Annual Report

For the year ended 31 December 2013

HALOSOURCE

A WATER TECHNOLOGY COMPANY

HaloSource, Inc.

Annual Report

For the Year Ended

31 December 2013

Financial Highlights

HaloSource, Inc. is a clean water technology company that develops and manufactures products and out-licenses proprietary technology for the water treatment and antimicrobial coatings markets. The Company operates in four primary business segments: Water Purification (through its “HaloPure” brand), Recreational Water (through its “SeaKlear” brand), Environmental Water (through its “HaloKlear” brand), and Anti-microbial Coatings (through its “HaloShield” brand). A summary of the 2013 financial highlights is provided below:

Financial Highlights (in $000's except share and per share amounts)		2012		2013	Change
Revenue by Segment					
Recreational water (SeaKlear)	$	8,809	$	11,385	30%
Environmental water (HaloKlear)	$	2,099	$	1,303	-37%
Water purification (HaloPure)	$	2,149	$	3,214	50%
Anti-microbial coatings (HaloShield)	$	214	$	161	-25%
Total consolidated	$	13,271	$	16,063	21%
Gross Margin	$	4,371	$	6,532	
Gross Margin%		33%		41%	
Total operating expenses	$	16,628	$	18,560	
Operating loss	$	(12,257)	$	(12,028)	
Net loss	$	(12,401)	$	(12,463)	
Net loss per share - basic and diluted	$	(0.14)	$	(0.08)	
Shares used to compute basic and diluted loss per share (in 000's)		91,853		156,411	
Cash used in operating activities	$	(11,168)	$	(12,367)	

2013 Highlights

We continued to make progress in 2013 with several key achievements and milestones announced, all of which provides a solid foundation for future growth in line with the strategic plan:

- Drinking Water: As a key component of our strategic plan we further tightened our focus as an innovation partner to global corporations such as Perfect, Tupperware, and Eureka Forbes. In December 2013 we extended the stand-still agreement with the world's largest gravity-fed water purifier company for another year, continuing to ship cartridges in support of their test market and, ultimately, national launch. We also completed a supply agreement for pitchers and pitcher cartridges with H2O International, a key conduit to one of the world's largest consumer product companies.

- Recreational Water: Growth in the segment rebounded in 2013 as we expanded distribution, drove better sales force execution, and brought an exciting new line of consumer and service friendly water care products to market led by our SeaKlear® line of Mighty Pods™ products. Sales of Mighty Pods products exceeded expectations by a significant margin in our first year of launch and with increasing uptake we are very excited for the future of this convenient form factor as we expand the line to include above-ground pool and hot tub applications in addition to our current in-ground pool line up. We opened up new distribution channels and geographies with the largest pool and spa retailer in the US and the world's largest retailer.

- Environmental Water: The business struggled during 2013; however, with most of the issues now behind us and a clear focus on forming strategic partnerships as the route to market, just as in other aspects of our business, we have been able to increase our sales with targeted major industry players. We will continue to focus on deployment of our class leading biopolymer chemistry and our innovation pipeline for this segment through these partners with a focus on regulated and environmentally sensitive applications.

Chairman & Chief Executive's Statement

2013 was another year of progress for our company as we continued to gain traction with the strategy put in place just under 2 years ago. This focuses our efforts toward innovation in water purification chemistry as a component of the treatment solutions offered by strategic partners with significant market reach/reputation and ownership.

This focus in each segment of our business enables our engineers and scientists to create and continuously improve the application of our unique, class leading solutions to the challenges faced by end users and consumers in each aspect of the businesses we serve.

We are establishing ourselves as the innovation partner for a number of important strategic players who are already well established as market and channel leaders in their segments. While many of our solutions are impactful in themselves, they can often be used in conjunction with other chemistry or technologies to significantly improve "system" performance in terms of output, efficacy in contaminant kill and/or removal, as well as improving the safety and environmental footprint of the original technology deployed.

In Drinking Water, deployment of our unique bromine based HaloPure® purification technology not only meets and exceeds U.S. Environmental Protection Agency and China Ministry of Health standards for germ kill, but we are now developing advanced applications which remove other highly toxic water borne contaminants from solution, such as lead, arsenic and fluoride.

In Environmental Water, our greener biopolymer solutions provide a far lower or even zero environmental impact footprint when compared with other chemical solutions now in use in applications such as construction, storm water management, simple mining, and oil and gas. In addition, our solutions can be highly tailored according to each issue being faced and/or used in combination with other established technologies (reverse osmosis, for example) to create significant improvements in output, cost of operation, total cost of ownership and wastage.

Similarly, in the Recreational Water business our focus is on contaminant removal and ease of use/dosing led by our Mighty Pods products which provide crystal clear and clean water while reducing the need for excessive levels of harsh chemicals. Consumer, Retail and Service industry reaction to our Mighty Pods products format tells us we are onto a real winner in this segment as simplicity, safety and effectiveness at a reasonable premium overcomes the complexity, mess and safety concerns of the backyard chemistry set.

We are very encouraged by our progress in 2013 and are only now scratching the surface of the huge opportunities that exist for commercial applications of our water purification technology in the global market place. We will continue to focus our approach through the creation of strategic partnerships as the route to market.

We are very excited at the prospects for growth in all segments of our business in 2014 and beyond as we reach for cash flow breakeven and aggressive future growth funded from business operations. We will continue to focus on being a company worthy of our people, our partners, our customers and consumers while making a critical difference in the world by bringing clean water to those we serve.

Jerry Wetherbee
Chairman of the Board of Directors
25 March 2014

Martin Coles
President and Chief Executive Officer, Director
25 March 2014

Business and Financial Review

Group revenue for 2013 increased 21% year-on-year to $16.1 million, driven by significant growth in the Company's Recreational Water revenue to $11.4 million (up 30% from $8.7 million in 2012) and Drinking Water revenue to $3.2 million (up 50% from $2.1 million in 2012). The Company signed several new supply agreements specific to its Recreational Water and Drinking Water businesses which opened up new distribution channels and created continued expansion and awareness of the Company's products in these two segments.

Revenue from the Company's Environmental Water segment of $1.3 million was 37% lower compared with $2.2 million in 2012, which management believes was driven primarily by difficulties in overcoming regulatory hurdles in international markets as well as adverse weather conditions in the western United States. With regulatory issues now behind us and the right partnerships being put in place we anticipate a strong return to growth in 2014 and beyond.

The Company's antimicrobial coatings revenue of $0.2 million did not change significantly from the previous year.

Gross margins, at 41%, improved from 2012, as the Company started to benefit from scale efficiencies across both our Drinking Water and Recreational Water businesses, as well as improved margins due to sales mix and lower raw material costs in our Recreational Water business. Operating expenses totaled $18.6 million, up from $16.6 million in 2012. The net loss for the year was $12.4 million, essentially unchanged from 2012, which includes the impact of non-cash costs related to share based compensation of $0.6 million and $0.7 million in 2013 and 2012. During the second half of 2013, the Company embarked on an even more aggressive cost management effort with the goal of lowering spending by 15% in 2014. Management believes improved margins and our cost reduction efforts should reduce cash consumption going forward.

At 31 December 2013, the Company had a total of $13.0 million in cash, comprised of cash and cash equivalents ($1.8 million), restricted cash ($1.9 million) and short-term investments ($9.3 million). The Company believes it has sufficient capital to fund its plans for future growth and execute against its strategy.

Technology and Product Development

As a primary driver of our strategy, our technology development efforts continue to march forward. During 2013 we received US patent approval for a number of key innovations including the next generation of our bead chemistry, Poly II. This advancement is very exciting as it enables us to cut the complexity and cost of manufacturing while maintaining the same level of efficacy, a major step forward in our point of use drinking water technology.

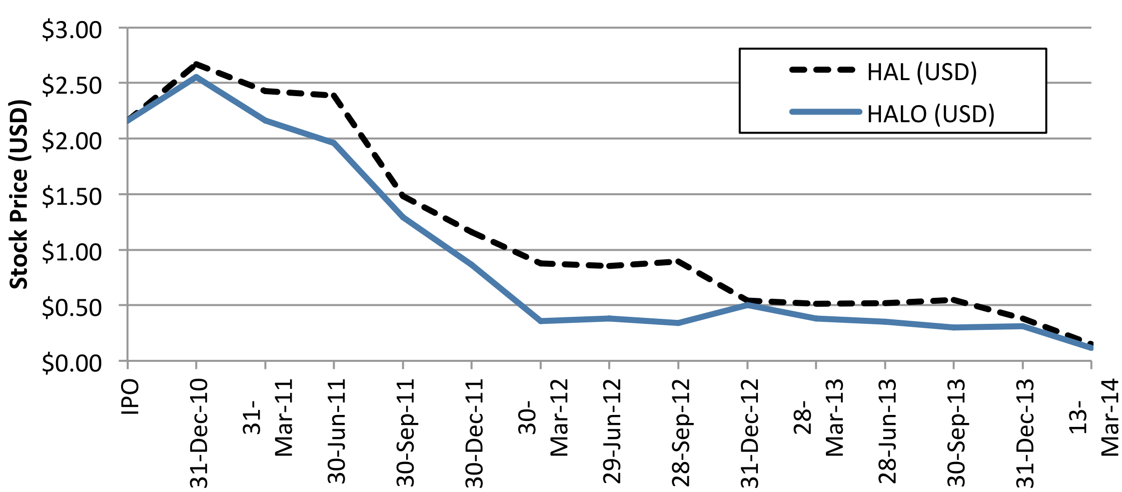
Employee Headcount

Employee headcount at the beginning of the year was 118 and as of 31 December 2013 stood at 126. The increase from the prior year is due primarily to additions associated with production ramps in China. For 2014, with cash-flow breakeven in mind, we expect headcount to continue to expand in production areas but fall in all other areas.

Outlook

We made significant positive progress in 2013, advancing our efforts to become the "innovation partner" to our customers. We continue to be approached regularly by leading multi-national companies who seek our expertise in water chemistry. We believe, in the long run, these relationships will continue to deliver highly scalable revenue via indirect channels to market.

Share Price Performance



NOTE: HAL is restricted Reg-S stock and HALO is unrestricted

Key Risks and Uncertainties

The Company continues to face and address a number of key risks and uncertainties as it grows and scales its businesses.

- Economic environment – risks are inherent as we operate in multiple markets on multiple continents. These risks manifest themselves in the form of industry risk, currency risk and political risk.
- Partner adoption pacing – as we go to market with and through strategic partners, we continue to be dependent upon partner pacing for product launches and channel execution.
- Consumer acceptance – as we launch finished consumer products, acceptance of these offerings in the marketplace is critical to achievement of our growth targets.
- Regulatory hurdles – we intend to continue investing, proactively, in meeting all international and country regulatory, safety and efficacy standards. The timing of these processes and approvals is difficult to predict; however, the Company is establishing a track record of achievement and clearances.
- Competition – technology development is dynamic and the Company continues to invest and innovate against a strong platform of synthetic and natural polymers, intellectual property and new products.
- Key personnel – finding and keeping strong people is vital to our business and growth plans. We are building out Human Resources capabilities across the organization and investing in the development of our Leadership Team and high-potential staff.
- Key raw materials costs or disruption in the availability of raw materials – some of our products rely on key commodities which are subject to rising prices. Changes in raw material availability may both affect prices and our ability to obtain adequate amounts of such raw materials. We manage procurement of key commodities through our global supply chain organization, including, but not limited to, evaluating new suppliers and working with existing suppliers, and pass through cost increases when economics dictate.
- Liquidity and funding – the Company has a history of losses and expects to incur further operating losses in the near future. In order to generate sufficient revenue to achieve profitability, the Company must successfully maintain its existing relationships and build new relationships with its customers to develop the reach and application of the Company's technologies. There can be no assurance that these efforts will be successful. The Company was successful in raising $25 million through a secondary offering of its common stock in October 2012. Management believes current funding will be sufficient to finance the Company's operations for at least one year from the date of signing the financial statements. However, if necessary, the Company may seek to raise additional funds beyond 2014. If adequate funds are not available, the Company may be required to reduce the scope, delay or eliminate some or all of its planned commercial activities.
- Going concern - In determining the appropriate basis of preparation of the financial statements, we are required to consider whether the company can continue in operational existence for the foreseeable future. We remain positive about the direction, focus and momentum of the business. We further have a reasonable expectation, supported by cash flow forecasts that the Company's existing resources and facilities provide it with adequate funding to support its activities and continue in operational existence for the foreseeable future. It is on this basis that we consider it appropriate to prepare the financial statements on a going concern basis. The financial statements do not include the adjustments that would result if the company was unable to continue as a going concern.
- Litigation – from time to time we receive claims and inquiries from third parties alleging that our technology may infringe the third parties' proprietary rights, especially patents. Third parties have also asserted claims against us alleging contract breaches, fraudulent misrepresentation or

misappropriation. These claims, even if not meritorious, could force us to spend significant financial and managerial resources.

Directors of HaloSource, Inc.

The Company's board is committed to high standards of corporate governance and aims to follow appropriate governance practice. As a company incorporated in the U.S. and listed on AIM, the Company is not subject to the requirements of the UK Combined Code. The board currently comprises two executive directors and five independent non-executive directors, and the roles and responsibilities of Chairman and CEO are separated. Periodically the directors review the composition of the board, and consider whether additional skills are required linked to the Company's objectives at the time. Initial appointment of a new director is made by the board and then put to shareholders for ratification in general meeting. Subsequently, each director is put forward for re-election to the shareholders every year. Biographies of the directors appear below, and demonstrate a range of experience and calibre to bring the right level of independent judgment to the board. The board is responsible for the group's system of internal control and for reviewing its effectiveness. Such a system can only provide reasonable, but not absolute, assurance against material misstatement or loss. The board believes that the group has internal control systems in place appropriate to the size and nature of its business. The board is satisfied that the scale of the group's activities do not warrant the establishment of an internal audit function. The board is also responsible for identifying the major business risks faced by the group and for determining the appropriate course of action to manage those risks. Formal meetings are held quarterly to review strategy, management and performance of the group, with additional meetings between those dates convened as necessary. The audit committee, which comprises a majority of the non-executive directors and is chaired by Massoud Entekhabi, considers and determines actions in respect of any control or financial reporting issues they have identified or that are raised by the auditors. The board has a formal schedule of matters specifically reserved to it for decision. Details of the constitution of the compensation committee are provided in the Corporate Governance Statement on page 10. The members of the Board are as follows:

Jerry Lynn Wetherbee: (aged 68) Non-Executive Chairman

Mr. Wetherbee served as HaloSource's President and Chief Executive Officer from June 1999 to March 2004 when he became Chairman. Prior to joining the Company, he held the position of chief executive officer of Spectrum Aeromed, Inc., a medical-equipment manufacturing firm, for four years to 1998. His career also includes 17 years in the healthcare industry as executive vice president and chief operating officer of Sterling Healthcare Corporation in Bellevue, WA, president and chief executive officer of Crest View Hospital in Casper, WY, and as associate administrator and chief operating officer at Memorial Hospital of Natrona County in Casper, WY where he started in 1977. Mr. Wetherbee spent eight years in the United States Air Force as an engineer and pilot. He holds both a BS and MS in Mechanical Engineering from the University of North Dakota.

Martin Patrick Coles: (aged 58) President, Chief Executive Officer and Director

Mr. Coles joined HaloSource as a member of the Board in July 2011 and was appointed President and Chief Executive officer in October 2011. Prior to joining the Company, he held the positions of Chief Operating Officer and later, President of Starbucks Coffee International. His career also includes 35 years of serving in a variety of senior executive and board roles at companies including Procter & Gamble, PepsiCo, Nike and Reebok. He also served as a non-executive director at Levi Strauss. Mr. Coles began his career at Procter & Gamble UK in 1977 as a graduate entry Production Manager. Mr. Coles currently serves on the not-for-profit International Education Advisory Board which is affiliated with the Seattle School District and as Chairman of the University of Washington Business School at Bothell advisory board, and has previously served as Chairman of the UW Foster Business School advisory board and as a member of the Albers Business School advisory board of Seattle University, where he remains a fellow of the Albers Business School. He is a graduate of the University of Wales at Swansea where he received a BSc in Biochemistry.

James Allan Thompson: (aged 43) Chief Financial Officer, Senior Vice President, Business Development and Director

Mr. Thompson joined HaloSource in August 2004 as Chief Financial Officer. Mr. Thompson was re-appointed Senior Vice President Business Development in October 2013, which position he previously served from January 2012 to July 2012. Mr. Thompson also served as General Manager - Americas from July 2012 to October 2013.. Prior to joining HaloSource, Mr. Thompson was a principal with Alexander Hutton Venture Partners, LP, a regional venture capital firm investing in emerging growth companies, and formerly an associate with Alexander Hutton Capital, LLC where he raised capital for technology start-ups in the Pacific Northwest of the US. Prior to business school, he was a securities analyst with Security Capital Group and began his career as a credit analyst for Continental Illinois National Bank. Mr. Thompson has a BBA from Gonzaga University and an MBA from the University of Washington.

Kent Lawrence Johnson: (aged 70) Non-Executive Director

Mr. Johnson has served on the Board since March 2002. Mr. Johnson is a managing director of Alexander Hutton Venture Partners, LP, a venture capital fund he co-founded in 1999 and which is a shareholder of the company. He is also a managing director of Aebig & Johnson Business Resolutions, LLC. Mr. Johnson was a founding board member of F5 Networks Inc. (NASDAQ:FFIV) and Ostex International, Inc (NASDAQ:OSTX) and is currently a director of Access Technology Solutions and Vera Whole Health, Inc. In the mid-1990s he was chairman and founder of Alexander Hutton Capital, LLC, a NASD-registered broker/dealer. Mr. Johnson was chief executive officer of two software companies and a forest products company from 1980 to 1994. He started his career as a management consultant and CPA with Arthur Anderson LP in 1971, having previously served as an officer in the US Army. Mr. Johnson has a BA in business administration from the University of Washington and an MBA from Seattle University, where he was formerly a member of the Board of Trustees and audit committee and currently is an adjunct professor. At Seattle University he is also an advisory board member of the Business School's Entrepreneurship Center and endowed the Lawrence K. Johnson Chair of Entrepreneurship in 2001.

Alan Roy Matthews: (aged 52) Non-Executive Director

Mr. Matthews has served on the Board since July 2008. He is currently Chief Financial Officer of Anthesis Consulting Group, a newly established global sustainable business practice consultancy. Previously he served for 5 years as managing director of corporate finance at Origo Partners Plc, a London listed private equity investment business focused on Asia. Mr Matthews has held board positions with a number of international companies operating in developing markets, responsible for financial functions, business development and corporate strategy. He brings over 20 years' experience in investment banking with roles in research, corporate finance and corporate broking at ANZ, Beeson Gregory (now Investec), HSBC and Seymour Pierce. He has been involved in a large number of fundraisings for companies in both private and public markets, across a broad range of industry sectors including technology, consumer and business services. After reading history at Cambridge University, he qualified as a Chartered

Accountant with PricewaterhouseCoopers in its London office. He is a member of the UK's Securities & Investment Institute and an alumnus of the London Business School.

Michael Elliott Ducey: (aged 65) Non-Executive Director

Mr. Ducey has served on the Board since October 2010. He is the ex-chief executive officer of Compass Minerals International, Inc., a NYSE listed salt producer where he was initially appointed as President in 2002. Mr. Ducey has 40 years of experience in the chemical industry, starting in 1972 with Borden Chemical where he had various roles in management, sales, marketing, planning & commercial development, including serving as president and chief executive officer. He has considerable board experience: currently he is a director of Apollo Global Management, Inc., a NYSE listed private equity organization and Verso Paper Holding, Inc., a NYSE listed paper company. He was the non-executive chairman of TPC Group, Inc., a formally NASDAQ listed hydrocarbons company, ex-director of Smurfit-Stone Container Corp., a formally NYSE listed corrugated container producer and ex-director of UAP Holding, Inc., a formally NYSE listed agricultural chemical company. Mr. Ducey has a BA in Economics from Otterbein College and an MBA from the University of Dayton.

Massoud Entekhabi: (aged 59) Non-Executive Director

Mr. Entekhabi has served on the Board since October 2010. He is currently a member of Zenith Equity Partners, a private investment firm in Southern California which he founded in 2003, and is also a Director, Chief Operating Officer and Chief Financial Officer at Prime Focus World NV, a Hollywood, California based world leader in offering visual effects and 3D Conversion services to the major film studios globally. Prior to this he was a general partner and a managing director of TL Ventures, a venture capital firm with $1.4 billion of assets under management, from 2000. Mr. Entekhabi has significant experience with listed technology companies, having been a director of GMarket, Ixia and Fastclick, which are or were all NASDAQ listed companies, as well as having been on the boards of a number of private technology companies. Mr. Entekhabi has over three decades of experience in accountancy having started his career with Coopers & Lybrand (later PricewaterhouseCoopers) in 1973 in London. He is a Fellow of the Institute of Chartered Accountants in England & Wales and a CPA (U.S.).

Board meetings and attendance

The following table shows the attendance of Directors at meetings of the Board, and attendance of committee members at meetings of the Audit Committee, Compensation Committee, Nomination Committee and AIM Rules Compliance and Corporate Governance Committee, during the 2012 financial year.

	Board	Audit Committee	Compensation Committee	Nomination Committee	AIM Rules Compliance and Corporate Governance Committee
Number of Meetings Held	**7**	**6**	**3**	**4**	**4**
J Wetherbee	7	4	-	2	4
M Coles	7	-	-	4	-
J Thompson	6	-	-	-	3
K Johnson	7	6	3	-	-
A Matthews	6	-	3	-	4
M Ducey	6	-	-	4	4
M Entekhabi	5	5	2	-	3

Corporate Governance Statement

The Company has taken note of the UK Corporate Governance Code ("the UK Code", formerly "the Combined Code") published in June 2010 and has applied its principles of corporate governance commensurate with the Company's size, notwithstanding that the rules of the London Stock Exchange do not require companies that have securities traded on AIM to formally comply with the UK Code. The UK Code and associated guidance can be found on the Financial Reporting Council website at **www.frc.org.uk/corporate/ukcgcode.cfm**. The Board is accountable to the Company's shareholders for good governance and the statement set out below describes how the principles identified in the UK Code are applied to the Company.

The Company has established an Audit Committee, a Compensation Committee, a Nominations Committee and an AIM Rules Compliance and Corporate Governance Committee with the following roles within the Company:

Audit Committee

The current members of the Audit Committee are Massoud Entekhabi (Chairman), Jerry Wetherbee and Kent Johnson. Meetings will be held not less than three times a year. As Chief Financial Officer, James Thompson will be invited to attend meetings where appropriate and the Company's auditors will be regularly invited to attend meetings including at the planning stage before the audit and after the audit at the reporting stage. The role of the committee is to consider matters relating to the appointment of the Company's auditors and the independence of the Company's auditors and review the integrity of the Company's annual and interim reports, preliminary results announcements and any other formal announcement relating to its financial performance. The committee will also review the effectiveness of the Company's system of internal control, compliance procedures and overall risk management.

Compensation Committee

The current members of the Compensation Committee are Kent Johnson (Chairman), Massoud Entekhabi and Alan Matthews. The primary duty of the committee is to determine and agree with the Board the framework or broad policy for the remuneration of the Company's Executive Directors and such other members of the executive management as it is designated to consider. The remuneration of the Non-Executive Directors is a matter for the Chairman and the Company's Executive Directors. No Director or manager may be involved in any decisions as to their own remuneration.

Nomination Committee

The current members of the Nomination Committee are Michael Ducey (Chairman), Jerry Wetherbee and Martin Coles. The Nomination Committee is responsible for identifying and nominating members of the Board, recommending directors to be appointed to each committee of the Board and the chair of such committees and overseeing the evaluation of the Board.

AIM Rules Compliance and Corporate Governance Committee

The current members of the AIM Rules Compliance and Corporate Governance Committee are Michael Ducey (Chairman), Jerry Wetherbee, Alan Matthews, Massoud Entekhabi, and James Thompson. The committee will meet at least four times a year and at any other time when requested by a member of the committee. The committee will be responsible for, *inter alia*, monitoring the quality of internal procedures and controls to enable compliance by the Company with the AIM Rules for Companies and the timely and accurate disclosure of all information that is required to be disclosed in order to satisfy the Company's legal and regulatory obligations. The Company has adopted a share dealing code for Directors and key employees which the Directors believe appropriate for an AIM quoted company. The Company will comply with Rule 21 of the AIM Rules for Companies relating to directors' dealings and, in addition, will take all reasonable steps to ensure compliance by the Company's applicable employees.

Relations with Shareholders

Copies of the Annual Report and Financial Statements are issued to all shareholders and copies are available on the Company's website (www.halosource.com). The Company also uses its website to provide information to shareholders and other interested parties. The Corporate Secretary and Chief Financial Officer also deal with shareholder correspondence as and when it arises throughout the year. At the Annual General Meeting the shareholders are entitled to raise questions and queries, and the Chairman along with the Chief Executive Officer and other Directors are available before and after the meeting for further discussions with shareholders. The Chief Executive Officer and Chief Financial Officer have regular meetings with institutional investors, private client brokers, individual shareholders, fund managers and analysts to discuss information made public by the Company. The Chairman and the Non-Executive Directors are always available to shareholders on all matters relating to governance and strategy.

Internal Control

The Board is ultimately responsible for the Company's system of internal control and reviewing its effectiveness on an ongoing basis. The system is designed to manage rather than eliminate the risk of failure to achieve the Company's strategic objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss. The key risk management processes and internal control procedures include the following:

- The close involvement of the Executive Directors in all aspects of the day-to-day operations, including regular meetings with senior staff from across the Company and a review of the monthly operational reports compiled by senior management;

- Clearly defined responsibilities and limits of authority. The Board has responsibility for strategy and has adopted a schedule of matters which are required to be brought to it for decision;

- A comprehensive system of financial reporting, forecasting and budgeting. Detailed budgets are prepared annually for all parts of the business. Reviews occur through the management structure culminating in a Company budget which is considered and approved by the Board. Company management accounts are prepared monthly and submitted to the Board for review. Variances from budget and prior year are closely monitored and explanations are provided for significant variances.

- A continuous process for identifying, evaluating and managing significant risks across the Company together with a comprehensive annual review of risks which covers both financial and non-financial areas. The Board is committed to maintaining high standards of business conduct and ethics, and has an ongoing process for identifying, evaluating and managing any significant risks in this regard. The Board is also responsible for the operation and review of the Company's whistle-blowing policy. The internal control procedures are delegated to the Executive Directors and senior management and are reviewed in the light of the ongoing assessment of the Company's significant risks.

Martin Coles
President, Chief Executive Officer and Director
25 March 2014

Directors' Report

For the Year-ended 31 December 2013

Principal Activities

HaloSource, Inc. is a clean water and antimicrobial technology company that develops and manufactures products and out-licenses proprietary technology for the water treatment and antimicrobial coatings markets. The Company's technologies are based upon proprietary polymer chemistries that can be applied to commonplace starting materials, both synthetic (e.g. polystyrene, vinyl, polyester) and natural (e.g. cotton) in a wide range of applications. The Company's principal antimicrobial technology was developed at Auburn University in the early 1990's.

Business Review

The information that fulfils the requirements of the business review, including details of the 2013 results, principal risks and uncertainties and the outlook for future years are set out in the Chairman's Statement and the Business and Financial Review, on page 5.

Dividends

The Directors do not recommend the payment of a dividend and no dividends have been paid during the year.

Directors

The following Directors held office during the 2013 financial year and up to the date of signing the financial statements:

- Jerry Wetherbee
- Martin Coles
- James Thompson
- Kent Johnson
- Alan Matthews
- Michael Ducey
- Massoud Entekhabi

Biographical details of the Directors are shown on page 7.

Re-election of Directors

Each Director is re-elected annually at the Company's Annual General Meeting ("AGM"). The 2014 AGM is scheduled for 9:30 a.m. PDT on 24 April 2014 at the Company's headquarters located at 1725 220th Street SE, Suite 103, Bothell, Washington 98021.

Directors' Remuneration and Interests

The Remuneration Report is set out on page 15. It includes details of Directors' remuneration, interests in the shares of the Company and share options.

Health and Safety

The Company is fully aware of its obligations to maintain high health and safety standards at all times, and the safety of our customers and employees is of paramount importance. The Company's operations are managed at all times in such a way as to ensure, so far as reasonably practical, the health, safety and welfare of all of our employees and all other persons who may be attending our premises.

Corporate Governance

The Board's Corporate Governance Report is set out on page 10.

Share Capital and Substantial Shareholdings

Details of the share capital of the Company as at 31 December 2013 are set out in Note 9 to the consolidated financial statements. At 26 March 2014, a total of 156,484,041 of common shares were outstanding and the Company had received notification that the following have an interest in more than 3% of the issued ordinary share capital:

Invesco Perpetual	41.1%
Baillie Gifford & Co	5.0%
Henderson Global Investors	4.8%
JO Hambro Capital Management	4.8%
UBS Prime Brokerage	3.9%
Asia Merchant Capital II	3.8%
Investec Asset Management	3.3%

Directors' Responsibilities Statement

Under Washington corporate law all corporate powers are exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its Board of Directors, subject to any limitation set forth in the articles of incorporation. In accordance with the UK Corporate Governance Code to which the Company has elected to adhere, the Board of Directors is responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations. Under Washington corporate law, the corporation is required to prepare and disseminate financial statements for each financial year. Consequently, management has prepared the consolidated financial statements in accordance with Generally Accepted Accounting Principles in the United States (U.S. GAAP) and the Board of Directors has accepted the responsibility for approval of the consolidated financial statements in accordance with its responsibilities.

Under Washington Corporate Law;

(1) A Director shall discharge the duties of a director, including duties as member of a committee:
- (a) In good faith;
- (b) With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
- (c) In a manner the director reasonably believes to be in the best interests of the corporation.

(2) In discharging the duties of a director, a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(a) One or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;
(b) Legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or
(c) A committee of the Board of Directors of which the Director is not a member if the Director reasonably believes the committee merits confidence.

(3) A Director is not acting in good faith if the director has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (2) above unwarranted.

(4) A Director is not liable for any action taken as a director, or any failure to take any action, if the director performed the duties of the Director's office in compliance with the foregoing.

Auditors and Disclosure of Information to Auditors

All of the current Directors have taken all the steps that they ought to have in order to make themselves aware of any information needed by the Company's auditors for the purposes of their audit and to establish that the auditors are aware of that information. The Directors are not aware of any relevant audit information of which the auditors are not aware.

Independent Auditors

BDO USA, LLP have indicated their willingness to continue in office. A resolution concerning their reappointment will be proposed at the Annual General Meeting.

Martin Coles
President, Chief Executive Officer and Director
25 March 2014

Remuneration report

As an AIM quoted Company HaloSource, Inc. is not required to comply with Schedule 8 of The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008. The following disclosures are therefore made on a voluntary basis. The information is unaudited.

Remuneration Policy

Remuneration policy in respect of Executive Directors is designed to ensure that the Company achieves its potential and increases shareholder value. In respect of basic salary, the objective is to ensure that the Company retains and attracts high caliber executives with the skills, experience and motivation necessary to direct and manage the affairs of the Company. The remuneration consists of the following elements:

Base pay

Executive Directors' base pay is designed to reflect the experience, capabilities and role within the business. Salary levels are reviewed annually and are benchmarked against the median position in similar companies.

Annual bonus

All Executive Directors and members of senior management participate in the Company's annual bonus scheme (Management Incentive Plan), which is based on the achievement of individual and Company performance targets.

Service Contracts

The Executive Directors entered into employment agreements at their hire-dates. Employment can be terminated by either Party at any time. These agreements also include six-month severance obligations which are described in detail in part IX in the Company's Admission Document.

All non-executive Directors are appointed for successive annual terms for an initial period of three years and are terminable at any time by Non-Executive Directors vacating his or her office as a Director, being removed from office by a valid resolution of the Shareholders or by failing to be elected annually by the Shareholders. Further detail on non-Director service contracts are described in detail in part IX in the company's Admission Document. The Director's remuneration for the 2013 financial year is as follows:

	Salary/Fees $US	Performance related bonus $US	Share-based payments $US	Benefits in kind[1] $US	Total 2013 $US	Total 2012 $US
Non-Executive Chairman:						
J Wetherbee	63,000	-	10,000	-	73,000	51,370
Executive:						
M Coles	425,000	50,000	270,837	10,414	756,251	778,584
J Thompson	255,481	25,000	10,013	7,714	298,208	240,757
Non-Executive:						
M Ducey	50,000	-	10,000	-	60,000	39,970
M Entekhabi	50,000	-	10,000	-	60,000	39,970
K Johnson[2]	-	-	10,000	-	10,000	17,470
A Matthews	50,000	-	10,000	-	60,000	39,970
Total	$ 893,481	$ 75,000	$ 330,850	$ 18,128	$ 1,317,459	$ 1,208,091

[1] Benefits in kind reflect medical, life insurance and long term disability insurance premiums paid by the Company, as well as matching contributions paid by the Company to its 401(k) retirement plan.
[2] Mr. Johnson's fee of $50,000 and $22,500 for 2013 and 2012, respectively, was paid to Alexander Hutton Venture Partners, LP where he is a managing director.

The interests of the Directors at 31 December 2013 in the shares of the Company, not including interests of investment funds in respect of which the Director may have a managerial interest, and with respect to which such Director disclaims beneficial ownership, were:

	Number of Common Shares
Kent Johnson	834,605
Jerry Wetherbee	416,976
James Thompson	438,395
Martin Coles	472,790
Michael Ducey	337,591
Massoud Entekhabi	102,133
Alan Matthews	207,133

Share Options

Options over ordinary shares awarded to Executive Directors under the Stock Option Plans in place on 31 December 2013 were:

Option Holder	Scheme	Type of Option	Date of Grant	Earliest exercise date and date of vesting	Exercise price	Number of shares
M Coles	2010 Equity Incentive	NSO	21 July 2011	Performance Vesting	$1.42	200,000
	2010 Equity Incentive	ISO	1 November 2011	1 November 2012	$1.00	400,000
	2010 Equity Incentive	NSO	1 November 2011	1 November 2012	$1.00	400,000
	2010 Equity Incentive	ISO	19 January 2012	1 November 2012	$0.86	200,000
	2010 Equity Incentive	NSO	21 November 2012	21 November 2013	$0.60	300,000
	2010 Equity Incentive	NSO	25 April 2013	25 April 2014	$0.37	400,000
	2010 Equity Incentive	NSO	25 April 2013	Performance Vesting	$0.37	300,000
J Thompson	2002 Share Option	ISO	19 July 2007	18 July 2008	$0.33	25,000
	2002 Share Option	ISO	17 January 2008	16 January 2009	$0.85	175,000
	2002 Share Option	ISO	15 January 2009	15 January 2010	$0.52	125,000
	2002 Share Option	ISO	21 January 2010	21 January 2011	$0.28	125,000
	2010 Equity Incentive	ISO	19 January 2012	19 January 2013	$0.86	18,293
	2010 Equity Incentive	ISO	25 April 2013	25 April 2014	$0.37	70,000



Consolidated Financial Statements

Years ended December 31, 2012 and 2013

HALOSOURCE

A WATER TECHNOLOGY COMPANY

HaloSource, Inc. and Subsidiaries

Contents

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Seattle, WA 98101

Independent Auditor's Report

Board of Directors and Stockholders
HaloSource, Inc.
Bothell, Washington
United States of America

We have audited the accompanying consolidated financial statements of HaloSource, Inc. and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2012 and 2013, and the related consolidated statements of comprehensive loss, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of HaloSource, Inc. and its subsidiaries as of December 31, 2012 and 2013, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

BDO USA, LLP

Seattle, Washington
United States of America

March 25, 2014

Consolidated Financial Statements

HaloSource, Inc. and Subsidiaries

Consolidated Balance Sheets

	As of December 31, 2012 US$000	As of December 31, 2013 US$000
	(except share data)	
ASSETS		
Current assets		
Cash and cash equivalents	$ 15,635	**$ 1,762**
Restricted cash	1,871	**1,941**
Short-term investments	9,329	**9,314**
Accounts receivable, less allowance for doubtful accounts of $13 in 2012, $20 in 2013	3,582	**6,085**
Inventories — net	3,702	**3,626**
Prepaid expenses and other current assets	1,090	**1,539**
Total current assets	35,209	**24,267**
Property and equipment — net	3,697	**4,018**
Goodwill	2,180	**2,180**
Other intangible assets — net	968	**846**
Deposits	264	**276**
Total assets	$ 42,318	**$ 31,587**
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 2,085	**$ 2,549**
Accrued expenses and other current liabilities	572	**1,257**
Salaries and benefits payable	493	**603**
Current portion of debt and capital lease obligations	1,252	**1,082**
Total current liabilities	**4,402**	**5,491**
Long-term portion of debt and capital lease obligations	64	**45**
Deferred rent	1,172	**1,167**
Deferred tax liability	74	**104**
Total liabilities	5,712	**6,807**
Commitments and contingencies (Note 7)		
Stockholders' equity		
Common stock, no par value; 200,000,000 shares authorized; 156,193,131 and 156,484,041 issued and outstanding at December 31, 2012 and 2013, respectively	130,097	**130,665**
Accumulated other comprehensive income (loss)	4	**73**
Accumulated deficit	(93,495)	**(105,958)**
Total stockholders' equity	36,606	**24,780**
Total liabilities and stockholders' equity	$ 42,318	**$ 31,587**

See accompanying notes to consolidated financial statements.

HaloSource, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Loss

	Years ended December 31, 2012 US$000	**2013 US$000**
	(except per share data)	
Revenue - net	$ 13,271	**$ 16,063**
Cost of goods sold	8,900	**9,531**
Gross profit	4,371	**6,532**
Operating expenses		
Research and development	2,541	**2,656**
Selling, general, and administrative	14,087	**15,904**
Total operating expenses	16,628	**18,560**
Operating loss	(12,257)	**(12,028)**
Other income (expense), net		
Other income (expense), net	2	**(27)**
Interest income	61	**128**
Interest expense	(130)	**(178)**
Foreign exchange loss	(39)	**(315)**
Total other expense, net	(106)	**(392)**
Loss before income taxes	(12,363)	**(12,420)**
Income taxes	(38)	**(43)**
Net loss	(12,401)	**(12,463)**
Other comprehensive income (loss)		
Unrealized loss on available-for-sale investments	(2)	**(35)**
Foreign currency translation adjustments	15	**104**
Other comprehensive income	13	**69**
Comprehensive loss	$ (12,388)	**$ (12,394)**
Basic and diluted net loss per share	$ (0.14)	**$ (0.08)**
Shares used to compute basic and diluted loss per share (000's)	91,853	**156,411**

See accompanying notes to consolidated financial statements.

HaloSource, Inc. and Subsidiaries

Consolidated Statements of Stockholders' Equity

	Common Stock Shares 000	Common Stock Amount US$000	Accumulated Other Comprehensive Income (Loss) US$000	Accumulated Deficit US$000	Total Stockholders' Equity US$000
Balance, January 1, 2012	74,451	$ 104,785	$ (9)	$ (81,094)	$ 23,682
Exercise of common stock options	1,568	255	-	-	255
Issuance of shares upon vesting of restricted stock	174	-	-	-	-
Issuance of unvested restricted stock	-	112	-	-	112
Share-based compensation	-	553	-	-	553
Shares issued, net of offering costs	80,000	24,392	-	-	24,392
Other comprehensive income	-	-	13	-	13
Net loss	-	-	-	(12,401)	(12,401)
Balance, December 31, 2012	156,193	130,097	4	(93,495)	36,606
Exercise of common stock options	8	1	-	-	1
Issuance of shares upon vesting of restricted stock	283	-	-	-	-
Issuance of unvested restricted stock	-	50	-	-	50
Share-based compensation	-	517	-	-	517
Other comprehensive income	-	-	69	-	69
Net loss	-	-	-	(12,463)	(12,463)
Balance, December 31, 2013	156,484	$ 130,665	$ 73	$ (105,958)	$ 24,780

See accompanying notes to consolidated financial statements.

HaloSource, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

	Years ended December 31, 2012 US$000	**2013 US$000**
Operating Activities		
Net loss	$ (12,401)	**$ (12,463)**
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,094	**1,085**
Allowance for inventory, sales returns and bad debts	(55)	**(8)**
Share-based compensation	665	**567**
Loss on disposal of property, equipment and other assets	1	**9**
Realized losses on short-term investments	18	**13**
Deferred income taxes	37	**30**
Changes in operating assets and liabilities:		
Accounts receivable	(1,020)	**(2,561)**
Inventories	491	**(21)**
Prepaid expenses and other assets	(3)	**(514)**
Accounts payable	296	**702**
Accrued expenses and other current liabilities	(96)	**751**
Salaries and benefits payable	(372)	**109**
Deferred rent	177	**(66)**
Net Cash Used in Operating Activities	(11,168)	**(12,367)**
Cash Flows From Investing Activities		
Purchase of property and equipment	(991)	**(1,365)**
Purchase of short-term investments	(7,552)	**(8,122)**
Sales of short-term investments	8,500	**8,090**
Increase in restricted cash	(25)	**(73)**
Net Cash Used in Investing Activities	(68)	**(1,470)**
Cash Flows from Financing Activities		
Proceeds from public offering, net of offering costs	24,392	**-**
Borrowings under short-term debt	1,240	**89**
Repayments of debt and capital lease obligations	(111)	**(50)**
Proceeds from exercise of stock options	100	**1**
Net Cash Provided by Financing Activities	**25,621**	40
Effect of exchange rate changes on cash	(15)	**(76)**
Net Increase (Decrease) in Cash and Cash Equivalents	14,370	**(13,873)**
Cash and Cash Equivalents, beginning of year	1,265	**15,635**
Cash and Cash Equivalents, end of year	$ 15,635	**$ 1,762**
Supplemental disclosures of cash flow information:		
Cash paid for interest	$ 130	**$ 178**
Cash paid for income taxes	8	**-**
Supplemental disclosures of noncash investing and financing activities:		
Increase in property and equipment from tenant improvement allowance	913	**60**
Proceeds from exercise of stock options reduced by severance payable	155	**-**

See accompanying notes to consolidated financial statements.

1. Summary of significant accounting policies

Nature of business

HaloSource, Inc. and its subsidiaries (together, the “Company” or “HaloSource”) are a global clean water technology company, headquartered near Seattle in Bothell, WA, U.S.A. with subsidiaries in India and China and operations in other markets around the world through its relationships with distributors and other third parties. HaloSource is committed to relentless innovation, industry-leading products and ongoing support for water-related philanthropy. The Company’s proprietary technologies for drinking and recreational water, textile coatings, and environmentally friendly wastewater recycling, enable our partners to rid the world’s water of impurities and return it responsibly to the earth. HaloSource markets its products under its brand names of HaloPure®, HaloShield, SeaKlear®, AquaPill, PoolMark, HaloKlear™, StormKlear and Mighty Pods™.

Basis of presentation

The Company follows accounting standards set by the Financial Accounting Standards Board, commonly referred to as the “FASB”. The FASB sets U.S. generally accepted accounting principles (“U.S. GAAP”) that the Company follows to ensure it consistently reports its financial position, results of operations, and cash flows. The presentation of the Company’s financial information for the years ended December 31, 2012 and 2013 in accordance with U.S. GAAP is appropriate given the Company is incorporated in the State of Washington in the United States. References to U.S. GAAP issued by the FASB in the Company’s notes to its consolidated financial statements are to the FASB Accounting Standards Codification, sometimes referred to as the “Codification” or “ASC”.

Principles of consolidation

The consolidated financial statements include the accounts of HaloSource and its wholly owned subsidiaries: HaloSource International, Inc., HaloSource Asia, Inc., HaloSource Hong Kong Ltd., HaloSource China Inc., SeaKlear Pool Pills LLC, HaloSource Technologies Pvt. Ltd., HaloSource Water Purification Technology (Shanghai) Co. Ltd., HASO Corporation, and HaloSource Water Purification Importacoes Ltda. Intercompany transactions and balances have been eliminated.

Liquidity and Capital Resources

The Company has generally incurred net losses and negative operating cash flows and at December 31, 2013, the Company had an accumulated deficit of approximately $106 million. For the year ended December 31, 2013, the Company’s net loss was $12.5 million and cash used in operating activities was $12.4 million. The Company has implemented certain cost savings measures and implemented other plans that are expected to reduce the net loss and cash used by operations in 2014 as compared to 2013. In order to generate sufficient revenue to achieve profitability, the Company must successfully maintain its existing relationships and build new relationships with its customers to develop the reach and application of the Company’s technologies. There can be no assurance that these efforts will be successful. The Company continues to face significant risks associated with successful execution of its strategy. These risks include, but are not limited to, technology and product development, introduction and market acceptance of new products and services, changes in the marketplace, liquidity, competition from existing and new competitors which may enter the marketplace, and retention of key personnel. Management plans to continue to finance the Company’s operations with a combination of currently available cash and short-term investments and may attempt to raise additional funds in the near future. Management believes current funding will be sufficient to finance the Company's operations through the remainder of 2014; however, if necessary, the Company may seek other financing options during 2014. If adequate funds are not available, the Company may be required to reduce the scope, delay or eliminate some or all of its planned commercial activities. The accompanying financial statements have been prepared assuming that the Company will continue as a going concern, which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. The financial statements for the year ended December 31, 2013 do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from uncertainty related to the Company's ability to continue as a going concern.

Use of estimates

The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates include, among others, the Company's allowance for doubtful accounts, sales returns, inventory obsolescence, share-based compensation, and impairment evaluations for goodwill and long-lived assets.

Cash and cash equivalents

The Company considers all highly liquid instruments purchased with original maturity of three months or less to be cash equivalents. Cash and cash equivalents consist of demand deposits and money market funds with a federally insured financial institution. The Company maintains the majority of its cash and cash equivalents at a qualified financial institution. The Company's non-interest bearing transaction accounts were insured under the FDIC's general deposit rules, which provided unlimited coverage through December 31, 2013. Subsequent to December 31, 2013, balances in the Company's accounts may exceed federally insured limits.

Restricted Cash

Restricted cash primarily represents cash collateral used to secure working capital borrowing needs related to operations of the Company's foreign subsidiaries. In April 2011, the Company established a working capital line of credit arrangement through Axis Bank in India. In consideration for establishing this working capital line of credit with Axis Bank, the Company entered a Sanction of Credit Facilities Agreement with Axis Bank to secure all borrowings under this line of credit. As such, the Company established a standby letter of credit with Wells Fargo Bank NA under which the Company has provided cash collateral to secure all borrowings by its foreign subsidiary under the working capital line of credit. The line of credit with Axis Bank allows for borrowings up to 70,000,000 Indian Rupees ("Rs."), or approximately $1,133,000 as of December 31, 2013. As of December 31, 2013, borrowings under this line of credit totaled Rs. 65,670,000, or approximately $1,063,000. As of December 31, 2012, borrowings under this line of credit totaled Rs. 66,300,000, or approximately $1,212,000.

As of December 31, 2012 and 2013, the Company had restricted cash of $1,871,000 and $1,941,000, respectively, of which $1,551,000 represents the minimum amount of secured borrowings under the Sanction of Credit Facilities Agreement with Axis Bank. The Company maintains the restricted cash holdings in money market funds, or other short duration investment options, as allowed under the Security Agreement. See further discussion of the Axis Bank line of credit in Note 6 below.

The remaining balance of restricted cash at December 31, 2013 of $390,000 represents required cash collateral held by Wells Fargo NA for potential forward exchange contract settlement exposure as discussed in further detail in the *Forward exchange contracts* policy discussion below and also in Note 14 below. At December 31, 2012, there was $320,000 in restricted cash serving as collateral for forward exchange contracts.

Short-term investments

The Company's short-term investments consist primarily of investment grade securities rated A, or better, by national rating agencies and comparably rated commercial paper and notes with maturities of one year or less. All short term securities are classified as available-for-sale and are recorded at fair value. Unrealized holding gains and losses are recorded, net of tax, as a component of accumulated other comprehensive income (loss). Unrealized losses are reviewed by specific identification and are charged against net earnings when a decline in fair value is deemed to be other than temporary. Unrealized losses were $2,000 as of December 31, 2012 and $35,000 as of December 31, 2013. Realized losses of $18,000 and $13,000 have been included in other income (expense), net, in the consolidated statements of comprehensive loss for 2012 and 2013, respectively. Purchases and sales are recorded on a trade date basis.

Trade accounts receivable

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The Company's payment terms will typically range from 30-60 days. However, as a result of seasonality in the Company's recreational water segment, the Company will, at times, offer certain promotions which may include extended payment terms to their customers. These promotions typically involve product purchases from customers at the end of the pool and spa season with payment due the following spring when the pool and spa season resumes. The Company's historical collection experience with extended payment terms has been reliable with minimal exposure to bad debts.

The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company determines the allowance by regularly evaluating individual customer receivables and considering a customer's financial condition, credit history, current economic conditions, and payment history where available. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. Recoveries of trade receivables previously written-off are recorded when received. The Company does not have any off-balance-sheet credit exposure related to its customers.

Inventories

Inventories are stated at the lower of cost or market value. The cost of inventory is determined based on the first-in first-out (FIFO) method. Provisions are made as necessary to reduce inventory amounts to their net realizable value or to provide for excess and/or obsolete products.

Prepaid expenses and other current assets

Prepaid expenses and other current assets include non-trade receivables that are collectible in less than 12 months and various prepaid amounts that will be charged to expenses within 12 months.

Property and equipment

Property and equipment are stated at cost, less accumulated depreciation. Depreciation and amortization are computed using the straight-line method over the following useful lives:

Machinery and equipment	5 - 7 years
Furniture and fixtures	3 - 5 years
Office equipment	3 - 5 years
Leasehold improvements	Lesser of expected lease term or useful life

Goodwill and impairment of goodwill

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in business combinations. Goodwill is not amortized but is tested for impairment annually on December 31 or more frequently if events or changes in circumstances indicate that the asset might be impaired. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assignment of assets and liabilities to reporting units, assignment of goodwill to reporting units, and determination of the fair value of each reporting unit. The fair value of each reporting unit is estimated using a discounted cash flow methodology. This analysis requires significant judgments, including estimation of future cash flows, which is dependent on internal forecasts, estimation of the long-term rate of growth for the Company, estimation of the useful life over which cash flows will occur, and determination of the weighted average cost of capital. Changes in these estimates and assumptions could materially affect the determination of fair value and goodwill impairment for each reporting unit. Reporting units are evaluated annually. No impairments were recorded during the years ended December 31, 2012 or 2013.

Other intangible assets

Other intangible assets represent definite-lived intangible assets acquired as part of business combinations and include purchased patents, customer relationships, trademarks, trade names and licenses. Other intangible assets are amortized over their estimated useful lives using the straight-line method. Internally generated patents, plus the costs to maintain those patents, are expensed as incurred.

Impairment of long-lived assets

Long-lived assets to be held and used, including property, plant, and equipment and intangible assets with definite lives, are assessed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the total of the expected undiscounted future cash flows is less than the carrying amount of the asset, a loss, if any, is recognized for the difference between the fair value and carrying value of the assets. Impairment analyses, when performed, are based on the Company’s business and technology strategy, management’s views of growth rates for the Company’s business, anticipated future economic and regulatory conditions, and expected technological availability. For purposes of recognition and measurement, the Company groups its long-lived assets at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other assets and liabilities. No impairment charges were recorded in the years ended December 31, 2012 or 2013.

Foreign currency

The functional currency of HaloSource, Inc. and its U.S. subsidiaries is the U.S. dollar. The functional currencies of the Company's international subsidiaries, which are the Chinese Yuan and the Indian Rupee, are the local currency of the country in which the subsidiary is located. Assets and liabilities are translated at the year-end exchange rates and income statement items are translated at the average exchange rates for the year. Resulting translation adjustments are shown as a component of comprehensive income (loss) and are included in net income only upon sale or liquidation of the related foreign subsidiary.

Gains and losses that arise from exchange rate fluctuations on sales, purchase transactions and monetary assets and liabilities denominated in a currency other than the functional currency are included in the statements of comprehensive loss as incurred.

Forward Exchange Contracts

In May 2012, the Company began entering into forward exchange contracts with Wells Fargo NA in order to reduce foreign currency risk exposure associated with certain intercompany debt balances which are denominated in the Indian Rupee. As part of this arrangement, Wells Fargo NA required cash collateral in the amount of $320,000 and $390,000 at December 31, 2012 and 2013, respectively, as security for potential forward exchange contract settlement exposure with the Company. The Company maintains the restricted cash holdings in money market funds, or other short duration investment options. See further discussion of the forward exchange contracts in Note 14 below.

Revenue recognition

The Company's revenue consists primarily of product sales and royalty income. Revenue from product sales is recognized, net of sales allowances, when title transfers to distributors and customers, collection of the relevant receivable is reasonably assured, persuasive evidence of an arrangement exists, and the sales price is fixed or determinable. Revenue from royalty income is recognized based upon the sales recorded by the licensees. Royalty income is billed to licensees on a quarterly basis or charged against the minimum royalty prepayment on a monthly basis.

The Company will occasionally enter into licensing arrangements with customers that involve exclusive rights to certain products and/or certain territories in which the Company operates, or which may require the Company to not actively pursue alternative customers or sales of new products in a certain market for a specified period of time. The Company recognizes revenue under these licensing arrangements using a sales model. Under a sales model, recognizing revenue at the beginning (commencement) of the license period may be appropriate if the earnings process is complete, the "license" or other IP is delivered, all obligations have been met or satisfied, except those items that would qualify as separate units of accounting, and all other criteria for revenue recognition have been met. During both 2013 and 2012, the Company entered into a standstill licensing agreement which included a fee of $500,000 in each year. The Company evaluated this license under the sales method and determined all obligations had been met upon commencement of the agreement and therefore recognized the license fee in its entirety upon commencement of the agreement in each year. The license fee recognized in each year has been included in Revenue – net on the consolidated statements of comprehensive loss.

Shipping and handling costs

Shipping and handling costs include costs incurred to physically move the product from the Company's place of business to the customer's designated location. Amounts billed to customers related to shipping and handling costs incurred are included in net revenue, and associated costs are included in cost of goods sold. Shipping and handling costs not billed to customers are included under selling, general, and administrative expenses and amounted to $360,000 and $428,000 for the years ended December 31, 2012 and 2013, respectively.

Research and development costs

Research and development costs are expensed as incurred.

Rent expense

The Company's headquarters office space in Bothell, Washington and the Company's manufacturing facility in Bangalore, India include certain rent-free periods and scheduled rent increases over the lease term. The Company recognizes the effect of all rent variances over the expected life of the lease on a straight-line basis. During 2013 the Company moved its pilot plant operations to a new facility in Bothell. As part of the lease agreement for the new facility, the landlord provided for tenant improvement allowances of $60,000 for renovation of the new facility. This amount has been included as a reduction of the aggregate rental costs for this facility over the term of the lease providing level rental expense over the expected term of the lease. Any variances between cash rental payments and straight-line expense recognition are recorded as a liability, which is included in deferred rent in the accompanying consolidated balance sheets.

The Company leases office space under non-cancelable operating leases. For leases that contain pre-determined, fixed escalations of the minimum rent, the Company recognizes the rent expense on a straight-line basis and records the cumulative difference between the rent expense and the cash rent payable as a liability. Leases meeting the criteria for capitalization under ASC topic 840, *Leases*, are reported as capital leases.

Comprehensive loss

Comprehensive loss is the change in equity during a period resulting from transactions and all other events and circumstances from non-owner sources. Accumulated other comprehensive loss on the accompanying consolidated balance sheets consists of foreign currency translation adjustments and unrealized gains and losses from changes in the fair value of available-for-sale investments.

Income taxes

Income taxes are accounted for using an asset and liability method that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial statement and tax basis of assets and liabilities at the applicable enacted tax rates. A valuation allowance is provided when it is more likely than not that some portion, or all, of the deferred tax assets will not be realized. The Company evaluates the realizability of its deferred tax assets by assessing its valuation allowance and by adjusting the amount of such allowance, if necessary. The factors used to assess the likelihood of realization include the Company's forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets.

The Company recognizes the tax benefit from uncertain tax positions only if it is more likely than not that the tax positions will be sustained on examination by the tax authorities, based on the technical merits of the position. The tax benefit is measured based on the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement.

Share-based compensation

The Company recognizes compensation expense for awards of equity instruments to employees based on the grant date fair value of those awards. For stock options, the Company utilizes the Black-Scholes option pricing model to estimate the fair value of employee stock-based compensation at the date of the grant, which requires the input of subjective assumptions including expected volatility, expected term, and a risk free interest rate. The Company estimates volatility and expected term using market comparable entities as well as historical evidence related to its own stock price since the date of its initial public offering ("IPO") in October 2010. The risk free interest rate is estimated using comparable published federal funds rates. Compensation expense for stock options is recognized for those options expected to vest, net of a forfeiture rate, generally over four year graded vesting schedules.

Compensation expense for non-vested stock awards, or restricted stock awards, is based on the market price of the Company's stock on the date of grant and is recorded equally over the vesting period, which is typically one year.

Public offering costs

Costs directly attributable to new public offerings are charged directly to stockholders' equity.

Net loss per share

Basic net loss per share is computed using the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed using the weighted average number of common and potentially dilutive shares outstanding during the period. Potentially dilutive shares consist of the incremental common shares issuable upon conversion of the exercise of common stock options and warrants. The Company had a net loss for all periods presented herein; therefore, none of the options or warrants outstanding during each of the periods presented, as discussed in Notes 8 and 9, were included in the computation of diluted loss per share as they were antidilutive. Total potentially dilutive shares of 4,715,000 and 6,353,000 of common stock were excluded from the calculations of diluted loss per share for the years ended December 31, 2012 and 2013, respectively.

Fair value of financial instruments

The carrying value of cash and cash equivalents, accounts receivable and accounts payable approximates their fair value based on the liquidity of these financial instruments or based on their short-term nature.

U.S. GAAP establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions. In determining fair value, the Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible, as well as considering counter-party credit risk in its assessment of fair value.

The carrying value of the Company's restricted cash and short-term investments is based on Level 1 observable market quotations. The Company has no Level 2 or Level 3 fair value measurements.

Litigation and other contingencies

The Company may be subject to a variety of legal proceedings which could arise in the ordinary course of business or from its shareholders. The Company evaluates its exposure to threatened or pending litigation on a regular basis. To the extent it were required, the Company would evaluate the potential amount of loss related to litigation as well as the potential range of outcomes related to such loss. Determining the amount of potential loss and the range of potential outcomes requires significant judgment. The Company will record a loss contingency if an amount becomes both probable and measurable. In addition, any such proceedings, whether meritorious or not, could be time consuming, costly, and result in the diversion of significant operational resources or management time.

Reclassifications

Certain amounts in the prior period financial statements have been reclassified for comparative purposes to conform to current period presentation with no effect on the previously reported results of operations.

New accounting pronouncements

In February 2013, the FASB issued Accounting Standards Update ("ASU") 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Classified out of Accumulated Other Comprehensive Income*, to resolve the competing concerns of preparers and users regarding the most cost-effective and user beneficial way to report information about adjustments for items reclassified out of accumulated other comprehensive income. The Board decided to provide reporting entities with a choice to report the effect of reclassifications on the face of the statement where net income or loss is presented, or in the footnotes to the financial statements. The Company adopted ASU 2013-02 beginning January 1, 2013 and has elected to include this information on the face of its consolidated statements of comprehensive loss.

In July 2013, the FASB issued ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*, to clarify the balance sheet presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. ASU 2013-11 is effective for fiscal years beginning after December 15, 2013. The Company will adopt ASU 2013-11 effective January 1, 2014, and expects this ASU will have no material effect on the Company's consolidated financial statements.

2. Inventories

Inventories as of December 31, consist of the following:

	2012 US$000	2013 US$000
Raw materials	$ 2,404	$ 2,163
Finished goods	1,298	1,463
Inventories, net	**$ 3,702**	**$ 3,626**

During the years ended December 31, 2012 and 2013, the Company recorded cost of goods sold of $180,000 and $40,000, respectively, to reduce certain inventory items from their recorded cost to their estimated net realizable value. The inventory reported in the consolidated balance sheets as of December 31, 2012 and 2013 is net of write-downs of inventory carrying values due to obsolescence of $489,000 and $443,000, respectively.

3. Property and equipment, net

Property and equipment as of December 31, consist of the following:

	2012 US$000	2013 US$000
Machinery and equipment	$ 3,172	$ 3,329
Furniture and fixtures	223	228
Office equipment	883	939
Leasehold improvements	1,979	2,710
Construction in process	38	10
	6,295	7,216
Less accumulated depreciation and amortization	(2,598)	(3,198)
Property and equipment, net	**$ 3,697**	**$ 4,018**

Depreciation and amortization related to property and equipment for the years ended December 31, 2012 and 2013 totaled $969,000 and $964,000, respectively.

4. Other intangible assets

Other intangible assets as of December 31, consist of the following:

	Useful Lives	2012 US$000	2013 US$000
Licenses	5 years	$ 80	$ 80
Trademarks and trade names	Up to 15 years	190	190
Patents	Up to 15 years	913	913
Customer relationships	10 years	1,077	1,077
		2,260	2,260
Less accumulated amortization		(1,292)	(1,414)
Other intangible assets, net		**$ 968**	**$ 846**

Amortization of other intangible assets for the years ended December 31, 2012 and 2013, totaled $125,000 and $122,000, respectively. Amortization expense for 2014, 2015, 2016, 2017, 2018 and thereafter is expected to be $122,000, $122,000, $122,000, $122,000, $122,000, and $236,000, respectively.

5. Income taxes

Loss before income taxes consisted of the following:

	Year ended December 31, 2012 US$000	2013 US$000
US	$ (10,985)	$ (12,315)
International	(1,378)	(105)
Loss before income taxes	**$ (12,363)**	**$ (12,420)**

The federal and state income tax provision is summarized as follows:

	2012 US$000	2013 US$000
Current taxes:		
US Federal	$ -	$ -
US State and Local	-	9
International	1	-
Current taxes	1	9
Deferred taxes	37	34
Provision for income taxes	**$ 38**	**$ 43**

Deferred income taxes reflect the net tax effects of (a) temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes, and (b) operating losses and tax credit carry forwards.

The tax effects of significant items comprising the Company's deferred taxes are as follows:

	As of December 31, 2012 US$000	2013 US$000
Deferred income tax assets:		
Net operating loss carry forwards	$ 30,102	$ 34,223
Basis difference in definite-lived intangible assets	62	70
Accrued expenses and reserves	370	443
Federal tax credit carry forwards	702	759
Deferred income tax assets	31,236	35,495
Deferred income tax liabilities:		
Basis difference in fixed assets	(43)	(33)
Basis difference in goodwill	(72)	(106)
Deferred income tax liabilities	(115)	(139)
Net deferred tax assets before valuation allowance	31,121	35,356
Less valuation allowance	(31,195)	(35,460)
Net deferred tax liabilities	**$ (74)**	**$ (104)**

ASC 740 requires that the tax benefit of net operating losses, temporary differences and credit carry forwards be recorded as an asset to the extent that management assesses that realization is "more likely than not". Realization of the future tax benefits is dependent on the Company's ability to generate sufficient taxable income within the carry forward period. Because of the Company's recent history of operating losses, management believes that recognition of the deferred tax assets arising from the above-mentioned future tax benefits is currently not likely to be realized and, accordingly, has provided a valuation allowance.

The deferred tax asset valuation allowance increased by $4,203,000 and $4,014,000 in 2012 and 2013, respectively.

None of the valuation allowance for deferred tax assets associated with excess tax deductions from stock based compensation arrangements will be allocated to contributed capital if the future tax benefits are subsequently recognized.

As of December 31, 2013, the Company had federal net operating loss carry forwards of $100,887,000, state net operating loss carry forwards of $2,437,000 and foreign loss carry forwards of $1,194,000. The Company also had federal research and development tax credit carry forwards of $986,000. The net operating loss and tax credit carry forwards will expire in varying amounts during the years 2018 through 2033. The Company's net operating loss carry forwards and tax credit carry forwards are subject to limitations on annual utilization due to prior or future changes of control, as defined by Internal Revenue Code Sections 382 and 383. These limitations vary by year but generally limit usage of net operating loss carry forwards during years 2014 through 2030. As of December 31, 2013, the Company's federal net operating loss carry forwards would be limited to an aggregate amount of $95,439,000 to offset future taxable income during years 2014 through 2033. Tax credit carry forwards are limited to $759,000 as of December 31, 2013.

The effective tax rate of the Company's provision for income taxes differs from the federal statutory rate as follows:

	2012	2013
Federal statutory rate	34.3%	34.0%
State tax	0.7	0.5
Incentive stock options	(1.2)	(1.0)
Change in valuation allowance	(34.0)	(34.8)
Other	(0.8)	0.2
General business credit	0.6	0.5
Effective rate	(0.4%)	(0.6%)

Uncertain tax positions

The Company performs an analysis of uncertain income tax positions related to recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. Based on management's review of the Company's tax positions, the Company had no significant unrecognized tax benefits as of December 31, 2012 or 2013.

The Company's continuing practice is to recognize interest and/or penalties related to income tax matters in income tax expense which were insignificant for all periods presented. At December 31, 2012 and 2013, the Company had no accrued interest related to uncertain tax positions and no accrued penalties.

The Company files income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. Due to the Company's operating loss carry forwards, the U.S. federal statute of limitations remains open for all years dating back to 1997.

6. Foreign line of credit

In May 2011, HaloSource Technologies Pvt. Ltd. ("HaloSource Technologies"), a wholly-owned subsidiary of HaloSource, Inc. which is located in Bangalore, India, entered into a Sanction of Credit Facilities Agreement with Axis Bank for a credit facility for up to an amount of Rs. 70,000,000, or approximately at $1,133,000 at December 31, 2013. This line of credit is available for borrowings to support working capital needs of HaloSource Technologies. Any borrowings under the line of credit bear interest at a base-rate, plus 1.85% or approximately 12% annually. As of December 31, 2013, borrowings under this line of credit totaled Rs. 65,670,000, or approximately $1,063,000. As of December 31, 2013, the Company was in compliance with all terms and conditions of this line of credit and the line of credit is payable upon demand.

As a condition to borrowing under this line of credit, the Company is required to maintain a standby letter of credit through Wells Fargo Bank NA in an amount equivalent to 110% of the line of credit, or Rs. 77,000,000, approximately $1,246,000 at December 31, 2013; further, Wells Fargo Bank NA requires a restricted cash balance of 105.3% of the standby letter of credit. The Company has in turn restricted cash of $1,551,000 under the standby letter of credit in order to meet the minimum collateral requirements for the outstanding borrowings under the foreign line of credit.

7. Commitments and contingencies

Litigation and other contingencies

On December 2, 2011, the Company was named as a defendant in a lawsuit, captioned Molycorp Minerals, LLC ("Molycorp") v. HaloSource, Inc., in the United States District Court for the District of Colorado. During the year ended December 31, 2013, the Company and Molycorp reached a mutually beneficial agreement to settle the claims without a material impact on the Company's consolidated financial statements.

Other than the matter noted above, as of December 31, 2013 and through March 24, 2014, the date this report was available to be issued, the Company was not involved in any other material pending litigation, claims or assessments.

Operating and capital leases

The Company has entered into operating lease agreements for its various office and manufacturing facilities worldwide and capital lease agreements for certain equipment. These leases are in effect through 2023. During the year ended December 31, 2013, the Company entered into a new building lease, accounted for as an operating lease, for its new pilot manufacturing and research and development facility in Bothell, Washington. In addition, the Company has operating leases for its headquarters office facilities in Bothell, Washington, as well as its manufacturing facilities in Shanghai, China and Bangalore, India.

The new lease for the Company's pilot manufacturing facility in Bothell, Washington replaced the previous land and building leases for its manufacturing location previously in Raymond, Washington.

Future minimum rental payments under capital lease obligations and operating leases as of December 31, 2013, are as follows:

Years ending December 31,	Capital US$000	Operating US$000
2014	$ 20	$ 802
2015	19	811
2016	19	665
2017	6	655
2018	-	674
Thereafter	-	2,635
Total future minimum lease payments	64	$ 6,242
Less amount representing interest	-	
Present value of future minimum lease payments	64	
Less current portion	(20)	
Total long-term portion of capital lease obligation	$ 44	

Total rent expense under operating lease agreements for the years ended December 31, 2012 and 2013 was $893,000 and $881,000, respectively.

Licensing agreements

The Company currently has exclusive licensing agreements with two research institutes and an individual licensor for specific applications of the technology used in certain of its products. The licensing agreements require minimum royalty payments of $550,000 per year until the earlier of the expiration of the licensed technology patents included under the agreements or termination of the agreements by the Company. The agreements are valid until the expiration of the last to expire of any patent rights under the agreements. Of the currently licensed technology, the latest patent expiration date occurs in 2023. Royalty expense under these agreements was $550,000 for each of the years ended December 31, 2012 and 2013. In addition, the Company paid research grants and recorded expense of $2,000 and $0 in 2012 and 2013, respectively. These costs have been recorded in research and development expenses.

Guarantees and indemnities

During its normal course of business, the Company has made certain guarantees, indemnities and commitments under which it may be required to make payments in relation to certain transactions. These indemnities include intellectual property and other indemnities to the Company’s customers and suppliers in connection with the sales of its products, and indemnities to directors and officers of the Company to the maximum extent permitted under the laws of the State of Washington. Historically, the Company has not incurred any losses or recorded any liabilities related to performance under these types of indemnities.

Other commitments

The Company routinely enters into purchase commitments primarily for purchases of raw materials for its supply chain and for purchases related to capital equipment. As of December 31, 2013, outstanding purchase commitments were not material individually or in the aggregate.

8. Stock options and share-based compensation

In September 2010, the Board of Directors and shareholders replaced the Vanson HaloSource, Inc. 2002 Stock Option Plan (the "2002 Plan") and approved the HaloSource, Inc. 2010 Equity Incentive Plan (the "2010 Plan"). The 2010 Plan provides for the issuance of incentive and non-statutory common stock options, restricted stock grants ("RSUs") and stock appreciation rights to employees, directors, and consultants of the Company. In conjunction with the Company's 2013 Annual General Meeting which was held in April 2013, the Company included a proposal to its shareholders to increase the number of shares of Common Stock reserved for issuance under its 2010 Equity Incentive Plan (the "2010 Plan") by 5,000,000, from 3,000,000 to 8,000,000. The Company was successful in obtaining the required number of shareholder votes to approve this proposal. During the years ended December 31, 2012 and December 31, 2013, the Company issued stock options and restricted stock awards under its 2010 Plan totaling 1,550,173 and 2,340,690, respectively. As of December 31, 2013, the Company had 3,272,235 shares available for issuance under the 2010 Plan.

The 2002 Plan was terminated in 2010 at the time the 2010 Plan was adopted. Based on this, stock option grants are no longer allowed under the 2002 Plan; however, options outstanding under the 2002 Plan remain outstanding with no change to their originally granted terms. Any options that are cancelled or forfeited under the 2002 Plan are returned to the 2002 Plan, but are not available for re-issuance.

The Company recognizes share-based compensation costs for an award on a straight-line basis over the requisite service period for each separately vesting portion of the award as if the award was, in substance, multiple awards. In 2012 and 2013, the Company recorded total stock based compensation expense of $665,000 and $567,000, respectively, including expense related to Restricted Stock Units ("RSUs") granted under the 2010 Plan of $112,000 and $50,000, respectively. No income tax benefit was recognized in the consolidated statements of comprehensive loss for share-based compensation arrangements.

Stock-based compensation for all share-based payment awards is measured at grant date, based on the fair value of the award using an option pricing model, and is recognized as expense over the employee's requisite service period, net of a forfeiture rate. The principal assumptions the Company used in applying the option-pricing model were as follows:

	2012	2013
Expected life	6.1 to 6.5 years	5.0 to 9.5 years
Expected volatility	67.4% to 76.9%	65.8% to 74.3%
Risk free interest rate	0.8% to 1.3%	0.8% to 1.9%
Forfeiture rate	5.0%	5.0%
Dividend yield	0%	0%

Because the Company has limited historical patterns, the expected life of the stock options is based on the experience of similar publicly traded companies and management's judgment. The expected volatility is based on volatility from comparable options with similar publicly traded companies as well as historical evidence related to the Company's own stock price since the date of its IPO in October 2010. The risk-free interest rate is based on the implied yield on a U.S. Treasury zero-coupon issue with a remaining term equal to the expected term of the option. The dividend yield is based on the projected annual dividend payment per share divided by the stock price at the date of grant. The Company has not paid dividends in the past and does not intend to pay dividends in the near future.

The following shares of common stock have been reserved for issuance under the Company's stock-based compensation plans as of December 31, 2013:

Outstanding options – 2002 Plan	1,573,056
Outstanding options – 2010 Plan	4,205,989
Stock options available for grant – 2010 Plan	3,272,235
Total common shares reserved for future issuance	9,051,280

The aggregate intrinsic value of options outstanding, vested or expected to vest, and exercisable at December 31, 2013 was $59,000, $58,000 and $32,000, respectively. Moreover, the total intrinsic value of options exercised during 2012 and 2013 was $820,000 and $2,000, respectively. The weighted average grant date fair value of options granted during 2012 and 2013 was $0.45 and $0.22, respectively. The total cash received by the Company upon exercise of stock options during 2012 and 2013 was $100,000 and $1,000, respectively.

As of December 31, 2013, there was $582,000 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the 2002 and the 2010 Plans. That cost is expected to be recognized over a weighted-average period of 4.2 years.

2002 Plan

Stock options were granted at exercise prices equal to the fair market value of the stock on the date of grant. Vesting schedules were determined by the Board of Directors. There were no options granted under the 2002 Plan during 2012 or 2013. The options granted under this Plan generally have four-year graded vesting schedules. Stock options generally expire 10 years after the date of grant. Stock option activity for the 2002 Plan during the years ended December 31, 2012 and 2013 is summarized in the table below:

	2012		2013	
	Shares Underlying Options	Weighted Average Exercise Price	Shares Underlying Options	Weighted Average Exercise Price
Outstanding – January 1	4,931,520	$ 0.36	1,637,431	$ 0.49
Options exercised	(1,556,565)	0.16	(7,750)	0.14
Options cancelled and forfeited	(1,737,524)	0.41	(56,625)	0.39
Outstanding – December 31	1,637,431	$ 0.49	1,573,056	$ 0.49
Options exercisable at December 31	1,480,298	$ 0.51	1,562,570	$ 0.49

The following table provides information regarding outstanding and exercisable options under the 2002 Plan as of December 31, 2013:

	Options Outstanding		Options Exercisable	
Exercise Prices	Number Outstanding	Weighted Average Remaining Option Term (years)	Number Exercisable	Weighted Average Remaining Option Term (years)
$0.14	108,000	1.34	108,000	1.34
$0.28	473,354	6.07	463,160	6.06
$0.33	221,000	3.52	221,000	3.52
$0.52	307,000	5.07	307,000	5.07
$0.85	461,702	4.11	461,702	4.11
$1.11	2,000	6.56	1,708	6.56
	1,573,056	4.61	1,562,570	4.61

2010 Plan

Stock options are granted at exercise prices equal to the fair market value of the stock on the date of grant. Vesting schedules are determined by the Board of Directors. Options granted under the 2010 Plan were granted with exercise prices within a range from $0.34 to $0.86 in 2012 and within a range from $0.18 to $0.37 in 2013, which represents the fair market value of the stock on the date of grant. Stock options granted in 2012 and 2013 generally have four-year graded vesting schedules. Stock options generally expire 10 years after the date of grant.

The table below summarized stock option activity for the 2010 Plan for the years ended December 31, 2012 and 2013:

	2012		2013	
	Shares Underlying Options	Weighted Average Exercise Price	Shares Underlying Options	Weighted Average Exercise Price
Outstanding – January 1	1,221,708	$ 1.26	2,355,074	$ 0.99
Options granted	1,254,123	0.71	2,205,555	0.35
Options exercised	(11,111)	0.45	-	-
Options forfeited	(109,646)	1.24	(354,640)	0.64
Outstanding – December 31	2,355,074	$ 0.99	4,205,989	$ 0.68
Options exercisable at December 31	379,735	$ 1.29	982,027	$ 1.02

The following table provides information regarding outstanding and exercisable options under the 2010 Plan as of December 31, 2013:

	Options Outstanding		Options Exercisable	
Exercise Prices	Number Outstanding	Weighted Average Remaining Option Term (years)	Number Exercisable	Weighted Average Remaining Option Term (years)
\$0.18 - \$0.33	245,000	9.80	-	-
\$0.34 - \$0.57	1,954,790	9.26	93,648	8.61
\$0.60 - \$0.86	842,199	8.35	358,015	8.24
\$1.00 - \$1.42	1,047,000	7.78	443,810	7.83
\$2.11 - \$2.56	117,000	7.00	86,554	7.00
	4,205,989	8.68	982,027	7.98

Restricted Stock Grants

In the fourth quarter of 2010, the Company began issuing restricted stock grants to Directors as part of their annual compensation for services provided to the Company. Restricted stock grants are grants which entitle the holder to shares of common stock as the award vests. The Company's restricted stock grants generally vest quarterly over one year following the date of each quarterly meeting of the Company's Board of Directors. Compensation cost is based on the market price on the grant date and is recognized equally as the restricted stock grants vest, typically over a one year period. For the years ended December 31, 2012 and 2013, the Company issued restricted stock grants totaling 296,050 and 135,135, respectively, and recorded compensation expense related to these restricted stock grants of approximately \$112,000 and \$50,000, respectively.

As of December 31, 2013, there was no unrecognized stock-based compensation expense related to non-vested restricted stock grants.

9. Common stock

Total authorized common shares are 200,000,000. As of December 31, 2013, the Company has 156,484,041 issued and outstanding shares of common stock.

Initial public offering

In September 2010, the Company obtained shareholder approval for an IPO on the Alternative Investment Market (AIM), a sub-market of the London Stock Exchange. The Company subsequently issued 23,293,733 new common shares to the public for 135 UK pence per share (equivalent to \$2.15 US dollars per share) on AIM on October 18, 2010.

2012 offering of common stock

In October 2012, the Company announced the successful placing of 80,000,000 new common shares on the London Stock Exchange's Alternative Investment Market ("AIM"). The new common shares were issued at a price of 20 UK pence per share (equivalent to \$0.32 US dollars per share at the time of the placing) on AIM on October 19, 2012. In connection with the offering, the Company sought certain waivers from its shareholders. The Articles of Incorporation of the Company provide that each shareholder would have a pre-emption right to purchase its pro-rata share of these new common shares, provided that the Pre-emptive Rights are subject to waiver by existing shareholders of the Company holding 75% of the Company’s outstanding common shares. The Articles of Incorporation of the Company also provide that if any shareholder of the Company, together with its concert parties, acquires through an allotment of new common shares in a placing, sufficient shares to hold a beneficial interest in 30% or more of the Company’s voting shares, then that shareholder and its concert parties must make an offer to acquire the shares of all other shareholders in cash, subject to waiver of such obligation by existing shareholders of the Company holding a majority of the Company’s outstanding common shares, excluding the proposed allottee, its concert parties and its affiliates. The Company was successful in obtaining these requisite waivers.

Newly issued common shares and certain shares held by existing shareholders were offered in the initial AIM listing only to non-US persons outside the United States; in turn, the offer and issuance were exempt from registration under the U.S. Securities Act pursuant to the SEC's Regulation S. Most of the newly issued common shares offered in the 2012 listing were also only offered to non-US persons outside the United States; the offer and issuance were again exempt from registration under the U.S. Securities Act pursuant to the SEC's Regulation S. A portion of the 2012 offering was made available to the directors and officers of the Company pursuant to Regulation D of Rule 506 of the Securities Act of 1933. The Company’s common shares trade on AIM under the HAL.LN and HALO.LN ticker symbols. All newly issued common shares are first listed on the HAL.LN ticker symbol. The HAL.LN line of stock represents common shares that still bear the restrictive legend on transfer pursuant to the US Securities Act of 1933 and may be traded only in certificated form. Furthermore, such shares may not be knowingly offered, sold, pledged or otherwise transferred, directly or indirectly, to or for the account or benefit of any U.S. person; provided, however, that holders of the Company's common shares sold pursuant to Regulation S have the opportunity to offer, sell, and transfer shares in transactions meeting the requirements of Regulation S, which provide defined exemptions from the registration requirements. In addition, if the HAL.LN shares meet the requirements of Rule 144 of the Securities Act, a holder may transfer the relevant common shares from the HAL.LN to the HALO.LN line of stock and the restrictive legend will be removed from the common shares. The HALO.LN shares are unrestricted.

Warrants for common stock

As of December 31, 2013, outstanding warrants to purchase common stock totaled 574,343 and have an exercise price of $1.34 per share. Substantially all of the warrants outstanding at December 31, 2013 expire on December 31, 2015.

10. Related party transactions

During 2012 and 2013, the Company was provided legal services, which are included in selling, general, and administrative expenses in the accompanying consolidated statements of comprehensive loss, of $100,000 and $40,000, respectively, from a firm whose partner is a stockholder of the Company and its former secretary. The Company owed this firm $3,000 and $17,000 at December 31, 2012 and 2013, respectively, which are included in accounts payable in the accompanying consolidated balance sheets.

The Company also paid royalties for certain patent rights of $450,000 in each of 2012 and 2013 to a university which held stock in the Company. Royalty payments are allocated between cost of goods sold, where there are identifiable product and sublicense revenues, as well as research and development expenses in the accompanying consolidated statements of comprehensive loss for the years ended December 31, 2012 and 2013. The Company had no outstanding accounts payable to the university at December 31, 2012 or 2013.

11. Employee benefit plan

The Company offers the HaloSource, Inc. 401(k) Plan (the “Plan”) to all employees meeting certain service requirements, and the Plan is funded by voluntary employee salary deferrals up to the limits permitted by the U.S. Internal Revenue Service for any plan year. In 2013, the Company made discretionary matching contributions totaling $86,000. In 2012, the Company made discretionary matching contributions totaling $115,000.

12. Business and credit concentration

One of the Company’s Recreational Water customers individually accounted for 16 percent of the Company’s 2012 revenue and 24 percent of the Company’s 2013 revenue. Accounts receivable from this customer represented 9 percent of the total accounts receivable at December 31, 2012 and 17 percent of the total accounts receivable at December 31, 2013.

Essentially all of the Company’s revenue from its Water Purification segment is generated in emerging market countries, including India and China. During 2012 the majority of Water Purification revenue was derived from one customer in India and one customer in China. During 2013 the majority of Water Purification revenue was derived from two customers in India and one customer in China. In addition, essentially all raw materials and manufacturing facilities used in the Water Purification segment are sourced from or located in the same emerging market countries. These markets represent varying political and regulatory environments that can potentially affect Water Purification operations.

13. Segment reporting

The Company measures the results of its reportable segments based on revenue and gross profit. The Company does not allocate operating expenses, income taxes or interest income (expense) to the reportable business units for purposes of reporting to the chief operating decision maker.

The Company’s operating segments are: Water Purification, Recreational Water, Environmental Water Remediation, and Anti-microbial Coatings. Information on reportable segments and a reconciliation to consolidated net loss for the years ended December 31, 2012 and 2013 are presented below. Also presented below are total assets by operating segment as of December 31, 2012 and 2013. The Company does not report to the chief operating decision maker its capital expenditures or assets for the Recreational Water or Environmental Water segments and does not assign intangible assets to the segments.

Year ended December 31, 2012

(US $000's)	Recreational Water	Environmental Water	Water Purification	Antimicrobial Coatings	Unallocated	Consolidated
Revenue	$ 8,809	$ 2,099	$ 2,149	$ 214	$ -	$ 13,271
Gross profit (loss)	3,681	866	(283)	107	-	4,371
Operating expenses	-	-	-	-	(16,628)	(16,628)
Interest expense, net	-	-	-	-	(69)	(69)
Other expenses, net	-	-	-	-	(37)	(37)
Income taxes	-	-	-	-	(38)	(38)
Net loss	-	-	-	-	-	$ (12,401)
Assets	-	-	6,542	$ 31	35,745	$ 42,318

Year ended December 31, 2013

(US $000's)	Recreational Water	Environmental Water	Water Purification	Antimicrobial Coatings	Unallocated	Consolidated
Revenue	$ 11,385	$ 1,303	$ 3,214	$ 161	$ -	$ 16,063
Gross profit (loss)	5,539	(18)	881	130	-	6,532
Operating expenses	-	-	-	-	(18,560)	(18,560)
Interest expense, net	-	-	-	-	(50)	(50)
Other expenses, net	-	-	-	-	(342)	(342)
Income taxes	-	-	-	-	(43)	(43)
Net loss	-	-	-	-	-	$ (12,463)
Assets	-	-	5,822	$ -	25,765	$ 31,587

The majority of the Company's revenue from its Water Purification segment is generated in India and China. Long-lived assets located in India amounted to $764,000 and $487,000 at December 31, 2012 and 2013, respectively. Long-lived assets located in China amounted to $611,000 and $494,000 at December 31, 2012 and 2013, respectively. The remaining long-lived assets are located in the United States.

14. Forward exchange contracts

The Company is exposed to foreign currency exchange-rate fluctuations in the normal course of its business, which the Company manages from time to time through the use of forward foreign exchange contracts. Forward foreign exchange contracts are used to hedge the impact of fluctuations of foreign exchange on certain assets or liabilities denominated in a currency other than the functional currency of the Company or its subsidiaries. The Company has chosen not to apply hedge accounting to these foreign exchange contracts. The Company uses forward foreign exchange contracts to mitigate risk and does not intend to engage in speculative transactions. The forward foreign exchange contracts are entered into by the Company and its subsidiaries primarily to hedge intercompany payables denominated primarily in Indian Rupee. These contracts do not contain any credit-risk-related contingent features. Further, the Company seeks to manage the counterparty risk associated with these forward foreign exchange contracts by limiting transactions to counterparties with which the Company has an established banking relationship. In addition, the contracts are limited to a time period of less than one year, generally three months or less.

During the years ended December 31, 2012 and December 31, 2013, these forward foreign exchange contracts resulted in realized gains (losses) of ($47,000) and ($34,000), respectively.

The realized gains and losses were partially offset by realized and unrealized gains and losses on foreign denominated accounts receivable and foreign denominated intercompany payables during the same periods. Realized gains and losses related to forward foreign exchange contracts are recorded in foreign exchange gain (loss) on the consolidated statements of comprehensive loss and the assets and liabilities for these contracts are recorded in prepaid and other current assets and accrued expenses and other current liabilities on the consolidated balance sheets. As of December 31, 2013 and 2012, the Company had no outstanding forward foreign exchange contracts.

15. Subsequent events

The Company has evaluated subsequent events through March 25, 2014, which is the date on which the consolidated financial statements were available to be issued.

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