement to our restricted common stock. On May 23, 2005, the Tatko suit was dismissed with prejudice by the Circuit Court. No amounts have been recorded as receivable in our consolidated financial statements and no amount has been accrued as a loss as the outcome of the claim against Tatko is not determinable.

On May 28, 2004, Sun Solar filed a lawsuit in the Federal Court of Canada, against us, Flexible Ltd., and our Chief Executive Officer, Daniel B. O'Brien. Sun Solar is seeking: (a) a declaration that the trademark "Tropical Fish" is available for use by Sun Solar; (b) injunctive relief against our further use of the "Tropical Fish" trademark; and (c) monetary damages exceeding \$7,000,000 for the alleged infringement by us, Flexible Ltd. and Mr. O'Brien of the "Tropical Fish" trademark, as well as any other "confusingly similar trademarks" or proprietary trade dresses. On August 9, 2004, we, Flexible Ltd. and Mr. O'Brien filed our defense and a counterclaim against Sun Solar. The counterclaim seeks: (x) injunctive relief against further use of the "Tropical Fish" trademark by Sun Solar; (y) a declaration that we own the "Tropical Fish" trademark, or, in the alternative, the trademark is not distinctive and should

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be struck from the trademark registry; and (z) monetary damages exceeding \$50,000. The parties have completed documentary discovery and examinations for discovery of all parties. No amounts have been recorded as receivable in our consolidated financial statements and no amounts have been accrued as potential losses as the outcome of this claim is not determinable.

10

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

There were no matters submitted to the vote of our shareholders in the quarter ended December 31, 2005.

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

MARKET FOR SECURITIES

Our common stock began trading on the American Stock Exchange under the symbol "FSI" on November 19, 2002. Prior to that, our stock traded on the over-the-counter market and was quoted on the NASD Electronic Bulletin Board.

The following is the range of high and low closing sales or bid prices for our common stock for the periods indicated:

| | | HIGH | LOW |
|------------------------------|----------------|--------|--------|
| YEAR ENDED DECEMBER 31, 2005 | First Quarter | \$5.14 | \$3.52 |
| | Second Quarter | 4.89 | 3.70 |
| | Third Quarter | 5.09 | 3.80 |
| | Fourth Quarter | 4.05 | 2.70 |
| YEAR ENDED DECEMBER 31, 2004 | First Quarter | 5.20 | 3.92 |
| | Second Quarter | 5.15 | 4.30 |
| | Third Quarter | 5.05 | 3.09 |
| | Fourth Quarter | 4.15 | 2.82 |

Prices since November 19, 2002 represent high and low prices on the American Stock Exchange. Prices prior to November 19, 2002 represent inter-dealer quotations which do not include retail mark-ups, markdowns, or commissions, and do not necessarily represent actual transactions. As of December 31, 2005, we had 33 record holders of our common stock. Such shares are owned by an estimated 1,590 beneficial owners.

Our common stock also trades on the Frankfurt stock market under the symbol "FXT."

DIVIDEND POLICY

We have not paid any dividends on our common stock, and it is not anticipated that any dividends will be paid in the foreseeable future. Our board of directors intends to follow a policy of retaining earnings, if any, to finance our growth. The declaration and payment of dividends in the future will be determined by the board of directors in light of conditions then existing, including our earnings, financial condition, capital requirements and other factors.

EQUITY COMPENSATION PLAN INFORMATION

The following table contains certain information relating to outstanding options to purchase our common stock granted pursuant to individual compensation arrangements as of December 31, 2005, our most recently completed fiscal year.

| PLAN CATEGORY | NUMBER OF SECURITIES TO BE ISSUED UPON EXERCISE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS | WEIGHTED-AVERAGE EXERCISE PRICE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS |
|--|---|--|
| | (a) | (b) |
| Equity compensation plans approved by security holders (1): | -- | -- |
| Equity compensation plans not approved by security holders (2): | 1,060,740 | \$3.44 |
| TOTAL | 1,060,740 | \$3.44 |

(1) We have not granted any shares to purchase our common stock pursuant to equity compensation plans that have been approved by our shareholders.

(2) (a) Consists of non-qualified options to purchase our common stock that have been granted pursuant to individual compensation arrangements and not pursuant to any equity compensation plan. All of the grants made during our fiscal year are submitted for shareholder approval at such fiscal year's annual shareholder meeting and, to date, our shareholders have approved all of the grants.

(b) If the grantee is an employee, and if he or she ceases to be employed by us, the grantee may, during the 30-day period following termination of employment, exercise the option to the extent the option was exercisable on the date of termination. In the case of death or disability, the grantee (or his or her administrator) has twelve months from the date of death or disability to exercise the option to the extent the option was exercisable on the date of death or disability.

(c) The options are subject to adjustment by reason of a recapitalization, reclassification, stock split, combination of shares, dividend or other distribution payable in capital stock. Upon a merger, liquidation, dissolution or other consolidation, we shall provide each grantee with one-months' prior written notice informing the grantee that he or she may exercise the option in full (to the extent it has not been previously exercised) within such one-month period. Following such date, the options shall be terminated.

(d) The options may not be transferred, assigned, pledged or hypothecated in any way (except by will or the laws of descent) and are not subject to

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execution, attachment or similar process.

12

(e) All of the options granted have terms of between one and six years from and after the date of grant and reflect exercise prices equal to the fair market value of a share of our common stock as determined by our board of directors on the date of grant thereof. As set forth below, all of the options contain vesting provisions pursuant to which the options are 100% exercisable within a determinable number of months from and after the date of grant:

| ----- OPTIONS 100% EXERCISABLE WITHIN 12 MONTHS FROM AND AFTER THE DATE OF GRANT ----- | OPTIONS 100% EXERCISABLE WITHIN 12 MONTHS FROM AND AFTER THE DATE OF GRANT (CONT.) ----- | OPTIONS 100% EXERCISABLE WITHIN 24 MONTHS FROM AND AFTER THE DATE OF GRANT ----- | W |
|--|--|---|---|
| A. Options: 68,000 Grant Date: 12.01.01 Vest Date: 12.01.01 | I. Options: 12,000 Grant Date: 4.2.04 Vest Date: 12.31.04 | A. Options: 5,000 Grant Date: 4.10.02 Vest Date: 12.31.03 | A |
| B. Options: 12,000 Grant Date: 01.01.02 Vest Date: 01.01.02 | J. Options: 20,000 Grant Date: 5.21.04 Vest Date: 12.31.04 | B. Options: 10,000 Grant Date: 4.23.03 Vest Date: 12.31.04 | B |
| C. Options: 158,000 Grant Date: 12.31.02 Vest Date: 12.31.03 | K. Options: 25,000 Grant Date: 5.24.04 Vest Date: 12.31.04 | C. Options: 164,000 Grant Date: 11.26.03 Vest Date: 12.31.04 | |
| D. Options: 50,000 Grant Date: 2.16.03 Vest Date: 12.31.03 | L. Options: 10,000 Grant Date: 6.14.04 Vest Date: 6.30.04 | D. Options: 209,000 Grant Date: 11.26.04 Vest Date: 12.31.05 | |
| E. Options: 10,000 Grant Date: 4.23.03 Vest Date: 12.31.03 | M. Options: 250,000 Grant Date: 09.02.04 Vest Date: 6.30.05 | | |
| F. Options: 5,000 Grant Date: 5.26.03 Vest Date: 12.31.03 | N. Options: 5,000 Grant Date: 9.24.04 Vest Date: 12.31.04 | | |
| G. Options: 2,000 Grant Date: 9.18.03 Vest Date: 12.31.03 | | | |
| H. Options: 8,000 Grant Date: 3.15.04 Vest Date: 12.31.04 | | | |

WARRANTS OUTSTANDING

On April 14, 2005, we announced that we had raised \$3,375,000 pursuant to a private placement of up to 1,800,000 shares of our common stock. The investors collectively purchased 900,000 shares of our common stock at a per

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share purchase price of \$3.75, together with warrants to purchase up to 900,000 additional shares of our common stock. The warrants have a four-year term and are immediately exercisable at a price of \$4.50 per share.

On June 8, 2005, we announced that we had raised an additional \$327,750 pursuant to a private placement of up to 174,800 shares of our common stock. An investor purchased 87,400 shares of our common stock at a per share purchase price of \$3.75, together with a warrant to purchase up to 87,400 additional shares of our common stock. The warrant has a four-year term and is immediately exercisable at a price of \$4.50 per share. Costs associated with these two capital raises were \$471,254, making the net proceeds \$3,231,496.

13

WARRANTS 100% EXERCISABLE WITHIN
12 MONTHS FROM AND AFTER THE DATE
OF GRANT

- A. Warrants: 900,000
Grant Date: 4.14.05
Vest Date: 4.14.05
- B. Warrants: 87,400
Grant Date: 6.08.05
Vest Date: 6.08.05

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION.

Our operating activities are related primarily to manufacturing and marketing our swimming pool conservation products and manufacturing and marketing our biopolymer products.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Securities and Exchange Commission ("SEC") has recently issued Financial Reporting Release ("FRR") No. 60, Cautionary Advice Regarding Disclosure About Critical Accounting Policies, suggesting companies provide additional disclosure and commentary on those accounting policies considered most critical. A critical accounting policy is one that is both important to the portrayal of our financial condition and results, and requires management's most difficult, subjective or complex judgments. Typically, the circumstances that make these judgments difficult, subjective and/or complex have to do with the need to make estimates about the effect of matters that are inherently uncertain. We believe the accounting policies below represent our critical accounting policies as contemplated by FRR No. 60 (see Note 3 of the Notes to Consolidated Financial Statements for a detailed discussion on the application of these and other accounting policies):

Allowances for Product Returns. We grant certain of our customers the right to return product which they are unable to sell. Upon sale, we evaluate the need to record a provision for product returns based on our historical experience, economic trends and changes in customer demand.

Allowances for Doubtful Accounts Receivable. We evaluate our accounts receivable to determine if they will ultimately be collected. This evaluation includes significant judgments and estimates, including an analysis of

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receivables aging and a review of large accounts. If, for example, the financial condition of our customers deteriorates resulting in an impairment of their ability to pay or a pattern of late payment develops, allowances may be required.

Provisions for Inventory Obsolescence. We may need to record a provision for estimated obsolescence and shrinkage of inventory. Our estimates would consider the cost of inventory, the estimated market value, the shelf life of the inventory and our historical experience. If there are changes to these estimates, provisions for inventory obsolescence may be necessary.

14

RESULTS OF OPERATIONS

Separate financial data for each of our operating segments is provided below. We evaluate the performance of our operating segments based on the following:

| | DECEMBER 31, | | | % CHANGE 2005-2004 |
|----------------------------------|-----------------------|-----------------------|---------------------|-----------------------|
| | 2005 | 2004 | 2003 | |
| Sales | | | | |
| Energy Segment | \$1,053,507 | \$1,015,018 | \$2,321,120 | 4% |
| Polymer Segment | 5,655,887 | 2,377,919 | --* | 138% |
| Consolidated | 6,709,394 | 3,392,937 | 2,321,120 | 98% |
| Gross Profit Margin | | | | |
| Energy Segment | 473,475 | 502,121 | 958,056 | (6%) |
| Polymer Segment | 2,250,338 | 1,559,741 | --* | 46% |
| Consolidated | 2,723,813 | 2,061,862 | 958,056 | 32% |
| SG&A | | | | |
| Energy Segment | 2,166,472 | 2,029,340 | 1,664,146 | 7% |
| Polymer Segment | 1,738,745 | 1,291,825 | --* | 35% |
| Consolidated | 3,905,217 | 3,321,165 | 1,664,146 | 18% |
| Interest Income | | | | |
| Energy Segment | 4,550 | 34,258 | 203,310 | (87%) |
| Polymer Segment | 103 | -- | --* | -- |
| Consolidated | 4,653 | 34,258 | 203,310 | |
| Write-down of Investments | | | | |
| Energy Segment | -- | 32,500 | -- | -- |
| Polymer Segment | -- | -- | --* | --* |
| Consolidated | -- | 32,500 | -- | -- |
| Net Income (Loss) | \$ (1,176,751) | \$ (1,257,545) | \$ (476,888) | (6%) |

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* Polymer segment data is not available as indicated. Our Polymer segment was formed after the acquisition of certain assets of Donlar in June 2004.

SEGMENT DATA

As reflected in the table set forth in our "Results of Operations" above, we operate in two segments: (a) development and marketing of two lines of energy and water conservation products, and (b) manufacture of biodegradable polymers and chemical additives used primarily within the petroleum, chemical, utility and mining industries. Our traditional operating activities related to the production and sale of our energy conversation product line. Upon acquiring the Donlar assets, we formed NanoChem, which was formed as our wholly-owned subsidiary in exchange for the capital contribution necessary to purchase the Donlar assets. The assets we acquired from Donlar include domestic and international patents and business processes relating to the production of TPAs and other environmental products and technologies, as well as a manufacturing plant. These assets are currently used by NanoChem for its revenue-producing activities.

15

YEARS ENDED DECEMBER 31, 2005 AND 2004

Sales for the year ended December 31, 2005 were \$6,709,394 compared to \$3,392,937 for the 2004 period, an increase of \$3,316,457, or 98 %. The sales increase was primarily the result of the revenue provided by NanoChem, our new subsidiary formed from the assets acquired from the Donlar bankruptcy estate.

Our Energy segment had sales of \$1,053,507 for the year ended December 31, 2005, as compared to \$1,015,018 for the year ended December 31, 2004, an increase of 4%. This slight increase is primarily the result of substantial "Tropical Fish" product still in the market, which product is being sold by our discontinued distributor, and our brand building efforts in connection with our ECO\$AVR(R) product line. We expect revenue in this segment to increase more in fiscal 2006 as brand recognition of our ECO\$AVR(R) product line continues to grow and our marketing efforts of the WATER\$AVR(R) product line begin to produce increased sales. Our Polymer segment achieved sales of \$5,655,887 for the year ended December 31, 2005, as compared to \$2,377,919 for the year ended December 31, 2004. This increase is attributable to a full year of operation combined with increased sales on a quarter by quarter basis.

We experienced a loss of \$1,176,751, or \$0.09 per share, as compared to a loss of \$1,257,545, or \$0.11 per share in fiscal 2004. The three largest contributors to the loss were:

- o The brand building, marketing and extra staffing costs to market and develop the ECO\$AVR(R) product line incurred throughout the year that were not reflected in sales because dealers that had been sold product by our discontinued distributor still had substantial "Tropical Fish" product. We believe that very little old product is on the shelves and that costs and revenue for ECO\$AVR(R) will be better balanced in fiscal 2006.
- o All divisions maintained or increased sales and marketing costs in the fourth quarter in order to increase the probability of sales increases in all of fiscal 2006. We considered the extra costs necessary to position us for growth.
- o Litigation costs became significant in fiscal 2005 compared to

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fiscal 2004 as a result of the need to protect our assets from potential litigation or unwarranted claims. The costs are manageable, but we will make every effort to reduce these costs going forward without adversely affecting shareholder value.

Our overall gross profit margin on product sales decreased to 40.6% in the year ended December 31, 2005, a decrease from 60.8% in the year ended December 31, 2004. This decrease in gross margin was primarily due to the increased costs of all raw materials tied to the high price of oil. Our Polymer segment, which achieved a gross profit margin of 65.6% in fiscal 2004, experienced a substantial rise in cost of goods sold, reducing the gross margin to 39.8% in fiscal 2005. Our Energy segment achieved a gross profit margin of 44.9%, which is a slight decrease of 4.6% over the year ended December 31, 2004.

Gross profit margin represents sales less cost of sales and producing. The major categories of costs included in cost of sales and producing are cost of goods, distribution costs and costs of our buying department. Distribution costs consist of all warehouse receiving and inspection costs, warehousing costs, all transportation costs associated with shipping goods from our facilities to our customers and

16

other costs of distribution. We do not exclude any portion of distribution costs from cost of sales. Our gross margins may not be comparable to those of other entities because some entities include all of the costs related to their overhead in cost of sales. However, we exclude a portion of cost of sales from gross profit and instead include such costs as a line item in operating expenses (such as depreciation).

We incurred operating expenses in the year ended December 31, 2005 of \$3,905,217, as compared to \$3,321,165 in the year ended December 31, 2004. In fiscal 2005, we increased sales and marketing costs in connection with our WATER\$AVR(R) product, which was reflected in increased wages, office, rent, telecommunications and travel expenses. We incurred higher professional fees in the year ended December 31, 2005 primarily due to increased legal and accounting expenses and specific consultants directed at integrating the functions and sales of NanoChem as quickly as possible. Depreciation expense was \$685,768 for the year ended December 31, 2005, as compared to \$388,071 for the year ended December 31, 2004, reflecting depreciation for additional property and equipment added in fiscal 2004.

There was no income tax provision for the year ended December 31, 2005, as we had no taxable income. Our Energy segment had interest income of \$4,550 for the year ended December 31, 2005, as compared to \$34,258 for the year ended December 31, 2004, as we used capital to purchase assets and develop our business. We experienced a net loss of \$1,176,751 for the year ended December 31, 2005, as compared to a loss of \$1,257,545 for the year ended December 31, 2004.

With the addition of the Donlar assets, we became a much larger company with commensurate increases in most expense segments. However, we were able to reduce certain expenses, such as consulting (\$156,652 for the year ended December 31, 2005, as compared to \$166,099 for the year ended December 31, 2004) and telecommunications (\$40,458 for the year ended December 31, 2005, as compared to \$41,895 for the year ended December 31, 2004, despite adding three new locations), as a result of more careful cost control in our WaterSavr subsidiary. The large increase in investor relations (\$558,013 versus \$215,670) has to do with the stock options that vested in relation to the capital raisings that closed on April 14, 2005 and June 8, 2005. This resulted in non-cash transactions of \$422,500 and without this, we would have seen a large decrease in this expense.

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YEARS ENDED DECEMBER 31, 2004 AND 2003

Sales for the year ended December 31, 2004 were \$3,392,937, as compared to \$2,321,120 for the comparable 2003 period, an increase of \$1,071,817, or 46%. The sales increase was primarily the result of the revenue provided by our new subsidiary, NanoChem.

Our Energy segment had sales of \$1,015,018 for the year ended December 31, 2004, as compared to \$2,321,120 for the year ended December 31, 2003, a decrease of 56%. This decrease is primarily the result of substantial "Tropical Fish" product still in the market, which product is being sold by our discontinued distributor, and our brand building efforts in connection with our ECO\$AVR(R) product line. We expect revenue in this segment to increase in fiscal 2005 as brand recognition of our ECO\$AVR(R) product line continues to grow and our marketing efforts of the WATER\$AVR(R) product line begin to produce increased sales. Our Polymer segment achieved sales of \$2,377,919 for the year ended December 31, 2004. There is no comparable data from the Polymer segment for the year ended December 31, 2003 because our Polymer segment was formed after the acquisition of certain assets of Donlar in June 2004.

We experienced a loss of \$1,257,545, or \$0.11 per share, as compared to a loss of \$476,888 in fiscal 2003. The three largest contributors to the loss were:

17

- o The brand building, marketing and extra staffing costs in ECO\$AVR(R) sales incurred throughout the year that were not reflected in sales because dealers that had been sold product by our discontinued distributor still had substantial "Tropical Fish" product.
- o All divisions maintained or increased sales and marketing costs in the fourth quarter in order to increase the probability of sales increases in all of fiscal 2005.
- o Litigation costs became significant in fiscal 2004 compared to fiscal 2003 as a result of the need to protect our assets from suit.

Our overall gross profit margin on product sales increased to 60.8% in the year ended December 31, 2004, an increase from 41.3% in the year ended December 31, 2003. This increase in gross margin was primarily due to the addition of our Polymer segment, which achieved a gross profit margin of 65.6%. Our Energy segment achieved a gross profit margin of 49.5%, which is an increase of 8.2% over the year ended December 31, 2003.

Gross profit margin represents sales less cost of sales and producing. The major categories of costs included in cost of sales and producing are cost of goods, distribution costs and costs of our buying department. Distribution costs consist of all warehouse receiving and inspection costs, warehousing costs, all transportation costs associated with shipping goods from our facilities to our customers and other costs of distribution. We do not exclude any portion of distribution costs from cost of sales. Our gross margins may not be comparable to those of other entities because some entities include all of the costs related to their overhead in cost of sales. However, we exclude a portion of cost of sales from gross profit and instead include such costs as a line item in operating expenses (such as depreciation).

We incurred operating expenses in the year ended December 31, 2004 of

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\$3,321,165, as compared to \$1,664,146 in the year ended December 31, 2003. In fiscal 2004, we also increased sales and marketing costs in connection with our WATER\$AVR(R) product, which was reflected in increased wages, office, rent, telecommunications and travel expenses. We incurred higher professional fees in the year ended December 31, 2004 primarily due to increased legal and accounting expenses and specific consultants directed at integrating the functions and sales of NanoChem as quickly as possible. Depreciation expense was \$388,071 for the year ended December 31, 2004, as compared to \$37,712 for the year ended December 31, 2003, reflecting depreciation for additional property and equipment added in fiscal 2004.

There was no income tax provision for the year ended December 31, 2004, as no tax installment payments were made during the year while we recorded an income tax benefit of \$25,892 for the year ended December 31, 2003. Our Energy segment had interest income of \$34,258 for the year ended December 31, 2004, as compared to \$203,310 for the year ended December 31, 2003, as we used capital to purchase assets and develop our business. We experienced a net loss of \$1,257,545 for the year ended December 31, 2004, as compared to a loss of \$476,888 for the year ended December 31, 2003.

With the addition of the Donlar assets, we became a much larger company with commensurate increases in most expense segments. However, we were able to reduce certain expenses, such as travel (\$132,632 for the year ended December 31, 2004, as compared to \$150,116 for the year ended December 31, 2003) and telecommunications (\$41,895 for the year ended December 31, 2004, as compared to \$41,445 for the year ended December 31, 2003, despite adding three new locations), as a result of more careful cost control in our WaterSavr subsidiary.

18

LIQUIDITY AND CAPITAL RESOURCES

The following section discusses the effects of changes in our balance sheet and cash flow on our liquidity and capital resources. The following table summarizes our cash, cash equivalents and working capital that directly have an impact on our immediate and future cash needs and sources:

| | 2005 | 2004 | INCREASE (DECREASE) |
|---------------------------|------------|------------|------------------------|
| Cash and cash equivalents | \$ 526,292 | \$ 558,795 | \$ (32,503) |
| Short-term investments | -- | 559,440 | (559,440) |
| Working capital | 3,110,090 | (101,121) | 3,211,211 |
| Short-term loan | -- | 3,150,000 | (3,150,000) |

The overall decrease in short-term investments and cash and cash equivalents was primarily a result of the cash used to purchase the assets comprising our NanoChem division. Cash was also used to market our WATER\$AVR(R) product line, which has not yet attained significant sales to maintain positive cash flow. The increase in working capital is primarily due to paying off the short-term loan that was used to purchase the assets of the above mentioned NanoChem division.

Historically, prior to fiscal 2004, our operations have been cash flow positive after considering the positive adjustments to net income resulting from stock-based compensation expense and depreciation. In the year ended December 31, 2005, our operations generated a slightly positive cash flow as we continued to acquire a large amount of inventory. In the year ended December 31, 2004, our operations generated negative cash flow as we acquired a large amount of

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inventory and we financed the purchase of our NanoChem division through the redemption of short-term investments. In order to build our business, develop and research our products and sustain our start-up operations, we have relied mainly on external equity financing.

We expect that cash provided by operating activities may fluctuate in future periods as a result of a number of factors, including the fluctuations in our operating results, shipments, accounts receivable collections and inventory management. As our sales continue to build, our accounts receivable will increase and our overall inventory levels will also increase.

We have no commitments or guarantees in the next 12 months that will materially affect our cash position or needs and we believe we have sufficient capital to support our business and operations for at least the next 12 months. We anticipate utilizing approximately \$300,000 in the next twelve months attempting to close sales in California, Spain and Australia, and to extend certain core US patents to select other countries. Approximately 80% of such expenditures are related to our WATER\$AVR(R) product line.

There can be no assurance that any of the expenditures will result in additional sales revenues. In the event that our capital resources are not sufficient for our continued expansion, new capital will be needed or marketing expenses will have to be curtailed until capital is available. There is no guarantee that capital will be available on terms acceptable to us or at all. We have no investment banking agreements in place at thistime.

19

RESTATED FINANCIAL STATEMENTS

Stock-based Compensation Expense

The financial statements for the periods ended September 30, 2002 through June 30, 2005 have been restated to correct stock-based compensation expense. In October 2005, while completing a registration statement for securities issued in the second quarter of 2005, we determined that certain disclosures made in connection with our stock-based compensation expense required adjustment.

In September 2002, we entered into a distribution agreement with Ondo Nalco Company ("Ondo") whereby Ondo agreed to serve as the exclusive distributor of our WATER\$AVR(R) products for so long as Ondo maintained a certain threshold sales level as defined in the agreement. As consideration for signing the agreement, Ondo was granted an option to purchase 2,000,000 shares of our common stock. Half of the option for one million shares was exercisable immediately at an exercise price of \$4.25 for each common share. The remaining half of the option for 1,000,000 shares was exercisable after certain threshold sales targets were achieved at a price of \$5.50 for each common share.

In determining the stock-based compensation expense for the nine months ended September 30, 2002, we expensed the entire fair value of the stock option believing that the option fully vested upon the signing of the agreement. In our October 2005 review, however, we determined that: (i) first, as stated above, half of the option to purchase 1,000,000 shares of common stock did not vest and was not exercisable until the threshold sales target had been met, which would not be until five years after the signing of the distribution agreement; and (ii) second, we did not consider Emerging Issues Task Force ("EITF") No. 96-18, Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services; EITF No. 00-18, Accounting Recognition for Certain Transactions Involving Equity Instruments

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Granted to Other Than Employees; and EITF No. 01-9, Accounting for Consideration Given by a Vendor to a Customer.

During the three months ended March 31, 2003, Ondeo achieved the first threshold sales target, and accordingly, we should have recorded a corresponding stock-based compensation expense of \$54,080. However, since the entire stock-based compensation expense had been recorded in the financial statements for the quarter ended September 30, 2002 and in the year ended December 31, 2002, we did not record any additional stock-based compensation expense as a result of the attained first threshold level.

In the fourth quarter of the year ended December 31, 2003, we determined that Ondeo was not going to attain the minimum sales targets stipulated in the agreement. Consequently, the agreement and corresponding stock option was cancelled. We accounted for the cancellation of the stock option in accordance with Statement of Financial Accounting Standard No. 123, Accounting for Stock-based Compensation and reversed \$2,480,200 of the stock-based compensation expense previously recorded in fiscal 2002. Had we accounted for the cancellation of the stock option correctly, we would have reversed the amended stock-based compensation expense of \$54,080 that was recorded in the first quarter ended March 31, 2003.

20

In light of the above, the net effect of the adjustments to our financial statements is as follows:

1. \$2,704,000 in stock-based compensation expense recorded in September 2002 has been reversed;
2. \$54,080 in stock-based compensation expense has been recorded in the quarter ended March 31, 2003, as Ondeo met the first sales threshold under the agreement;
3. \$54,080 in stock-based compensation expense has been reversed in the year ended December 31, 2003, as Ondeo failed to meet subsequent sales thresholds under the agreement, resulting in the cancellation of the stock option;
4. As stated above, we previously recorded a stock-based compensation expense of \$2,704,000 in December 2002. As a result of canceling the stock option, we previously recorded a recovery of \$2,480,000 of stock-based compensation expense at December 31, 2003. This \$2,480,000 recovery has been reversed, in conjunction with the reversal of \$2,704,000 in stock-based compensation expense originally recorded; and
5. For the periods ended March 31, 2004 to June 30, 2005, the net effect of these adjustments is to decrease capital in excess of par value by \$223,800 and increase retained earnings by \$223,800.

Inventory

On January 24, 2006, in the course of generating the audited financial statements for the quarter and year ended December 31, 2005, we discovered a material inventory error in the financial statements filed as part of our Form 10-QSB for the quarter ended September 30, 2005. In conducting the inventory count at our NanoChem facility for the quarter ended September 30, 2005, we overstated our inventory by \$183,398. This clerical error led to our decision to restate our financial statements for the three months ended September 30, 2005. Accordingly, our previously issued financial statements covering the quarter

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ended September 30, 2005 should no longer be relied upon.

On January 25, 2006, management discussed the conclusion described above with our audit committee of the board of directors ("Audit Committee") and Cinnamon Jang Willoughby & Company ("CJW"), our independent registered public accounting firm. CJW informed the Audit Committee that it concurs with management's conclusion described above. As a result, we filed amended consolidated financial statements for the quarter ended September 30, 2005 on February 1, 2006.

The amended financial statements reflect adjustments to the financial statements as follows:

1. Our inventory as of September 30, 2005 has been reduced by \$183,398;
2. Our net loss for the quarter ended September 30, 2005 has been increased by \$183,398;
3. Our loss per share for the quarter ended September 30, 2005 has been increased to \$0.03;
4. Our net loss for the nine months ended September 30, 2005 has been increased by \$183,398;
5. Our net loss per share for the three and nine months ended September 30, 2005 has been increased to \$0.06; and

21

6. Our net loss for the three and nine months ended September 30, 2005 has been increased by \$183,398.

We are presently unaware of any evidence that the restatements described above are due to any material noncompliance by us, as a result of misconduct, with any financial reporting requirement under the federal securities laws. Our Audit Committee is working with management and CJW to assure that we are taking the appropriate approach to resolving the issues related to the restatements, as well as any further issues that may be identified during the course of its review.

RISK FACTORS

This Form 10-KSB contains forward-looking information based on our current expectations. Because our actual results may differ materially from any forward-looking statements made by us, this section includes a discussion of important factors that could affect our actual future results, including, but not limited to, our product sales, expenses, net income and earnings per share.

RISKS RELATED TO OUR BUSINESS

WE HAVE A LIMITED OPERATING HISTORY UPON WHICH TO EVALUATE OUR POTENTIAL FOR FUTURE SUCCESS.

Although we were incorporated in 1991, we have been operating in our present form only since 1998. To date, we have generated limited revenues from the sale of our products and do not expect to generate significant revenues until we sell a significantly larger number of our products. Accordingly, we have only a limited operating history upon which you can base an evaluation of our business and prospects. The likelihood of our success must be considered in light of the risks and uncertainties frequently encountered by middle stage companies like ours in an evolving market. If we are unsuccessful in addressing

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these risks and uncertainties, our business will be materially harmed.

WE HAVE INCURRED SIGNIFICANT OPERATING LOSSES SINCE INCEPTION AND MAY NOT SUSTAIN PROFITABILITY IN THE FUTURE.

We have experienced operating losses and negative cash flow from operations since our inception and we currently have an accumulated deficit. To the extent our revenues do not increase, our results of operations and liquidity will be materially adversely affected. If we experience slower than anticipated revenue growth or if our operating expenses exceed our expectations, we may not achieve profitability. Even if we achieve profitability in the future, we may not be able to sustain it.

FLUCTUATIONS IN OUR OPERATING RESULTS MAY CAUSE OUR STOCK PRICE TO DECLINE.

Given the nature of the markets in which we participate, we cannot reliably predict future revenues and profitability. Changes in competitive, market and economic conditions may cause us to adjust our operations. A high proportion of our costs are fixed, due in part to our sales, research and development and manufacturing costs. Thus, small declines in revenue could disproportionately affect our operating results. Factors that may affect our operating results and the market price of our common stock include:

- o demand for and market acceptance of our products;
 - o competitive pressures resulting in lower selling prices;
 - o adverse changes in the level of economic activity in regions in which we do business;
- 22
- o adverse changes in industries, such as swimming pool construction, on which we are particularly dependent;
 - o changes in the portions of our revenue represented by various products and customers;
 - o delays or problems in the introduction of new products;
 - o the announcement or introduction of new products, services or technological innovations by our competitors;
 - o variations in our product mix;
 - o the timing and amount of our expenditures in anticipation of future sales;
 - o increased costs of raw materials or supplies; and
 - o changes in the volume or timing of product orders.

WE HAVE NOT PAID, AND DO NOT EXPECT TO PAY, DIVIDENDS ON OUR COMMON STOCK.

We have not paid any dividends on our common stock since our inception and do not intend to pay any dividends to our common shareholders in the foreseeable future. We intend to reinvest any earnings in the development and expansion of our business.

OUR OPERATIONS ARE SUBJECT TO SEASONAL FLUCTUATION.

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The use of our swimming pool products increases in summer months in most markets and results in our sales from January to June being greater than in July through December. Markets for our WATER\$AVR(R) product are also seasonal, dependent on the wet versus dry seasons in particular countries. We attempt to sell into a variety of countries with different seasons on both sides of the equator in order to minimize seasonality. Our TPA business is the least seasonal, however there is a small increase in the spring related to inventory building for the crop season in the United States and a small slowdown in December as oilfield customers run down stock in advance of year end, but otherwise, little seasonal variation. We believe we are able to adequately respond to these seasonal fluctuations by reducing or increasing production as needed.

INTERRUPTIONS IN OUR ABILITY TO PURCHASE RAW MATERIALS AND COMPONENTS MAY ADVERSELY AFFECT OUR PROFITABILITY.

We purchase certain raw materials and components from third parties pursuant to purchase orders placed from time to time. Because we do not have guaranteed long-term supply arrangements with our suppliers, any material interruption in our ability to purchase necessary raw materials or components could have a material adverse effect on our business, financial condition and results of operations.

OUR WATER\$AVR(R) PRODUCT HAS NOT PROVEN TO BE A REVENUE PRODUCING PRODUCT AND WE MAY NEVER RECOUP THE COST ASSOCIATED WITH ITS DEVELOPMENT.

The marketing efforts of our WATER\$AVR(R) product may result in continued losses. We introduced our WATER\$AVR(R) product in June 2002 and, to date, we have delivered quantities for testing by potential customers, but only one customer has ordered the product for commercial use. This product can achieve success only if it is ordered in substantial quantities by commercial customers who have determined that the water saving benefits of the product exceed the costs of purchase and deployment of the product. We can offer no assurance that we will receive sufficient orders of this

23

product to achieve profits or cover the additional expenses incurred to manufacture and market this product. We expect to spend \$400,000 on the marketing and production of our WATER\$AVR(R) product in fiscal 2006.

IF WE DO NOT INTRODUCE NEW PRODUCTS IN A TIMELY MANNER, OUR PRODUCTS COULD BECOME OBSOLETE AND OUR OPERATING RESULTS WOULD SUFFER.

Without the timely introduction of new products and enhancements, our products could become obsolete over time, in which case our revenue and operating results would suffer. The success of our new product offerings will depend upon several factors, including our ability to:

- o accurately anticipate customer needs;
- o innovate and develop new products and applications;
- o successfully commercialize new products in a timely manner;
- o price our products competitively and manufacture and deliver our products in sufficient volumes and on time; and
- o differentiate our products from our competitors' products.

In developing any new product, we may be required to make a substantial

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investment before we can determine the commercial viability of the new product. If we fail to accurately foresee our customers' needs and future activities, we may invest heavily in research and development of products that do not lead to significant revenues.

WE ARE DEPENDENT UPON CERTAIN CUSTOMERS.

Among our current customers, we have identified six that are sizable enough that the loss of any one would be significant. Any such loss of one or more of these customers could result in a substantial reduction in our revenues. For this reason, we concentrate on maintaining good sales relations with these customers. We also try and minimize this risk by seeking out new customers.

OUR ACQUISITION ACTIVITIES COULD DISRUPT OUR ONGOING BUSINESS.

In June 2004, our subsidiary, NanoChem, completed the acquisition of certain assets of Donlar, which provided us with domestic and international patents relating to environmental products and technologies, as well as a 56,780 sq. ft. manufacturing plant on 40 acres of property in an area outside of Chicago, Illinois. Acquisitions such as these often involve risks, including: (i) disruption of our ongoing business; and (ii) an inability to successfully integrate the acquired technologies and operations into our business and maintain uniform standards, controls, policies and procedures. In addition, in order to finance future acquisitions, we may have to raise additional funds, through either public or private financings. We may be unable to obtain such funds or may be able to do so only on unfavorable terms.

ECONOMIC, POLITICAL AND OTHER RISKS ASSOCIATED WITH INTERNATIONAL SALES AND OPERATIONS COULD ADVERSELY AFFECT OUR SALES.

In the year ended December 31, 2005, revenues from shipments made outside of the United States accounted for approximately 80% of our revenues, 65% in the year ended December 31, 2004 and 10% in the year ended December 31, 2003. Since we sell our products worldwide, our business is subject to risks associated with doing business internationally. We anticipate that revenues from international

24

operations will continue to represent a sizable portion of our total revenue. Accordingly, our future results could be harmed by a variety of factors, including:

- o changes in foreign currency exchange rates;
- o changes in a country or region's political or economic conditions, particularly in developing or emerging markets;
- o longer payment cycles of foreign customers and difficulty of collecting receivables in foreign jurisdictions;
- o trade protection measures and import or export licensing requirements;
- o differing tax laws and changes in those laws;
- o difficulty in staffing and managing widespread operations;
- o differing protection of intellectual property and changes in that protection; and
- o differing regulatory requirements and changes in those

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requirements.

WE ARE SUBJECT TO CREDIT RISK AND MAY BE SUBJECT TO SUBSTANTIAL WRITE-OFFS IF ONE OR MORE OF OUR SIGNIFICANT CUSTOMERS DEFAULT ON THEIR PAYMENT OBLIGATIONS TO US.

We currently allow our major customers between 30 and 45 days to pay for each shipment of product we make to them. This practice, while customary, presents an accounts receivable write-off risk in that if one or more of our significant customers defaulted on their payment obligations to us, such write-off, if substantial, would have a material adverse effect on our business and results of operations. While we have exposure to this type of risk, we are no longer subject to the concentrated credit risk that we were previously subject to because of our relationship with Sun Solar. In addition, while our exposure to a bad debts and write-offs credit risk may increase as we service a larger number of customers in the swimming pool and personal spa, water evaporation and TPA industries, the effect of any such bad debts and write-offs will be minimized as a result of the increase in the numbers of our customers and overall revenues.

OUR PRODUCTS CAN BE HAZARDOUS IF NOT HANDLED, STORED AND USED PROPERLY; LITIGATION RELATED TO THE HANDLING, STORAGE AND SAFETY OF OUR PRODUCTS WOULD HAVE A MATERIAL ADVERSE EFFECT ON OUR BUSINESS AND RESULTS OF OPERATIONS.

Some of our products are flammable and must be stored properly to avoid fire risk. Additionally, some of our products may cause irritation to a person's eyes if they are exposed to the concentrated product. Although we label our products to warn of such risks, our sales could be reduced if our products were to be viewed as being dangerous to use or if they are implicated in causing personal injury or property damage. We are not currently aware of any circumstances in which our products have caused harm or property damage to consumers. Nevertheless, litigation regarding the handling, storage and safety of our products would have a material adverse effect on our business and results of operations.

OUR FAILURE TO COMPLY WITH ENVIRONMENTAL REGULATIONS MAY CREATE SIGNIFICANT ENVIRONMENTAL LIABILITIES AND FORCE US TO MODIFY OUR MANUFACTURING PROCESSES.

We are subject to various federal, state and local environmental laws, ordinances and regulations relating to the use, storage, handling and disposal of certain of our chemical substances. Under such laws, we may become liable for the costs of removal or remediation of these substances that have been used by

25

our consumers or in our operations. Such laws may impose liability without regard to whether we knew of, or caused, the release of such substances. Any failure by us to comply with present or future regulations could subject us to the imposition of substantial fines, suspension of production, alteration of manufacturing processes or cessation of operations, any of which could have a material adverse effect on our business, financial condition and results of operations.

OUR FAILURE TO PROTECT OUR INTELLECTUAL PROPERTY COULD IMPAIR OUR COMPETITIVE POSITION.

While we own certain patents and trademarks, some aspects of our business cannot be protected by patents or trademarks. Accordingly, in these areas there are few legal barriers that prevent potential competitors from copying certain of our products, processes and technologies or from otherwise

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entering into operations in direct competition with us. In particular, we have been informed that our former exclusive agent for the sale of our products, Sun Solar, is now competing with us in the swimming pool and personal spa markets. As a former distributor, they were given access to many of our sales, marketing and manufacturing techniques. Accordingly, we are doing all that we can to ensure our proprietary products and technologies are not used by them (or others) without our permission.

OUR PRODUCTS MAY INFRINGE ON THE INTELLECTUAL PROPERTY RIGHTS OF OTHERS, AND RESULTING CLAIMS AGAINST US COULD BE COSTLY AND PREVENT US FROM MAKING OR SELLING CERTAIN PRODUCTS.

Third parties may seek to claim that our products and operations infringe their patent or other intellectual property rights. We may incur significant expense in any legal proceedings to protect our proprietary rights or to defend infringement claims by third parties. In addition, claims of third parties against us could result in awards of substantial damages or court orders that could effectively prevent us from making, using or selling our products in the United States or abroad.

A CLAIM FOR DAMAGES COULD MATERIALLY AND ADVERSELY AFFECT OUR FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Our business exposes us to potential product liability risks, particularly with respect to our consumer swimming pool and consumer TPA products. There are many factors beyond our control that could lead to liability claims, including the failure of our products to work properly and the chance that consumers will use our products incorrectly or for purposes for which they were not intended. There can be no assurance that the amount of product liability insurance that we carry will be sufficient to protect us from product liability claims. A product liability claim in excess of the amount of insurance we carry could have a material adverse effect on our business, financial condition and results of operations.

OUR ONGOING SUCCESS IS DEPENDENT UPON THE CONTINUED AVAILABILITY OF CERTAIN KEY EMPLOYEES.

Our business would be adversely affected if the executive services of Daniel B. O'Brien ceased to be available to us because we currently do not have any other employee with an equivalent level of expertise in and knowledge of our industry. If Mr. O'Brien no longer served as our President and Chief Executive Officer, we would have to recruit one or more new executives, with no real assurance that we would be able to engage a replacement executive with the required skills on satisfactory terms. The market for skilled employees is highly competitive, especially for employees in the fields in which we operate. While our compensation programs are intended to attract and retain the employees required for it to be successful, there can be no assurance that we will be able to retain the services of all our key employees or a sufficient number to execute on our plans, nor can there be any assurances that we will be able to continue to attract new employees as required.

26

ITEM 7. FINANCIAL STATEMENTS.

Our consolidated financial statements and notes thereto appear on pages F-1 to F-22 of this Annual Report on Form 10-KSB for the year ended December 31, 2005.

FLEXIBLE SOLUTIONS INTERNATIONAL, INC. AND SUBSIDIARIES
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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Report of Independent Registered Public Accounting Firm, Cinnamon Jang Willoughby & Company
Consolidated Balance Sheet as of December 31, 2005 and 2004
Consolidated Statements of Operations for the Years Ended December 31, 2005 and 2004
Consolidated Statements of Operations for the Three Months Ended December 31, 2005 and 2004
Consolidated Statements of Cash Flows for the Years Ended December 31, 2005 and 2004
Consolidated Statements of Stockholders' Equity for the Years Ended December 31, 2005 and 2004
Notes to Consolidated Financial Statements

27

CINNAMON JANG WILLOUGHBY & COMPANY
Chartered Accountants
A PARTNERSHIP OF INCORPORATED PROFESSIONALS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the board of directors and stockholders of FLEXIBLE SOLUTIONS INTERNATIONAL,

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INC.:

We have audited the consolidated balance sheet of Flexible Solutions International, Inc. as at December 31, 2005 and 2004 and the consolidated statements of operations, stockholders' equity and cash flows for the years then ended. The consolidated financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these consolidated financial statements.

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

In our opinion the consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2005 and 2004 and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2005 in conformity with generally accepted accounting principles in the United States of America.

As described in note 3 to the consolidated financial statements, the accompanying consolidated financial statements of Flexible Solutions International, Inc. as of December 31, 2004 and 2003 and for the years then ended have been restated.

On February 11, 2005 (September 30, 2005 as to the effects of the restatements described in note 3), we reported separately to the shareholders of Flexible Solutions International, Inc. on consolidated financial statements for the same period, audited in accordance with auditing standards generally accepted in the United States of America and prepared in accordance with accounting principles generally accepted in the United States of America.

Cinnamon Jang Willoughby & Company,
Chartered Accountants

Burnaby, British Columbia
February 6, 2006

F-1

FLEXIBLE SOLUTIONS INTERNATIONAL, INC.
CONSOLIDATED BALANCE SHEET
DECEMBER 31, 2005 AND 2004
(U.S. DOLLARS)

| | DECEMBER 31, 2005 | DECEMBER 31, 2004 RESTATED (SEE NOTE 3) |
|---------------------------|-------------------|---|
| ASSETS | | |
| CURRENT | | |
| Cash and cash equivalents | \$ 526,292 | \$ 558,795 |

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| | | |
|--|--------------|--------------|
| Short term investments | -- | 559,440 |
| Accounts receivable | 758,463 | 501,372 |
| Income tax | 28,918 | 92,963 |
| Loan receivable | 35,228 | 38,570 |
| Inventory | 2,314,979 | 1,416,588 |
| Prepaid expenses | 137,315 | 131,280 |
| | ----- | ----- |
| | 3,801,195 | 3,299,008 |
| PROPERTY, EQUIPMENT AND LEASEHOLDS | 4,657,383 | 5,250,346 |
| PATENTS | 143,822 | -- |
| INVESTMENT | 369,000 | 271,000 |
| | ----- | ----- |
| | \$ 8,971,400 | \$ 8,820,354 |
| | ===== | ===== |
| LIABILITIES | | |
| CURRENT | | |
| Accounts payable and accrued liabilities | \$ 691,105 | \$ 250,129 |
| Short-term loan | -- | 3,150,000 |
| | ----- | ----- |
| | 691,105 | 3,400,129 |
| | ----- | ----- |
| STOCKHOLDERS' EQUITY | | |
| CAPITAL STOCK | | |
| Authorized | | |
| 50,000,000 common shares with a par value of \$0.001 each | | |
| 1,000,000 preferred shares with a par value of \$0.01 each | | |
| Issued and outstanding: | | |
| 12,981,316 (2005: 11,831,916) common shares | 12,981 | 11,832 |
| CAPITAL IN EXCESS OF PAR VALUE | 11,422,219 | 7,439,621 |
| OTHER COMPREHENSIVE INCOME | 153,254 | 100,179 |
| DEFICIT | (3,308,158) | (2,131,407) |
| | ----- | ----- |
| TOTAL STOCKHOLDERS' EQUITY | 8,280,295 | 5,420,225 |
| | ----- | ----- |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 8,971,400 | \$ 8,820,354 |
| | ===== | ===== |

COMMITMENTS AND CONTINGENCIES (SEE NOTES 17 & 18)

--See Notes to Consolidated Financial Statements.--

F-2

FLEXIBLE SOLUTIONS INTERNATIONAL, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004
(U.S. DOLLARS)

YEARS ENDED DECEMBER 31,
2004

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| | 2005 | RESTATED (SEE NOTE 3) |
|---|----------------|--------------------------|
| SALES | \$ 6,709,394 | \$ 3,392,937 |
| COST OF SALES | 3,985,581 | 1,331,075 |
| GROSS PROFIT | 2,723,813 | 2,061,862 |
| OPERATING EXPENSES | | |
| Wages | 798,569 | 932,283 |
| Administrative salaries and benefits | 241,819 | 133,120 |
| Advertising and promotion | 95,094 | 97,946 |
| Investor relations and transfer agent fee | 558,013 | 215,670 |
| Office and miscellaneous | 156,652 | 166,099 |
| Insurance | 145,596 | 73,375 |
| Interest expense | 64,275 | 68,384 |
| Rent | 237,113 | 177,667 |
| Consulting | 156,917 | 398,753 |
| Professional fees | 374,140 | 308,534 |
| Travel | 136,661 | 132,632 |
| Telecommunications | 40,458 | 41,895 |
| Shipping | 43,830 | 28,866 |
| Research | 57,806 | 58,552 |
| Commissions | 121,513 | 9,578 |
| Bad debt expense (recovery) | -- | (10) |
| Currency exchange | (28,096) | 20,000 |
| Utilities | 19,089 | 69,750 |
| Depreciation | 685,768 | 388,071 |
| | 3,905,217 | 3,321,165 |
| LOSS BEFORE OTHER ITEMS AND INCOME TAX | (1,181,404) | (1,259,303) |
| INTEREST INCOME | 4,653 | 34,258 |
| WRITE DOWN OF INVESTMENT | -- | (32,500) |
| LOSS BEFORE INCOME TAX | (1,176,751) | (1,257,545) |
| INCOME TAX (RECOVERY) | -- | -- |
| NET LOSS | \$ (1,176,751) | \$ (1,257,545) |
| DEFICIT, BEGINNING | \$ (2,131,407) | \$ (873,862) |
| DEFICIT, ENDING | \$ (3,308,158) | \$ (2,131,407) |
| NET LOSS PER SHARE | \$ (0.09) | \$ (0.11) |
| WEIGHTED AVERAGE NUMBER OF SHARES | 12,541,084 | 11,827,734 |

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--See Notes to Consolidated Financial Statements.--

F-3

FLEXIBLE SOLUTIONS INTERNATIONAL, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THREE MONTHS ENDED DECEMBER 31, 2005 AND 2004
(U.S. DOLLARS)

| | THREE MONTHS ENDED DECEMBER 31, | |
|--|---------------------------------|----------------------------------|
| | 2005 | 2004 RESTATED (SEE NOTE 3) |
| SALES | \$ 1,519,591 | \$ 981,012 |
| COST OF SALES | 1,115,698 | 501,761 |
| GROSS PROFIT | \$ 403,893 | 479,251 |
| OPERATING EXPENSES | | |
| Wages | 158,968 | 325,341 |
| Administrative salaries and benefits | 75,983 | 38,147 |
| Advertising and promotion | 33,162 | 24,688 |
| Investor relations and transfer agent fee | 6,528 | 42,506 |
| Office and miscellaneous | 29,665 | 12,046 |
| Insurance | 40,722 | 39,900 |
| Interest expense | 2,087 | 39,020 |
| Rent | 68,553 | 62,956 |
| Consulting | 39,062 | 104,644 |
| Professional fees | 140,432 | 96,388 |
| Travel | 31,476 | 52,801 |
| Telecommunications | 8,470 | 13,431 |
| Shipping | 9,523 | 6,916 |
| Research | 18,558 | 37,552 |
| Commissions | 9,354 | 9,578 |
| Bad debt expense (recovery) | -- | 787 |
| Currency exchange | (85,882) | 14,334 |
| Utilities | 4,426 | 23,280 |

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| | | |
|--|----------------|----------------|
| Depreciation | 197,041 | 28,535 |
| | 788,127 | 972,850 |
| LOSS BEFORE OTHER ITEMS AND INCOME TAX | \$ (384,234) | \$ (493,599) |
| INTEREST INCOME | 508 | 794 |
| WRITE DOWN OF INVESTMENT | -- | (32,500) |
| LOSS BEFORE INCOME TAX | \$ (383,726) | \$ (525,305) |
| INCOME TAX (RECOVERY) | -- | -- |
| NET LOSS | \$ (383,726) | \$ (525,305) |
| DEFICIT, BEGINNING | (2,924,432) | (1,606,102) |
| DEFICIT, ENDING | \$ (3,308,158) | \$ (2,131,407) |
| NET LOSS PER SHARE | \$ (0.03) | \$ (0.04) |
| WEIGHTED AVERAGE NUMBER OF SHARES | 12,896,533 | 11,831,916 |

--See Notes to Consolidated Financial Statements.--

F-4

FLEXIBLE SOLUTIONS INTERNATIONAL, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR YEARS ENDED DECEMBER 31, 2005 AND 2004
(U.S. DOLLARS)

| | YEARS ENDED DECEMBER 31, | |
|--|--------------------------|-----------------------|
| | 2005 | 2004 |
| | | RESTATED (SEE NOTE |
| OPERATING ACTIVITIES | | |
| Net income (loss) | \$ (1,176,751) | \$ (1,25 |
| Stock compensation expense | 525,450 | 29 |
| Depreciation | 685,768 | 38 |
| Write down of investments | -- | 3 |
| Changes in non-cash working capital items: | 34,467 | (53 |
| (Increase) Decrease in accounts receivable | (257,091) | 43 |
| (Increase) Decrease in inventory | (898,391) | (90 |
| (Increase) Decrease in prepaid expenses | (6,035) | (3 |
| Increase (Decrease) in accounts payable | 440,975 | 9 |

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| | | |
|--|-------------|-------|
| Increase (Decrease) in income taxes | 64,045 | (|
| Increase (Decrease) in amounts due to shareholders | -- | (|
| ----- | | |
| CASH (USED IN) OPERATING ACTIVITIES | (622,030) | (96 |
| ----- | | |
| INVESTING ACTIVITIES | | |
| Short-term investments | 559,440 | 4,47 |
| Investments | (98,000) | |
| Loan receivable | 3,342 | (2 |
| Acquisition of the assets of Donlar Corporation | -- | (3,19 |
| Development of patents | (143,822) | |
| Acquisition of property and equipment | (92,805) | (12 |
| ----- | | |
| CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES | 228,154 | 1,13 |
| ----- | | |
| FINANCING ACTIVITIES | | |
| Short-term loan | (3,150,000) | |
| Proceeds from issuance of common stock | 3,458,286 | 5 |
| ----- | | |
| CASH PROVIDED BY FINANCING ACTIVITIES | 308,296 | 5 |
| ----- | | |
| Effect of exchange rate changes on cash | 53,075 | 9 |
| ----- | | |
| INFLOW (OUTFLOW) OF CASH | (32,503) | 32 |
| Cash and cash equivalents, beginning | 558,795 | 23 |
| ----- | | |
| CASH AND CASH EQUIVALENTS, ENDING | \$ 526,292 | \$ 55 |
| ----- | | |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | |
| Interest paid | \$ 64,275 | \$ 6 |
| Interest received | 508 | 3 |
| ----- | | |

--See Notes to Consolidated Financial Statements.--

F-5

FLEXIBLE SOLUTIONS INTERNATIONAL, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2005 AND 2004
(U.S. DOLLARS)

CAPITAL IN ACCUMULATED

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| | SHARES | PAR VALUE | EXCESS OF PAR VALUE AS RESTATED (NOTE 3) | EARNINGS (DEFICIENCY) AS RESTATED (NOTE 3) | COMPREHENSIVE INCOME |
|---------------------------|------------|-----------|---|---|-------------------------|
| BALANCE DECEMBER 31, 2003 | 11,794,916 | \$ 11,794 | \$ 7,082,813 | \$ (873,862) | \$ |
| Translation adjustment | -- | -- | -- | -- | -- |
| Net income (loss) | -- | -- | -- | (1,257,545) | |
| Comprehensive income | -- | -- | -- | -- | -- |
| Shares issued: | | | | | |
| Exercise of stock options | 37,000 | 38 | 57,463 | -- | |
| Stock option compensation | -- | -- | 299,345 | -- | |
| BALANCE DECEMBER 31, 2004 | 11,831,916 | \$ 11,832 | \$ 7,439,621 | \$ (2,131,407) | \$ |
| Translation adjustment | -- | -- | -- | -- | -- |
| Net income (loss) | -- | -- | -- | (1,176,751) | |
| Comprehensive income | | | | | |
| Shares issued: | | | | | |
| Exercise of stock options | 162,000 | 162 | 226,638 | -- | |
| Private placement | 987,400 | 987 | 3,250,509 | -- | |
| Stock option compensation | -- | -- | 525,450 | -- | |
| BALANCE DECEMBER 31, 2005 | 12,981,316 | \$ 12,981 | \$ 11,442,218 | \$ (3,328,158) | \$ |

--See Notes to Consolidated Financial Statements.--

F-6

FLEXIBLE SOLUTIONS INTERNATIONAL, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2005
(U.S. DOLLARS)

1. BASIS OF PRESENTATION.

These consolidated financial statements include the accounts of Flexible Solutions International, Inc. (the "Company"), and its wholly-owned subsidiaries Flexible Solutions, Ltd. ("Flexible Ltd."), NanoChem Solutions

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Inc., WaterSavr Global Solutions Inc., NanoDetect Technologies Inc. and Seahorse Systems Inc. All inter-company balances and transactions have been eliminated. The parent company was incorporated May 12, 1998 in the State of Nevada and had no operations until June 30, 1998 as described below.

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

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

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

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

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

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

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

The acquisition costs assigned to property and equipment are all direct costs incurred by the Company to purchase the Donlar assets. These costs include due diligence fees paid to outside parties

F-7

investigating and identifying the assets, legal costs directly attributable to the purchase of the assets, plus applicable transfer taxes. These costs have been assigned to the individual assets based on their proportional fair values and will be amortized based on the rates associated with the related assets.

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2. SIGNIFICANT ACCOUNTING POLICIES.

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

(a) Cash and Cash Equivalents.

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

(b) Inventory and Cost of Sales.

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

(c) Property, Equipment and Leaseholds.

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

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

Property and equipment are written down to net realizable value when management determines there has been a change in circumstances which indicates its carrying amount may not be recoverable. No write-downs have been necessary to date.

(d) Impairment of Long Lived Assets.

The Company assesses the recoverability of its long lived assets by determining whether the carrying value of the long lived assets can be recovered over their remaining lives through undiscounted future operating cash flows using a discount rate reflecting the Company's average cost of funds. The assessment of the recoverability will be impacted if estimated future operating cash flows are not achieved. For the years ended December 31, 2005 and 2004, no impairment charges have been recognized.

F-8

(e) Investments.

Investment in corporations subject to significant influence and investments in partnerships are recorded using the equity method of accounting. On this basis, the Company's share of income and losses of the corporations and partnerships is included in earnings and the Company's investment therein

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adjusted by a like amount. Dividends received from these entities reduce the investment accounts. Portfolio investments not subject to significant influence are recorded using the cost method.

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

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

(f) Foreign Currency.

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

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

(g) Revenue Recognition.

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

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

(h) Stock Issued in Exchange for Services.

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

(i) Stock-based Compensation.

The Company applies the fair value based method of accounting prescribed by Statement of Financial Accounting Standards ("FAS") No. 123, Accounting for Stock-based Compensation, in accounting for stock issued in exchange for services to consultants and non-employees.

F-9

FAS No. 123 encourages, but does not require, companies to record compensation cost for stock-based compensation plans to employees at fair value.

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The Company has chosen to account for stock-based compensation to employees and directors using Accounting Principles Board Opinion ("APB") No. 25, Accounting for Stock Issued to Employees. Accordingly, compensation cost for stock options for employees is measured as the excess, if any, of the quoted market price of the Company's stock at the date of the grant over the amount an employee is required to pay for the stock.

The Company adopts the disclosure provisions of FAS No. 123 for stock options granted to employees and directors. The Company discloses on a supplemental basis, the pro-forma effect of accounting for stock options awarded to employees and directors, as if the fair value based method had been applied, using the Black-Scholes option-pricing model.

(j) Comprehensive Income.

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

(k) Income (Loss) Per Share.

Income (loss) per share is calculated by dividing net income (loss) by the weighted average number of shares outstanding. Diluted loss per share is computed by giving effect to all potential dilutive options that were outstanding during the year. For the years ended December 31, 2005, 2004 and 2003, all outstanding options were anti-dilutive.

(l) Use of Estimates.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and would impact the results of operations and cash flows.

(m) Financial Instruments.

The fair market value of the Company's financial instruments comprising cash, short-term investment, accounts receivable, income tax recoverable, loan receivable, accounts payable and accrued liabilities and amounts due to shareholders were estimated to approximate their carrying values due to immediate or short-term maturity of these financial instruments.

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

(n) Recent Accounting Pronouncements.

In December 2004, the Financial Accounting Standards Board ("FASB") issued revised FAS No. 123(R), Share-Based Payment, which replaces FAS No. 123, Accounting for Stock-Based Compensation, which superseded APB Opinion No. 25, Accounting for Stock Issued to Employees. FAS No. 123(R) requires the cost of all share-based payment transactions to be recognized in an entity's financial statements, establishes fair value as the measurement objective and requires entities to apply a fair-value-based measurement method in accounting for share-based payment transactions. FAS No. 123(R) applies to all awards granted,

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modified, repurchased or cancelled after July 1, 2005, and unvested portions of

F-10

previously issued and outstanding awards. The Company will adopt this statement for its first quarter starting January 1, 2006 and will continue to evaluate the impact of adopting this statement.

3. RESTATEMENTS AS A RESULT OF CORRECTING STOCK-BASED COMPENSATION EXPENSE.

In October 2005, while completing a registration statement for securities issued in the second quarter of 2005, the Company determined that certain stock-based compensation expense required adjustment. In September 2002, the Company entered into a distribution agreement with Ondeo Nalco Company ("Ondeo") whereby Ondeo agreed to serve as the exclusive distributor of the Company's WATER\$AVR(R) products for so long as Ondeo maintained a certain threshold sales level as defined in the agreement. As consideration for signing the agreement, Ondeo was granted an option to purchase 2,000,000 shares of the Company's common stock. Half of the option for 1,000,000 shares was exercisable immediately at an exercise price of \$4.25 for each common share. The remaining half of the option for 1,000,000 shares was exercisable after certain threshold sales targets were achieved at a price of \$5.50 for each common share.

In determining the stock-based compensation expense for the nine months ended September 30, 2002, the Company expensed the entire fair value of the stock option believing that the option fully vested upon the signing of the agreement. In the Company's October 2005 review, however, the Company determined that: (i) first, as stated above, half of the option to purchase 1,000,000 shares of common stock did not vest and was not exercisable until the threshold sales target had been met, which would not be until five years after the signing of the distribution agreement; and (ii) second, the Company did not consider Emerging Issues Task Force ("EITF") No. 96-18, Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services; EITF No. 00-18, Accounting Recognition for Certain Transactions Involving Equity Instruments Granted to Other Than Employees; and EITF No. 01-9, Accounting for Consideration Given by a Vendor to a Customer.

To correctly account for the stock options granted to Ondeo, the stock-based compensation expense included in consulting expense should have been measured at the date the performance obligation was complete and then recognized on a rational and systematic manner in relation to the sales achieved by Ondeo. Had the Company correctly accounted for these stock options, stock-based compensation expense for the year would have been nil as no sales had yet been achieved. Instead, the Company recorded a stock-based compensation expense of \$2,704,000 for the year.

During the three months ended March 31, 2003, Ondeo achieved the first threshold sales target, and, accordingly, the Company should have recorded a corresponding stock-based compensation expense of \$54,080. However, since the entire stock-based compensation expense had been recorded in the financial statements for the quarter ended September 30, 2002 and in the year ended December 31, 2002, the Company did not record any additional stock-based compensation expense as a result of the attained first threshold level.

In the fourth quarter of the year ended December 31, 2003, it was determined that Ondeo was not going to attain the minimum sales targets stipulated in the exclusive distributorship agreement. Consequently the exclusive distributorship agreement and corresponding stock options were cancelled. The Company accounted for the cancellation of the stock options in accordance with FAS No. 123, Accounting for Stock-based Compensation, and reversed \$2,480,200 of the stock-based compensation expense previously recorded

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in fiscal 2002. Had the Company accounted for the cancellation of the stock options correctly, it would have reversed the stock-based compensation of expense of \$54,080 that was recorded in the first quarter ended March 31, 2003.

F-11

The following presents the effect on the Company's previously issued financial statements for the years ended December 31, 2004 and 2003:

Balance sheet as at December 31, 2004 -

| | PREVIOUSLY REPORTED | INCREASE (DECREASE) |
|--------------------------------|------------------------|------------------------|
| Capital in excess of par value | \$ 7,663,421 | \$ (223,800) |
| Accumulated deficiency | (2,355,207) | 223,800 |

Statement of operations for the year ended December 31, 2004 -

| | PREVIOUSLY REPORTED | INCREASE (DECREASE) |
|--------------------|------------------------|------------------------|
| Deficit, beginning | \$ (1,097,662) | \$ 223,800 |
| Deficit, ending | (2,355,207) | 223,800 |

Statement of operations for the three months ended December 31, 2004 -

| | PREVIOUSLY REPORTED | INCREASE (DECREASE) |
|--------------------|------------------------|------------------------|
| Deficit, beginning | \$ (1,829,903) | \$ 223,800 |
| Deficit, ending | (2,355,207) | 223,800 |

Balance sheet as at December 31, 2003 -

| | PREVIOUSLY REPORTED | INCREASE (DECREASE) |
|--------------------------------|------------------------|------------------------|
| Capital in excess of par value | \$ 7,306,613 | \$ (223,800) |
| Accumulated deficiency | (1,097,662) | 223,800 |

Statement of operations for the year ended December 31, 2003 -

| | PREVIOUSLY REPORTED | INCREASE (DECREASE) |
|---|------------------------|------------------------|
| Expenses | \$ (816,054) | \$ 2,480,200 |
| Income (loss) before other item and income tax | 1,774,110 | (2,480,200) |
| Income (loss) before income tax | 1,977,420 | (2,480,200) |

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| | | |
|-----------------------------|-------------|-------------|
| Net income (loss) | 2,003,312 | (2,480,200) |
| Net income (loss) per share | 0.17 | (0.21) |
| Deficit, beginning | (3,100,974) | 2,704,000 |
| Deficit, ending | (1,097,662) | 223,800 |

Statement of cash flows for the year ended December 31, 2003 -

| | PREVIOUSLY REPORTED | INCREASE (DECREASE) |
|---------------------------|------------------------|------------------------|
| Net income (loss) | \$ 2,003,312 | \$ (2,480,200) |
| Stock option compensation | (2,357,630) | 2,480,200 |

F-12

Statement of operations for the three months ended December 31, 2003 -

| | PREVIOUSLY REPORTED | INCREASE (DECREASE) |
|---|------------------------|------------------------|
| Expenses | \$ (2,162,917) | \$ 2,480,200 |
| Income (loss) before other item and income tax | 2,268,695 | (2,480,200) |
| Income (loss) before income tax | 2,316,809 | (2,480,200) |
| Net income (loss) | 2,316,809 | (2,480,200) |
| Net income (loss) per share | 0.20 | (0.21) |
| Deficit, beginning | (3,414,471) | 2,704,000 |
| Deficit, ending | (1,097,662) | 223,800 |

4. SHORT-TERM INVESTMENT.

Short-term investment consists of a certificate of deposit bearing interest at 4.03% and maturing September 11, 2005. The Company withdrew the certificate of deposit prior to maturity for the purchase of the assets that formed our NanoChem division and to provide cash flow to operations.

5. LOAN RECEIVABLE.

| | 2005 | 2004 |
|----------------------------------|-----------|-----------|
| 5% loan receivable due on demand | \$ 35,228 | \$ 38,570 |

6. PREPAID EXPENSES.

| | 2005 | 2004 |
|-------------------------------|------------|------------|
| Security deposit and prepaids | \$ 137,315 | \$ 131,280 |

7. PROPERTY, PLANT AND EQUIPMENT.

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| | Cost | Accumulated Amortization | 2005 Net |
|-------------------------|--------------|-----------------------------|--------------|
| Buildings | \$ 3,144,259 | \$ 455,918 | \$ 2,688,341 |
| Computer hardware | 54,258 | 24,296 | 29,962 |
| Furniture and fixtures | 17,258 | 6,293 | 10,965 |
| Office equipment | 29,577 | 14,496 | 15,081 |
| Manufacturing equipment | 2,180,311 | 692,103 | 1,488,208 |
| Trailer | 1,995 | 1,164 | 831 |
| Leasehold improvements | 39,605 | 18,243 | 21,362 |
| Trade show booth | 7,473 | 3,026 | 4,447 |
| Land | 398,186 | -- | 398,186 |
| | \$ 5,872,922 | \$ 1,215,539 | \$ 4,657,383 |

F-13

8. PATENTS

In fiscal 2005, the Company started the patent process for additional WATER\$AVR(R) products. As the patent process is not yet completed, amortization has not yet been recognized. Patents are amortized over their useful lives once granted.

| | 2005 | 2004 |
|---------|------------|------|
| Patents | \$ 143,822 | -- |

9. INVESTMENTS.

| | 2005 | 2004 |
|---|------------|------------|
| Tatko Inc. | \$ 271,000 | \$ 271,000 |
| Air-Water Interface Delivery and Detection Inc. | 98,000 | -- |
| | \$ 369,000 | \$ 271,000 |

On May 31, 2003, the Company acquired an option to purchase a 20% interest in the outstanding shares of Tatko Inc. ("Tatko") for consideration of the issuance of 100,000 shares of the Company's common stock. The option to purchase the shares of Tatko expires on May 31, 2008. The cost of the investment has been accounted for based on the fair market value of the Company's common stock on May 31, 2003. For further information on this option, see Contingencies (Note 18) below.

In 2005, NanoDetect purchased 32.7 shares of equity in Air Water Interface Delivery and Detection Inc. ("AWD") for a total cost of \$98,000. This investment represents only 3.3% of the issued and outstanding shares of AWD and, accordingly, will be accounted for under the cost method.

10. COMPREHENSIVE INCOME (LOSS).

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| | 2005 | 2004 | |
|----------------------------|-------------|----------------|----|
| Net income (loss) | (1,176,751) | \$ (1,257,545) | \$ |
| Other comprehensive income | 53,075 | 97,156 | |
| | (1,123,676) | \$ (1,160,389) | \$ |

F-14

11. INCOME TAX.

Total income tax expenses differs from the amounts computed by applying the combined Canadian federal and provincial statutory rate of 30% to income before income taxes and the U.S. federal statutory rate of 35% to income before income taxes. The income to which this is applied is as follows:

| | 2005 | 2004 | |
|--|-------------|--------------|----|
| Income (loss) before income tax per entity: | | | |
| Flexible Solutions International, Inc. | (749,872) | \$ (652,196) | \$ |
| Flexible Solutions, Ltd. | (690,710) | (677,894) | |
| WaterSavr Global Solutions Inc. | (247,864) | (195,368) | |
| NanoChem Solutions Inc. | 511,695 | 267,915 | |
| Consolidated income (loss) before income tax | (1,176,751) | (1,257,543) | |
| Permanent difference - stock option benefit | 525,450 | 299,345 | |
| Depreciation | (503,705) | -- | |
| Miscellaneous | 12,774 | 7,874 | |
| Taxable income (loss) for tax purposes | (1,142,232) | \$ (950,324) | \$ |

Application of the federal and provincial statutory rates results in the following:

| | 2005 | 2004 | |
|---|------|------|----|
| Expected tax expense (recovery) at statutory rates: | | | |
| From Canadian operations | -- | -- | \$ |
| From U.S. operations | -- | -- | |
| Income tax expense (recovery) | -- | -- | \$ |

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Deferred income taxes reflect the tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The Company's deferred tax liability calculated at a 35% tax rate consists of the following:

| | 2005 | |
|---|-----------|----|
| Non-capital loss carry forwards | 1,304,321 | \$ |
| Book over tax value of property and equipment | (452,944) | |
| Valuation allowance | (851,377) | |

F-15

The Company's losses for income tax purposes were \$3,726,632 (2004 - \$1,598,701), which may be carried forward to apply against future income tax, expiring between 2010 and 2025. The future tax benefit of these loss carry-forwards has been offset with a full valuation allowance. These losses expire as follows:

| | | |
|------|----|-----------|
| 2010 | \$ | 93,649 |
| 2014 | | 392,655 |
| 2015 | | 679,350 |
| 2018 | | 16,858 |
| 2019 | | 13,414 |
| 2022 | | 268,007 |
| 2023 | | 403,187 |
| 2024 | | 1,336,940 |
| 2025 | | 522,572 |

12. NET INCOME (LOSS) PER SHARE.

| | Net income (loss) (numerator) As Restated (Note 3) | Shares (denominator) |
|-----------------------|---|-------------------------|
| 2005 Basic net income | \$ (1,176,751) | 12,541,084 |
| 2004 Basic net income | \$ (1,257,545) | 11,827,734 |
| 2003 Basic net income | \$ (476,888) | 11,734,880 |

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Options to purchase 1,060,740 shares of the Company's common stock at prices ranging from \$1.40 to \$4.55 per share were outstanding during the year ended December 31, 2005 (2004: options to purchase 1,241,740 shares of the Company's common stock at prices ranging from \$1.00 to \$4.60 per share; and 2003: options to purchase 1,711,000 shares of the Company's common stock at prices ranging from \$1.00 to \$4.25 per share), but were excluded from the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of the Company's common stock. There were no preferred shares issued and outstanding for the years ended December 31, 2005, 2004 or 2003.

13. STOCK OPTIONS.

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

F-16

The following table summarizes the Company's stock option activity for the years ended December 31, 2005 and 2004:

| | Number of shares | Exercise price per share |
|----------------------------|------------------|--------------------------|
| Balance, December 31, 2003 | 1,711,000 | \$1.00 - \$4.25 |
| Granted | 572,740 | \$3.00 - \$4.60 |
| Exercised | (37,000) | \$1.00 - \$2.50 |
| Expired | (5,000) | \$4.25 |
| Cancelled | (1,000,000) | \$1.50 - \$3.50 |
| Balance, December 31, 2004 | 1,241,740 | \$1.00 - \$4.60 |
| Granted | 30,000 | \$3.58 - \$4.40 |
| Exercised | (162,000) | \$1.40 |
| Cancelled | (49,000) | \$3.00 - \$4.25 |
| Balance, December 31, 2005 | 1,060,740 | \$1.40 - 4.55 |

The Company applies APB Opinion No. 25 and related interpretations in accounting for stock options granted to its employees and, accordingly, compensation expense of nil (2004 - nil) was recognized as wages expense. Had compensation expense been determined as provided in FAS No. 123 using the Black-Scholes option-pricing model, the pro forma effect on the Company's net income (loss) and per share amounts would be as follows:

| | 2005 | 2004 |
|--------------------------------|----------------|----------------|
| Net income (loss), as reported | \$ (1,176,751) | \$ (1,257,545) |

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| | | |
|--|-------------|-------------|
| Net income (loss), pro forma | (1,414,520) | (1,647,491) |
| Net income (loss) per share, as reported | (0.09) | (0.11) |
| Net income (loss) per share, pro forma | (0.11) | (0.14) |

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

| | 2005 | 2004 |
|-----------------------|-------|-------|
| Expected life - years | 5.0 | 5.0 |
| Interest rate | 3.85% | 3.5% |
| Volatility | 52% | 49.0% |
| Dividend yield | --% | --% |

During the year ended December 31, 2005, the Company granted 30,000 (2004 - 275,400) stock options to consultants and has applied FAS No. 123 using the Black-Scholes option-pricing model, which resulted in additional expenses of \$9,350 (2004 - \$299,345). During the year ended December 31, 2005, the Company recognized \$93,600 in expenses for 90,000 options granted in the year ended December 31, 2004, but which vested in the year ended December 31, 2005. During the year ended December 31, 2005, 250,000 options, which were granted in 2004, vested according to the fulfillment of certain milestones, which resulted in additional expenses of \$422,500.

F-17

14. WARRANTS

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

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

The following table summarizes the Company's warrant option activity for the year ended December 31, 2005 (no prior activity):

| | Number of shares | Exercise price per share |
|----------------------------|------------------|--------------------------|
| Balance, December 31, 2004 | -- | -- |

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| | | |
|----------------------------|---------|--------|
| Granted | 987,400 | \$4.50 |
| Exercised | -- | -- |
| Cancelled | -- | -- |
| | | |
| Balance, December 31, 2005 | 987,400 | \$4.50 |
| | | |

15. CAPITAL STOCK.

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

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The purpose of these transactions was to provide sufficient working capital for the Company to retire the debt remaining from its acquisition of certain assets from Donlar Corporation in June 2004. Costs associated with these two capital raises were \$471,254, making the net proceeds \$3,231,496.

During the year ender December 31, 2005 the Company issued 162,000 shares of common stock at \$1.40 per share upon exercise of stock options.

During the year ended December 31, 2004, the Company issued 37,000 shares of common stock at prices ranging from \$1.00 to \$2.50 per share upon exercise of stock options.

F-18

16. SEGMENTED, SIGNIFICANT CUSTOMER INFORMATION AND ECONOMIC DEPENDENCY.

The Company operates in two segments:

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

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

The Company's traditional operating activities related to the production and sale of its energy conversation product line. Upon acquiring the Donlar assets, the Company formed NanoChem, which was formed as its wholly-owned subsidiary in exchange for the capital contribution necessary to purchase the Donlar assets. The assets the Company acquired from Donlar include domestic and international patents and business processes relating to the production of TPAs

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and other environmental products and technologies, as well as a manufacturing plant. These assets are currently used by NanoChem for its revenue-producing activities.

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

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

| | EWCP | BPCA | Tot |
|---------------------------------|--------------|--------------|------|
| Revenue | \$ 1,053,507 | \$ 5,655,877 | \$ 6 |
| Interest revenue | 4,550 | 103 | |
| Interest expense | 6,610 | 57,665 | |
| Depreciation and amortization | 58,084 | 627,684 | |
| Segment profit (loss) | (1,688,446) | 511,695 | (1) |
| Segment assets | 394,122 | 4,407,083 | 4 |
| Expenditures for segment assets | 216,421 | 20,206 | |

There is no segment data for fiscal 2003 as our additional segment was added in June 2004.

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

| | 2005 | 2004 |
|--------------------------|--------------|--------------|
| Canada | \$ 121,963 | \$ 712,517 |
| United States and abroad | 6,587,431 | 2,680,420 |
| Total | \$ 6,709,394 | \$ 3,392,937 |

F-19

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

| | 2005 | 2004 |
|---------------|--------------|--------------|
| Canada | \$ 387,892 | \$ 238,807 |
| United States | 4,413,313 | 5,011,539 |
| Total | \$ 4,801,205 | \$ 5,250,346 |

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17. COMMITMENTS.

The Company is committed to minimum rental payments for property and premises aggregating approximately \$358,808 over the term of four leases, the last expiring on June 30, 2009.

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

| | |
|------|---------|
| 2006 | 216,160 |
| 2007 | 58,336 |
| 2008 | 56,208 |
| 2009 | 28,104 |

18. CONTINGENCIES.

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

On November 13, 2003, Patrick Grant, an ex-employee, filed a lawsuit in the Circuit Court of Cook County, Illinois against the Company, WaterSavr Global Solutions Inc. ("WGS"), the wholly-owned subsidiary of the Company and Daniel B. O'Brien, the Company's Chief Executive Officer. The plaintiff claims damages for breach of contract, tortious interference with an agreement and various wrongful discharge claims. The plaintiff seeks monetary damages in excess of \$1,020,000 for the breach of contract and tortious interference claims and unspecified compensatory and punitive damages in the wrongful discharge claims. The parties completed mandatory mediation ordered by the Circuit Court and will next appear in court for case management, at which time the court will set discovery deadlines. The Company considers the case without merit and is vigorously disputing the claims. In addition, the Company intends to file counterclaims against the plaintiff for failure to repay financial obligations owed to the Company of almost \$40,000, as well as unspecified damages arising out of the plaintiff's disclosure of confidential information to a client during his employment at WGS. No amounts have been recorded as receivable and no accrual has been made for any loss in the Company's consolidated financial statements as the outcome of the claim filed by the plaintiff is not determinable.

F-20

On May 28, 2004, Sun Solar Energy Technologies, Inc. ("Sun Solar"), filed a lawsuit in the Federal Court of Canada, against the Company, Flexible Ltd., and Mr. O'Brien. Sun Solar is seeking: (a) a declaration that the trademark "Tropical Fish" is available for use by Sun Solar; (b) injunctive relief against further use of the "Tropical Fish" trademark by the Company; and (c) monetary damages exceeding \$7,000,000 for the alleged infringement by the Company, Flexible Ltd. and Mr. O'Brien of the "Tropical Fish" trademark, as well

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as any other "confusingly similar trademarks" or proprietary trade dresses. On August 9, 2004, the Company, Flexible Ltd. and Mr. O'Brien filed their defense and filed a counterclaim against Sun Solar. The counterclaim seeks: (x) injunctive relief against further use of the "Tropical Fish" trademark by Sun Solar; (y) a declaration that the "Tropical Fish" trademark is owned by the Company, or, in the alternative, is not distinctive and should be struck from the trademark registry; and (z) monetary damages exceeding \$50,000. The parties have completed documentary discovery and examinations for discovery of all parties. No amounts have been recorded as receivable in the Company's consolidated financial statements and no amounts have been accrued as potential losses as the outcome of this claim is not determinable.

On July 23, 2004, the Company filed a breach of contract suit in the Circuit Court of Cook County, Illinois against Tatko. The action arises out of a joint product development agreement entered into between the Company and Tatko in which the Company agreed to invest \$10,000 toward the product development venture and granted to Tatko 100,000 shares of the Company's restricted common stock. In return, Tatko granted the Company a five-year option to purchase 20% of Tatko's outstanding capital stock. Tatko has since refused to collaborate on the agreement and the Company seeks declaratory relief stating that Tatko is not entitled to the 100,000 shares of the Company's restricted common stock. The litigation is still pending at this time.

In addition, Tatko filed its own suit on September 24, 2004 in the Circuit Court of Cook County, Illinois seeking declaratory relief of its entitlement to the Company's restricted common stock. On May 23, 2005, the Tatko suit was dismissed with prejudice by the Circuit Court.

No amounts have been recorded as receivable in the Company's consolidated financial statements and no amount has been accrued as a loss as the outcome of the claim against Tatko is not determinable.

19. SUBSEQUENT EVENTS.

On January 24, 2006, in the course of generating the audited financial statements for the quarter and year ended December 31, 2005, the Company discovered a material inventory error in the financial statements filed as part of its Form 10-QSB for the quarter ended September 30, 2005. In conducting the inventory count at its NanoChem facility for the quarter ended September 30, 2005, the Company overstated its inventory by \$183,398. This clerical error led to the Company's decision to restate the financial statements for the three months ended September 30, 2005. Accordingly, the Company's previously issued financial statements covering the quarter ended September 30, 2005 should no longer be relied upon.

On January 25, 2006, management discussed the conclusion described above with the Company's audit committee of the board of directors ("Audit Committee") and Cinnamon Jang Willoughby & Company ("CJW"), the Company's independent registered public accounting firm. CJW informed the Audit Committee that it concurs with management's conclusion described above. As a result, on February 1, 2006, the Company filed amended consolidated financial statements for the quarter ended September 30, 2005.

F-21

Statement of operations for the nine months ended September 30, 2005 -

PREVIOUSLY
REPORTED

INCREASE
(DECREASE)

RESTATE

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| | | | | | | |
|--------------------|----|-------------|----|-----------|----|-----|
| Cost of goods sold | \$ | 2,686,485 | \$ | 183,398 | \$ | 2, |
| Gross margin | | 2,503,318 | | (183,398) | | 2, |
| Net income (loss) | | (609,627) | | (183,398) | | (|
| Earnings per share | | (0.05) | | (0.01) | | |
| Deficit, beginning | \$ | (2,131,407) | | -- | \$ | (2, |
| Deficit, ending | | (2,741,034) | | (183,398) | | (2, |

Statement of operations for the three months ended September 30, 2005 -

| | | PREVIOUSLY REPORTED | | INCREASE (DECREASE) | | RESTATE |
|--------------------|----|------------------------|----|------------------------|----|---------|
| Cost of goods sold | \$ | 554,540 | \$ | 183,398 | \$ | (|
| Gross margin | | 747,547 | | (183,398) | | |
| Net income (loss) | | (185,508) | | (183,398) | | (|
| Earnings per share | | (0.01) | | (0.02) | | |
| Deficit, beginning | \$ | (2,555,526) | \$ | -- | \$ | (2, |
| Deficit, ending | | (2,741,034) | | (183,398) | | (2, |

Balance sheet as at September 30, 2005 -

| | | PREVIOUSLY REPORTED | | INCREASE (DECREASE) | | RESTATE |
|--------------------|----|------------------------|----|------------------------|----|---------|
| Inventory | \$ | 2,355,729 | \$ | (183,398) | \$ | 2, |
| Deficit, beginning | \$ | (2,131,407) | | -- | \$ | (2, |
| Deficit, ending | | (2,741,034) | | (183,398) | | (2, |

20. COMPARATIVE FIGURES.

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

F-22

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 8A. CONTROLS AND PROCEDURES.

Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our periodic reports to the SEC is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and regulations, and that such information is accumulated and communicated to our management, including our principal

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executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. Our disclosure controls and procedures are designed to provide a reasonable level of assurance of reaching our desired disclosure control objectives.

As of the end of the period covered by this Annual Report on Form 10-KSB for the year ended December 31, 2005, we carried out an evaluation, under the supervision and with the participation of management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined under Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended). Based upon that evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to us (including our consolidated subsidiaries) that is required to be included in our periodic reports.

The prior accounting treatment of our stock-based compensation expense was done in consultation and in accordance with the advice of our independent accountants. Moreover, the restatement relative to our inventory was a clerical error. Accordingly, management does not believe that the restatements of our financial statements indicate or result from a material weakness with respect to our disclosure controls and procedures or our internal controls over financial reporting.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 8B. OTHER INFORMATION.

None.

28

PART III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(A) OF THE EXCHANGE ACT.

DIRECTORS AND EXECUTIVE OFFICERS

The following table sets forth our directors and officers and their respective ages and positions:

| Name | Age | Position |
|-----------------------|-----|---------------------|
| Daniel B. O'Brien | 49 | President, Director |
| John H. Bientjes | 52 | Director |
| Dr. Robert N. O'Brien | 84 | Director |
| Dale Friend | 49 | Director |
| Eric Hodges | 57 | Director |

Daniel B. O'Brien has served as the President and Chief Executive Officer, as well as a director, of our company since June 1998. He has been involved in the swimming pool industry since 1990, when he founded our

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subsidiary, Flexible Ltd., which was purchased by us in 1998. From 1990 to 1998, Mr. O'Brien was also a teacher at Brentwood College where he was in charge of outdoor education.

John H. Bientjes has been a member of our board of directors since February 2000. Since 1984, Mr. Bientjes has served as the manager of the Commercial Aquatic Supplies Division of D.B. Perks & Associates, Ltd., located in Vancouver, British Columbia, a company that markets supplies and equipment to commercial swimming pools which are primarily owned by municipalities. Mr. Bientjes graduated in 1976 from Simon Fraser University in Vancouver, British Columbia with a Bachelor of Arts Degree in Economics and Commerce.

Dr. Robert N. O'Brien has been a member of our board of directors since June 1998. Dr. O'Brien was a Professor of Chemistry at the University of Victoria from 1968 until 1986 at which time he was given the designation of Professor Emeritus. He held various academic positions since 1957 at the University of Alberta, the University of California at Berkley, and the University of Victoria. While teaching, Dr. O'Brien acted as a consultant and served on the British Columbia Research Council from 1968 to 1990. In 1987, Dr. O'Brien founded the Vancouver Island Advanced Technology and Research Association. Dr. O'Brien received his Bachelor of Applied Science in Chemical Engineering from the University of British Columbia in 1951; his Masters of Applied Science in Metallurgical Engineering from the University of British Columbia in 1952; his Ph.D. in Metallurgy from the University of Manchester in 1955; and was a Post Doctoral Fellow in Pure Chemistry at the University of Ottawa from 1955 through 1957. Dr. Robert N. O'Brien and Daniel B. O'Brien are father and son.

Dale Friend was elected a director in December 2002. Ms. Friend has served as the company comptroller for a Lock and Security firm in Vancouver since August 2004. She was a Senior Trust Analyst for Alderwoods Group, a company engaged in funeral and mortuary services, from August 2002 to February 2003. She also served as an Advanced Accountant for such firm from 1999 to August 2002. From 1979 to 1998, Ms. Friend was with Telus in various accounting, auditing and financial planning positions.

Eric Hodges was elected a director in September 2004. Mr. Hodges is an accountant from Victoria who has over three decades of experience. He received his financial education from the University of Washington in Seattle where he played for the Huskies football program. Mr. Hodges continued playing football after college, with a successful, multiyear professional career with the British Columbia Lions of the Canadian Football League. In the past five years, Mr. Hodges has owned and

29

operated Eric G. Hodges & Associates, a Victoria-based accounting firm with both Canadian and U.S. clientele. Eric is extremely familiar with both Canadian and United States generally accepted accounting principles ("GAAP"), since he has clients in both countries. Furthermore, his wide range of experience with small and quickly growing companies will be an asset to the board of directors.

Directors are elected annually and hold office until the next annual meeting of our stockholders and until their successors are elected and qualified. We reimburse directors for any expenses incurred in attending board of directors meetings. We also compensate directors \$1,000 annually and grant the three independent directors an option to purchase 5,000 common shares each year that they serve. There have been no material changes to the procedures by which security holders may recommend nominees to our board of directors. All executive offices are chosen by the board of directors and serve at the board's discretion.

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BOARD COMMITTEES

Our board of directors has established an Audit Committee and a Compensation Committee.

Audit Committee

Our Audit Committee, consisting of John Bientjes, Dale Friend and Eric Hodges, all of whom are independent directors and have strong financial backgrounds, facilitates and maintains open communications among our board of directors, our Audit Committee, senior management and our independent auditors. Our Audit Committee also serves as an independent and objective party to monitor our financial reporting process and internal control system. In addition, our Audit Committee reviews and appraises the efforts of our independent auditors. Our Audit Committee meets periodically with management and our independent auditors. The Audit Committee held [FOUR] meetings in fiscal 2005 and all members participated. Our board of directors has determined that Mr. Bientjes meets the SEC's definition of audit committee financial expert. Each of the members of the Audit Committee are "independent," as such term is used in Item 7(d) (3) (iv) of Schedule 14A under the Securities Exchange Act of 1934, as amended.

Compensation Committee

Our Compensation Committee, consisting of Dr. Robert O'Brien and John Bientjes, establishes salary, incentive and other forms of compensation for our Chief Executive Officer, and administers our stock option programs. Our Compensation Committee meets periodically with management and our independent auditors. The Compensation Committee held one meeting in fiscal 2005 and both of the members participated.

CODE OF ETHICS

Between the year ended December 31, 2003 and July 2005, we had not adopted a written Code of Ethics applicable to our senior management and senior financial staff. However, effective as of August 2005, our board of directors has adopted a Code of Ethics that applies to our Chief Executive Officer, our Chief Financial Officer and our Principal Accounting Officer, as well as to the other senior management and senior financial staff of our company. Our Code of Ethics complies with the requirements imposed by the Sarbanes-Oxley Act of 2002 and the rules and regulations issued thereunder for codes of ethics applicable to such officers. Our board of directors has reviewed and will continue to evaluate its role and responsibilities with respect to the new legislative and other requirements of the SEC. Interested persons can obtain a copy of our Code of Ethics, without charge and upon request, by writing to: Investor Relations, c/o Flexible Solutions International, Inc. 615 Discovery St., Victoria, British Columbia, V8T

30

5G4, CANADA. Interested persons may also obtain a copy of our Code of Ethics by printing it from the "Investor Info--Insider Trading Reports" page of our website, at <http://www.flexiblesolutions.com>.

SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Based solely upon a review of our records, we are not aware of any of our officers, directors or beneficial owners of more than 10% of our securities that failed to timely file one or more reports disclosing beneficial ownership of our securities as required under Section 16(a) of the Securities Exchange Act of 1934, as amended, during the fiscal year ended December 31, 2005.

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ITEM 10. EXECUTIVE COMPENSATION.

EXECUTIVE COMPENSATION

SUMMARY COMPENSATION TABLE

The following table sets forth certain information about the compensation paid or accrued to the person who was our Chief Executive Officer (the "named executive officer") during the fiscal year ended December 31, 2005.

| | ANNUAL COMPENSATION | | | | LONG-TERM COMPE | |
|-------------------|---------------------|--------|-------|---------------------------------|----------------------------|--|
| | Year | Salary | Bonus | Other Annual Compensation | Awards | |
| | | | | | Restricted Stock Awards | Securities Underlying Options/SARs |
| | | (\$) | (\$) | (\$) | (\$) | (#) |
| Daniel B. O'Brien | 2005 | 98,914 | -- | -- | -- | -- |
| President, Chief | 2004 | 40,000 | -- | -- | -- | 20,000 |
| Executive Officer | 2003 | 40,000 | -- | -- | -- | 50,000 |

OPTION/SAR GRANTS IN LAST FISCAL YEAR (INDIVIDUAL GRANTS)

The following table provides certain information about the stock options granted to the named executive officer in the year ended December 31, 2004. There were no stock options granted to the named executive officer in the year ended December 31, 2005.

| Name | No. of Securities Underlying Options/SARs Granted (#) | Percent of Total Options/SARS Granted to Employees in Fiscal Year | Exercise or Base Price (\$/share) |
|-------------------|--|---|--------------------------------------|
| Daniel B. O'Brien | 50,000 shares | 15.3% | \$3.00 |

31

AGGREGATED OPTION/SAR EXERCISES IN LAST FISCAL YEAR AND FISCAL YEAR-END OPTION/SAR VALUES

The following table sets forth certain information about stock options exercised in fiscal 2005 and the value of unexercised stock option held as of December 31, 2005 by the named executive officer.

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| Name | Shares Acquired on Exercise (#) | Value Realized (\$) | Number of Securities Underlying Unexercised Options/SARs at FY-End (#) | | Value |
|-------------------|---------------------------------------|---------------------------|--|---------------|--------------|
| | | | Exercisable | Unexercisable | Options/SARs |
| Daniel B. O'Brien | 100,000 | \$140,000 | 120,000 | 0 | \$434,500 |

DIRECTOR COMPENSATION

We have agreed to issue to our non-employee directors options to purchase 5,000 shares of our common stock annually for serving as a director. However, Dr. Robert N. O'Brien will not receive director options in any year in which he receives options for other services. We currently pay Dr. O'Brien additional options for assisting in research and development and patent prosecution. The amount of such options are determined annually by the board of directors with Dr. O'Brien abstaining from the vote on such matter. No options were granted in fiscal 2005. In fiscal 2004, Dr. O'Brien received the following options for such services and he did not receive director options:

| Option Price | No. of Options | Expiration |
|--------------|----------------|------------|
| \$3.00 | 25,000 | December |

Our outside directors received the following options in 2004:

| Name | Option Price | No. of Options | Expiration |
|------------------|--------------|----------------|------------|
| John H. Bientjes | \$3.00 | 5,000 | December |
| Dale Friend | \$3.00 | 5,000 | December |
| Eric Hodges | \$3.00 | 5,000 | December |

EMPLOYMENT CONTRACTS AND CHANGE IN CONTROL ARRANGEMENTS

We have not entered into any employment agreements or change in control agreements with the named executive officer.

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

The following table sets forth certain information regarding the beneficial ownership of our common stock as of March 2, 2006 by (i) each stockholder who is known by us to own beneficially more than five percent of our

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outstanding common stock, (ii) each member of our board of directors, (iii) the named executive officer, and (iv) by all of our executive officers and directors as a group. The information as to each person or entity has been furnished by such person or group.

| | Shares Beneficially Owned (1) | |
|-------------------------------|-------------------------------|------------|
| | Common Stock | Percentage |
| Daniel B. O'Brien (2) (3) | 4,746,900 | 36.6% |
| Dr. Robert N. O'Brien (2) (3) | 1,875,000 | 14.4% |
| John Bientjes | 25,000 | 0.2% |
| Dale Friend | - | - |
| Eric Hodges | - | - |
| | | |
| As a group (5 persons) | 6,646,900 | 51.2% |

- (1) Applicable percentage of ownership at March 2, 2006, is based upon 12,981,316 shares of Common Stock outstanding. Beneficial ownership is determined in accordance with the rules of the SEC and includes voting and investment power with respect to shares shown as beneficially owned. Shares of common stock subject to options or warrants currently exercisable or exercisable within 60 days of March 2, 2006, are deemed outstanding for computing the shares and percentage ownership of the person holding such options or warrants, but are not deemed outstanding for computing the percentage ownership of any other person or entity.
- (2) Address for this shareholder is 2614 Queenswood Dr., Victoria, British Columbia, V8N 1X5, CANADA.
- (3) Includes shares which may be acquired on the exercise of stock options as follows.

| Name | No. of Options | Exercise Price | Ex |
|--------------------|----------------|----------------|-----|
| Daniel O'Brien | 50,000 | \$4.25 | Dec |
| | 20,000 | \$3.60 | Dec |
| | 50,000 | \$3.00 | Nov |
| Dr. Robert O'Brien | 25,000 | \$4.25 | Dec |
| | 25,000 | \$3.60 | Dec |
| | 25,000 | \$3.00 | Nov |
| John Bientjes | 5,000 | \$4.25 | Dec |
| | 5,000 | \$3.60 | Dec |
| | 5,000 | \$3.00 | Nov |
| Dale Friend | 5,000 | \$4.25 | Dec |
| | 5,000 | \$3.60 | Dec |
| | 5,000 | \$3.00 | Nov |
| Eric Hodges | 5,000 | \$3.60 | Dec |
| | 5,000 | \$3.00 | Nov |

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SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS

For a tabular description of securities authorized for issuance under equity compensation plans, please refer to Item 5 hereof.

33

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

Our director, Dr. Robert N. O'Brien, developed substantially all of our products and has assigned his patent rights to such products to us. We have no agreement with Dr. O'Brien requiring him to conduct any research and development activities for us, but we anticipate that any future inventions which may be of interest to us will continue to be assigned to us by Dr. O'Brien, although he has no legal obligation to do so. Dr. O'Brien does not receive any salary or royalties from us for any research and development activities, although our board of directors does consider such activities undertaken by Dr. O'Brien when it grants stock options to Dr. O'Brien. Dr. O'Brien is a member of our board of directors, but abstains from all proceedings of the board concerning his stock option grants. Please refer to Item 10 above for further information. Dr. O'Brien is the father of our Chief Executive Officer, Daniel B. O'Brien.

ITEM 13. EXHIBITS.

| Number | Description |
|--------|--|
| 3.1 | Articles of Incorporation of the Registrant. (1) |
| 3.2 | Bylaws of the Registrant. (1) |
| 21.1 | Subsidiaries. (2) |
| 23.1 | Consent of Independent Accountants. |
| 31.1 | Certification of Principal Executive Officer Pursuant to ss.302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Principal Financial Officer Pursuant to ss.302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Principal Executive Officer Pursuant to 18 U.S.C. ss.1350 and ss.906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Principal Financial Officer Pursuant to 18 U.S.C. ss.1350 and ss.906 of the Sarbanes-Oxley Act of 2002. |

- (1) Previously filed as an exhibit to our Registration Statement on Form 10-SB filed with the Commission on February 22, 2000, and incorporated herein by reference.
- (2) Previously filed as an exhibit to our Registration Statement on Form SB-2 filed with the Commission on January 22, 2003, and incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

Cinnamon Jang Willoughby & Company, Certified Public Accountants ("CJW"), are our independent auditors and have examined our financial statements for each of the fiscal years ended December 31, 2005 and 2004.

AUDIT FEES

CJW was paid aggregate fees of \$27,357 and \$23,240 for the for the fiscal years ended December 31, 2005 and 2004, respectively, for professional services rendered in the audit of our annual financial statements and for the reviews of the financial statements included in our quarterly reports on Form

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10-QSB during these fiscal years.

AUDIT-RELATED FEES

CJW was paid \$25,305 for the fiscal year ended December 31, 2005 for assurance and related services reasonably related to the performance of the audit or review of our financial statements. No such fees were paid for the fiscal year ended December 31, 2004.

34

TAX FEES

CJW was paid aggregate fees of \$2,150 and \$2,075 for the fiscal years ended December 31, 2005 and 2004, respectively, for professional services rendered for tax compliance, tax advice and tax planning. The nature of these services was the calculation and filing of our income tax returns for the fiscal years ended December 31, 2005 and 2004.

ALL OTHER FEES

CJW was paid no other fees for professional services during the fiscal years ended December 31, 2005 and 2004.

AUDIT COMMITTEE PRE-APPROVAL POLICIES

Rules adopted by the SEC in order to implement requirements of the Sarbanes-Oxley Act of 2002 require public company audit committees to pre-approve audit and non-audit services. Effective as of December 2002, our Audit Committee has adopted a policy for the pre-approval of all audit, audit-related and tax services, and permissible non-audit services provided by our independent auditors. The policy provides for an annual review of an audit plan and budget for the upcoming annual financial statement audit, and entering into an engagement letter with the independent auditors covering the scope of the audit and the fees to be paid. Our Audit Committee may also from time-to-time review and approve in advance other specific audit, audit-related, tax or permissible non-audit services. In addition, our Audit Committee may from time-to-time give pre-approval for audit services, audit-related services, tax services or other non-audit services by setting forth such pre-approved services on a schedule containing a description of, budget for and time period for such pre-approved services. The policies require our Audit Committee to be informed of each service and the policies do not include any delegation of our Audit Committee's responsibilities to management. Our Audit Committee may delegate pre-approval authority to one or more of its members. The member to whom such authority is delegated will report any pre-approval decisions to our Audit Committee at its next scheduled meeting.

During the year ended December 31, 2005, our Audit Committee approved 100% of the total fees that were paid to CJW. Our Audit Committee has determined that the rendering of all other non-audit services by CJW is compatible with maintaining CJW's independence. During the year ended December 31, 2005, none of the total hours expended on our financial audit by CJW were provided by persons other than CJW's full-time permanent employees.

SIGNATURES

In accordance with the requirements of Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: March 6, 2006.

FLEXIBLE SOLUTIONS INTERNATIONAL, INC.

By: /s/ DANIEL B. O'BRIEN

 Name: Daniel B. O'Brien
 Title: President and Chief Executive Officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

| Signature | Title | Date |
|---|--|---------------|
| /s/ DANIEL B. O'BRIEN ----- Daniel B. O'Brien | President and Chief Executive Officer (principal executive officer), Chief Financial Officer (principal accounting officer) and Director | March 6, 2006 |
| /s/ JOHN H. BIENTJES ----- John H. Bientjes | Director | March 7, 2006 |
| /s/ ROBERT N. O'BRIEN ----- Robert N. O'Brien | Director | March 7, 2006 |
| /s/ DALE FRIEND ----- Dale Friend | Director | March 7, 2006 |
| /s/ ERIC G. HODGES ----- Eric G. Hodges | Director | March 7, 2006 |

