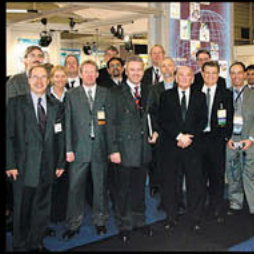




# VELAN

**2010 annual report**  
**Celebrating 60 years**







During bench testing in Velan's R&D Department, this dual-plate check valve can be cycled in any position.

Designed to avoid the heavy erosion and clogging expected in this difficult copper slurry environment, these 8" Class 1500 metal-seated ball valves are installed in a pumping station 2,600 meters above sea level. The slurry is pumped at nearly 3,000 PSI through several kilometers of pipeline linking the mine to the processing plant.



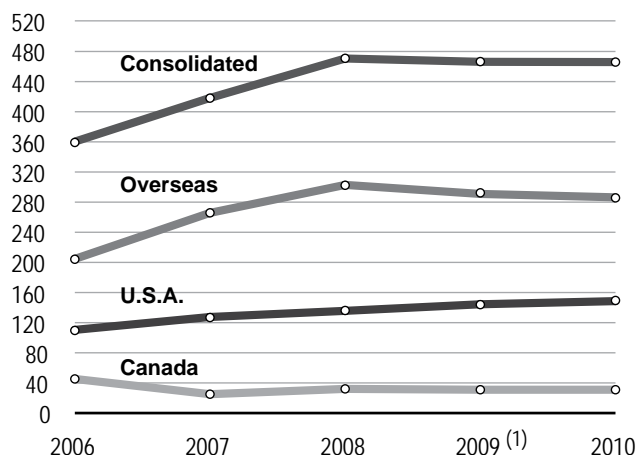
## About the cover photos

This year Velan is celebrating 60 years in the industrial valve business. As a tribute, we have created a collage of images representing our history and corporate evolution. These are the people whose hard work and dedication to our vision will help drive us forward into the future.

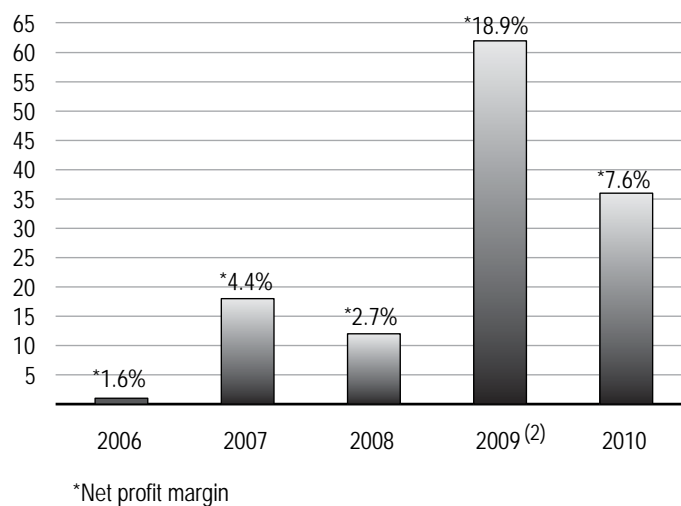
Velan was featured as the cover story in Valve World Magazine's June issue titled "Velan: Celebrating 60 years."

# 2010 Highlights

**Sales** (in millions of dollars)



**Net Earnings** (in millions of dollars)



## Years Ended

**Feb 2010**  
12 months

**Feb 2009**  
9 months

**May 2008**  
12 months

**May 2007**  
12 months

**May 2006**  
12 months

(in thousands of dollars, except per share amounts and number of employees)

### Income statement data

Sales	\$ 465,945	\$ 326,859	\$ 470,657	\$ 418,321	\$ 360,322
Gross profit	149,012	92,302	121,409	115,705	94,317
Gross margin	32.0%	28.2%	25.8%	27.7%	26.2%
Engineering, selling, general and administrative and research expenses	74,635	57,497	77,868	71,788	66,294
Earnings before income taxes	56,304	69,987	24,994	31,363	13,349
Net earnings	35,523	61,733	12,480	18,412	5,774
Net profit margin	7.6%	18.9%	2.7%	4.4%	1.6%
Earnings per share <sup>(3)</sup>	1.60	2.77	0.56	0.82	0.26

### Balance sheet data

Net cash <sup>(4)</sup>	\$ 103,787	\$ 63,485	\$ 26,029	\$ 8,597	\$ 43,299
Working capital	275,928	258,074	227,105	208,341	185,601
Capital assets	73,418	70,270	62,852	56,017	54,476
Total assets	512,697	506,520	470,468	410,786	350,114
Total debt	4,002	4,927	19,745	9,665	6,429
Shareholders' equity	346,184	327,115	272,029	256,653	237,746
Number of employees					
Canada	911	937	928	895	863
United States	189	198	197	199	193
Overseas	640	668	733	703	658
Total	1,740	1,803	1,858	1,797	1,714

(1) The 2009 sales data includes the sales for the 9-month 2009 fiscal year plus those of the 4<sup>th</sup> quarter of the 2008 fiscal year.

(2) On July 21, 2008, the Company sold its 50% interest in an Italian joint venture company for net proceeds of \$44.1 million resulting in a tax exempt gain of \$36.6 million.

(3) See note 9 in the Notes to the Consolidated Financial Statements.

(4) Net cash is defined as cash & cash equivalents plus short-term investments less bank indebtedness & short-term bank loans.

# Message to our shareholders and employees

## Highlights

- Celebrating our 60<sup>th</sup> year
- Net earnings were \$35.5 million or \$1.60 per share
- Sales were \$465.9 million
- Net cash reached \$103.8 million or \$4.66 per share
- Order backlog is \$503.0 million

As we celebrate our 60th year, we are pleased to report excellent results for our fiscal year ended February 28th, 2010. We had net earnings of \$35.5 million, which represents 7.6% of our sales of \$465.9 million.



A.K. Velan, C.E.O. with Tom Velan, President.

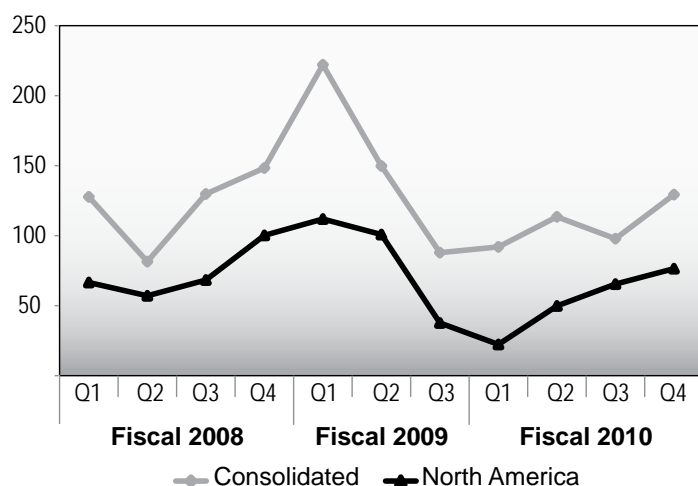
## Sales, order bookings and backlog

Our sales of \$465.9 million increased 9.3% over the same period last year after adjusting for the previous sales by our Italian joint venture because we sold our share of this company in July 2008. In order to make meaningful comparisons, any reference to last year is for the same twelve-month period encompassing our nine-month fiscal year plus the fourth quarter of our fiscal 2008 year. We have also eliminated the consolidation of our 50% ownership in our Italian joint venture from the comparative figures.

Order bookings of \$432.6 million decreased by 28.9% compared to our record bookings of \$608 million last year. The bookings include an unfavourable currency impact of about \$31.1 million. We had strong bookings in nuclear markets with bookings of \$193.1 million in our French subsidiaries and \$43.6 million in Velan North America. (Nuclear orders are longer term projects

with many special requirements that take a long time to complete.) Our bookings in other markets were down mainly due to the continuing impact of the global financial crisis, which has delayed new projects and reduced spending in energy-related markets. There has been a positive trend in bookings over the last three quarters in our North American operations, however, we still need to substantially increase bookings of shorter term orders very soon to make up for the shortfall in shorter term backlog.

Our order bookings were lower than sales so our backlog decreased by 6.4% to end the year at \$503 million. From this backlog, only \$321.1 million can be manufactured and sold by the end of fiscal 2011 because we have many longer term orders. At the start of fiscal 2010, we had \$405.7 million of order backlog that could be sold within one year. Compared to a year ago, we have \$84.6 million less order backlog scheduled for delivery within twelve months. Currently, we already have \$135.8 million of orders on hand scheduled for delivery during fiscal 2012.



Quarter Bookings (CAD Millions) excluding Velan SRL

## Earnings

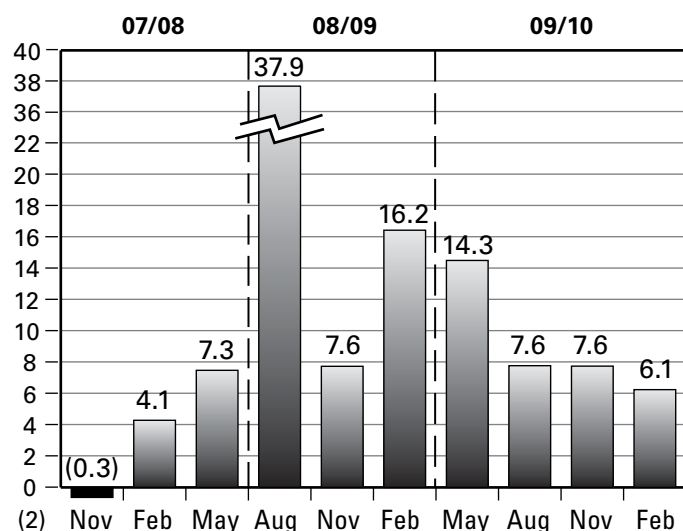
Our net earnings of \$35.5 million are the third highest earnings in our history. Last year was a record year with net earnings of \$67 million, including a gain of \$36.6 million on the sale of our Italian joint venture.

This year there were again important currency variations. The Canadian dollar declined compared to the US dollar an average of less than 1% and strengthened by 20.9% based on the period end rates. Changes in the period end currency rates result in unrealized gains or losses on consolidation of our integrated subsidiaries, while changes in the average foreign exchange rates affect our operating results.

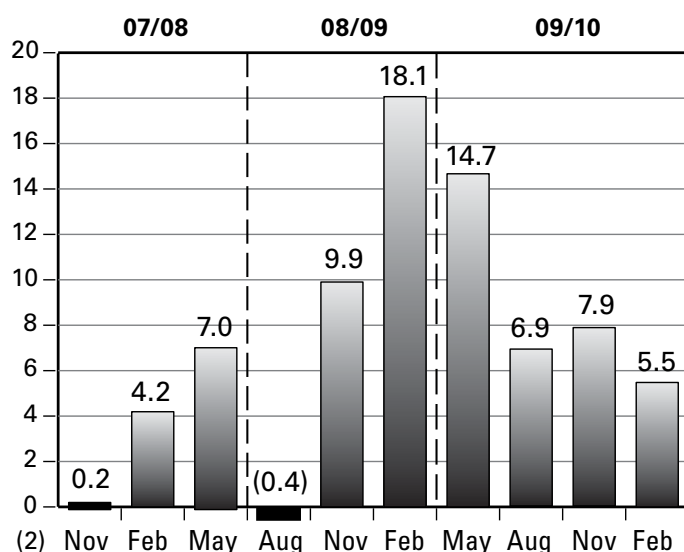


# Message to our shareholders and employees

To more clearly explain our operating results each quarter taking into account large currency swings, we issue a graph of our Adjusted Net Operating Earnings by quarter. In the graph we adjust for extraordinary events such as the sale of our Italian joint venture as well as the impact of all realized and unrealized foreign currency translation including currency hedging, financial instruments, and the unrealized currency gains and losses on consolidation of our integrated subsidiaries. All the figures have been adjusted for the ten quarters and we have also removed the earnings of our Italian joint venture from the comparative figures. Although this is a non-GAAP analysis, we think that this analysis gives a better and more consistent view of the operating results. This year our Adjusted Net Operating Earnings were \$35.0 million compared to \$34.6 million last year.



Quarterly Consolidated Net Earnings (CAD Millions)



Quarterly Adjusted Net Operating Earnings (CAD Millions)

Our fiscal year 2011 should be our last year reporting in Canadian dollars. Simultaneously with our transition to IFRS accounting standards on March 1, 2011, we expect to change our reporting currency to US dollars.

## Nuclear renaissance

The global nuclear power industry is expanding after years of limited activity. There are many opportunities for us in the new resurgence in nuclear power plant construction and this year we booked \$236.7 million of orders in nuclear. This includes orders for new nuclear power plants in China, France, and Slovakia as well as spare parts, maintenance and replacement valves for existing operating plants. Our nuclear order backlog reached \$338.2 million at the year end. We have been active in the nuclear industry since its inception and we are the company with the widest range of operating experience in PWR, BWR, ABWR, Candu (PHWR), VVER, and Pebble Bed (PBMR) reactors. We have also booked many major valve orders for the new EPR nuclear plants.



Nuclear control valve

In addition to our standard nuclear gate, globe, and check valves, we have also booked our first order for nuclear control valves based on our Adareg control valve technology and an order for main steam isolation valves (MSIV) for the Mochovce nuclear power plant in Slovakia. Although we have many nuclear valve competitors, there continue to be excellent nuclear sales

## Message to our shareholders and employees



*Ribbon cutting ceremony for the expansion of Velan S.A.S's plant in Lyon, France. Attendees include upper management from Velan S.A.S; Jean-Jack Queyranne, Président de la Région Rhône-Alpes (pictured cutting the ribbon), as well as a number of other local dignitaries; and Tom Velan, President, Velan Inc. (second from right).*

opportunities around the world. We are investing to increase our capacity to supply nuclear valves both in France and North America. Our subsidiary in Lyon, France, recently completed a \$5.6 million investment to expand the plant and add equipment.

### Financial strength

We have a very strong balance sheet with shareholders' equity of \$346.2 million, which is \$15.55 per share. Our net cash increased by \$40.3 million from the beginning of the fiscal year to reach a record level of \$103.8 million or \$4.66 per share. The increase is a result of excellent net earnings and favourable non-cash working capital movements. Customer deposits increased by 12.6% to \$58.1 million. Our strong cash position puts us in a good position to pursue strategic acquisitions, joint ventures, and other growth opportunities around the world.

### Outlook

The period immediately following the start of the global financial crisis in September 2008 was characterized by the falling price of oil, lower commodity prices, falling demand, and a credit squeeze that impacted many projects. This resulted in a period of lower order bookings (except for nuclear), lower material prices, a weaker Canadian dollar, and increased sales and earnings as we shipped our record backlog of orders booked in 2008. In the six quarters following September 2008, we have reported strong sales and earnings results but lower bookings. Although there have now been more positive trends in the global economy, this has not yet resulted in an upward trend in our markets with the exception of nuclear markets. There has been downward pressure on valve prices and we expect this will continue. Now our margins are being squeezed as material prices are increasing and the Canadian dollar has risen 20.9% to settle close to parity with the US dollar.

We are starting the new fiscal year with \$84.6 million less backlog that can be sold within a year than at the start of last year; in addition, some of our plants don't have enough orders due to the lower bookings. Due to the lower backlog and bookings, we have reduced our global manpower by 144 people as of April 30th, 2010, compared to the beginning of fiscal 2010. This 8% reduction means that our total manpower is down to 1659 people. We expect that it will take time for the capital-intensive project market to fully recover and in the meantime competition is fierce on the projects that are going ahead as competitors fight to maintain market share and sales volume in a down market. Due to the lower non-nuclear bookings combined with a stronger Canadian dollar and weak Euro, we expect our sales revenues will decline in the current year.

There are positive indications that our markets will improve in the second half of this fiscal year. The Chairman of the VMA (Valve Manufacturers Association of America) has recently stated, "Overall, the decade has been good for the valve business. The period between 2004 and 2008 was actually unprecedented in growth. Like essentially all manufacturing industries, 2009 showed a steep decline in demand and was troubling for our industry. Fortunately it appears that the situation has stabilized this year and the forecast looks good for the next few years." We have also enjoyed a period of solid organic growth since 2004 but now we are facing a downturn year before we can benefit from an improving global economic cycle.

Despite the tough market environment over the last six quarters, our continuing large backlog of orders and strong balance sheet put us in a good position to continue to cope with the impact of the downturn in our markets. Under the circumstances, we are very pleased with our results this year and we would like to take this opportunity to acknowledge the contribution of all our employees around the world toward achieving these results. At the same time, we are concerned by the slow recovery in our markets, by our lower order bookings, and by the strength of the Canadian dollar. We regret that market conditions have forced us to lay off some of our employees and we hope that this is a temporary measure. We expect that this will be a challenging year with lower sales and reduced margins. We continue to focus our efforts on pursuing business opportunities around the world in order to book enough orders so that we can continue to build on the excellent results achieved over the last six quarters.

A.K. Velan  
Chief Executive Officer

T. C. Velan  
President

# Management's discussion and analysis

May 18, 2010

The following discussion provides an analysis of the consolidated operating results and financial position of Velan Inc. ("the Company") for the year ended February 28, 2010. This Management's Discussion and Analysis ("MD&A") should be read in conjunction with the Company's audited consolidated financial statements for the year ended February 28, 2010 and the nine-month period ended February 28, 2009. The Company's consolidated financial statements have been prepared in accordance with Canadian Generally Accepted Accounting Principles ("GAAP"). The significant accounting policies upon which these consolidated financial statements have been prepared are detailed in Note 1 of the Company's audited consolidated financial statements. All foreign currency transactions, balances and overseas operations have been converted to Canadian dollars, the Company's functional and reporting currency. Selected annual information for the three most recently completed reporting periods and a summary of quarterly results for each of the eight most recently completed quarters is included further in this report. Additional information relating to the Company, including the Annual Information Form and Proxy Information Circular, can be found on SEDAR at [www.sedar.com](http://www.sedar.com).

## BASIS OF PRESENTATION AND ANALYSIS

Effective February 28, 2009, the Company changed its year end from May 31<sup>st</sup> to the last day of February. This change was made in order to better match the Company's business cycle. As is required, the Company's consolidated financial statements were prepared for the twelve-month period ended February 28, 2010 with comparative figures for the nine-month period ended February 28, 2009. In order to provide a more meaningful analysis of the Company's financial performance, the results for the twelve-month period ended February 28, 2010 will also be compared to the twelve-month period ended February 28, 2009 in this MD&A. The twelve-month period ended February 28, 2009 has also been adjusted to exclude the impact of the Company's former Italian joint venture company on operations and cash flows. Reconciliations of these amounts can be found at the end of this report.

In this MD&A, the Company has presented measures of performance or financial condition which are not defined under Canadian GAAP ("non-GAAP measures") and are therefore unlikely to be comparable to similar measures presented by other companies. These measures are used by management in assessing the operating results and financial condition of the Company and are reconciled with the performance measures defined under Canadian GAAP. Reconciliations of these amounts can be found at the end of this report.

## FORWARD-LOOKING INFORMATION

This MD&A may include forward-looking statements, all of which are subject to risks and uncertainties. These risks and uncertainties are disclosed in the Company's filings with the appropriate securities commissions and include among other matters, risks related to foreign exchange, raw material pricing, tax matters, foreign investment and operations as well as contingent liabilities. No forward-looking statement can be guaranteed and actual future results may differ materially from those expressed herein. The Company disclaims any responsibility to update or revise these forward-looking statements except as required by the applicable securities laws.

## OVERVIEW

The Company designs, manufactures and markets on a worldwide basis a broad range of industrial valves for use in most industry applications including power generation, oil and gas, refining and petrochemicals, chemical, LNG and cryogenics, pulp and paper, and shipbuilding. The Company is a world leader in steel industrial valves operating 13 manufacturing plants worldwide with 1,740 employees. The Company's head office is located in Montreal, Canada. The Company's business strategy is to design, manufacture, and market new and innovative valves with emphasis on quality, safety, ease of operation, and long service life. The Company's strategic goals include, but are not limited to, increasing market share in the nuclear power market, investing in talent development of high-potential employees, adding talent where necessary, providing high customer service, enhancing manufacturing and sales capabilities in emerging markets such as Brazil, Russia, India and China, and continually improving operational excellence. In addition, the Company will continue efforts to identify and pursue strategic acquisitions.

The consolidated financial statements of the Company include the North American operations comprising four Canadian and one U.S. manufacturing plants. The overseas operations include manufacturing plants in France, Portugal, U.K., Korea, Taiwan, and China. The Company's operations also include a 50%-owned Korean foundry and a distribution company in Germany.

# Management's discussion and analysis

## CONSOLIDATED HIGHLIGHTS

(millions, excluding per share amounts)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>	Increase (decrease)	% Increase (decrease)
<b>Consolidated statements of earnings</b>				
Sales	\$465.9	\$426.4	\$39.5	9.3%
Gross profit	149.0	116.1	32.9	28.3%
Gross profit %	32.0%	27.2%		
Net earnings	35.5	67.0	(31.5)	(47.0)%
Net earnings %	7.6%	15.7%		
Earning per share – basic	1.60	3.10	(1.50)	(48.4)%
– diluted	1.59	3.10	(1.51)	(48.4)%
Weighted average shares outstanding	22.3	22.3		
<b>Consolidated statements of cash flows</b>				
Net cash generated from operations	67.6	16.1	51.5	319.9%
Net cash provided by (used for) investing activities	(13.7)	18.4	(32.1)	(174.5)%
Net cash provided by (used for) financing activities	(9.5)	(6.9)	(2.6)	(37.7)%
<b>Demand data</b>				
Net new orders received	432.6	608.0	(175.4)	(28.9)%
Period ending backlog of orders	503.0	537.6	(34.6)	(6.4)%



# Management's discussion and analysis

## Highlights of fiscal 2010 as well as factors that may impact fiscal 2011

The Company continued to execute well in a difficult market environment, achieving excellent results for its fiscal 2010 year as well as the twelve-month period ended February 2009. The twelve-month period ended February 2009 benefited from a \$36.6 million, one-time tax exempt gain on disposition of a business. Adjusting for this one-time item the comparison of net earnings would be:

(millions, excluding per share amounts)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>
Net earning	\$35.5	\$67.0
Net gain on disposition of a business	-	(36.6)
Adjusted net earnings	35.5	30.4
Earnings per share – basic	1.60	3.10
Net gain on disposition of business	-	(1.64)
Adjusted earnings per share – basic	1.60	1.46

When the global financial crisis and recession started in September 2008, many of the Company's customers and markets were negatively impacted. The Company had a high backlog of orders leading into the recession which allowed it to achieve the above excellent results. However, the recession did negatively impact the Company's new sales order bookings in all markets except the nuclear power market. Despite improved signs in the general economy, demand for the Company's products continues to be under pressure. Distributors continue to work through their inventory de-stocking programs and there is typically a delay before positive trends in the general economy translates into increased spending in the long-term capital intensive project market. The Company believes demand for its products will rebound but continues to have limited visibility as to the timing. Recent increases in commodity and oil prices are a positive sign.

### Net new orders received ("Bookings")

(millions)	QUARTERS ENDED							
	February 2010	November 2009	August 2009	May 2009	February 2009	November 2008	August 2008	May 2008
<b>Bookings</b>	\$129.3	\$97.8	\$113.5	\$92.0	\$90.0	\$147.7	\$222.1 <sup>2</sup>	\$148.2 <sup>2</sup>
<b>Year to date</b>	\$432.6				\$608.0			

As shown in the table above, bookings for fiscal 2010 have decreased by 28.9% when compared to the twelve-month period ended February 2009. Bookings would have decreased by 47.9% if not for the increase in orders for the nuclear power market.

The Company began its fiscal 2011 year with a healthy backlog but it is composed of a higher proportion of longer-term nuclear orders.

(millions)	February 2010	February 2009	February 2008 <sup>1</sup>
<b>Backlog</b>	\$503.0	\$537.6	\$430.8
<b>For delivery within the subsequent fiscal year</b>	\$321.1	\$405.7	\$310.2
<b>For delivery beyond the subsequent fiscal year</b>	\$181.9	\$131.9	\$93.6
<b>Percentage – beyond the subsequent fiscal year</b>	36.2%	24.5%	21.7%

<sup>1</sup> Non-GAAP measures – see reconciliations at the end of this report

<sup>2</sup> Reduced by the bookings recorded by the Company's former Italian joint venture company

## Management's discussion and analysis

As a result of this shift in backlog some of the Company's manufacturing plants have capacity to fill for fiscal 2011. The timing of the receipt of new orders plays a crucial role as to whether the gaps in the manufacturing plants can be filled and whether the orders can be converted into revenues during fiscal 2011. For short-cycle business, orders can be filled and shipped relatively quickly but uncertainty remains as to when distributors will start replenishing their stock. For project orders, quoting activity continues but the Company believes many new projects remain in the planning stage. When these new projects will begin placing orders remains difficult to predict. A number of other factors, some of which are beyond the control of the Company, also have a bearing on the cycle time from new project order to revenue: the customer's delivery date; the complexity of the order; whether the Company has the necessary raw material in-house; supplier lead times; to name a few.

The Company believes its margins will be challenged in fiscal 2011:

- Global supply currently exceeds global demand putting downward pressure on sales prices.
- Rising steel prices have prompted suppliers to request increases.
- The Canadian dollar has strengthened significantly against the Company's main selling currency, the U.S. dollar.

The Company has taken certain measures to align its cost structure with the reduced near term demand and stands ready to take further action if necessary. Global headcount was reduced by 8.0% between February 28, 2009 and April 30, 2010. The Company continues to review other costs which may be reduced. One of the Company's strategic goals is to improve operational excellence through lean, global sourcing, working capital management and cost controls. There have been large variations in global currencies over the last few years and this trend has continued up to the date of this report. As the U.S. dollar is the Company's principal currency for sales and purchases, fluctuations in the Canadian/U.S. exchange rate have the greatest impact on the Company's reported results. To mitigate the potential adverse effects of these currency fluctuations the Company employs a currency risk management program of matching cash receipts in a foreign currency with cash disbursements in that same currency and hedging the remaining net exposure. The Company believes these initiatives will help protect its margins in the near term and deliver profitability improvement when demand returns to more normalized levels.

By increasing its focus on cash management during the recession, the Company increased its net cash<sup>1</sup> by \$40.3 million ending the year with \$103.8 million, a record level. Excellent net earnings together with positive non-cash working capital movements resulted in the Company generating net cash from operations of \$67.6 million. The Company placed greater emphasis on its accounts receivable management and as a result it reduced its accounts receivable balance by \$26.8 million. The Company also realigned its inventory purchases to reflect the reduced demand in most markets and the increased demand in the nuclear power market.

- Inventory purchases for non-nuclear power markets were decreased resulting in a decrease in inventory of \$40.0 million; and
- Inventory purchases for the nuclear power market were increased resulting in an increase of \$33.9 million.

These two factors resulted in a net reduction in inventory of \$6.1 million.

Despite the challenges of the economic downturn and the uneven recovery, the Company believes it is well positioned to weather the storm as it is virtually debt free, has sufficient amounts of liquidity and a large backlog of orders. The Company also believes it is well positioned to capitalize on the new resurgence in nuclear power plant construction around the world. The Company has been active in the nuclear industry since its inception and is a world leader in the design and manufacture of nuclear gate, globe and check valves. As at February 28, 2010 the Company's order backlog was \$503.0 million and its net cash<sup>1</sup> plus unused credit facilities amounted to \$150.8 million which it believes, along with future cash flows generated from operations, is sufficient to meet its financial obligations, maintain its capacity, satisfy its working capital requirements, and execute on its business strategy. However, there can be no assurance that the economic conditions currently affecting the Company's end-user markets will not materially adversely affect the Company's results of operations or financial condition.

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<sup>1</sup> Non-GAAP measures – see reconciliations at the end of this report

# Management's discussion and analysis

## SUMMARY OF RESULTS

Summary financial data derived from the Company's financial statements for the three most recently completed reporting periods are as follows:

**For the reporting periods ended**  
(in thousands of dollars, excluding number of shares and per share amounts)

	Twelve-month period ended February 28, 2010	Nine-month period ended February 28, 2009	Twelve-month period ended May 31, 2008
<b>Operating Data</b>			
Sales	\$465,945	\$326,859	\$470,657
Net Earnings	35,523	61,733	12,480
Earnings per Share			
- Basic	1.60	2.77	0.56
- Diluted	1.59	2.77	0.56
<b>Balance Sheet Data</b>			
Total Assets	512,697	506,520	470,468
Total Long-term financial liabilities	10,999	11,267	21,226
<b>Shareholder Data</b>			
Cash dividends per share			
- Multiple Voting Shares*	0.32	0.24	-
- Subordinate Voting Shares	0.32	0.24	-
Outstanding Shares at report date			
- Multiple Voting Shares*	15,566,567		
- Subordinate Voting Shares	6,663,901		

\* Multiple Voting Shares (five votes per share) are convertible into Subordinate Voting Shares on a 1 to 1 basis.

During the current reporting period, the Company, operating under a Normal Course Issuer Bid ("NCIB"), repurchased and cancelled 84,200 Subordinate Voting Shares for a cash consideration of \$1,056.

Sales for the twelve-month period ended February 28, 2010 increased by \$139.1 million or 42.6% compared to the nine-month period ended February 28, 2009. The significant increase is principally due to the change in year end. Sales for the nine-month period ended February 28, 2009 decreased by \$143.8 million or 30.6% from \$470.7 million to \$326.9 million as compared to the twelve-month period ended May 31, 2008. The significant decrease is principally due to the sale of the Italian joint venture company and the change in year end.

Gross profit for the twelve-month period ended February 28, 2010 amounted to \$149.0 million an increase of \$56.7 million from the \$92.3 million reported for the nine-month period ended February 28, 2009. The significant increase is due principally to the change in year end. Gross profit percentage increased from 28.2% to 32.0% when compared to the nine-month period ended February 28, 2009. A positive currency impact is the main reason for the increase in gross profit percentage. Gross profit for the nine-month period ended February 28, 2009 amounted to \$92.3 million, a \$29.1 million dollar decrease from the \$121.4 million reported for the year ended May 31, 2008. The significant decrease is principally due to the change in year end and the sale of the Italian joint venture company. Gross profit percentage for the nine-month period ended February 28, 2009 increased from 25.8% to 28.2% when compared to the year ended May 31, 2008. The positive impact of the weakening of the Canadian dollar is the main reason for the increased gross profit percentage.

Engineering, selling, general and administrative and research expenses for the twelve-month period ended February 28, 2010 increased by \$17.1 million or 29.7% to \$74.6 million from the \$57.5 million reported for the nine-month period ended February 28, 2009. The change in year end is the main reason for the increase. Engineering, selling, general and administrative and research expenses for the nine-month period ended February 28, 2009 decreased by \$20.4 million or 26.2% to \$57.5 million from the \$77.9 million reported for the year ended May 31, 2008. The significant decrease is principally due to the change in year end and the sale of the Italian joint venture company.

For the twelve-month period ended February 28, 2010 the Company reported a loss on translation of integrated subsidiaries in the amount of \$7.6 million compared to a gain of \$5.7 million reported for the nine-month period ended February 28, 2009. The



# Management's discussion and analysis

significant strengthening of the Canadian dollar against the U.S. dollar, based on period end rates, is the main reason for the fluctuation. The Company reported a gain on the translation of integrated subsidiaries in the amount of \$5.7 million for the nine-month period ended February 28, 2009 compared to a \$4.2 million loss reported for the year ended May 31, 2008. The significant weakening of the Canadian dollar against the U.S. dollar, based on period end rates, is the principal reason for this fluctuation.

In the nine-month period ended February 28, 2009 the Company sold its 50% interest in an Italian joint venture company, considered a variable interest entity for cash consideration of \$44.1 million (€27.65 million) all of which was received at closing. The disposition of the net assets resulted in a tax exempt gain of \$36.6 million. Adjusting for this gain, the net earnings would have been \$25.1 million or \$1.13 per share.

## IMPACT OF FOREIGN EXCHANGE ON RESULTS

There have been large variations in global currencies over the last few years and this trend has continued up to the date of this report. As the U.S. dollar is the Company's principal currency for sales and purchases, fluctuations in the Canadian/U.S. exchange rate have the greatest impact on the Company's reported results.

### Significant currency impacts affecting gross profit

The Company's gross profit is impacted by changes in both the average and period end rates.

#### 1. Changes in the average rate

A strengthening of the Canadian dollar has the following significant impacts:

- (a) Current U.S. dollar sales are translated to a lower Canadian dollar amount.
- (b) Canadian dollar labour and overhead, a significant portion of the Company's total labour and overhead costs, increase as a percentage of sales resulting in a lower gross profit percentage.
- (c) Current U.S. dollar purchases are translated to a lower Canadian dollar amount. However, these purchases are accumulated in inventory and do not have an immediate impact on gross profit. To the extent that current sales (lower Canadian dollar sales – see (a) above) are of inventory bought when the Canadian dollar was weaker, material cost of sales increases as a percentage of sales resulting in a lower gross profit percentage.

The opposite impact will occur when the Canadian dollar weakens.

#### 2. Changes in the period end rate

A strengthening of the Canadian dollar has the following significant impacts:

- (a) The Company does not use hedge accounting for foreign currency derivative financial instruments as a result they are carried at fair value at each balance sheet date with changes in fair value recorded in cost of sales in the period in which these changes arise. The valuation methods used for determining the fair value of these instruments is highly dependent on the period end exchange rate. All things remaining equal, a gain will be recognized on the fair value of these instruments if the Canadian dollar strengthens resulting in a higher gross profit percentage. Recording changes in fair value of these instruments results in a significant timing difference because gains or losses are being recorded in current period earnings whereas these instruments are intended to hedge future cash flows.
- (b) U.S. dollar monetary assets and liabilities in the Company's Canadian operations are translated at each balance sheet date with resulting gains and losses recorded in cost of sales. Since the Company has more U.S. dollar denominated monetary assets than liabilities, all things remaining equal, a strengthening of the Canadian dollar results in a loss on translation and a lower gross profit percentage.

Typically the amount of the Company's foreign currency derivative financial instruments is greater than its net U.S. dollar denominated foreign currency assets accordingly the net of (a) and (b) will result in a higher gross profit percentage. The opposite impact will occur when the Canadian dollar weakens.

### Significant currency impacts reported separately below the gross profit level

The Company separately reports the non-taxable, unrealized gain or loss on translation of integrated subsidiaries. The translation gain or loss is principally due to the translation of the Company's U.S. operations. A strengthening of the Canadian dollar against the U.S. dollar results in a translation loss being recorded. The opposite impact will occur when the Canadian dollar weakens.

# Management's discussion and analysis

The table below illustrates the volatility of the Canadian/U.S. exchange rate:

	Twelve-month period ended February 28, 2010	Nine-month period ended February 28, 2009	Twelve-month period ended May 31, 2008
Canadian dollar appreciation (depreciation) – as compared to the <b>average rate</b> of the prior year	(0.5%)	(10.7%)	12.1%
Canadian dollar appreciation (depreciation) – as compared to the previous <b>period end rate</b>	20.9%	(22.0%)	7.7%

## RESULTS OF OPERATIONS – twelve-month period ended February 28, 2010 compared to the twelve-month period ended February 28, 2009

### Sales

(millions)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>
Sales	\$465.9	\$426.4

Sales increased \$39.5 million or 9.3% compared to the comparative reporting period. The increased sales were attributable mainly to our French, UK and German operations. Beginning the current year with a large backlog was the main contributor to this increase (see discussion below on *bookings and backlog*). Also, a few large project orders did not get shipped in the prior year due to customer delays related to the global financial crisis. These orders were shipped and the related revenue was recognized during the first half of the current fiscal year. The reported sales figure for the current reporting period includes a negative currency impact of approximately \$2.4 million.

### Bookings and backlog

(millions)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>
Bookings	\$432.6	\$608.0

Bookings decreased by \$175.4 million or 28.9% when compared to the previous twelve-month period. The decrease was due to a decline in short-cycle orders and an unfavourable currency impact of approximately \$31.1million. The unfavourable currency impact is mainly due to the Canadian dollar strengthening against the U.S. dollar by 20.9%, based on period end rates. The decrease in short-cycle orders were primarily a result of distributors lowering their inventory levels in response to lower oil and natural gas pricing and demand. These declines were partially offset by increases in longer-term orders for the nuclear power market.

<sup>1</sup> Non-GAAP measures – see reconciliations at the end of this report

# Management's discussion and analysis

These two factors resulted in a higher proportion of the Company's backlog being longer-term.

(millions)	February 2010	February 2009
Backlog	\$503.0	\$537.6
For delivery within the subsequent fiscal year	\$321.1	\$405.7
For delivery beyond the subsequent fiscal year	\$181.9	\$131.9
Percentage – beyond the subsequent fiscal year	36.0%	24.5%

The backlog includes an unfavourable currency impact of approximately \$32.2 million. The unfavourable currency impact is mainly due to the Canadian dollar strengthening against the U.S. dollar by 20.9%, based on period end rates.

The Company believes demand for its products will rebound and while the exact timing of this remains difficult to predict recent increases in commodity and oil prices are a positive sign.

## Gross profit

(millions)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>
Gross profit	\$149.0	\$116.1
Gross profit percentage	32.0%	27.2%

As previously mentioned, gross profit is impacted by both the average and period end exchange rates (see discussion on *impact of foreign exchange on results – significant currency impacts affecting gross profit*). Adjusting for the currency impact the gross profit percentage would have been approximately 0.5% more favourable than the comparative reporting period. This favourable variance is principally due to increased sales which resulted in an increased absorption of the Company's fixed overhead.

## Engineering, selling and general and administrative expenses ("SG&A")

(millions)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>
SG&A	\$74.6	\$72.5
As a percentage of sales	16.0%	17.0%

SG&A increased by \$2.1 million or 2.9% compared to the comparative reporting period. The increase is mainly a result of increased employee-related costs and costs associated with the Company's ongoing asbestos litigation (see *contingencies* section). These increases were partially offset by decreases in commission and freight expense. As a percent of sales these costs improved by 1.0%.

## Interest expense

(millions)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>
Total interest expense	\$0.5	\$0.9

<sup>1</sup> Non-GAAP measures – see reconciliations at the end of this report



# Management's discussion and analysis

Interest expense decreased by \$0.4 million compared to the comparative reporting period. The decrease is due to debt being repaid and not replaced.

## Amortization expense

(millions)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>
Amortization expense	\$9.6	\$8.1

Amortization expense increased by \$1.5 million compared to the comparative reporting period. The increase is attributable to the prior year's investment in the Company's Montreal plants. The investment included additional plant facilities, machinery and equipment for the purpose of increasing capacity, improving productivity and enhancing the Company's R&D capabilities.

## Other income

(millions)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>
Other income	\$1.0	\$1.4

The Company's policy is to hold temporarily unneeded cash in very low risk investments. Decreases in interest rates are the main reason for the decline in other income.

## Non-controlling interest

(millions)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>
Non-controlling interest	\$1.4	\$0.8

This amount relates to the non-controlling interest's share of the profit recorded by the Company's joint venture, considered to be a variable interest entity, and non-wholly-owned subsidiary companies. The increase in the current reporting period relates mainly to increased profitability of the Company's 50%-owned Korean foundry.

## Foreign exchange (gain) loss on translation of integrated subsidiaries

(millions)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>
Foreign exchange (gain) loss on translation of integrated subsidiaries	\$7.6	\$(5.4)

This gain or loss arises from the translation of the Company's integrated subsidiary companies and is principally related to the U.S. / Canadian exchange rate differential between the last period end and the current period end. Based on the period end rates the Canadian dollar has strengthened against the U.S. dollar by 20.9% when compared to February 28, 2009 resulting in a non-deductible loss of \$7.6 million. In the comparative reporting period, the Canadian dollar weakened by 22.6% resulting in a non-taxable gain of \$5.4 million.

The results of translation of self-sustaining subsidiaries are not recorded in the Statement of Earnings but in a separate statement entitled Comprehensive income (loss). The translation adjustment amounted to a loss of \$8.5 million in the current twelve-month period compared to a gain of \$0.8 million in the comparative reporting period. These translation adjustments are mainly related to the euro/Canadian exchange rate differential between the last year end and the current period end. In the current period the Canadian dollar strengthened by 12.6% against the euro. In the prior period, the Canadian dollar weakened by 7.4%.

<sup>1</sup> Non-GAAP measures – see reconciliations at the end of this report

# Management's discussion and analysis

## Income taxes

	Twelve-month period ended February 28, 2010		Twelve-month period ended February 28, 2009 <sup>1</sup>	
(in millions, excluding percentages)	\$	%	\$	%
Earnings before tax	56.3		77.2	
Tax calculated at domestic tax rates applicable to earnings in the respective countries	18.1	32.2	24.8	32.1
Tax effects of:				
Tax exempt gain on disposition of a business	-	-	(11.3)	(14.6)
Non-deductible (taxable) foreign exchange loss (gain) on integrated subsidiaries	2.3	4.2	(1.7)	(2.2)
Non-controlling interest	0.4	0.8	0.7	0.9
Other permanent differences	(0.1)	(0.2)	(2.3)	(3.0)
Provision for income taxes	20.7	37.0	10.2	13.2

The effective income tax rates for each period are not representative of the Company's normal effective rates due to the non-taxable gain on disposition of a business, non-taxable foreign exchange loss (gain) on translation of integrated subsidiaries, non-controlling interest as well as other non-temporary differences between financial reporting and taxation. As shown above the Company's tax rate before any non-taxable items is 32.2% for the current twelve-month period and 32.1% for the comparative reporting period. This rate will vary depending on the proportion of profits earned in each country in which the Company operates.

<sup>1</sup> Non-GAAP measures – see reconciliations at the end of this report

# Management's discussion and analysis

## SUMMARY OF QUARTERLY RESULTS

Summary financial data derived from the Company's unaudited financial statements from each of the eight most recently completed quarters are as follows:

**For the quarters in months ending August, November, February and May**  
(in thousands of dollars, excluding per share amounts)

	QUARTERS ENDED							
	February 2010	November 2009	August 2009	May 2009	February 2009	November 2008	August 2008	May 2008
Sales	\$116,795	\$111,205	\$117,580	\$120,365	\$130,147	\$109,851	\$86,861	\$139,418
Net Earnings	6,058	7,563	7,586	14,316	16,246	7,550	37,937	7,293
Earnings per share								
- Basic	0.28	0.34	0.34	0.64	0.73	0.34	1.70	0.33
- Diluted	0.27	0.34	0.34	0.64	0.73	0.34	1.70	0.33

Adjusting for the approximate impact of the Italian joint venture company, quarter over quarter sales have steadily increased over the eight quarters presented above, with the exception of the quarter ended February 2010 compared to February 2009. The increased sales were mainly a result of increased demand in the Company's end-user markets particularly in oil and gas, nuclear power and mining. As discussed earlier in the *highlights* section the increased demand occurred in the twelve-month periods ended February 2009 and 2008. The Company's sales and net earnings benefited from shipping these orders in the quarters presented above. Demand for the Company's products has fallen during the last four quarters as a result of the global recession and financial crisis (see *highlights* section). Fluctuations between quarters are partially due to the timing of the shipments and revenue recognition for large project orders.

Net earnings for the quarter ended August 2008 include a tax exempt gain of \$36.6 million, or \$1.64 per share, related to the sale of the Company's interest in an Italian joint venture company. Adjusting for the gain, net earnings for the quarter would have been \$1.3 million or \$0.06 per share.

As can be seen from the above quarterly results, the net earnings in each quarter do not always fluctuate directly with sales. As discussed earlier in the section entitled *impact of foreign exchange on results*, foreign exchange rate variations are the main reason for this volatility.

The table below helps illustrate this fact.

	QUARTERS ENDED							
	February	November	August	May	February	November	August	May
Canadian dollar appreciation (depreciation) – as compared to the <b>average rate</b> of the comparative quarter	17.5%	8.3%	(7.6%)	(17.2%)	(18.7%)	(14.3%)	2.9%	12.6%
Canadian dollar appreciation (depreciation) – as compared to the previous <b>period end rate</b>	(0.1%)	3.7%	0.3%	16.5%	(2.8%)	(14.2%)	(6.5%)	(0.9%)

## RESULTS OF OPERATIONS – quarter ended February 28, 2010 compared to the quarter ended February 28, 2009

### Sales

(millions)	Three-month period ended February 28, 2010	Three-month period ended February 28, 2009
Sales	\$116.8	\$130.1

Sales decreased by \$13.3 million or 10.2% compared to the same quarter last year. The decrease is mainly attributable to the Company's North American operations. A negative currency impact of approximately \$10.7 million is the main reason for the decrease as the Canadian dollar was on average 17.5% stronger against the U.S. dollar compared to the same quarter last year.



# Management's discussion and analysis

## Bookings and backlog

(millions)	Three-month period ended February 28, 2010	Three-month period ended February 28, 2009
Bookings	\$129.3	\$90.0

Bookings increased by \$39.3 million or 43.7% compared to last year. A few large orders for the nuclear power market were booked in the current quarter.

(See discussion in the *highlights* section presented earlier in this report).

## Gross profit

(millions)	Three-month period ended February 28, 2010	Three-month period ended February 28, 2009
Gross profit	\$33.0	\$45.2
Gross profit percentage	28.3%	34.7%

As previously mentioned, gross profit is impacted by both the average and period end exchange rates (see discussion on *impact of foreign exchange on results – significant currency impacts affecting gross profit*). Adjusting for the currency impact, gross profit percentage would have been 1.4% less than the same quarter last year. This unfavourable variance is principally due to lower sales which results in less absorption of the Company's fixed overhead costs.

## SG&A

(millions)	Three-month period ended February 28, 2010	Three-month period ended February 28, 2009
SG&A	\$20.8	\$21.4
As a percentage of sales	17.8%	16.5%

SG&A decreased by \$0.6 million or 2.8% compared to the same quarter last year. Lower shipments in the quarter resulted in lower commission and freight expense.

## Interest expense

(millions)	Three-month period ended February 28, 2010	Three-month period ended February 28, 2009
Interest expense	\$0.1	\$0.4

Interest expense decreased by \$0.3 million compared to the same quarter last year. The decrease is due to debt being repaid and not replaced.

# Management's discussion and analysis

## Amortization expense

(millions)	Three-month period ended February 28, 2010	Three-month period ended February 28, 2009
Amortization expense	\$2.4	\$2.4

Amortization expense remained the same.

## Other income

(millions)	Three-month period ended February 28, 2010	Three-month period ended February 28, 2009
Other income	\$0.1	\$0.5

The Company's policy is to hold temporarily unneeded cash in very low risk investments. Decreases in interest rates are the main reason for the decline in other income.

## Non-controlling interest

(millions)	Three-month period ended February 28, 2010	Three-month period ended February 28, 2009
Non-controlling interest	\$0.5	\$0.6

This amount relates to the non-controlling interest's share of the profit recorded by the Company's joint venture, considered to be a variable interest entity, and non-wholly-owned subsidiary companies.

## Foreign exchange (gain) loss on translation of integrated subsidiaries

(millions)	Three-month period ended February 28, 2010	Three-month period ended February 28, 2009
Foreign exchange (gain) loss on translation of integrated subsidiaries	\$0.1	\$(1.4)

The gain or loss arises from the translation of the Company's integrated subsidiary companies and is mainly related to the U.S. / Canadian exchange rate differential between the last quarter end and the current quarter end. Based on the period end rates, the Canadian dollar has strengthened 0.3% from November 30, 2009 against the U.S. dollar. Last year the Canadian dollar weakened by 2.9% from November 30, 2008.

The results of the translation of self-sustaining subsidiaries are not recorded in the Statement of Earnings but in a separate statement entitled Comprehensive income (loss). The translation adjustment amounted to a loss of \$6.9 million for the current reporting period and a gain of \$0.7 million for the comparative reporting period. In the current quarter, the Canadian dollar strengthened by 10.6% against the euro.

## Income taxes

The effective income tax rates for each period are not representative of the Company's normal effective rates due to non-taxable foreign exchange loss (gain) on translation of integrated subsidiaries, non-controlling interest as well as other non-temporary differences between financial reporting and taxation. Adjusting for non-temporary differences the Company's effective tax rate is in the mid-thirties. This will vary depending on the proportion of profits earned in each jurisdiction in which the Company operates.

# Management's discussion and analysis

## Net earnings

(millions)	Three-month period ended February 28, 2010	Three-month period ended February 28, 2009
Net earning	\$6.1	\$16.2

Lower sales and negative currency impact are the main reasons for the decrease in net earnings compared to the same quarter last year.

## LIQUIDITY AND CAPITAL RESOURCES – a discussion of liquidity risk, credit facilities, cash flows and proposed transactions

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they come due. The Company manages its liquidity risk by continually monitoring its future cash requirements. Cash flow forecasting is performed in the operating entities and aggregated by the Company's corporate finance team. The Company's policy is to maintain sufficient cash and cash equivalents and available credit facilities in order to meet its present and future operational needs.

The following table presents the Company's financial liabilities identified by type and future contractual dates of payment:

(In thousands)	As at February 28, 2010				
	Total \$	Less than 1 year \$	1 to 3 Years \$	4 to 5 Years \$	After 5 years \$
Long-term debt	4,002	46	442	2,968	546
Accounts payable and accrued liabilities (including losses on derivative financial instruments)	68,248	68,248	-	-	-
Customer deposits	58,146	58,146	-	-	-
Provision for performance guarantees	11,470	11,470	-	-	-
Bank indebtedness and short-term bank loans	3,463	3,463	-	-	-
Other long-term liabilities	7,043	310	481	608	5,644
Operating leases	758	318	440	-	-
Purchase obligations <sup>1</sup>	7,342	7,342	-	-	-

As at February 28, 2010 the Company's net cash<sup>2</sup> plus unused credit facilities amounted to \$150.8 million which it believes, along with future cash flows generated from operations, is sufficient to meet its financial obligations, maintain its capacity, satisfy its working capital requirements, and execute on its business strategy. The Company is in compliance with all covenants related to its debt and credit facilities.

As a corollary to the managing its liquidity risk the Company also monitors the financial health of its key suppliers. During this economic downturn, greater emphasis has been placed on monitoring the financial health of suppliers including their access to adequate financing. To date, none of the Company's key suppliers have ceased production or delivery.

## Proposed transactions

Although it continues to explore various opportunities, the Company has not committed to any material asset or business acquisitions or dispositions.

<sup>1</sup> Includes only purchase commitments with foreign suppliers which are covered by letters of credit

<sup>2</sup> Non-GAAP measures – see reconciliations at the end of this report



# Management's discussion and analysis

## Cash flows

### Net cash<sup>1</sup>

(millions)	February 2010	November 2009	February 2009	November 2008	February 2008 <sup>2</sup>
Net cash <sup>1</sup>	\$103.8	\$100.5	\$63.5	\$61.0	\$34.3

The Company's net cash<sup>1</sup> increased \$3.3 million during the quarter and \$40.3 million from the beginning of the fiscal year to reach a record level of \$103.8 million. The increase is a result of excellent net earnings and favourable non-cash working capital movements. Net cash<sup>1</sup> increased by \$2.5 million during the same quarter last year and increased by \$29.2 million from February 29, 2008. The net proceeds on the sale of the Italian joint venture company amounted to \$42.5 million and is the main reason for the increase in the prior twelve-month period. The increase during the quarter ended February 28, 2009 was a result of excellent net earnings.

### Net cash generated from (used by) operations

(millions)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>	Three-month period ended February 28, 2010	Three-month period ended February 28, 2009
Net cash generated from (used by) operating activities	\$67.6	\$16.1	\$12.8	\$11.8

Net cash generated from operating activities increased by \$51.5 million and \$1.0 million for the three and twelve-month periods, respectively, when compared to the prior year. The increase in the twelve-month period is principally due to increased net earnings. The increase in the three-month period is a result of positive non-cash working capital movements.

### Accounts receivable

(millions)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>	Three-month period ended February 28, 2010	Three-month period ended February 28, 2009
Accounts receivable decrease (increase)	\$26.8	\$(15.5)	\$(1.4)	\$(0.4)

Accounts receivable balances are a function of the timing of sales and cash collections. The accounts receivable balance decreased in the current twelve-month period but increased in the prior twelve-month period. Lower sales in the current quarter along with an increased focus on accounts receivable management are the main reasons for the decrease in the current twelve-month period. Accounts receivable for both the current quarter and last year's quarter remained stable.

### Inventory

(millions)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>	Three-month period ended February 28, 2010	Three-month period ended February 28, 2009
Inventory decrease (increase)	\$6.1	\$(57.4)	\$18.4	\$(11.0)
Customer deposits increase (decrease)	\$6.3	21.3	\$0.8	\$(1.0)

<sup>1</sup> Non-GAAP measures – see reconciliations at the end of this report

<sup>2</sup> Excludes net cash related to the Company's former Italian joint venture

## Management's discussion and analysis

Inventory typically increases in times of rising backlog and order bookings and decreases when the opposite occurs. During the current three and twelve-month periods the Company decreased its inventory. The Company realigned its inventory purchases to reflect current demand. Inventory purchases for non-nuclear power markets were decreased and purchases for the nuclear power market were increased. Inventory increased in the three and twelve-month periods last year as orders and backlog were increasing at a significant rate.

In order to help finance its investment in inventory, the Company, where possible, obtains customer deposits for large orders. Customer deposits increased in the current and prior twelve-month periods and remained fairly stable in both the current and prior quarter.

	February 28, 2010	February 28, 2009
Inventory, net of customer deposits, as a percentage of backlog <sup>1</sup>	29.5%	30.0%

Inventory, net of customer deposits, as a percentage of backlog<sup>1</sup> has remained fairly stable over the last year despite fluctuations in bookings and backlog.

### Accounts payable and accrued liabilities

(millions)	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009 <sup>1</sup>	Three-month period ended February 28, 2010	Three-month period ended February 28, 2009
Accounts payable and accrued liabilities (decrease) increase	\$(23.6)	\$38.0	\$(3.5)	\$(2.4)

The large decrease in the current twelve-month period is mainly a result of decreases in accrued inventory purchases and mark to market losses on derivative financial instruments. The fluctuation in the quarters remained fairly stable.

The Company reinstated its annual dividend in August 2008. The Company pays \$0.08 per share quarterly. Dividends paid during the current twelve-month period amounted to \$7.1 million compared to \$3.6 million in the comparative twelve-month period.

Operating under an NCIB, the Company repurchased and cancelled 84,200 Subordinate Voting Shares for a cash consideration of \$1,056. In the comparative reporting period, 4,300 Subordinate Voting Shares were repurchased and cancelled for a cash consideration of \$47.

<sup>1</sup> Non-GAAP measures – see reconciliations at the end of this report

# Management's discussion and analysis

## FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

The Company's activities expose it to a variety of financial risks: market risk (including currency risk, fair value interest rate risk and cash flow interest rate risk), credit risk and liquidity risk. The Company's overall financial risk management programme focuses on mitigating unpredictable financial market risks and their potential adverse effects on the Company's financial performance.

The Company's financial risk management is generally carried out by the corporate finance team based on policies approved by the Board of Directors. The identification, evaluation and hedging of the financial risks is the responsibility of the corporate finance team in conjunction with the finance teams of the Company's subsidiary companies and variable interest entities. The Company uses derivative financial instruments to hedge certain risk exposures. Use of derivative financial instruments is subject to a policy which requires that no derivative transaction be entered into for the purpose of establishing a speculative or leveraged position (the corollary being that all derivative transactions are to be entered into for risk management purposes only).

### Risk overview

The Company's financial instruments and the nature of risks which they may be subject to are set out in the following table:

Financial instrument	Risks				
	Credit	Liquidity	Market risks		
			Currency	Interest rate	Other price
Cash and cash equivalents	X		X	X	
Short-term investments	X		X	X	
Bank indebtedness	X		X	X	
Short-term bank loans	X		X	X	
Accounts receivable	X		X		
Accounts payable and accrued liabilities		X	X		
Customer deposits		X	X		
Provision for performance guarantees		X	X		
Derivative financial instruments	X	X	X		
Long-term debt		X	X	X	

### Market risk

#### Currency risk

Currency risk on financial instruments is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. The Company operates internationally and is exposed to foreign exchange risk arising from various currency exposures. Currency risk arises when future commercial transactions and recognized assets and liabilities are denominated in a currency other than a company's functional currency. The Company has operations with different functional currencies, each of which will be exposed to currency risk based on its specific functional currency.

When possible the Company matches cash receipts in a foreign currency with cash disbursements in that same currency. The remaining anticipated net exposure to foreign currencies is hedged. To hedge this exposure, the Company uses foreign currency derivatives, primarily foreign currency forward contracts. These derivatives are not designated as hedges for accounting purposes.

# Management's discussion and analysis

The amounts outstanding as at February 28, 2010 and 2009 are as follows:

	Range of exchange rates		(\$000) Gain (Loss)		(\$000) Notional Amount		
	2010	2009	2010	2009	2010	2009	
Foreign exchange forward contracts							
Sell US\$ for CAS							
0 to 15 months	1.04070 - 1.24150	0.99420-1.28140	3,023	(3,934)	103,900	63,140	US\$
Buy US\$ for CAS							
0 to 12 months	-	1.0667-1.23400	-	400	-	4,242	US\$
Sell US\$ for KRF							
0 to 12 months	-	1.043-1.393	-	(1,270)	-	7,181	US\$
Buy British Pounds for CAS							
0 to 12 months	1.7795 - 1.7796	1.8510-1.8717	(157)	(127)	900	3,200	Pounds
Sell Euro for CAS							
0 to 12 months	1.5680 - 1.5717	-	472	-	3487	0	Euro
Sell US\$ for Euro							
0 to 12 months	1.3174 - 1.5427	1.26-1.5686	(628)	(2,766)	5,416	18,123	US\$
Buy US\$ for Euro							
0 to 12 months	1.2944 - 1.5090	1.2580-1.5370	352	2,158	5,677	14,271	US\$
Buy British Pounds for Euro							
0 to 12 months	0.8800	0.7925-0.9368	(2)	(536)	2,451	5,069	Pounds
Sell CAS\$ for Euro							
0 to 20 months	1.4313 - 1.4447	-	(3)	-	734	-	CAS\$
Buy CAS\$ for Euro							
0 to 20 months	1.4185 - 1.5700	-	65	-	836	-	CAS\$
Currency Options							
Buy US\$ for CAS							
0 to 12 months	-	.9770-1.2210	-	(4,976)	-	24,990	US\$
Sell US\$ for CAS							
0 to 12 months	-	.9770-1.2210	-	390	-	35,700	US\$
Total Gain (Loss)			3,122	(10,661)			

Foreign exchange forward contracts are contracts whereby the Company has the obligation to sell or buy the currencies at the strike price. Currency options are contracts whereby the Company has the right but not the obligation to sell or buy the currencies. Written options are contracts whereby the Company has the obligation to buy Canadian dollars at the strike rate if the counterparty exercises the option. The fair value of the foreign currency instruments is recorded in the consolidated statement of earnings and reflects the estimated amounts the Company would have paid or received to settle these contracts.

The following table provides a sensitivity analysis of the Company's most significant foreign exchange exposures related to its net position in foreign currency financial instruments. The net position is calculated as at February 28, 2010 and is comprised of foreign currency monetary assets and liabilities plus outstanding foreign currency derivative contracts. It does not include the impact of all the sales and cost of sales in foreign currency. A hypothetical strengthening of 5.0% of the following currencies would have had the following impact:



# Management's discussion and analysis

	2010	
	Net earnings	Other
(In Thousands)	(loss)	comprehensive
	\$	income (loss)
		\$
US dollar strengthening against the Canadian dollar	(1,427)	-
US dollar strengthening against the Euro	193	-
Euro strengthening against the British Pound Sterling	249	-

A hypothetical weakening of 5.0% of the above currencies would have had the opposite impact.

For the purposes of the above analysis, foreign exchange exposure does not include the translation of subsidiary companies and variable interest entities into the Company's reporting currency.

## Cash flow and fair value interest rate risk

The Company's exposure to interest rate risk is related primarily to its credit facilities, long-term debt and cash and cash equivalents. Items at variable rates expose the Company to cash flow interest rate risk, and items at fixed rates expose the Company to fair value interest rate risk. The Company's long-term debt and credit facilities predominately bear interest, and its cash and cash equivalents earn interest, at variable rates. An assumed 0.5 percentage point change in interest rates would not have a material impact on the net earnings or cash flows of the Company.

## Credit risk

Credit risk is the risk of an unexpected loss if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises primarily from the Company's trade accounts receivable.

The Company's credit risk related to its trade accounts receivable is concentrated and as at February 28, 2010, three (2009 – three) customers accounted for more than 5% each of its trade accounts receivable of which one customer accounted for 14.1 % (2009 – 14.7%) and the Company's 10 largest customers accounted for 57.5 % (2009 – 58.6%).

In order to mitigate its credit risk, the Company performs a continual evaluation of its customers' credit and performs specific evaluation procedures on all its new customers. In performing its evaluation, the Company analyzes the ageing of accounts receivable, historical payment patterns, customer creditworthiness and current economic trends. A specific credit limit is established for each customer and reviewed periodically. An allowance for doubtful accounts is recorded when, based on management's evaluation, the collection of an account receivable is not reasonably certain.

The Company also has credit risk relating to derivative financial instruments, cash and cash equivalents and short-term investments, which it manages by dealing with highly rated financial institutions.

The Company's credit risk is limited to the carrying value of the trade accounts receivable and the gains on foreign currency derivative contracts.

# Management's discussion and analysis

The table below summarizes the ageing of the trade accounts receivable as at February 28:

	2010 \$	2009 \$
Current	67,688	81,535
Past due 0 to 30 days	13,948	11,637
Past due 31 to 90 days	4,386	4,896
Past due more than 90 days	860	5,693
	86,882	103,761
Less: Allowance for doubtful accounts	1,124	793
Trade accounts receivable	85,758	102,968
Other receivables	9,788	20,365
Total accounts receivable	95,546	123,333

The table below summarizes the movement in the allowance for doubtful accounts:

	2010 \$
<b>Balance – Beginning of period</b>	793
Bad debt expenses	746
Recoveries of trade accounts receivable	(333)
Writeoff of trade accounts receivable	(82)
<b>Balance – End of period</b>	1,124

The Company placed greater emphasis on its accounts receivable management during this economic downturn. As shown above, the Company has not experienced significant bad debts. Its allowance for doubtful accounts as a percentage of total trade accounts receivable is 1.3% (2009 – 0.8%). The percentage of trade receivables past due more than 90 days is 1.0% (2009 – 5.5%) demonstrating an improvement in the ageing of the Company's receivables.

**Liquidity risk** – see discussion in *liquidity and capital resources* section

## CONTINGENCIES (in thousands, excluding number of cases)

Two of the Company's U.S. subsidiaries have been named as defendants in a number of pending lawsuits that seek to recover damages for personal injury allegedly caused by exposure to asbestos-containing products manufactured and sold in the past. Management believes it has a strong defence related to certain products that may have contained an internal asbestos containing component. Of the 803 claims outstanding as at February 28, 2010 (February 28, 2009 – 5,796), 474 are filed in the State of Mississippi, with the remainder filed in California, Connecticut, Delaware, Florida, Illinois, Maine, Massachusetts, Minnesota, Missouri, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, and Virginia. During the twelve-month period ended February 28, 2010, the Company resolved 5,242 claims (twelve-month period ended February 28, 2009 – 112). The majority of these claims were dismissed by a U.S. federal court due to the inability of the plaintiffs to substantiate their claims. During the twelve-month period ended February 28, 2010, the Company was the subject of 249 new claims. Because of the many uncertainties inherent in predicting the outcome of these proceedings, as well as the course of asbestos litigation in the United States, management believes that it is not possible to make an estimate of the Company's asbestos liability. Accordingly, no provision has been set up in the accounts. Legal fees and costs related to these asbestos claims amounted to \$4,680 (twelve-month period ended February 28, 2009 – \$3,385).

# Management's discussion and analysis

## OFF-BALANCE SHEET ARRANGEMENTS

The Company has entered into certain off-balance sheet arrangements. They are fully described in notes 13 and 15 of the Company's audited consolidated financial statements. The types of transactions entered into, all of which are in the normal course of business, are as follows:

- Performance bond guarantees related to product warranty and on-time delivery
- Letters of credit issued to overseas suppliers
- Operating leases
- Foreign currency forward contracts

## RELATED PARTY TRANSACTIONS (in thousands of dollars)

The Company has entered into the following transactions with related parties, which are measured at their exchange value.

- a) PDK Machine Shop Ltd. ("PDK") is a company owned by certain relatives of the controlling shareholder. PDK is a supplier of machined material components for use in Velan's plants.

	Three months ended		Twelve months ended	
	February 28		February 28	
	2010	2009	2010	2009
Purchases of material components	\$344	\$644	\$1,651	\$2,666
Sales of raw material	48	36	166	227

The Company entered into an agreement with PDK pursuant to which it has the right to purchase the shares of PDK for a consideration equal to the book value thereof in the event that they propose to sell their shares to a third party. In the event that PDK proposes to sell all or substantially all of its assets to a third party, the Company has the right to purchase inventory at cost and other assets at book value. In the event of a proposed liquidation or sale of sufficient assets such that PDK cannot fulfill its obligations to the Company under any outstanding purchase orders, the Company also has the right and the obligation to purchase PDK's inventory at an amount equal to the cost thereof. The maximum obligation of the Company pursuant to such put right is \$200.

- b) SteamTree Systems, Inc. ("SteamTree") is a company, which is 50%-owned by a different relative of the controlling shareholder. SteamTree provides consulting and custom design services related to computer software and software applications. SteamTree developed and implemented a computerized quotations system presently used by Velan's Marketing department.

	Three months ended		Twelve months ended	
	February 28		February 28	
	2010	2009	2010	2009
Software development and consulting services	\$2	\$5	\$6	\$5

- c) The Company leases on a weekly basis a property from Velan Holdings Co. Ltd., the controlling shareholder. Velan Holdings Co. Ltd. charges weekly rates based on usage.

	Three months ended		Twelve months ended	
	February 28		February 28	
	2010	2009	2010	2009
Rent and expenses	\$4	\$19	\$40	\$97

# Management's discussion and analysis

## DISCLOSURE CONTROLS AND PROCEDURES

Disclosure controls and procedures are designed to provide reasonable assurance that all relevant information is gathered and reported to senior management, including the President, the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO), in a timely manner so that appropriate decisions can be made regarding public disclosure.

The President, CEO, and the CFO of the Company have evaluated, or caused the evaluation of, under their direct supervision, the effectiveness of the Company's disclosure controls and procedures (as defined in National Instrument 52-109 – Certification of Disclosure in Issuer's Annual and Interim Filings) as at February 28, 2010 and have concluded that such disclosure controls and procedures were designed and operating effectively.

## INTERNAL CONTROL OVER FINANCIAL REPORTING

Management is responsible for establishing and maintaining adequate internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian Generally Accepted Accounting Principles.

Management has evaluated the design and effectiveness of its internal controls and procedures over financial reporting (as defined in National Instrument 52-109 – Certification of Disclosure in Issuer's Annual and Interim Filings). The evaluation was based on the *"Internal Control-Integrated Framework"* issued by the *Committee of Sponsoring Organizations of the Treadway Commission (COSO)*. This evaluation was performed by the President, CEO, and the CFO of the Company with the assistance of other Company Management and staff to the extent deemed necessary. Based on this evaluation, the President, CEO, and CFO concluded that the internal controls and procedures over financial reporting were appropriately designed and operating effectively as at February 28, 2010.

The Company did not make any material changes to the design of internal controls over financial reporting during the year ended February 28, 2010 that have materially affected, or are reasonably likely to have materially affected, the Company's internal controls over financial reporting.

In spite of its evaluation, Management does recognize that any controls and procedures no matter how well designed and operated, can only provide reasonable assurance and not absolute assurance of achieving the desired control objectives. In the unforeseen event that lapses in the disclosure of internal controls and procedures occur and/or mistakes happen of a material nature, the Company intends to take the steps necessary to minimize the consequences thereof.

## CRITICAL ACCOUNTING ESTIMATES

The Company's financial statements are prepared in accordance with Canadian Generally Accepted Accounting Principles. The Company's significant accounting policies as described in note 1 of the Company's audited financial statements are essential to understanding the Company's results of operations, financial positions and cash flows. Certain of these accounting policies require critical accounting estimates that involve complex and subjective judgments and the use of assumptions, some of which may be for matters that are inherently uncertain and susceptible to change. The assumptions and estimates used are based on parameters which are derived from the knowledge at the time of preparing the financial statements and believed to be reasonable under the circumstances. In particular, the circumstances prevailing at this time and assumptions as to the expected future development of the global and industry specific environment were used to estimate the Company's future business performance. Where these conditions develop differently than assumed and beyond the control of the Company, the actual results may differ from those anticipated. These estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is changed.

The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are addressed below:

### Accounts receivable

The Company must report its accounts receivable at their net realizable value. This involves significant management judgment and requires the Company to perform continuous evaluations of their collectibility and to record an allowance for doubtful accounts when required. In performing its evaluation, the Company analyzes the ageing of accounts receivable, concentration of receivables by customer, customer creditworthiness and current economic trends. Any change in the assumptions used will impact the carrying value of the accounts receivable on the balance sheet with a corresponding impact made to SG&A.

### Inventory

Inventories must be valued at the lower of cost or net realizable value. A write down of the inventory will occur when its estimated market value less applicable variable selling expenses is below its carrying amount. This involves significant management judgment and is based on the Company's assessment of market conditions for its products determined by historical usage, estimated future

# Management's discussion and analysis

demand and, in some cases, the specific risk of loss on specifically identified inventory. Any change in the assumptions used in assessing this valuation will impact the carrying amount of the inventory and have a corresponding impact on cost of sales.

## **Provision for performance guarantees**

Provisions must be established for possible product warranty expenses and for possible late delivery penalties. The Company estimates its warranty exposure by taking into account past experience as well as any known technical problems and estimates of costs to resolve these issues. Included in some of the Company's orders is a penalty for delivering later than the contractual delivery dates. The penalty is typically for a percentage of the contract value. The Company estimates its exposure under these obligations based on an analysis of all identified or expected claims and its exposure based on contractual obligations. Any change in the assumptions used will impact the value of the provision for these guarantees on the balance sheet and have a corresponding impact on cost of sales.

## **Goodwill impairment test**

The Company tests goodwill, annually or more frequently if certain indicators arise, for impairment. Impairment is tested by comparing the fair value of the goodwill to its carrying value. The fair value is determined through the use of earnings multiples and discounted future cash flows which by their very nature require the use of estimates and judgment in each circumstance. Any change in the assumptions resulting in an excess of the carrying value over the fair value would be charged to the earnings statement with a corresponding reduction in the carrying value on the balance sheet.

## **Fair value of derivatives and other financial instruments**

The Company has evaluated the fair values of its financial instruments based on the current interest rate environment, related market values and current pricing of financial instruments with comparable terms. Any change in the assumptions used in assessing the amount of these instruments will impact their carrying amount of these assets and have a corresponding impact on the income statement.

## **Share-based compensation plan**

At times the Company grants share options to certain full-time employees, directors, officers and consultants. The Company uses the fair-value based method of accounting which uses an option pricing model to determine the fair value of the share options. This model is based on several assumptions such as the risk-free interest rate, expected dividend yield, expected life of the options and the expected volatility of the share price. The fair value is amortized to earnings as compensation cost over the vesting period as employees' services are rendered. A change in the assumptions used by the Company could have an impact on earnings.

## **Income taxes**

The Company must estimate its income taxes in each jurisdiction in which it operates. This involves assessing the likelihood of utilizing net operating losses against future taxable income as well as evaluating positions taken in tax returns with respect to situations in which applicable tax regulation is subject to interpretation. In the event these assessments are changed, there would be an adjustment to income tax expense with a corresponding adjustment to income tax on the balance sheet.

## **ACCOUNTING POLICIES ADOPTED DURING THE PERIOD**

### **Goodwill and intangible assets**

The Canadian Institute for Chartered Accountants ("CICA") issued Section 3064, "Goodwill and Intangible Assets", which establishes standards for the recognition, measurement, presentation and disclosure of intangible assets. This new section replaced Section 3062, "Goodwill and Other Intangible Assets" and Section 3450 "Research and Development Costs". The standards relating to goodwill in the new Section 3064 are unchanged from those included in Section 3062.

The adoption of this Section did not have an impact on the Company's financial position, earnings or cash flows.

### **Financial instruments – Disclosures**

In June 2009, the CICA amended Section 3862, "Financial Instruments – Disclosures", to include additional disclosure requirements about fair value measurement for financial instruments and liquidity risk disclosures. These amendments require a three-level hierarchy that reflects the significance of the inputs used in making the fair value measurements. Fair values of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Assets and liabilities in Level 2 include valuations using inputs other than the quoted prices for which all significant inputs are based on observable market data, either directly or indirectly. Level 3 valuations are based on inputs that are not based on observable market data.

The adoption of this amendment did not have an impact on the Company's financial position, earnings or cash flows.



# Management's discussion and analysis

## ACCOUNTING POLICIES THAT ARE NOT YET EFFECTIVE AND HAVE NOT BEEN EARLY ADOPTED

### Business combinations

The CICA issued Section 1582, "Business Combinations", which replaces Section 1581, "Business Combinations". The Section establishes standards for the accounting for a business combination. It provides the Canadian equivalent to International Financial Reporting Standard ("IFRS") 3 (Revised), "Business Combinations". The Section applies prospectively to business combinations for which the acquisition date is on or after the Company's annual reporting period beginning March 1, 2011. Earlier application is permitted.

The Company is currently evaluating the impact of the adoption of this new accounting standard on its consolidated financial statements.

### Consolidated financial statements and non-controlling interests

The CICA issued Section 1601, "Consolidated Financial Statements", and Section 1602, "Non-controlling Interests", which together replace Section 1600, "Consolidated Financial Statements". Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for accounting for a non controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. It is equivalent to the corresponding provisions of International Accounting Standard 27 (Revised), "Consolidated and Separate Financial Statements". The standards are effective for the Company's annual reporting period beginning on March 1, 2011, although earlier adoption is permitted as of the beginning of a fiscal year.

The Company is currently evaluating the impact of the adoption of these new accounting standards on its consolidated financial statements.

## INTERNATIONAL FINANCIAL REPORTING STANDARDS

In February 2008, the Canadian Standards Board (CASB) confirmed that publicly listed companies will be required to use International Financial Reporting Standards ("IFRS") in the preparation of financial statements for fiscal years beginning on or after January 1, 2011. As such, the Company will be required to use IFRS for interim and annual financial statements dated after March 1, 2011. However, this transition will require the restatement of comparative figures for the year ended February 28, 2011.

The Company has established a project team to plan for and achieve a smooth transition to IFRS. An external resource has also been engaged to assist, under the direction of Company management, with certain aspects of the project. The implementation project consists of three phases: the scoping and diagnostic phase (high-level impact assessment to identify key areas); the impact analysis, evaluation and design phase (project team to develop policy alternatives, draft financial statement content and determine changes to existing accounting policies, information systems and business processes); and the implementation and review phase (implement and approve changes to accounting policies, information systems, business processes, training programs, develop IFRS-compliant financial statements and obtain audit committee approval).

The following table summarizes the key elements of the Company's plan for transitioning to IFRS and the progress made against each activity:

# Management's discussion and analysis

Key activities	Milestones	Status
<b>Accounting policies and procedures:</b>		
<ul style="list-style-type: none"> <li>Identify differences between IFRS and the Company's existing policies and procedures</li> <li>Analyze and select ongoing policies where alternatives are permitted</li> <li>Analyze and determine which IFRS 1 exemptions will be taken on transition to IFRS</li> <li>Implement revisions to accounting and procedures manuals</li> </ul>	<ul style="list-style-type: none"> <li>Executive management approval and audit committee review of policy decisions by Q2 fiscal 2011</li> <li>Revised accounting policy and procedures manuals in place by changeover date</li> </ul>	<ul style="list-style-type: none"> <li>Accounting policy alternatives have been analyzed and recommendations made for the majority of key accounting policy decisions. These accounting policy decisions were preliminarily reviewed by executive management and by the audit committee in Q3 fiscal 2010</li> <li>Revisions to accounting and procedures manuals are being drafted as work on each area of IFRS progresses</li> </ul>
<b>Financial statement preparation:</b>		
<ul style="list-style-type: none"> <li>Prepare financial statements and note disclosure in compliance with IFRS</li> <li>Quantify the effects of converting to IFRS</li> <li>Prepare first-time adoption reconciliations required under IFRS 1</li> </ul>	<ul style="list-style-type: none"> <li>Executive management approval and audit committee review of draft financial statements by Q3 fiscal 2011</li> </ul>	<ul style="list-style-type: none"> <li>Development of financial statement format is in progress</li> <li>Draft note disclosures have been prepared in most areas</li> <li>The effects of the conversion are being quantified as work on each area progresses</li> </ul>
<b>Training and communication:</b>		
<ul style="list-style-type: none"> <li>Provide topic-specific training to key employees involved with the implementation</li> <li>Develop awareness of the likely impacts of the transition throughout the Company</li> <li>Provide company-specific training on revised policies and procedures to affected personnel</li> <li>Provide timely communication of the impacts of converting to IFRS to the Company's external stakeholders</li> </ul>	<ul style="list-style-type: none"> <li>Topic-specific training for IFRS project team members provided as work on each IFRS topic commences</li> <li>Company-specific training implemented prior to changeover</li> <li>Impacts of converting to IFRS communicated prior to changeover</li> </ul>	<ul style="list-style-type: none"> <li>IFRS project team members have completed topic-specific training</li> <li>Awareness presentations have been provided at various forums to prepare personnel for the changeover</li> <li>A training plan has been developed. Training will be given at a more detailed level for practitioners and a higher level for other personnel</li> <li>Communication to external stakeholders has been ongoing and will continue up to the changeover through the Company's MD&amp;A disclosures</li> </ul>
<b>Business impacts:</b>		
<ul style="list-style-type: none"> <li>Identify impacts of conversion on contracts including financial covenants and compensation arrangements</li> </ul>	<ul style="list-style-type: none"> <li>Impacts on contracts identified by Q3 fiscal 2011</li> </ul>	<ul style="list-style-type: none"> <li>Identification of impacts on contracts is ongoing</li> </ul>
<b>IT systems:</b>		
<ul style="list-style-type: none"> <li>Identify changes required to IT systems and implement solutions</li> <li>Determine and implement solution for capturing data under Canadian GAAP and IFRS during the year of transition (for comparative information)</li> </ul>	<ul style="list-style-type: none"> <li>Necessary changes to IT systems implemented by changeover date</li> <li>Solution for capturing financial data under multiple sets of accounting principles determined by Q1 fiscal 2011</li> </ul>	<ul style="list-style-type: none"> <li>Required changes to IT systems and data collection mechanisms are being identified as each work stream progresses</li> <li>IFRS record-keeping has been implemented</li> </ul>
<b>Control environment:</b>		
<ul style="list-style-type: none"> <li>For all changes to policies and procedures assess effectiveness of internal control over financial reporting and disclosure controls and procedures and implement any necessary changes</li> </ul>	<ul style="list-style-type: none"> <li>Sign-off by internal audit by Q4 fiscal 2011</li> </ul>	<ul style="list-style-type: none"> <li>Relevant controls are being assessed as each work stream progresses</li> <li>There has been no significant changes to internal controls over financial reporting as a result of the transition to IFRS</li> </ul>

## Management's discussion and analysis

The transition to IFRS requires the Company to apply IFRS 1, which are the requirements for preparing IFRS financial statements in the first reporting period after the changeover date. IFRS 1 includes a requirement for retrospective application of each IFRS as if they were always in effect. IFRS 1 also mandates certain exceptions from retrospective application and provides a series of optional exemptions to retrospective application. The IFRS 1 exemptions that are most relevant to the Company include:

Area of IFRS	Summary of exemption available
<b>Business combinations</b>	Three choices are provided for retrospective application to past business combinations: (i) apply the IFRS standard to all past business combinations; (ii) apply the standard to all business combinations after a particular date prior to the transition date; or (iii) apply the standard prospectively to all business combinations after the transition date. The Company currently elects to apply the standard to business combinations that occur after March 1, 2010.
<b>Property, plant and equipment</b>	Property, plant and equipment at the date of transition can be recorded at either fair value or carrying value. The option can be applied separately to each asset or class of assets. The Company currently expects to elect the use of the carrying value at the date of transition.
<b>Currency translation adjustments</b>	On transition, the cumulative translation gains or losses in accumulated other comprehensive income can be reclassified to retained earnings at the Company's election. The Company currently expects to reclassify its cumulative translation adjustments.

The key areas identified to date where the Company expects its accounting policies may differ from IFRS and that may impact the Company's consolidated financial statements are set out in the following table:

# Management's discussion and analysis

Accounting policy area	Impact of policy adoption
<b>Currency of measurement</b>	<p>Under IFRS, the indicators for determining functional currency are broken down into primary and secondary indicators. Under Canadian GAAP there are no primary or secondary indicators. As a result of this difference the Company and a number of its subsidiary companies are expected to change to the U.S. dollar as their functional currency. Given this change the Company also expects to elect the U.S. dollar as its reporting currency.</p> <p>Work on determining the impact of this change is ongoing.</p>
<b>Provisions</b>	<p>Under IFRS, contractual obligations are not necessarily required to set up a provision. There could be an expectation from third parties that the Company would honour a potential constructive obligation by an established pattern of past practice, published policies or a sufficiently specific current statement.</p> <p>Under IFRS, the amount recognized for provisions should be management's best estimate of the expenditure required to settle the obligation, taking into account risks and uncertainties. The IASB issued an exposure draft in order to amend IAS 37, <i>Provisions, Contingent Liabilities and Contingent Assets</i>. As per this exposure draft, there will be an unconditional obligation to record a liability, based on probability calculations, as compared with Canadian GAAP where provisions are recorded when it is more likely than not that an amount will have to be paid.</p> <p>Provisions may be recognized more frequently under IFRS. Work on determining the impact of this change is ongoing.</p>
<b>Impairment of long-lived assets</b>	<p>Under IFRS, assessments must be made at each reporting date whether or not there is any indication that an asset may be impaired. With the exception of goodwill, Canadian GAAP only requires an assessment when there was an indication an asset may be impaired.</p> <p>Canadian GAAP uses a two-step approach to impairment testing: first comparing the asset carrying values with undiscounted future cash flows to determine whether impairment exists; and then measuring any impairment by comparing asset carrying values with fair values. IFRS uses a one-step approach for both testing and measurement of impairment. This may result in more writedowns where carrying values of assets were previously supported under Canadian GAAP on an undiscounted cash flow basis but may not be supported on a discounted cash flow basis.</p> <p>IFRS requires reversal of impairment losses (excluding goodwill) where circumstances leading to the impairment have changed; this is prohibited under Canadian GAAP.</p> <p>The impact of this area will depend on future circumstances.</p>

The differences described are those existing based on current Canadian GAAP and IFRS. This list should not be regarded as a complete list of changes that will result from transition to IFRSs. It is intended to highlight those areas the Company believes to be most significant. However, the analysis of possible changes is still in process and not all decisions have been made where choices of accounting policies are available. The Company is not able at this moment to reliably quantify the impacts expected on its consolidated financial statements for these differences.

The IASB has a number of on-going projects on its agenda that may result in changes to existing IFRS prior to the Company's conversion to IFRS in 2011. The Company continues to monitor these projects and the impact that any resulting IFRS changes may have on its anticipated accounting policies, financial position or results of operations under IFRS for fiscal year 2011 and beyond.

# Management's discussion and analysis

## CERTAIN RISKS THAT COULD AFFECT OUR BUSINESS

### **Cyclical nature of end user markets**

The demand for the Company's products in any particular industry or market can vary significantly according to the level of economic activity in that industry. These potential variations may be mitigated by the fact that the Company's sales are diversified geographically as well as by end user market. There can be no assurance that an economic recession or downturns in certain industries or geographic locations will not have a significant adverse effect on the Company's sales.

### **Competition**

Competitive pressures in the Company's markets could lead to a loss of market share, which could negatively impact revenues, margins and net income. The Company also competes with manufacturers based in low wage countries which offer valves at substantially lower prices. There can be no assurance that the Company will be able to compete successfully against its current or future competitors or that competition will not have a material adverse effect on the Company's results of operations and financial condition.

### **Dependence upon key personnel**

The Company is dependent upon the abilities and experience of its executive officers and other key employees. There can be no assurance that the Company can retain the services of such executive officers and key employees. If several executive officers or other key employees were to leave the employ of the Company, its operations could be adversely affected.

### **Currency exchange rate risks**

The Company's results are reported in Canadian dollars. The majority of the Company's revenues and a material portion of its expenses are generated or incurred in U.S. dollars and are translated into Canadian dollars for the purposes of reporting the Company's results of operations. Due to the geographic mix of the Company's customers, fluctuations in the value of the Canadian dollar relative to the U.S. dollar results in variations in the sales and earnings of the Company expressed in Canadian dollars. The strengthening of the Canadian dollar relative to the U.S. Dollar is continuing to negatively impact the Company's results of operations. The Company also sells in euros and pounds sterling. The exchange rate between Canadian dollars and other currencies has varied significantly over the last five years. The Company enters into simple foreign currency forward contracts and currency options in order to manage a portion of its net exposure to foreign currencies. Risk related to currency fluctuations could have a material adverse effect on the results of the Company's operations.

### **Availability and prices of raw materials**

The price of raw materials, principally steel, represents a substantial portion of the cost of manufacturing the Company's products. Historically, there have been fluctuations in these raw material prices and in some instances price movements have been volatile (when associated with outside influences, over which the Company has no control). There can be no certainty that the Company will be able to pass on increases resulting from higher costs of raw materials to its customers through increases in selling prices, or otherwise absorb such cost increases without significantly affecting its margins.

In addition, certain raw materials are in short supply for a period of time. Typically, these shortages do not last long and the Company is usually able to ensure that its needs are met. However, there can be no assurances that its sources of supply will be adequate to supply all of its needs on a timely basis.

### **Labour relations**

A substantial portion of the Company's workforce is covered by union agreements. Although the Company has been successful in the past in negotiating renewals, there can be no assurance that this will continue. Failure to renegotiate these agreements could lead to work disruptions or higher labour costs, which could negatively impact results.

### **Reliance on key suppliers**

The Company has several key suppliers with whom it has invested in forging dies and casting patterns. While the Company has alternate sources for most material purchases, the loss of a key supplier could impact negatively on the Company.

### **Reliance on distributors and sales agents**

The Company is directly affected by the ability of independent third party distributors and sales agents retained by the Company to sell its products in their respective markets. The Company's continued success is thus dependent on its ability to attract and retain the distributors and sales agents it requires to support its existing business and to continue to grow.

### **Project undertakings**

In competing for the sales of valves, the Company may enter into contracts which provide for the production of valves at specified prices and in accordance with time schedules. These contracts may involve greater risks as a result of unforeseen increases in the prices of raw materials and other costs and due to more stringent terms and conditions. Contract terms may vary from customer to



# Management's discussion and analysis

customer, and normally call for liquidated damages or other penalties in case of non-performance or warranty issues. The Company has paid damages for late delivery on several contracts during the last two years.

## **Political and economic risks associated with international sales and operations**

Since the Company sells and manufactures its products worldwide, it is subject to risks associated with doing business internationally. The Company's business and operating results could be impacted by trade protection measures, changes in tax laws, possibility of expropriation and embargo, foreign exchange restrictions and political, military and/or terrorist disruptions or changes in regulatory environments.

## **Product liability and other lawsuits**

The Company, like other worldwide manufacturing companies, has been, and will continue to be, subject to a variety of potential liability claims or other lawsuits connected with its business operations, including potential liabilities and expenses associated with possible product defects or failures. While the Company maintains product liability insurance coverage which it considers to generally be in accordance with industry practice, such insurance does not cover certain categories of claims (including ongoing asbestos claims) to which the Company is subject. Product liability premiums have also increased significantly during the last several years. Accordingly, the Company cannot be certain that product liability insurance coverage will continue to be available to it at a reasonable cost, or, if available, would be adequate to cover its liabilities.

## **Environmental compliance matters**

The Company's operations and properties are subject to increasingly stringent laws and regulations relating to environmental protection, including air and water discharges, waste management and disposal and employee safety. Such laws and regulations both impose substantial fines for violations and mandate cessation of operations in certain circumstances, the installation of costly pollution control equipment, or the undertaking of costly site remediation activities. Furthermore, new laws and regulations, or stricter enforcement of existing laws and regulations, the discovery of previously unknown contamination or the imposition of new clean up requirements could require the Company to incur additional costs which could be significant.

## **Control of the company**

Velan Holding Co. Ltd. (the "Controlling Shareholder") owns 15,566,567 Multiple Voting Shares representing, in the aggregate, approximately 92.1% of the voting interests in the Company. Voting control enables the Controlling Shareholder to determine all matters requiring shareholder approval.

The Controlling Shareholder effectively has sufficient voting power to prevent a change in control of the Company. The sale of a significant number of Subordinate Voting Shares by the Controlling Shareholder pursuant to the exercise of the conversion right attached to the Multiple Voting Shares may impact upon the market price and liquidity thereof.

## **Income and other tax risks**

The Company operates in a number of different tax jurisdictions and has a significant amount of cross-border purchase and sale transactions. The tax rules and regulations in various countries are becoming more complex. There is a risk that one or more tax authorities could disagree with the tax treatment adopted by the Company, resulting in defense costs and possible tax assessments.

## **Compliance with regulatory requirements**

In accordance with National Instrument 52-109, the Chief Executive Officer, President and Chief Financial Officer of the Company are responsible for designing, maintaining, and evaluating the effectiveness of disclosure controls and procedures. The CEO, President and CFO are also responsible for the effective design of internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with Canadian GAAP. A system of controls is subject to certain inherent limitations and is partially based on the possibility or probability of future events. Accordingly, a system of internal controls can provide only reasonable, and not absolute, assurance of reaching the desired objectives.

# Management's discussion and analysis

## RECONCILIATIONS AND NON-GAAP MEASURES

Effective February 28, 2009, the Company changed its year end from May 31<sup>st</sup> to the last day of February. This change was made in order to better match the Company's business cycle. As is required, the Company's consolidated financial statements were prepared for the twelve-month period ended February 28, 2010 with comparative figures for the nine-month period ended February 28, 2009. In order to provide a more meaningful analysis of the Company's financial performance, the results for the twelve-month period ended February 28, 2010 were also compared to the twelve-month period ended February 28, 2009 in this MD&A. The twelve-month period ended February 28, 2009 was also adjusted to exclude the impact of the Company's former Italian joint venture company on operations and cash flows.

In this MD&A, the Company presented measures of performance or financial condition which are not defined under Canadian GAAP ("non-GAAP measures") and are therefore unlikely to be comparable to similar measures presented by other companies. These measures are used by management in assessing the operating results and financial condition of the Company and are reconciled with the performance measures defined under Canadian GAAP. Reconciliations of these amounts can be found below.

## STATEMENT OF EARNINGS

	Three-month period ended May 31, 2008	Nine-month period ended February 28, 2009	Twelve-month period ended February 28, 2009	Adjustments for the impact of the Company's former Italian Joint Venture	Twelve-month period ended February 28, 2009 As adjusted
(millions)					
Sales	\$139.4	\$326.9	\$466.3	(39.9)	\$426.4
Gross profit	37.4	92.3	129.7	(13.6)	116.1
SG&A	21.4	57.5	78.9	(6.4)	72.5
Total interest expense	0.6	0.9	1.5	(0.6)	0.9
Amortization expense	2.4	6.4	8.9	(0.8)	8.1
Other income	(0.3)	(1.4)	(1.7)	0.3	(1.4)
Net gain on disposition of a business	-	(36.6)	(36.6)	-	(36.6)
Non-controlling interest	1.1	1.1	2.3	(1.5)	0.8
Foreign exchange (gain) loss on translation of integrated subsidiaries	0.2	(5.7)	(5.4)	-	(5.4)
Earnings before tax	11.8	70.0	81.8	(4.6)	77.2
Current and future tax expense	4.5	8.3	12.8	(2.6)	10.2
Net earnings	\$7.3	\$61.7	\$69.0	(2.0)	\$67.0

# Management's discussion and analysis

## CASH FLOWS

(millions)	Three-month period ended May 31, 2008	Nine-month period ended February 28, 2009	Twelve-month period ended February 28, 2009	Adjustments for the impact of the Company's former Italian Joint Venture	Twelve-month period ended February 28, 2009 As adjusted
Cash provided from (required for):					
Net earnings	\$7.3	\$61.7	\$69.0	(2.0)	\$67.0
Items not affecting cash	3.9	(28.2)	(24.3)	(2.3)	(26.6)
Net change in non-cash working capital items	0.9	(18.7)	(17.8)	(6.5)	(24.3)
Operating activities	12.1	14.8	26.9	(10.8)	16.1
Investing activities	(3.9)	22.7	18.8	(0.4)	18.4
Financing activities	(9.0)	(8.4)	(17.4)	(10.5)	(6.9)
Effect of exchange rate on cash	1.2	0.6	1.8	(0.2)	1.6
Net change in cash and cash equivalents	0.4	29.7	30.1	(0.8)	29.2

## NON-CASH WORKING CAPITAL ITEMS

(millions)	Three- month period ended May 31, 2008	Nine-month period ended February 28, 2009	Twelve- month period ended February	Adjustments for the impact of the Company's former Italian Joint Venture	Twelve- month period ended February 28, 2009 As adjusted
Net changes in Accounts Receivable	(12.6)	(2.9)	(15.5)	-	(15.5)
Net changes in Inventory	(6.0)	(51.4)	(57.4)	-	(57.4)
Net changes in Customer Deposits	(0.7)	22.0	21.3	-	21.3
Net changes in Accounts Payable and Accrued Liabilities	19.9	18.0	38.0	-	38.0

# Management's discussion and analysis

## INVENTORY, NET OF CUSTOMER DEPOSITS, AS A PERCENTAGE OF BACKLOG

	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009
(millions)		
Inventory	206.5	212.8
Customer deposits	58.1	51.6
Net inventory	148.4	161.2
Backlog	503.0	537.6
Inventory, net of customer deposits, as a percentage of backlog	29.5%	30.0%

## NET CASH

	Twelve-month period ended February 28, 2010	Twelve-month period ended February 28, 2009
(millions)		
Cash and cash equivalents	106.9	66.8
Short-term investments	0.3	0.2
Bank indebtedness	(2.6)	(2.5)
Short-term bank loans	(0.8)	(1.0)
Net Cash	103.8	63.5



## **Velan Inc.**

Consolidated Financial Statements  
**February 28, 2010 and 2009**



May 18, 2010

## Auditors' Report

### To the Shareholders of Velan Inc.

We have audited the consolidated balance sheets of **Velan Inc.** as at February 28, 2010 and 2009 and the consolidated statements of earnings, retained earnings, comprehensive income and accumulated other comprehensive loss and cash flows for the year ended February 28, 2010 and for the nine-month period ended February 28, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at February 28, 2010 and 2009 and the results of its operations and its cash flows for the year ended February 28, 2010 and for the nine-month period ended February 28, 2009 in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP<sup>1</sup>*

<sup>1</sup> Chartered accountant auditor permit No. 19983

"PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP/s.r.l./s.e.n.c.r.l., an Ontario limited liability partnership, or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate legal entity.

# **Velan Inc.**

## **Consolidated Balance Sheets**

### **As at February 28, 2010 and 2009**

(in thousands of dollars)

	<b>2010</b>	<b>2009</b>
	<b>\$</b>	<b>\$</b>
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	106,940	66,776
Short-term investments	310	166
Accounts receivable	95,546	123,333
Inventories (note 3)	206,472	212,781
Income taxes recoverable	3,497	4,523
Deposits and prepaid expenses	5,959	8,683
Future income taxes (note 6)	4,735	4,054
	<hr/> 423,459	<hr/> 420,316
<b>Property, plant and equipment</b> (notes 4 and 7)	73,418	70,270
<b>Future income taxes</b> (note 6)	1,880	1,614
<b>Goodwill</b>	12,502	12,502
<b>Other assets</b>	<hr/> 1,438	<hr/> 1,818
	<hr/> <hr/> 512,697	<hr/> <hr/> 506,520
<b>Liabilities</b>		
<b>Current liabilities</b>		
Bank indebtedness (note 5)	2,630	2,454
Short-term bank loans (note 5)	833	1,003
Accounts payable and accrued liabilities	68,248	91,047
Dividend payable	1,778	1,786
Income taxes payable	3,473	3,605
Customer deposits	58,146	51,608
Provision for performance guarantees	11,470	7,438
Future income taxes (note 6)	907	2,771
Current portion of long-term debt (note 7)	46	530
	<hr/> 147,531	<hr/> 162,242
<b>Future income taxes</b> (note 6)	3,834	3,286
<b>Long-term debt</b> (note 7)	3,956	4,397
<b>Other long-term liabilities</b>	7,043	6,870
<b>Non-controlling interest</b>	<hr/> 4,149	<hr/> 2,610
	<hr/> <hr/> 166,513	<hr/> <hr/> 179,405
<b>Shareholders' Equity</b>		
<b>Capital stock</b> (note 8)	108,073	109,326
<b>Contributed surplus</b> (note 8)	2,016	1,622
<b>Retained earnings</b>	245,654	217,251
<b>Accumulated other comprehensive loss</b>	<hr/> (9,559)	<hr/> (1,084)
	<hr/> 346,184	<hr/> 327,115
	<hr/> <hr/> 512,697	<hr/> <hr/> 506,520

**Commitments and contingencies** (note 15)

**Approved by the Board of Directors**



A.K. Velan, Director



T.C. Velan, Director

# **Velan Inc.**

## Consolidated Statements of Retained Earnings

(in thousands of dollars)

	<b>For the year ended February 28, 2010 \$</b>	<b>For the nine-month period ended February 28, 2009 \$</b>
<b>Balance – Beginning of period</b>	217,251	160,873
Net earnings for the period	<u>35,523</u>	<u>61,733</u>
	<u>252,774</u>	<u>222,606</u>
Dividends		
Multiple voting shares	4,981	3,735
Subordinate voting shares	<u>2,139</u>	<u>1,620</u>
	<u>7,120</u>	<u>5,355</u>
<b>Balance – End of period</b>	<u>245,654</u>	<u>217,251</u>

# **Velan Inc.**

## **Consolidated Statements of Comprehensive Income and Accumulated Other Comprehensive Loss**

(in thousands of dollars)

	<b>For the year ended February 28, 2010 \$</b>	<b>For the nine-month period ended February 28, 2009 \$</b>
<b>Comprehensive income</b>		
<b>Net earnings for the period</b>	35,523	61,733
<b>Other comprehensive loss</b> , net of tax		
Foreign currency translation adjustment on self-sustaining operations	(8,475)	(669)
<b>Comprehensive income</b>	<u>27,048</u>	<u>61,064</u>
<b>Accumulated other comprehensive income (loss)</b>		
<b>Accumulated other comprehensive income (loss) – Beginning of period</b>	(1,084)	264
<b>Other comprehensive loss for the period</b>	(8,475)	(669)
<b>Realized translation adjustment on disposition of a self-sustaining foreign operation</b>	<u>-</u>	<u>(679)</u>
<b>Accumulated other comprehensive loss – End of period</b>	<u>(9,559)</u>	<u>(1,084)</u>

The sum of retained earnings and accumulated other comprehensive loss amounted to \$236,095 as of February 28, 2010 (February 28, 2009 – \$216,167).

# Velan Inc.

## Consolidated Statements of Earnings

(in thousands of dollars, excluding per share amounts)

	<b>For the year ended February 28, 2010 \$</b>	<b>For the nine-month period ended February 28, 2009 \$</b>
<b>Sales</b> (notes 10 and 11(a))	465,945	326,859
<b>Cost of sales</b> (note 11(a))	316,933	234,557
<b>Gross profit</b>	149,012	92,302
<b>Expenses (other income)</b>		
Engineering, selling, general and administrative and research (note 12)	74,635	57,497
Interest		
Long-term debt	265	487
Other	231	432
Amortization of property, plant and equipment	9,550	6,436
Net gain on disposition of a business	-	(36,595)
Foreign exchange loss (gain) on translation of integrated foreign subsidiaries (note 11(b))	7,594	(5,660)
Non-controlling interest	1,403	1,110
Other income	(970)	(1,392)
	92,708	22,315
<b>Earnings before income taxes</b>	56,304	69,987
<b>Provision for (recovery of) income taxes</b> (note 6)		
Current	22,822	7,218
Future	(2,041)	1,036
	20,781	8,254
<b>Net earnings for the period</b>	35,523	61,733
<b>Earnings per share</b> (note 9)		
Basic	1.60	2.77
Diluted	1.59	2.77

# Velan Inc.

## Consolidated Statements of Cash Flows

(in thousands of dollars)

	For the year ended February 28, 2010 \$	For the nine-month period ended February 28, 2009 \$
<b>Cash flows from</b>		
<b>Operating activities</b>		
Net earnings for the period	35,523	61,733
Items not affecting cash		
Net gain on disposition of a business	-	(36,595)
Amortization of property, plant and equipment	9,550	6,436
Future income taxes	(2,041)	1,036
Stock option expense	197	103
Gain on disposal of property, plant and equipment	(64)	(61)
Non-controlling interest	1,403	1,110
Net change in other long-term liabilities	167	(247)
	<u>44,735</u>	<u>33,515</u>
Changes in non-cash working capital items		
Accounts receivable	26,756	(2,900)
Inventories	6,075	(51,421)
Income taxes recoverable	988	(353)
Deposits and prepaid expenses	2,623	(6,014)
Accounts payable and accrued liabilities	(23,644)	18,023
Income taxes payable	(137)	2,289
Customer deposits	6,296	22,000
Provision for performance guarantees	3,883	(299)
	<u>22,840</u>	<u>(18,675)</u>
	<u>67,575</u>	<u>14,840</u>
<b>Investing activities</b>		
Net proceeds on disposition of a business	-	42,538
Short-term investments	(144)	771
Additions to property, plant and equipment	(14,038)	(20,425)
Proceeds on disposal of property, plant and equipment	90	117
Net change in other assets	366	(340)
	<u>(13,726)</u>	<u>22,661</u>
<b>Financing activities</b>		
Dividends	(7,128)	(3,570)
Repurchase of shares	(1,056)	(47)
Dividends to non-controlling interest	(87)	(119)
Short-term bank loans	(170)	(2,728)
Increase in long-term debt	-	248
Repayment of long-term debt	(1,061)	(2,195)
	<u>(9,502)</u>	<u>(8,411)</u>
<b>Effect of exchange rate differences on cash</b>	<u>(4,359)</u>	<u>621</u>
<b>Net change in cash</b>	<u>39,988</u>	<u>29,711</u>
<b>Net cash – Beginning of period</b>	<u>64,322</u>	<u>34,611</u>
<b>Net cash – End of period</b>	<u>104,310</u>	<u>64,322</u>
Net cash is composed of:		
Cash and cash equivalents	106,940	66,776
Bank indebtedness	(2,630)	(2,454)
	<u>104,310</u>	<u>64,322</u>
<b>Supplementary information</b>		
Interest paid	178	269
Income taxes paid	20,515	5,786



# **Velan Inc.**

## **Notes to Consolidated Financial Statements February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

### **1 Summary of accounting policies**

#### **Change of year-end**

The Company changed its year-end from May 31 to February 28, effective February 28, 2009.

#### **Basis of consolidation**

These financial statements represent the consolidation of the accounts of the parent company and entities over which it has control, its subsidiary companies and variable interest entities (“VIEs”) for which it is the primary beneficiary. Control exists when the Company has the power to govern the financial and operating policies of an entity in a manner generally associated with a shareholding of more than one half of the voting rights. Potential voting rights currently exercisable or convertible are considered when assessing control over an entity. Subsidiary companies and VIEs are fully consolidated from the date control has been transferred to the Company and de-consolidated from the date control ceases.

All subsidiary companies and VIEs prepare their financial statements at the same reporting date as the Company except for Velan Valvac Manufacturing Co. Limited, which has a December 31 fiscal year-end. Consolidated earnings include the Company’s share of the results of its operations to that date. Intercompany transactions, balances and unrealized gains or losses on transactions between companies are eliminated.

#### **Cash and cash equivalents**

Cash and cash equivalents include cash in hand, cash in banks, other short-term highly liquid investments with original maturities of three months or less, and bank indebtedness. Bank indebtedness is shown in current liabilities on the balance sheet. Interest is earned on cash and cash equivalents at rates ranging from 0.0% to 1.2%. Interest is paid on bank indebtedness at rates ranging from 4.3% to 5.2%.

#### **Short-term investments**

Short-term investments include all highly liquid investments with original maturities greater than three months but less than one year. Interest is earned on short-term investments at rates ranging from 3.2% to 5.0%.

#### **Inventories**

Inventories are valued at the lower of cost and net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less applicable variable selling expenses. Cost of inventories is determined as follows:

- a) raw materials using principally the weighted average method except for items that are not ordinarily interchangeable, in which case specific identification of their individual costs is used; and
- b) finished parts and finished goods using the raw material cost described in a) plus applicable direct labour and manufacturing overhead.

# **Velan Inc.**

## **Notes to Consolidated Financial Statements**

**February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

The value of obsolete or unmarketable inventory is based on the Company's assessment of market conditions for its products determined by historical usage, estimated future demand and, in some cases, the specific risk of loss on specifically identified inventory.

### **Property, plant and equipment**

Property, plant and equipment are valued at acquisition or manufacturing costs less any related government assistance, accumulated amortization and any accumulated impairment losses. Acquisition costs include any expenditure that is directly related to the acquisition of the item. Manufacturing costs include direct material and labour costs plus applicable manufacturing overheads.

Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost of the item can be reliably measured. The carrying amount of the replaced part is derecognized. All other repairs and maintenance are charged to the consolidated statement of earnings during the financial period in which they are incurred.

Land is not amortized. Amortization on the other property, plant and equipment is determined principally using the following methods and annual rates or terms:

	<b>Method</b>	<b>Rate/Term</b>
Buildings	Declining balance	4%-5%
Machinery and equipment and furniture and fixtures	Declining balance	10%-31%
Data processing equipment	Straight-line	3 years
Rolling stock	Declining balance	30%
Leasehold improvements	Straight-line	Over lease terms

### **Goodwill**

Goodwill represents the excess of the purchase price over the fair value of the Company's share of the net identifiable assets of the acquired subsidiary at the date of acquisition. Goodwill is carried at cost less accumulated impairment losses and is tested for impairment annually at the balance sheet date or more frequently if certain impairment indicators arise. Goodwill is allocated to operating units for the purpose of impairment testing. The allocation is made to those operating units or groups of operating units that are expected to benefit from the business combination in which the goodwill arose. Step I of the impairment test is performed by comparing the fair value of the goodwill to its carrying value. The fair value is determined through the use of earnings multiples and discounted future cash flows. If the carrying value of the operating unit is greater than its fair value, Step II of the impairment test is performed whereby goodwill is determined in the same way it was originally determined at the date of the business acquisition, that is, the excess of the operating unit's value over the fair value of the identifiable net assets of the operating unit. Any impairment is charged to the consolidated statement of earnings in the period in which the impairment is determined.

# **Velan Inc.**

## **Notes to Consolidated Financial Statements February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

### **Investment tax credits**

Investment tax credits are accounted for using the cost reduction method. Under this method, assistance relating to eligible expenditures is deducted from the cost of the related assets or related expenses in the period in which the expenditures are incurred, provided there is reasonable assurance of realization.

### **Customer deposits**

Customer deposits are funds received in advance on contracts for which revenue has yet to be recognized.

### **Revenue recognition**

Revenue comprises the fair value of the consideration received or receivable for the sale of goods and services in the ordinary course of the Company's activities. Revenue is shown net of sales and value-added taxes, returns, rebates and discounts.

Revenue is recognized when the amount of revenue can be reliably measured, it is probable that future economic benefits will flow to the Company and when specific criteria have been met for each of the Company's activities as described below.

#### **Sales of goods**

Sales of goods are recognized when the Company has delivered products to the customer and there is no unfulfilled obligation that could affect the customer's acceptance of the product. Delivery of the products does not occur until the products have been shipped to a specified location in accordance with the agreed upon shipping terms, the risk of obsolescence and loss have been transferred to the customer, and either the customer has accepted the products in accordance with the sales contract, the acceptance provisions have lapsed, or the Company has objective evidence that all criteria for acceptance have been satisfied. Customers have a right to return faulty product, and some products are sold with volume discounts. Sales are recorded based on the price specified in the sales contract, net of the estimated volume discounts and returns at the time of sale. Accumulated experience is used to estimate and provide for the discounts and returns. The volume discounts are assessed based on anticipated annual purchases.

#### **Sales of services**

Sales of services are recognized when the Company renders services.

#### **Interest income**

Interest income is recognized using the effective interest rate method.

# **Velan Inc.**

## **Notes to Consolidated Financial Statements**

**February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

### **Research and development costs**

Research and development costs are expensed as incurred unless the development costs meet the generally accepted criteria for deferral. As at February 28, 2010 and 2009, no costs have been deferred in the accounts of the Company.

### **Income taxes**

The provision for income taxes for the period comprises current and future taxes. Tax is recognized in the consolidated statement of earnings, except to the extent that it relates to items recognized in other comprehensive income or directly in equity. In this case the tax is recognized in other comprehensive income or directly in equity, respectively.

#### **Current income tax**

The current income tax charge is calculated on the basis of the tax laws enacted or substantively enacted at the balance sheet date in the countries where the Company generates taxable income. Management periodically evaluates positions taken in tax returns with respect to situations in which applicable tax regulation is subject to interpretation and establishes provisions where appropriate. Current tax liabilities are recognized for current tax to the extent unpaid for current and prior periods. A current tax asset is recognized when the tax amount paid exceeds the amount due with respect to current and prior periods. The benefit of a tax loss that can be carried back to recover current taxes of a prior period is recognized as an asset.

#### **Future income tax**

Future income tax is recognized, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amount in the consolidated financial statements. However, the future income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Future income tax is determined using tax rates and laws that have been enacted or substantively enacted by the balance sheet date and are expected to apply when the related future income tax asset is realized or the future income tax liability is settled. Future income tax assets are recognized only to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized.

Future income tax is provided on temporary differences arising on investments in subsidiary companies and VIEs, except where the timing of the reversal of the temporary difference is controlled by the Company and it is probable that the temporary difference will not reverse in the foreseeable future.

The Company reviews the valuation of its future income taxes on an ongoing basis and records adjustments, if necessary, to reflect their realizable amount.

# **Velan Inc.**

## **Notes to Consolidated Financial Statements**

**February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

### **Translation of accounts of foreign subsidiaries and joint venture companies**

#### **Integrated foreign operations**

The financial statements of the Company's integrated foreign subsidiaries are translated using the temporal method. Under this method, monetary assets and liabilities are translated at year-end rates and non-monetary assets and liabilities at rates prevailing at the transaction dates. Revenue and expenses (other than amortization, which is translated at the rate applicable to the related asset) are translated at average rates for the year. Gains and losses arising on translation are included in the consolidated statement of earnings for the period (note 11(b)).

#### **Self-sustaining foreign operations**

The financial statements of the Company's self-sustaining foreign subsidiaries and joint venture companies are translated using the current rate method. Under this method, all assets and liabilities are translated at period-end rates and revenue and expenses at the average rate for the period. Resulting gains and losses are included in the consolidated statement of comprehensive income for the period.

### **Foreign exchange translation**

Foreign currency balances and transactions are translated using the temporal method. Under this method, all monetary assets and liabilities in foreign currencies are translated at period-end rates and non-monetary assets are translated at rates prevailing at the transaction dates. Revenue and expenses in foreign currencies are translated at weekly rates throughout the period. Gains and losses arising on translation are included in the consolidated statement of earnings for the period.

### **Financial instruments**

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. The Company's financial assets comprise mainly cash and cash equivalents, short-term investments, accounts receivable and derivative financial instruments with a positive fair value. The Company's financial liabilities comprise mainly bank indebtedness, short-term bank loans, accounts payable and accrued liabilities, customer deposits, provisions for performance guarantees, long-term debt and derivative financial instruments with a negative fair value.

The Company recognizes a financial instrument on its balance sheet when the Company becomes party to the contractual provisions of the financial instrument or non-financial derivative contract (see embedded derivatives). Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantially all risks and rewards of ownership. All financial instruments are initially recognized at fair value and are classified into one of these five categories: held for trading, held-to-maturity investments, loans and receivables, available-for-sale assets and other financial liabilities. The classification depends on the purpose for which the financial instruments were acquired and their characteristics. Except in very limited circumstances, the classification is not changed subsequent to initial recognition.

# **Velan Inc.**

## **Notes to Consolidated Financial Statements**

**February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

### **Held for trading**

Financial instruments classified as held for trading are carried at fair value at each balance sheet date with the changes in fair value recorded in the consolidated statement of earnings in the period in which these changes arise. The Company has classified its cash and cash equivalents, short-term investments, derivative financial instruments, bank indebtedness and short-term bank loans as held for trading.

### **Held-to-maturity investments, loans and receivables and other financial liabilities**

Financial instruments classified as loans and receivables, held-to-maturity investments and other financial liabilities are carried at amortized cost using the effective interest rate method. The interest income or expense is included in the consolidated statement of earnings over the expected life of the instrument. Accounts receivable are classified as loans and receivables. Accounts payable and accrued liabilities, customer deposits, provision for performance guarantees and long-term debt, including interest payable, are classified as other financial liabilities, all of which are measured at amortized cost.

### **Available for sale**

Financial instruments classified as available for sale are carried at fair value at each balance sheet date with the changes in fair value recorded in other comprehensive income (loss) in the period in which the changes arise. Securities that are classified as available for sale and do not have a readily available market value are recorded at cost. Available-for-sale securities are written down to fair value through the consolidated statement of earnings whenever it is necessary to reflect other than temporary impairment. Upon derecognition, all cumulative gains or losses are then recognized in the consolidated statement of earnings.

### **Embedded derivatives**

Derivatives may be embedded in other financial instruments (the “host instrument”). Embedded derivatives are treated as separate derivatives if their economic characteristics and risks are not clearly and closely related to those of the host instrument, the terms of the embedded derivative are the same as those of a stand-alone derivative, and the combined contract is not held for trading or designated at fair value. These embedded derivatives are classified as held for trading.

The Company and its subsidiary companies and VIEs enter into certain contracts for the purchase and sale of non-financial items that are denominated in currencies other than their respective functional currencies. In cases where the foreign exchange component is not leveraged and does not contain an option feature, the contract is denominated in the functional currency of the counterparty or the non-financial item is routinely denominated in the currency of the contract or the currency of the contract is commonly used in the economic environment in which the transaction takes place, the embedded derivative is considered to be closely related and is not accounted for separately.

The fair value of the embedded derivatives related to sales contracts is recorded in sales; purchase contracts are recorded in cost of sales. On the consolidated balance sheet, gains are recorded in accounts receivable, losses in accounts payable.

# **Velan Inc.**

## **Notes to Consolidated Financial Statements February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

### **Fair value of financial instruments**

The Company has evaluated the fair values of its financial instruments based on the current interest rate environment, related market values and current pricing of financial instruments with comparable terms. The carrying value of its financial instruments is considered to approximate fair value, unless otherwise indicated.

### **Share-based compensation plans**

The Company operates a share-based compensation plan under which the Company receives services from employees as consideration for share options. The fair value of the employee services received in exchange for the grant of the options is amortized over the vesting period as compensation expense. The total amount to be expensed is determined by multiplying the number of options expected to vest with the fair value of one option as of the grant date as determined by the Black-Scholes option pricing model. Remaining an employee of the Company for a specified period of time is the only condition for vesting. This non-market performance condition is factored into the estimate of the number of options expected to vest. If it becomes obvious that the number of options expected to vest differs from that originally expected, the expense is adjusted accordingly. When options are exercised, the Company issues new shares. The proceeds received net of any directly attributable transaction costs are credited to capital stock.

### **Provision for performance guarantees**

Provision for performance guarantees includes warranties for product failure and, in some cases, guarantees for on-time delivery. In certain cases, this will result in the Company issuing a performance bond to its customers (note 15(a)). The Company estimates its exposure under these obligations based on an analysis of all identified or expected claims and an estimate of the cost to resolve those claims.

### **Impairment of long-lived assets**

The Company recognizes an impairment loss when the carrying amount of a long-lived asset is not recoverable and exceeds its fair value. A long-lived asset is not recoverable if its carrying amount exceeds the sum of the undiscounted cash flows expected to result from its use and eventual disposition. The amount of the impairment loss is measured as the amount by which the carrying amount of the asset exceeds its fair value. Fair value is determined by quoted market prices or prices of similar items when either of them is available. When they are not available, fair value is determined using the present value of future cash flows.

The Company tests these assets for recoverability whenever events or changes in circumstances indicate that their carrying amount may not be recoverable.



# **Velan Inc.**

## **Notes to Consolidated Financial Statements February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

### **Critical accounting estimates and judgments**

The Company's financial statements are prepared in accordance with Canadian generally accepted accounting principles. The Company's significant accounting policies as described above are essential to understanding the Company's results of operations, financial positions and cash flows. Certain of these accounting policies require critical accounting estimates that involve complex and subjective judgments and the use of assumptions, some of which may be for matters that are inherently uncertain and susceptible to change. The assumptions and estimates used are based on parameters which are derived from the knowledge at the time of preparing the financial statements and believed to be reasonable under the circumstances. In particular, the circumstances prevailing at this time and assumptions as to the expected future development of the global and industry-specific environment were used to estimate the Company's future business performance. Where these conditions develop differently than assumed and beyond the control of the Company, the actual results may differ from those anticipated. These estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is changed.

### **Comparative figures**

Certain comparative figures have been reclassified to conform to the current period's basis of presentation.

### **Accounting policies adopted during the period**

#### **Goodwill and intangible assets**

The Canadian Institute for Chartered Accountants ("CICA") issued Section 3064, "Goodwill and Intangible Assets", which establishes standards for the recognition, measurement, presentation and disclosure of intangible assets. This new Section replaced Section 3062, "Goodwill and Other Intangible Assets", and Section 3450, "Research and Development Costs". The standards relating to goodwill in the new Section 3064 are unchanged from those included in Section 3062.

The adoption of this Section did not have an impact on the Company's financial position, earnings or cash flows.

#### **Financial instruments – Disclosures**

In June 2009, the CICA amended Section 3862, "Financial Instruments – Disclosures", to include additional disclosure requirements about fair value measurement for financial instruments and liquidity risk disclosures. These amendments require a three-level hierarchy that reflects the significance of the inputs used in making the fair value measurements. Fair values of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Assets and liabilities in Level 2 include valuations using inputs other than the quoted prices for which all significant inputs are based on observable market data, either directly or indirectly. Level 3 valuations are based on inputs that are not based on observable market data.

# **Velan Inc.**

## **Notes to Consolidated Financial Statements**

**February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

The adoption of this amendment did not have an impact on the Company's financial position, earnings or cash flows.

### **Accounting policies that are not yet effective and have not been early adopted**

#### **Business combinations**

The CICA issued Section 1582, "Business Combinations", which replaces Section 1581, "Business Combinations". The Section establishes standards for the accounting for a business combination. It provides the Canadian equivalent to International Financial Reporting Standard 3 (Revised), "Business Combinations". The Section applies prospectively to business combinations for which the acquisition date is on or after the Company's annual reporting period beginning March 1, 2011. Earlier application is permitted. The Company is currently evaluating the impact of the adoption of this new accounting standard on its consolidated financial statements.

#### **Consolidated financial statements and non-controlling interests**

The CICA issued Section 1601, "Consolidated Financial Statements", and Section 1602, "Non-controlling Interests", which together replace Section 1600, "Consolidated Financial Statements". Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. It is equivalent to the corresponding provisions of International Accounting Standard 27 (Revised), "Consolidated and Separate Financial Statements". The standards are effective for the Company's annual reporting period beginning on March 1, 2011, although earlier adoption is permitted as of the beginning of a fiscal year.

The Company is currently evaluating the impact of the adoption of these new accounting standards on its consolidated financial statements.

# Velan Inc.

## Notes to Consolidated Financial Statements February 28, 2010 and 2009

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(in thousands, excluding number of shares and per share amounts)

### 2 Disposal of a business

During the prior period, the Company sold its 50% interest in an Italian joint venture company, considered a variable interest entity for which the Company was the primary beneficiary, for cash consideration of \$44,088 (€27,650), all of which was received at closing. The Company incurred expenses of \$325 related to the sale and recognized a gain of \$279 on a foreign exchange forward contract related to the sale which was included in the calculation of the gain on disposal, as outlined below.

Assets and liabilities of the joint venture company at the time of disposition were as follows:

	\$
Cash and cash equivalents	1,504
Accounts receivable	35,498
Inventories	22,899
Property, plant and equipment	6,462
Other assets	1,126
	<hr/>
	67,489
	<hr/>
Short-term bank loans	5,788
Accounts payable and accrued liabilities	25,065
Customer deposits	3,296
Long-term debt	13,661
Other liabilities	3,427
	<hr/>
	51,237
	<hr/>
<b>Net assets</b>	16,252
Less: Non-controlling interest's share	8,126
	<hr/>
<b>Net assets sold</b>	8,126
Gain on disposal of a business	35,962
	<hr/>
Proceeds on disposal of a business	44,088
Add: Gain on forward contract related to sale proceeds	279
Less: Disposal of cash	1,504
Less: Direct expenses related to the sale	325
	<hr/>
<b>Net proceeds on disposal of a business</b>	42,538

# **Velan Inc.**

## **Notes to Consolidated Financial Statements**

**February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

The net gain on disposal of a business includes:

	\$
Gain on disposal of a business	35,962
Realized translation adjustment on disposal of a self-sustaining foreign operation	<u>679</u>
	36,641
Add: Gain on forward contract related to sale proceeds	279
Less: Direct expenses related to the sale	<u>325</u>
	36,595
Net gain on disposal of a business	<u>36,595</u>

The Company continues to have significant activity in the same market and to that end maintains an ongoing business relationship with its former joint venture.

### **3 Inventories**

	<b>2010</b>	<b>2009</b>
	\$	\$
Raw materials	36,245	51,799
Finished parts	123,792	111,768
Finished goods	<u>46,435</u>	<u>49,214</u>
	<u>206,472</u>	<u>212,781</u>

The cost of inventories recognized as an expense and included in cost of sales amounted to \$317,888 (for the nine-month period ended February 28, 2009 – \$209,441).

As a result of changes in circumstances surrounding its inventory provisions, the Company recognized an expense of \$1,173 (for the nine-month period ended February 28, 2009 – \$2,347), net of reversals of \$6,414 (for the nine-month period ended February 28, 2009 – \$3,296).

The net book value of inventories pledged as security under the Company's credit facilities amounted to \$2,951 (February 28, 2009 – \$4,208).

# Velan Inc.

## Notes to Consolidated Financial Statements

February 28, 2010 and 2009

(in thousands, excluding number of shares and per share amounts)

### 4 Property, plant and equipment

Property, plant and equipment consist of the following:

	<b>2010</b>		
	<b>Cost</b>	<b>Accumulated</b>	<b>Net</b>
	<b>\$</b>	<b>amortization</b>	<b>\$</b>
		<b>\$</b>	
Land	11,802	-	11,802
Buildings	47,679	20,896	26,783
Machinery and equipment	130,469	99,156	31,313
Furniture and fixtures	6,132	5,512	620
Data processing equipment	8,044	5,864	2,180
Rolling stock	1,990	1,360	630
Leasehold improvements	192	102	90
	<b>206,308</b>	<b>132,890</b>	<b>73,418</b>
	<b>2009</b>		
	<b>Cost</b>	<b>Accumulated</b>	<b>Net</b>
	<b>\$</b>	<b>amortization</b>	<b>\$</b>
		<b>\$</b>	
Land	11,902	-	11,902
Buildings	44,435	20,510	23,925
Machinery and equipment	126,906	95,418	31,488
Furniture and fixtures	6,044	5,436	608
Data processing equipment	15,140	13,505	1,635
Rolling stock	1,987	1,307	680
Leasehold improvements	131	99	32
	<b>206,545</b>	<b>136,275</b>	<b>70,270</b>

# **Velan Inc.**

## **Notes to Consolidated Financial Statements**

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(in thousands, excluding number of shares and per share amounts)

### **5 Credit facilities**

- a) Velan Inc. and its US subsidiary company, Velan Valve Corp., have the following credit facilities available as at February 28, 2010:

#### **Unsecured**

##### **Credit facilities available**

##### **Borrowing rates**

\$48,158 (CA\$45,000 and US\$3,000) (2009 – \$58,817  
(CA\$55,000 and US\$3,000)) (note 13)

Prime rate

\$5,000 to purchase readily convertible foreign exchange  
forward contracts (note 13)

Prime rate

The above unsecured facilities are available by way of demand operating lines of credit, bank loans, letters of credit, bankers' acceptances, LIBOR loans, letters of guarantee and bank overdrafts. These facilities are subject to annual renewal.

- b) Foreign subsidiaries and joint venture companies have the following credit facilities available as at February 28, 2010:

#### **Secured by corporate guarantees**

##### **Credit facilities available**

##### **Borrowing rates**

Foreign subsidiaries

CA\$118,852 (€67,934; £3,795; KW7,394,400;  
CNY5,400) (2009 – CA\$57,180 (€26,145;  
£3,300; KW9,645,600)) (note 13)

0.05% to 7.07%  
(2009 – 0.9% to 8.5%)

Joint venture companies

CA\$2,576 (KW2,840,000)  
(2009 – CA\$1,567 (KW1,890,000)) (note 13)

4.31% to 6.36%  
(2009 – 3.72% to 5.49%)

The above credit facilities are available by way of bank loans, guarantees, letters of credit and foreign exchange forward contracts. The majority of these credit facilities have variable borrowing rates based on LIBOR, EONIA or prime rate. The borrowing rates listed above are the rates in effect as at February 28. The terms of the above facilities range from annual renewal to an indefinite term. The aggregate net book value of the assets pledged under the above credit facilities amounted to \$19,569 (2009 – \$18,971).

# **Velan Inc.**

## **Notes to Consolidated Financial Statements**

**February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

### **6 Income taxes**

The Company's effective income tax rate is made up as follows:

	<b>2010</b> %	<b>2009</b> %
Basic federal rate and surtax, less provincial abatement	18.84	19.40
Provincial tax rate	11.90	11.50
	<hr/>	<hr/>
	30.74	30.90
Net gain on disposition of a business	-	(16.16)
Non-deductible (taxable) foreign exchange loss (gain) on translation of integrated subsidiary companies	4.15	(2.50)
Non-controlling interest	0.76	0.49
Differences between Canadian statutory rates and those applicable to foreign subsidiaries and joint venture companies	1.46	0.76
Permanent differences and other	(0.20)	(1.70)
	<hr/>	<hr/>
	36.91	11.79

Future income taxes consist of the following amounts:

	<b>2010</b> \$	<b>2009</b> \$
Future income tax asset		
Current portion	4,735	4,054
Long-term portion	1,880	1,614
Future income tax liability		
Current portion	(907)	(2,771)
Long-term portion	(3,834)	(3,286)
	<hr/>	<hr/>
Net future income tax asset (liability)	1,874	(389)



# Velan Inc.

## Notes to Consolidated Financial Statements February 28, 2010 and 2009

(in thousands, excluding number of shares and per share amounts)

The significant components of the net future income tax asset are as follows:

	2010 \$	2009 \$
Property, plant and equipment	(3,538)	(2,811)
Non-deductible reserves	3,362	659
Investment tax credits	(286)	(440)
Inventories	2,131	2,171
Tax losses	36	81
Other – net	169	(49)
	<u>1,874</u>	<u>(389)</u>

Certain subsidiary companies have accumulated non-capital losses for income tax purposes amounting to approximately \$124, which may be carried forward to reduce taxable income in future years. The future tax benefit of \$36 arising from these losses has been recognized in the accounts as a future tax asset. These losses begin to expire in 2016.

### 7 Long-term debt

	2010 \$	2009 \$
a) Korean joint venture company (note 7(b))		
Bank loan (KW400,000; 2009 – KW1,000,000)	363	829
Bank loan (nil; 2009 – KW500,000)	-	415
Other (note 7(c))	<u>3,639</u>	<u>3,683</u>
	4,002	4,927
Less: Current portion	<u>46</u>	<u>530</u>
	<u>3,956</u>	<u>4,397</u>

#### b) Korean joint venture company

A bank loan of \$363 (KW400,000) bears interest at 2.25% and is repayable in 2012. Certain land, a building, and certain machinery and equipment are pledged as collateral for this loan.

# Velan Inc.

## Notes to Consolidated Financial Statements

February 28, 2010 and 2009

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(in thousands, excluding number of shares and per share amounts)

- c) Included in Other is an amount of \$2,962 (€2,067) related to an unconditional put option held by a minority shareholder in one of the Company's subsidiary companies. This is recognized as a liability instead of minority interest. The liability is initially recognized as the minority interest's share of the net identifiable assets of the subsidiary or VIE. Subsequently, the liability is carried at the amount of the present value of estimated future cash flows discounted at the original effective rate. Adjustments to the carrying value are recorded as interest expense in the consolidated statement of earnings.
- d) The following is a schedule of future debt payments:

	\$
February 2011	46
2012	439
2013	3
2014	2,965
2015	3
Subsequent years	<u>546</u>
	<u>4,002</u>

The aggregate net book value of the assets pledged as collateral under long-term debt agreements amounted to \$2,554 (2009 – \$2,406).

- e) The carrying value of the long-term debt approximates its fair value.

## 8 Capital stock

- a) Authorized – in unlimited number  
Preferred Shares, issuable in series  
Subordinate Voting Shares  
Multiple Voting Shares (five votes per share), convertible into Subordinate Voting Shares

- b) Issued

	2010 \$	2009 \$
6,663,901 Subordinate Voting Shares (2009 – 6,748,101) (note 8(c))	99,249	100,502
15,566,567 Multiple Voting Shares (2009 – 15,566,567)	<u>8,824</u>	<u>8,824</u>
	<u>108,073</u>	<u>109,326</u>

# Velan Inc.

## Notes to Consolidated Financial Statements

February 28, 2010 and 2009

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(in thousands, excluding number of shares and per share amounts)

- c) Pursuant to its Normal Course Issuer Bid, the Company is entitled to repurchase for cancellation a maximum of 333,670 Subordinate Voting Shares (2009 – 337,670) during the twelve-month period ended October 20, 2010. During the year ended February 28, 2010, 84,200 Subordinate Voting Shares (2009 – 4,300) were purchased for a cash consideration of \$1,056 (2009 – \$47) and cancelled. The amount by which the repurchase amount is below the stated capital of the shares has been credited to contributed surplus.
- d) The Company established a fixed share option plan (the “Share Option Plan”) in 1996, amended in fiscal 2007, to allow for the purchase of Subordinate Voting Shares by certain of its full-time employees, directors, officers and consultants.

The subscription price for Subordinate Voting Shares granted under options is the greater of (i) the weighted average trading price for such Subordinate Voting Shares for the five days preceding the date of grant during which the Subordinate Voting Shares were traded on the Toronto Stock Exchange (“TSX”) or (ii) the trading price for the Subordinate Voting Shares on the last day the Subordinate Voting Shares were traded on the TSX immediately preceding the date of grant.

The Share Option Plan provides that the maximum number of Subordinate Voting Shares issuable from time to time under the Share Option Plan is a fixed maximum percentage of 5% of the aggregate of the Multiple Voting Shares and the Subordinate Voting Shares issued and outstanding from time to time.

The granting of options is at the discretion of the Board of Directors which, at the date of grant, establishes the term and vesting period. Vesting of options generally commences twelve months after the date of grant and accrues annually over the vesting period provided there is continuous employment. The maximum term permissible is 10 years.

The fair value of the options is estimated as at the date of grant using an option pricing model with the following weighted average assumptions:

Risk-free interest rate	3.17%
Expected dividend yield	2.77%
Expected life of the options	4.94 years
Expected volatility	28.99%

The weighted average fair value of the options at grant date is \$2.46.

A compensation cost of \$197 (2009 – \$103) was recorded in the consolidated statement of earnings and credited to contributed surplus.

# Velan Inc.

## Notes to Consolidated Financial Statements February 28, 2010 and 2009

(in thousands, excluding number of shares and per share amounts)

The table below summarizes the status of the Share Option Plan.

	2010			2009		
	Number of shares	Weighted average exercise price \$	Weighted average contractual life in months	Number of shares	Weighted average exercise price \$	Weighted average contractual life in months
Outstanding – Beginning of period	200,000	11.27	51.6	30,000	12.81	38.5
Expired	6,667	11.00	-	-	-	-
Granted	-	-	-	170,000	11.00	60.0
Outstanding – End of period	193,333	11.28	38.8	200,000	11.27	51.6
Exercisable – End of period	86,667	11.63		20,000	12.81	

## 9 Earnings per share

Earnings per share is calculated using the weighted average number of shares outstanding of 22,264,101 (2009 – 22,317,330) and amounts to \$1.60 (2009 – \$2.77). Diluted earnings per share includes the effect of 200,000 dilutive options (2009 – 170,000) and amounts to 1.59 (2009 – 2.77)

The following table presents the options that could potentially dilute basic earnings per common share but which were not included in the calculation of diluted earnings per share because to do so would have been anti-dilutive.

	February 28, 2010	February 28, 2009
Options	-	30,000

# Velan Inc.

## Notes to Consolidated Financial Statements February 28, 2010 and 2009

(in thousands, excluding number of shares and per share amounts)

### 10 Segment disclosure

The Company's operations are principally in the manufacturing and sale of industrial valves.

#### Geographic distribution of sales and assets

	2010					
	Canada \$	United States \$	France \$	Other \$	Consolidation adjustment \$	Consolidated \$
Sales						
Customers						
Domestic	30,963	147,013	52,478	11,489	-	241,943
Export	102,130	-	44,972	76,900	-	224,002
Intercompany (export)	110,313	21,656	665	45,297	(177,931)	-
Total	243,406	168,669	98,115	133,686	(177,931)	465,945
Property, plant and equipment	38,730	5,375	10,472	18,905	(64)	73,418
Goodwill	-	-	-	-	12,502	12,502
Other identifiable assets	182,110	83,192	127,628	85,566	(51,719)	426,777
Total identifiable assets	220,840	88,567	138,100	104,471	(39,281)	512,697
	2009					
	Canada \$	United States \$	France \$	Other \$	Consolidation adjustment \$	Consolidated \$
Sales						
Customers						
Domestic	19,951	100,789	36,291	9,783	-	166,814
Export	79,552	-	20,145	60,348	-	160,045
Intercompany (export)	82,923	26,940	14	37,121	(146,998)	-
Total	182,426	127,729	56,450	107,252	(146,998)	326,859
Property, plant and equipment	38,303	5,363	8,188	18,390	26	70,270
Goodwill	-	-	-	-	12,502	12,502
Other identifiable assets	201,938	68,409	96,577	108,825	(52,001)	423,748
Total identifiable assets	240,241	73,772	104,765	127,215	(39,473)	506,520

The goodwill relates to one of the French operations but only arises on consolidation. The fair value of this French operation is used for the purpose of the goodwill impairment test.

In 2010, no customer represented more than 10% of the Company's total sales. In 2009, one customer represented more than 10% of the Company's sales.

# Velan Inc.

## Notes to Consolidated Financial Statements

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(in thousands, excluding number of shares and per share amounts)

### 11 Foreign exchange

- a) Foreign exchange gains (losses) realized on the translation of foreign currency balances, transactions and the fair value of foreign currency financial derivatives and embedded derivatives during the period are included in sales and cost of sales and amounted to:

	2010 \$	2009 \$
Sales	(1,591)	2,523
Cost of sales	13,389	(15,089)

- b) Foreign exchange loss (gain) on translation of integrated foreign subsidiaries consists of:

	2010 \$	2009 \$
US subsidiary	8,105	(6,994)
Korean subsidiary	(422)	1,384
Taiwanese subsidiary	342	(576)
Chinese subsidiary	(431)	526
	7,594	(5,660)

### 12 Research expenses

Research expenses include the following:

	2010 \$	2009 \$
Research expenditures	7,363	5,953
Less: Scientific research tax credits	1,713	1,702
	5,650	4,251

# Velan Inc.

## Notes to Consolidated Financial Statements February 28, 2010 and 2009

(in thousands, excluding number of shares and per share amounts)

### 13 Financial risk management

The Company's activities expose it to a variety of financial risks: market risk (including currency risk, fair value interest rate risk and cash flow interest rate risk), credit risk and liquidity risk. The Company's overall financial risk management program focuses on mitigating unpredictable financial market risks and their potential adverse effects on the Company's financial performance.

The Company's financial risk management is generally carried out by the corporate finance team, based on policies approved by the Board of Directors. The identification, evaluation and hedging of the financial risks are the responsibility of the corporate finance team in conjunction with the finance teams of the Company's subsidiary companies and VIEs. The Company uses derivative financial instruments to hedge certain risk exposures. Use of derivative financial instruments is subject to a policy which requires that no derivative transaction be entered into for the purpose of establishing a speculative or leveraged position (the corollary being that all derivative transactions are to be entered into for risk management purposes only).

#### Overview

The Company's financial instruments and the nature of risks which they may be subject to are set out in the following table:

Financial instrument	Risks				
	Credit	Liquidity	Market risks		
			Currency	Interest rate	Other price
Cash and cash equivalents	x		x	x	
Short-term investments	x		x	x	
Bank indebtedness	x	x	x	x	
Short-term bank loans	x	x	x	x	
Accounts receivable	x		x		
Accounts payable and accrued liabilities		x	x		
Customer deposits		x	x		
Provision for performance guarantees		x	x		
Derivative financial instruments	x	x	x		
Long-term debt		x	x	x	

# **Velan Inc.**

## **Notes to Consolidated Financial Statements**

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(in thousands, excluding number of shares and per share amounts)

### **Market risk**

#### **Currency risk**

Currency risk on financial instruments is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. The Company operates internationally and is exposed to foreign exchange risk arising from various currency exposures. Currency risk arises when future commercial transactions and recognized assets and liabilities are denominated in a currency other than a company's functional currency. The Company has operations with different functional currencies, each of which will be exposed to currency risk based on its specific functional currency.

When possible the Company matches cash receipts in a foreign currency with cash disbursements in that same currency. The remaining anticipated net exposure to foreign currencies is hedged. To hedge this exposure, the Company uses foreign currency derivatives, primarily foreign exchange forward contracts. These derivatives are not designated as hedges for accounting purposes.

The amounts outstanding as at February 28, 2010 and 2009 are as follows:

	<b>Range of exchange rates</b>		<b>Gain (loss)</b>		<b>Notional amount</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
			<b>\$</b>	<b>\$</b>		
<b>Foreign exchange forward contracts</b>						
Sell US\$ for CA\$						
0 to 15 months	1.04–1.24	0.99–1.28	3,023	(3,934)	US\$103,900	US\$63,141
Buy US\$ for CA\$						
0 to 12 months	-	1.06–1.23	-	400	-	US\$4,241
Buy £ for CA\$						
0 to 12 months	1.7795–1.7796	1.85–1.87	(157)	(127)	£900	£3,200
Sell US\$ for €						
0 to 12 months	1.32–1.54	1.26–1.57	(628)	(2,766)	US\$5,416	US\$18,123
Buy US\$ for €						
0 to 12 months	1.29–1.51	1.26–1.54	352	2,158	US\$5,677	US\$14,271
Buy £ for €						
0 to 12 months	0.88	0.79–0.94	(2)	(536)	£2,451	£5,069
Buy CA\$ for €						
0 to 20 months	1.42–1.57	-	65	-	CA\$836	-
Sell CA\$ for €						
0 to 20 months	1.43–1.44	-	(3)	-	CA\$734	-
Sell US\$ for KW						
0 to 12 months	-	1.043–1.393	-	(1,270)	-	US\$7,181
Sell € for CA\$						
0 to 12 months	1.568–1.572	-	472	-	€3,487	-
<b>Purchased options</b>						
Sell US\$ for CA\$						
0 to 12 months	-	0.97–1.22	-	390	-	US\$35,700
<b>Written options</b>						
Purchase US\$ for CA\$						
0 to 12 months	-	0.97–1.22	-	(4,976)	-	US\$24,990



# Velan Inc.

## Notes to Consolidated Financial Statements

February 28, 2010 and 2009

(in thousands, excluding number of shares and per share amounts)

Foreign exchange forward contracts are contracts whereby the Company has the obligation to sell or buy the currencies at the strike price. Currency options are contracts whereby the Company has the right but not the obligation to sell or buy the currencies. Written options are contracts whereby the Company has the obligation to buy Canadian dollars at the strike rate if the counterparty exercises the option. The fair value of the foreign currency instruments is recorded in the consolidated statement of earnings and reflects the estimated amounts the Company would have paid or received to settle these contracts. Gains on these instruments are recorded in accounts receivable; losses are recorded in accounts payable.

The following table provides a sensitivity analysis of the Company's most significant foreign exchange exposures related to its net position in the foreign currency financial instruments.\* A hypothetical strengthening of 5.0% of the following currencies would have had the following impact.

	<b>2010</b>	
	<b>Net earnings (loss)</b>	<b>Other comprehensive income (loss)</b>
	<b>\$</b>	<b>\$</b>
US dollar strengthening against the Canadian dollar	(1,427)	-
US dollar strengthening against the euro	192	-
Euro strengthening against the British pound sterling	249	-

	<b>2009</b>	
	<b>Net earnings (loss)</b>	<b>Other comprehensive income (loss)</b>
	<b>\$</b>	<b>\$</b>
US dollar strengthening against the Canadian dollar	(661)	-
US dollar strengthening against the euro	225	-
US dollar strengthening against the Korean won	(227)	-
British pound sterling strengthening against the Canadian dollar	201	-

A hypothetical weakening of 5.0% of the above currencies would have had the opposite impact.

For the purposes of the above analysis, foreign exchange exposure does not include the translation of subsidiary companies and VIEs into the Company's reporting currency.

\* The net position in foreign currency financial instruments includes cash and cash equivalents, short-term investments, bank indebtedness, short-term bank loans, derivative financial instruments, accounts receivable, accounts payable and accrued liabilities, customer deposits, provision for performance guarantees and long-term debt, including interest payable.

# **Velan Inc.**

## **Notes to Consolidated Financial Statements**

**February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

### **Cash flow and fair value interest rate risk**

The Company's exposure to interest rate risk is related primarily to its credit facilities, long-term debt and cash and cash equivalents. Items at variable rates expose the Company to cash flow interest rate risk and items at fixed rates expose the Company to fair value interest rate risk. The Company's long-term debt and credit facilities predominantly bear interest, and its cash and cash equivalents earn interest, at variable rates. An assumed 0.5 percentage point change in interest rates would not have a material impact on the net earnings or cash flows of the Company.

### **Credit risk**

Credit risk is the risk of an unexpected loss if a customer or counterparty to a financial instrument fails to meet its contractual obligations. Credit risk arises primarily from the Company's trade accounts receivable.

The Company's credit risk related to its trade accounts receivable is concentrated. As at February 28, 2010, three (2009 – three) customers accounted for more than 5% each of its trade accounts receivable, of which one customer accounted for 14.05% (2009 – 14.7%), and the Company's ten largest customers accounted for 57.54% (2009 – 58.6%).

In order to mitigate its credit risk, the Company performs a continual evaluation of its customers' credit and performs specific evaluation procedures on all its new customers. In performing its evaluation, the Company analyzes the ageing of accounts receivable, historical payment patterns, customer creditworthiness and current economic trends. A specific credit limit is established for each customer and reviewed periodically. An allowance for doubtful accounts is recorded when, based on management's evaluation, the collection of an account receivable is not reasonably certain.

The Company is also exposed to credit risk relating to derivative financial instruments, cash and cash equivalents and short-term investments, which it manages by dealing with highly rated financial institutions.

The Company's credit risk is limited to the carrying value of the trade accounts receivable and gains on derivative financial instruments.

# **Velan Inc.**

## **Notes to Consolidated Financial Statements** **February 28, 2010 and 2009**

(in thousands, excluding number of shares and per share amounts)

The table below summarizes the ageing of trade accounts receivable as at February 28:

	<b>2010</b>	<b>2009</b>
	<b>\$</b>	<b>\$</b>
Current	67,688	81,535
Past due 0 to 30 days	13,948	11,637
Past due 31 to 90 days	4,386	4,896
Past due more than 90 days	860	5,693
	<hr/>	<hr/>
	86,882	103,761
Less: Allowance for doubtful accounts	1,124	793
	<hr/>	<hr/>
Trade accounts receivable	85,758	102,968
Other receivables	9,788	20,365
	<hr/>	<hr/>
Total accounts receivable	95,546	123,333

The table below summarizes the movements in the allowance for doubtful accounts:

	<b>2010</b>	<b>2009</b>
	<b>\$</b>	<b>\$</b>
<b>Balance – Beginning of period</b>	793	587
Bad debt expenses	746	588
Recoveries of trade accounts receivable	(333)	(291)
Writeoff of trade accounts receivable	(82)	(91)
	<hr/>	<hr/>
<b>Balance – End of period</b>	1,124	793

### **Liquidity risk**

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they come due. The Company manages its liquidity risk by continually monitoring its future cash requirements. Cash flow forecasting is performed in the operating entities and aggregated by the Company's corporate finance team. The Company's policy is to maintain sufficient cash and cash equivalents and available credit facilities in order to meet its present and future operational needs.

# Velan Inc.

## Notes to Consolidated Financial Statements

February 28, 2010 and 2009

(in thousands, excluding number of shares and per share amounts)

The following tables present the Company's financial liabilities identified by type and future contractual dates of payment as at February 28:

	<b>2010</b>				
	<b>Total</b>	<b>Less than</b>	<b>1 to 3</b>	<b>4 to 5</b>	<b>After</b>
	<b>\$</b>	<b>1 year</b>	<b>Years</b>	<b>Years</b>	<b>5 years</b>
		<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Long-term debt	4,002	46	442	2,968	546
Accounts payable and accrued liabilities (including losses on derivative financial instruments)	68,845	68,845	-	-	-
Customer deposits	58,146	58,146	-	-	-
Provision for performance guarantees	11,649	11,649	-	-	-
Bank indebtedness and short-term bank loans	3,463	3,463	-	-	-
	<b>2009</b>				
	<b>Total</b>	<b>Less than</b>	<b>1 to 3</b>	<b>4 to 5</b>	<b>After</b>
	<b>\$</b>	<b>1 year</b>	<b>Years</b>	<b>Years</b>	<b>5 years</b>
		<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>
Long-term debt	4,927	530	916	3,030	451
Accounts payable and accrued liabilities (including losses on derivative financial instruments)	91,047	91,047	-	-	-
Customer deposits	51,608	51,608	-	-	-
Provision for performance guarantees	7,438	7,438	-	-	-
Bank indebtedness and short-term bank loans	3,457	3,457	-	-	-

### Fair value of financial instruments

The Company adopted the amendments to CICA Section 3862 for these annual consolidated financial statements; comparative disclosures are not required in the year of adoption. The amendments require the use of a fair value hierarchy in order to classify the fair value disclosures related to the Company's financial assets and financial liabilities that are recognized at fair value in the consolidated balance sheet.

# **Velan Inc.**

## **Notes to Consolidated Financial Statements** **February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

The fair value hierarchy has the following levels:

- Level 1 – quoted market prices in active markets for identical assets or liabilities;
- Level 2 – inputs other than quoted market prices included in Level 1 that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices); and
- Level 3 – unobservable inputs such as inputs for the asset or liability that are not based on observable market data. The level in the fair value hierarchy within which the fair value measurement is categorized in its entirety is determined on the basis of the lowest level input that is significant to the fair value measurement in its entirety.

The fair value of financial assets and financial liabilities measured in the consolidated balance sheet as of February 28, 2010 are as follows:

<b>Balance sheet classification and nature</b>	<b>February 28, 2010 \$</b>	<b>Quoted prices in active markets for identical assets (Level 1) \$</b>	<b>Significant observable inputs (Level 2) \$</b>	<b>Significant unobservable inputs (Level 3) \$</b>
<b>Assets</b>				
Cash and cash equivalents	106,940	106,940	-	-
Short-term investments	310	310	-	-
Derivative financial instruments (grouped with accounts receivable on the balance sheet)	4,253	-	4,253	-
<b>Liabilities</b>				
Bank indebtedness	2,630	2,630	-	-
Short-term bank loans	833	833	-	-
Derivative financial instruments (grouped with accounts payable and accrued liabilities on the balance sheet)	1,131	-	1,131	-

Fair value measurements of the Company's cash and cash equivalents, short-term investments, bank indebtedness and short-term bank loans are classified under Level 1 because such measurements are determined using quoted prices in active markets for identical assets.

Fair value measurements of the Company's derivative financial instruments are classified under Level 2 because such measurements are determined using published market prices or estimates based on observable inputs such as interest rates, yield curves, and spot and future exchange rates.

# **Velan Inc.**

## **Notes to Consolidated Financial Statements** **February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

### **14 Capital management**

The Company's capital management strategy is designed to maintain strong liquidity in order to pursue its organic growth strategy, undertake selective acquisitions and provide an appropriate investment return to its shareholders while taking a conservative approach to financial leverage.

The Company's financial strategy is designed to meet the objectives stated above and to respond to changes in economic conditions and the risk characteristics of underlying assets. In order to maintain or adjust its capital structure, the Company may issue or repurchase shares, raise or repay debt, vary the amount of dividends paid to shareholders or undertake any other activities it considers appropriate under the circumstances.

The Company monitors capital on the basis of its total debt to equity ratio. Total debt consists of all interest-bearing debt, and equity is defined as total shareholders' equity.

The total debt to equity ratio as at February 28 was as follows:

	<b>2010</b>	<b>2009</b>
	<b>\$</b>	<b>\$</b>
Bank indebtedness	2,630	2,454
Short-term bank loans	833	1,003
Current portion of long-term debt	46	530
Long-term debt	3,956	4,397
<b>Total debt</b>	<b>7,465</b>	<b>8,384</b>
<b>Shareholders' equity</b>	<b>346,184</b>	<b>327,115</b>
<b>Total debt to equity ratio</b>	<b>2.2%</b>	<b>2.6%</b>

The Company's objective is to conservatively manage the total debt to equity ratio and to maintain funding capacity for potential opportunities.

The Company's financial objectives and strategy as described above have remained unchanged since the last period. These objectives and strategies are reviewed annually or more frequently if the need arises.

The Company is in compliance with all covenants related to its debt and credit facilities, and is not subject to any capital requirements imposed by a regulator.

# **Velan Inc.**

## **Notes to Consolidated Financial Statements February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

### **15 Commitments and contingencies**

- a) In the normal course of business, the Company issues performance bond guarantees related to product warranty and on-time delivery as well as advance payment guarantees and bid bonds. As at February 28, 2010, the aggregate maximum value of these guarantees, if exercised, amounted to \$103,539 (2009 – \$67,281). The guarantees expire as follows:

	\$
February 2011	53,759
2012	26,057
2013	4,143
2014	5,508
2015	736
Subsequent years	<u>13,336</u>
	<u>103,539</u>

- b) The Company has outstanding purchase commitments with foreign suppliers, due in 2011, amounting to \$7,342 (2009 – \$30,694), which are covered by letters of credit.
- c) Future minimum payments under operating leases (related mainly to premises and machinery) are as follows:

	\$
February 28, 2011	318
2012	241
2013	127
2014	<u>72</u>
	<u>758</u>

# **Velan Inc.**

## **Notes to Consolidated Financial Statements**

**February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

- d) The Company has entered into an agreement with an affiliated company which is owned by certain relatives of the controlling shareholder. Pursuant to the agreement, the Company has the right to purchase the shares of the affiliated company for a consideration equal to the book value thereof in the event that the affiliated company proposes to sell its shares to a third party. In the event that the affiliated company proposes to sell all or substantially all of its assets to a third party, the Company has the right to purchase inventory at cost and other assets at book value. In addition, in the event of a proposed liquidation or sale of sufficient assets such that the affiliated company cannot fulfill its obligations to the Company under any outstanding purchase orders, the Company also has the right and obligation to purchase the affiliated company's inventory at an amount equal to the cost thereof. The maximum obligation of the Company pursuant to such put right is approximately \$200.
- e) Two of the Company's US subsidiaries have been named as defendants in a number of asbestos-related legal proceedings pertaining to products they formerly sold. Management believes it has a strong defence, and the subsidiaries have previously been dismissed from a number of similar cases. Because of the many uncertainties inherent in predicting the outcome of these proceedings, as well as the course of asbestos litigation in the United States, management believes that it is not possible to make an estimate of the subsidiaries' asbestos liability. Accordingly, no provision has been set up in the accounts.

Legal and related costs for these matters amounted to \$4,680 (2009 – \$2,755).

- f) Lawsuits and proceedings or claims arising from the normal course of operations are pending or threatened against the Company. Although at this time it is not possible to determine the outcome, based on the facts currently known, the Company does not believe that the ultimate outcome will have a material adverse effect on its financial position, results of operations or liquidity. No provision has been set up in the accounts.



# **Velan Inc.**

## **Notes to Consolidated Financial Statements**

**February 28, 2010 and 2009**

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(in thousands, excluding number of shares and per share amounts)

### **16 Transactions with related parties**

Transactions with related parties in the ordinary course of business, which are measured at the exchange value and are not otherwise disclosed separately in these financial statements, are as follows:

	<b>2010</b>	<b>2009</b>
	<b>\$</b>	<b>\$</b>
Affiliated company owned by certain relatives of the controlling shareholder		
Purchases – Material components	1,651	1,872
Sales – Material components	166	161
Amounts charged by an affiliated company in which a relative of the controlling shareholder owns a 50% interest		
Computer consulting	6	5
Accounts receivable		
Affiliated companies	65	1
Accounts payable and accrued liabilities		
Affiliated companies	158	96
Controlling shareholder	8	-
Amount charged by the controlling shareholder		
Rent and expenses	40	21
Legal fees charged by a firm in which a director of the Company is a partner (ceased being a related party as of November 17, 2008)	-	98

# Shareholder Information

## Head office

7007 Côte-de-Liesse  
Montreal, Quebec  
Canada H4T 1G2

## Website

www.velan.com

## Investor relations

John D. Ball  
Chief Financial Officer  
7007 Côte-de-Liesse  
Montreal, Quebec  
Canada H4T 1G2  
Tel.: (514) 748-7743, Ext. 5537  
Fax: (514) 908-0180

## Auditors

PricewaterhouseCoopers LLP

## Transfer agent

CIBC Mellon

## Shares outstanding as at February 28, 2010

6,663,901 Subordinate Voting Shares  
15,566,567 Multiple Voting Shares

## Listing

Symbol: VLN

## Price range

High \$16.00  
Low \$10.20

Closing on February 28, 2010: \$15.50

## Annual meeting

The Annual Meeting of Shareholders will be held  
July 9, 2010, at 11:00 a.m. in the Grand Salon of:  
Saint James Club of Montreal  
1145 Union Avenue  
Montreal, Quebec

## Corporate directors

A. K. Velan	Chief Executive Officer
I. C. Velan	Chairman of the Board, Executive Vice-President
T. C. Velan	President
G. Jellinek	Director
K. MacKinnon	Director
A. Martini	Director
W. Sheffield	Director
P. Velan	Director

## Corporate officers

A. K. Velan	Chief Executive Officer
T. C. Velan	President
I. C. Velan	Executive Vice-President
J. D. Ball	Chief Financial Officer
S. Cherlet	Executive Vice-President, Operations
V. Apostolescu	Vice-President, Quality Assurance
S. Bruckert	Vice-President, Human Resources and General Counsel, Corporate Secretary
J. del Buey	Vice-President, Severe Service Applications
P. Dion	Vice-President, Canadian Sales
V. Hannah	Vice-President, Finance
P. Lee	Vice-President, Sales - United States (Eastern Division)
G. Perez	Vice-President, Engineering
C. Pogue	Vice-President, Sales - United States (Western Division)
R. Sargent	Vice-President, International Marketing
A. Smith	Vice-President, Procurement and Overseas Manufacturing
G. Zarifah	Vice-President, Global Capital Investments and Production Technology
M. Zivic	Vice-President, International Sales

# Velan worldwide

## Head Office and Plant 5



**Montreal, Canada**  
**Velan Inc.**

## An extensive global network

- 13 manufacturing plants
- 27 sales offices
- 53 authorized service shops
- 4 stocking distribution centers
- 2 large R&D facilities
- 22 product lines
- More than 100 distributors worldwide

## Plant 1



**Montreal, Canada**  
**Velan Inc.**

## Plant



**Lyon, France**  
**Velan SAS**

## Plant



**Lisbon, Portugal**  
**Velan Valvulas Industriais, Lda.**

## Plant 2 and 7



**Montreal, Canada**  
**Velan Inc.**

## Plant



**Mennecy, France**  
**Segault SA**

## Plant



**Suzhou, China**  
**Velan Valve (Suzhou) Co., Ltd.**

## Plant 3



**Williston, VT, USA**  
**Velan Valve Corp.**

## Plant



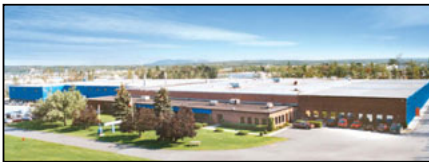
**Leicester, UK**  
**Velan Valves Ltd.**

## Plant



**Ansan City, South Korea**  
**Velan Ltd.**

## Plant 4 and 6 Distribution center



**Granby, Canada**  
**Velan Inc.**

## Distribution center



**Willich, Germany**  
**Velan GmbH**

## Plant



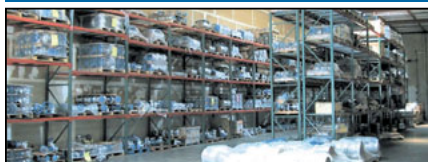
**Ansan City, South Korea**  
**Velan Ltd.**

## Distribution center



**Marietta, GA, USA**  
**VelEAST**

## Distribution center



**Benicia, CA, USA**  
**VelCAL**

## Plant



**Taichung, Taiwan**  
**Velan-Valvac**



**A world leader in industrial valve manufacturing supplying to:**

- Power
- Oil and Gas
- Refining and Petrochemicals
- Chemicals
- Pulp and Paper
- LNG and Cryogenics
- Marine
- Mining
- HVAC
- Water and Wastewater

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