



VELAN

Annual report 2015

2015 highlights



Members of the Velan France executive team with Tom Velan standing in the Velan S.A.S. manufacturing plant in Lyon, France, next to a 36" (900 mm) top-entry cryogenic butterfly valve ready for shipping to an LNG facility.



In 2014 Velan was recognized with an award for our continuous improvement and our corporate health, safety and environment culture. Also, our Canadian plants received certification for OHSAS 18001 and ISO 14001.



A.K. Velan, Founder and Chairman Emeritus of Velan, won the 2014 Grand Prix d'excellence, the highest distinction awarded by the Ordre des ingénieurs du Québec to its members and was featured on the cover of the OIQ's magazine.



2015 Engineers Canada Gold Medal Award.

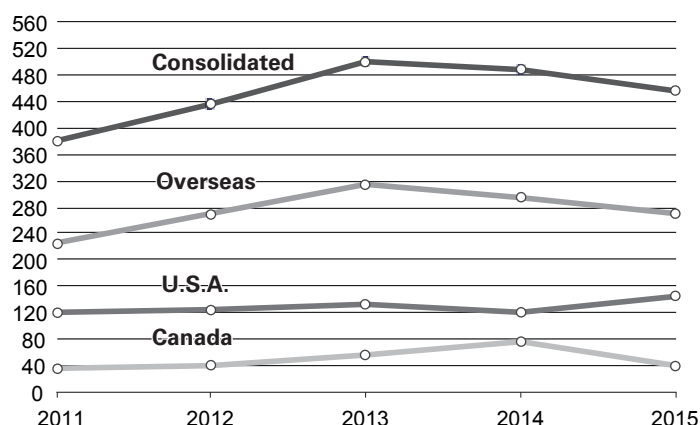
In May 2015, A.K. received the Gold Medal Award from Engineers Canada, their top distinction recognizing his 70 years of achievements as an engineer. This award is presented every year to an outstanding engineer who has stood out for his contributions to the profession.



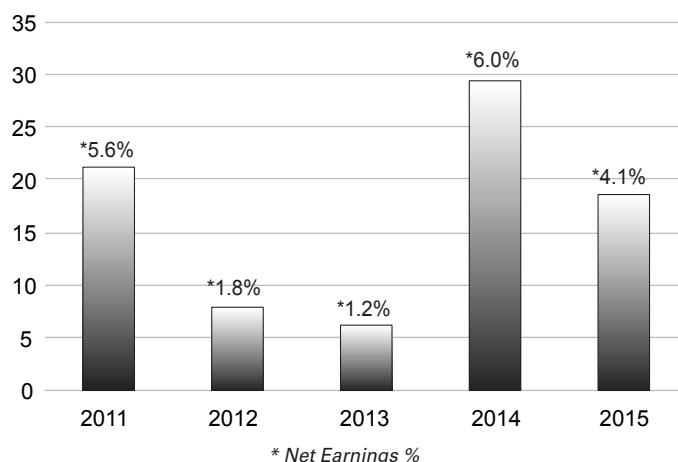
A Velan pneumatically operated metal-seated ball valve used for isolation in a hydrocracking unit in Asia.

2015 highlights

Sales
(in millions of U.S. dollars)



Net earnings⁽²⁾
(in millions of U.S. dollars)



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

| Years Ended | Feb 2015 | Feb 2014 | Feb 2013 | Feb 2012 | Feb 2011 |
|---|------------|------------|------------|------------|------------|
| Income statement data | | | | | |
| Sales | \$ 455,750 | \$ 489,257 | \$ 500,574 | \$ 437,135 | \$ 380,706 |
| Gross profit | 118,283 | 131,146 | 113,899 | 87,262 | 101,426 |
| Gross profit % | 26.0% | 26.8% | 22.8% | 20.0% | 26.6% |
| Administration costs | 88,391 | 87,143 | 90,985 | 83,620 | 73,597 |
| Income before income taxes | 28,965 | 42,762 | 12,018 | 6,097 | 28,424 |
| Adjusted net operating results ⁽¹⁾ | 18,580 | 29,409 | 15,681 | 5,630 | 21,224 |
| Adjusted net operating results ⁽¹⁾ % | 4.1% | 6.0% | 3.1% | 1.3% | 5.6% |
| Adjusted net operating results ⁽¹⁾ per share | 0.85 | 1.34 | 0.72 | 0.25 | 0.96 |
| Net earnings ⁽²⁾ | 18,580 | 29,400 | 6,169 | 7,892 | 21,224 |
| Net earnings ⁽²⁾ % | 4.1% | 6.0% | 1.2% | 1.8% | 5.6% |
| Net earnings ⁽²⁾ per share ⁽³⁾ | 0.85 | 1.34 | 0.28 | 0.36 | 0.96 |
| Statement of financial position data | | | | | |
| Net cash ⁽¹⁾ | \$ 75,612 | \$ 67,761 | \$ 19,787 | \$ 35,376 | \$ 113,024 |
| Working capital | 227,793 | 235,318 | 213,814 | 217,522 | 264,930 |
| Property, plant, and equipment | 91,285 | 96,605 | 90,630 | 72,961 | 64,622 |
| Total assets | 558,628 | 624,154 | 619,774 | 601,970 | 516,037 |
| Total debt | 14,827 | 22,087 | 26,850 | 9,587 | 5,011 |
| Equity | 345,093 | 359,119 | 328,173 | 335,577 | 337,723 |
| Number of employees | | | | | |
| Canada | 917 | 917 | 923 | 926 | 923 |
| United States | 181 | 188 | 182 | 178 | 178 |
| Europe | 528 | 526 | 535 | 519 | 372 |
| Asia | 441 | 429 | 390 | 358 | 295 |
| Total | 2,067 | 2,060 | 2,030 | 1,981 | 1,768 |

(1) This term is a measure of performance and/or financial condition that is not defined under International Financial Reporting Standards and is therefore unlikely to be comparable to similar measures presented by other companies. Such measures are used by management in assessing the operating results and financial condition of the Company. In addition, they provide readers of the Company's consolidated financial statements with enhanced understanding of its results and financial condition, and increase transparency and clarity into the operating results of its core business. Refer to the "Reconciliations of Non-IFRS Measures" section in the Company's Management Discussion and Analysis included in this Annual Report for a detailed calculation of this measure.

(2) Net earnings refers to net income attributable to Subordinate and Multiple Voting Shares.

(3) See note 21 in the Notes to the Consolidated Financial Statements.

Message to our shareholders and employees

(In U.S. dollars, unless otherwise stated.)

Highlights

- Sales of \$455.7 million
- Net earnings⁽¹⁾ of \$18.6 million
- Order backlog of \$437.8 million
- Order bookings of \$471.4 million
- Net cash⁽²⁾ of \$75.6 million

This year was a challenging year as the price of oil plunged and the U.S. dollar soared against the euro and Canadian dollar. Although our results were not as strong as last year, we recorded solid net earnings⁽¹⁾ of \$18.6 million, which were 4.1% of our sales of \$455.7 million.

Sales, order bookings, and backlog

Our sales of \$455.7 million declined 6.9% compared to last year. The strength of the U.S. dollar as well as the uncertainty in oil and gas markets resulting from the decline in the price of oil negatively impacted our sales. In addition, project delays on several large projects reduced sales. Sales in Canada were particularly hard hit, falling 49.5% from the record sales in the previous year. China continued to be our largest overseas market with sales of \$63.7 million, which was down 3.8% from the previous year. Our sales were diversified by customer, market, and geography as 59.1% of our sales were made outside of North America to more than 65 countries.

Order bookings of \$471.4 million were 13.2% higher than last year. Our bookings were higher than sales but our backlog of orders declined by 7.2% to \$437.8 million mainly due to the fall in the euro of 18.6% compared to the U.S. dollar considering period end rates resulting in a \$50.7 million reduction of our backlog. The bookings number was calculated using average rates and the euro only weakened 2.9% on average. Every year, our sales revenues consist of longer term project orders, made-to-order sales, and book and bill business of commodity valves stocked in our distribution centers. From the backlog of \$437.8 million, \$326.7 million is scheduled for delivery during our current fiscal year.



Tom Velan, Chairman of the Board and CEO (left), with Velan's President, Yves Leduc (right).

Subsequent to our year end, in March our French subsidiary booked \$27.6 million of orders including \$18.2 million of orders for valves for nuclear power plants in China. These orders follow the \$16.2 million of bookings for the China nuclear market in our fourth quarter. These orders are for the ACPR1000, Hualong One, and C-HTR technology, which are new third- and fourth-generation nuclear plants fully designed and developed in China. We are proud to be chosen to supply advanced safety-related valves for this new generation of advanced nuclear reactors. Our nuclear valves have now been selected for 49 of China's nuclear power plants and we continue to be a leader in the supply of nuclear valves to the Chinese nuclear industry, which is starting to recover from the negative impact of the Japanese Fukushima accident.

Net earnings⁽¹⁾

Our net earnings⁽¹⁾ of \$18.6 million or 4.1% of sales are down from \$29.4 million last year. Our net earnings⁽¹⁾ declined mainly due to the lower sales volume and the weakness of the euro compared to the U.S. dollar, as we consolidated less earnings from our profitable European subsidiaries. Our gross profit percentage remained relatively flat, declining slightly from 26.8% of sales

1) Net earnings refers to net income attributable to Subordinate and Multiple Voting Shares.

2) This term is a measure of performance and/or financial condition that is not defined under International Financial Reporting Standards and is therefore unlikely to be comparable to similar measures presented by other companies. Such measures are used by management in assessing the operating results and financial condition of the Company. In addition, they provide readers of the Company's consolidated financial statements with enhanced understanding of its results and financial condition, and increase transparency and clarity into the operating results of its core business. Refer to the "Reconciliations of Non-IFRS Measures" section in the Company's Management Discussion and Analysis included in this Annual Report for a detailed calculation of this measure.

Message to our shareholders and employees

to 26% due to a decline in volume partially offset by a higher margin product mix. Our costs related to asbestos lawsuits were \$6.1 million which is 11.2% higher than last year but 30.6% lower than the previous year. The fluctuations in asbestos-related costs are due more to the timing of settlement payments than to changes in long-term trends.



Yves Leduc speaks to Velan employees in Williston, Vermont.

New leadership

During the year, Yves Leduc was hired and appointed as the new President of Velan Inc. (the “Company”). This was an important milestone for the Company as Yves became the first President of the Company who is not a Velan family member. A.K. Velan, who has served the Company with passion and devotion for 65 years since founding the Company in 1950, has been given the honorary title of Founder and Chairman Emeritus after stepping down as Executive Chairman of the board at the age of 97. The Board of Directors appointed Tom Velan as the new Chairman of the Board. At the same time, Bill Sheffield was appointed Lead Director to strengthen the independence of the board.

Financial Strength

Our balance sheet remains strong as net cash⁽²⁾ reached \$75.6 million or \$3.45 per share while equity was \$345.1 million or \$15.73 per share. Our net cash⁽²⁾ was positively impacted by \$49.9 million in cash generated by our operations, which was partially offset by \$13.7 million of negative currency impacts due to the strength of the U.S. dollar. Our consolidated inventory decreased by \$20.6 million or 9.2% over the course of the year.

Outlook

These are challenging times in the global energy sector. The dramatic fall in the price of oil and the strengthening of the U.S. dollar against the euro and Canadian dollar has created uncertainty in energy markets, and oil companies have delayed or cancelled some large capital expenditures. The Canadian oil industry has been particularly hard hit due to the relatively high cost of production in the oil sands and steam-assisted gravity drainage (“SAGD”) industries.

In general terms, the weakening of the Canadian dollar against the U.S. dollar is positive for us as we have a lot of expenses denominated in Canadian dollars in our Canadian manufacturing plants and head office. On the other hand, the fall in the value of the euro means that we are consolidating less sales and net earnings⁽¹⁾ from our European subsidiaries when converted to our U.S. dollar reporting. Our European subsidiaries represent a majority of our net earnings⁽¹⁾ and net cash⁽²⁾ as well as having 52.5% of our consolidated backlog, so the large drop in the value of the euro may have an important negative impact on our future sales, earnings, and balance sheet.

The full impact of the low price of oil is not easy to determine. Our bookings and sales in Canada are and may continue to be negatively impacted. In general, upstream exploration is the part of the market that is most quickly and seriously affected by the lower price of oil and this has a direct effect on our Italian subsidiary, Velan ABV S.p.A. Otherwise we are primarily in



Fugitive emissions testing of a 4" (100 mm) Class 600 cast steel gate valve.

Message to our shareholders and employees



Partial view of production in Velan's plant in India.

the downstream part of the market, which is much less impacted since crack spreads actually increased due to the lower cost of oil. Also, our petrochemical and chemical industry customers generally benefit from the lower feedstock prices and that has been driving new investments, especially in the U.S. We also sell in other non-oil-related markets such as power and military shipbuilding.

Our plant in China has successfully added production of cast pressure seal valves enabling us to expand our product offering to the Chinese market. Our Indian plant has also extended its product scope to include cast steel gate valves up to 24" as well as bellow seal and cryogenic valves. We expect these relatively small plants to manufacture a growing part of our global valve supply over the coming years as they strengthen our local presence in these growth markets.

Under the leadership of our new President, we are driving an operational excellence plan in our North American operations, focused on improving our global supply chain performance, project execution and lead times, and cost competitiveness. These initiatives, combined with our superior product portfolio and track record in quality, will strengthen our position in

T. C. Velan
Chairman of the Board and
Chief Executive Officer



This 54" (1350 mm) Class 300 cast gate valve is one of the largest valves Velan has produced to date, measuring over 34' (10.36 m) in height and 7' 6" (2.29 m) in width. It weighs 48,000 lbs (21,772 kg) with its actuator. Standing in front of the valve is Stephen Cherlet, Velan's Chief Operations Officer.

servicing each of our markets worldwide. As we proved last year, the company is resilient, able to withstand unexpected swings in demand, owing in large part to the knowhow of our people and to being diversified both geographically and by end user markets. We have a solid order backlog of \$437.8 million, as we go after sales opportunities in a very competitive and challenging global market.

Yves Leduc
President

Management's discussion and analysis

May 19, 2015

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, 2015. This Management's Discussion and Analysis ("MD&A") should be read in conjunction with the Company's audited consolidated financial statements for the years ended February 28, 2015 and 2014. The Company's consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). The significant accounting policies upon which these consolidated financial statements have been prepared are detailed in Note 2 of the Company's audited consolidated financial statements. All foreign currency transactions, balances and overseas operations have been converted to U.S. dollars, the Company's 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 are 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.

BASIS OF PRESENTATION AND ANALYSIS

In this MD&A, the Company has presented measures of performance or financial condition which are not defined under IFRS ("non-IFRS 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 IFRS. Reconciliations of these amounts can be found at the end of this report.

FORWARD-LOOKING INFORMATION

This MD&A may include forward-looking statements, which generally contain words like "should", "believe", "anticipate", "plan", "may", "will", "expect", "intend", "continue" or "estimate" or the negatives of these terms or variations of them or similar expressions, 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 are included in this report (see *Certain Risks That Could Affect Our Business* section). While these statements are based on management's assumptions regarding historical trends, current conditions and expected future developments, as well as other factors that it believes are reasonable and appropriate in the circumstances, no forward-looking statement can be guaranteed and actual future results may differ materially from those expressed herein. The Company disclaims any intention or obligation to update or revise any forward-looking statements contained herein whether as a result of new information, future events or otherwise, except as required by the applicable securities laws. The forward-looking statements contained in this report are expressly qualified by this cautionary statement.

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, geothermal processes and shipbuilding. The Company is a world leader in steel industrial valves operating 17 manufacturing plants worldwide with 2,067 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 power markets, investing in talent development of high-potential employees, adding talent where necessary, providing high customer service, enhancing manufacturing and/or sales capabilities in emerging markets such as Brazil, Russia, India and China, and continually improving operational excellence.

The consolidated financial statements of the Company include the North American operations comprising four manufacturing plants and one distribution facility in Canada, as well as one manufacturing plant and three distribution facilities in the U.S. Significant overseas operations include manufacturing plants in France, Italy, Portugal, U.K., Korea, Taiwan, India, and China. The Company's operations also include a distribution facility in Germany and a 50%-owned Korean foundry.

Management's discussion and analysis

CONSOLIDATED HIGHLIGHTS¹

| (millions, excluding per share amounts) | Fiscal year ended February 28, 2015 | Fiscal year ended February 28, 2014 | Increase (decrease) | % Increase (decrease) |
|--|--|--|------------------------|-----------------------------|
| Consolidated statements of earnings | | | | |
| Sales | \$455.7 | \$489.3 | \$(33.6) | (6.9)% |
| Gross profit | 118.3 | 131.1 | (12.8) | (9.8)% |
| Gross profit % | 26.0% | 26.8% | | |
| Net earnings ² | 18.6 | 29.4 | (10.8) | (36.7)% |
| Net earnings ² % | 4.1% | 6.0% | | |
| Earnings per share – basic | 0.85 | 1.34 | (0.49) | (36.6)% |
| – diluted | 0.85 | 1.34 | (0.49) | (36.6)% |
| Weighted average shares outstanding | 21.9 | 22.0 | | |
| Consolidated statements of cash flows | | | | |
| Cash provided by operating activities | 49.9 | 75.5 | (25.6) | (33.9)% |
| Cash used in investing activities | (13.1) | (17.8) | 4.7 | 26.4% |
| Cash used by financing activities | (14.0) | (15.6) | 1.6 | 10.3% |
| Demand data | | | | |
| Net new orders received | 471.4 | 416.6 | 54.8 | 13.2% |
| Period ending backlog of orders | 437.8 | 471.7 | (33.9) | (7.2)% |

¹ All dollar amounts in this schedule are denominated in U.S. dollars.

² Net earnings refers to net income attributable to Subordinate and Multiple Voting Shares.

Management's discussion and analysis

Highlights of fiscal 2015 as well as factors that may impact fiscal 2016

(unless otherwise noted, all amounts are in U.S. dollars and all comparisons are to the prior fiscal year)

- Net earnings¹ amounted to \$18.6 million or \$0.85 per share compared to \$29.4 million or \$1.34 per share last year. The \$10.8 million decrease in net earnings¹ is primarily attributable to lower sales volume and higher administration costs, in particular an increase in costs recognized in connection with the Company's ongoing asbestos litigation (see *Contingencies* section) as well as increased research and development costs in one of the Company's French subsidiaries related to new product qualifications.
- Sales amounted to \$455.7 million, a decrease of \$33.6 million or 6.9% from the prior year. The Company's shipments of certain large project orders were lower for the current year compared to the prior year, despite the improved execution in the second half of the year.
- Net new orders received ("bookings"), which were calculated based on actual orders received converted at average exchange rates, amounted to \$471.4 million, an increase of \$54.8 million or 13.2% compared to last year. This increase is primarily attributable to increased bookings in the Company's French and German subsidiaries.
- Although bookings outpaced sales in the year, the Company ended the current fiscal year with a backlog of \$437.8 million, a decrease of \$33.9 million or 7.2% from the end of the prior year. This decrease is mainly attributable to the weakening of the Euro against the U.S. dollar over the course of the year, which had a \$50.7 million negative impact on the Company's backlog in the year.
- Gross profit percentage remained relatively stable, marginally decreasing by 0.8 percentage points from 26.8% to 26.0%. While the Company had a greater proportion of higher margin product sales, particularly spare parts and valves without third party actuators, in the first half of the year, this trend was reversed in the second half of the year as the Company shipped a greater proportion of project orders, which generally entail lower gross margins.
- The Company generated net cash² from operations of \$49.9 million. This source of net cash² is primarily attributable to positive cash net earnings¹ and favourable working capital movements.
- The Company ended the year with net cash² of \$75.6 million, an increase of \$7.9 million or 11.7% since the beginning of the current fiscal year. The Company's cash balance was negatively impacted by the 18.6% drop in the Euro spot rate against the U.S. dollar since the beginning of the current fiscal year, which resulted in a \$14.4 million reduction in the Company's net cash².
- Foreign currency impacts:
 - Based on average exchange rates, the Euro weakened 2.9% against the U.S. dollar when compared to the same period last year. This weakening resulted in the Company's net profits from its European subsidiaries being reported as lower U.S. dollar amounts in the current fiscal year.
 - Based on average exchange rates, the Canadian dollar weakened 7.1% against the U.S. dollar when compared to the same period last year. This weakening resulted in the Company's Canadian dollar expenses being reported as lower U.S. dollar amounts in the current fiscal year.
 - The unfavourable impact of the Euro decrease was generally offset by the favourable impact of the Canadian dollar decrease.

¹ Net earnings refers to net income attributable to Subordinate and Multiple Voting Shares.

² Non-IFRS measures – see reconciliations at the end of this report.

Management's discussion and analysis

The Company's margins and operational profitability remained relatively stable over the course of the current year, as the drop in net earnings¹ was due principally to a drop in sales and a slight increase in non-operational administration costs. The drop in sales is primarily attributable to delays in shipments of certain large project orders from the Company's North American and German operations. There were many factors which led to these delays. The German operations were negatively impacted by delays in shipments to a large Asian project that encountered contractual issues. For the North American operations, some delays were caused by supply chain issues as some of our suppliers were late in delivering raw materials. Other delays were due to customer-related and internal operational issues such as change orders and requests to delay shipments. The Company commenced several initiatives near the end of the fiscal year, namely the Valve Project Management ("VPM") process. The goal of VPM is to streamline all aspects of the manufacturing cycle, thus improving delivery performance in the short term and decreasing lead times in the longer term. The ultimate goal is to improve the competitiveness of the Company's project manufacturing business.

The Company's French operations continued to perform well in the current fiscal year. Despite a 4% drop in its sales, its net earnings¹ improved by 16.6% as it sold a greater proportion of high margin spare parts and cryogenic valves to compensate for the reduction of projects in the nuclear valve business. After two years of weakness in nuclear valve bookings following the Fukushima accident, the Company anticipates an increase in global demand for nuclear power plants, particularly in Asia.

The Company's Italian operations continued to report positive earnings for a second consecutive year. While its sales remained relatively stable, its net earnings¹ improved by 15.9%, reflecting the improvements the Company has made in the management and operations of its Italian subsidiary, Velan ABV S.p.A. ("ABV"), since its acquisition in 2011. The Company continues to view this acquisition as a good opportunity to grow its sales and earnings over the coming years, despite the short-term challenges it faces regarding the recent drop in crude oil prices, which may have an impact on bookings for its valves destined for upstream oil and gas projects.

Other factors that may impact fiscal year 2016

Despite the increase in bookings during fiscal year 2015, the Company's backlog declined by 7.2% as the 18.6% drop in the Euro spot rate against the U.S. dollar had a \$50.7 million negative impact on the Company's backlog in the year. The decline in the Euro presents the Company with both opportunities and challenges. On the one hand, the decline in the Euro will allow the Company's European subsidiaries to be more competitive when bidding on U.S. dollar-denominated projects, particularly in Asia and the Middle East. However, it will also negatively impact the Company's consolidated net earnings¹ and other comprehensive income as the results of operations and financial position of these European subsidiaries will be reported as lower U.S. dollar amounts on consolidation. It may also reduce the competitiveness of the Company's North American subsidiaries when bidding on contracts against European competitors.

The 46.8% drop in Brent crude oil prices since the beginning of fiscal year 2015 also presents the Company with both challenges and opportunities. As mentioned above, the drop in oil prices may have a negative impact on valves destined for upstream oil and gas projects, particularly in offshore drilling and the Canadian oil sands. However, there are opportunities in the downstream oil and gas business, namely in refining and petrochemical projects, since refining crack spreads actually increased due to the lower oil price which may lead to more projects in these industries. The Company is currently pursuing many leads related to these projects, particularly in the Middle East.

Due to its diversification in both geography and type of industry, the Company is well positioned to meet the many challenges it currently faces. It continues to believe that the global demand for its products is strong and is working to increase bookings in future years by continuously improving its operational excellence through lean manufacturing initiatives, global sourcing, working capital management and cost controls. However, there can be no assurance that outside economic and geopolitical factors will not materially adversely affect the Company's results of operations or financial condition.

¹ Net earnings refers to net income attributable to Subordinate and Multiple Voting Shares.

Management's discussion and analysis

SUMMARY OF RESULTS

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

For the reporting periods ended on the following dates
(in thousands of U.S. dollars, excluding number of shares and per share amounts)

| | Fiscal year ended February 28, 2015 | Fiscal year ended February 28, 2014 | Fiscal year ended February 28, 2013 |
|---------------------------------------|--|--|--|
| Operating Data | | | |
| Sales | \$455,750 | \$489,257 | \$500,574 |
| Net Earnings ¹ | 18,580 | 29,400 | 6,169 |
| Earnings per Share | | | |
| - Basic | 0.85 | 1.34 | 0.28 |
| - Diluted | 0.85 | 1.34 | 0.28 |
| Balance Sheet Data | | | |
| Total Assets | 558,628 | 624,154 | 619,774 |
| Total Long-Term Financial Liabilities | 12,720 | 19,992 | 24,393 |
| Shareholder Data | | | |
| Cash dividends per share | | | |
| - Multiple Voting Shares ² | 0.36 | 0.31 | 0.32 |
| - Subordinate Voting Shares | 0.36 | 0.31 | 0.32 |
| Outstanding Shares at report date | | | |
| - Multiple Voting Shares ² | 15,566,567 | | |
| - Subordinate Voting Shares | 6,372,601 | | |

Sales for fiscal year 2015 decreased by 6.9% compared to fiscal year 2014. Despite the improved execution in the second half of the year, the Company's shipments of certain large project orders were lower for fiscal year 2015 compared to fiscal year 2014. Sales for fiscal year 2014 decreased by \$11.3 million or 2.3%, compared to the record level for fiscal year 2013. This decrease is primarily attributable to a decrease in nuclear sales following the Fukushima crisis which was partially offset by an increase in sales in Canada to the Alberta oil and gas industry.

Gross profit for fiscal year 2015 amounted to \$118.3 million, a decrease of \$12.8 million from fiscal year 2014. Gross profit percentage for fiscal year 2015 marginally decreased from the 26.8% reported in fiscal year 2014 to 26.0%. While the Company had a greater proportion of higher margin product sales, particularly spare parts and valves without third party actuators, in the first half of fiscal year 2015, this trend was reversed in the second half of that year as the Company shipped a greater proportion of project orders, which generally entail lower gross margins. Gross profit for fiscal year 2014 amounted to \$131.1 million, an increase of \$17.2 million from fiscal year 2013. Gross profit percentage for fiscal year 2014 also increased from the 22.8% reported in fiscal year 2013 to 26.8%. The increase in gross profit percentage reported for fiscal year 2014 is mainly attributable to a higher margin product mix, particularly spare part sales, and improved efficiencies.

Administration costs for fiscal year 2015 increased by \$1.3 million when compared to fiscal year 2014. Such increase was principally due to an increase in research and development costs in one of the Company's French subsidiaries related to new product qualifications, and an increase in costs associated with the Company's ongoing asbestos litigation (see *Contingencies* section). Administration costs for fiscal year 2014 decreased by \$3.9 million when compared to fiscal year 2013. This decrease was mainly attributable to decreases in sales commissions and costs associated with the Company's ongoing asbestos litigation (see *Contingencies* section). The fluctuation in asbestos costs is due more to the timing of settlement payments than to changes in long-term trends.

The fiscal year 2013 net earnings¹ were also negatively impacted by an \$11.7 million non-cash goodwill impairment loss related to the ABV cash-generating unit.

¹ Net earnings refers to net income attributable to Subordinate and Multiple Voting Shares.

² Multiple Voting Shares (five votes per share) are convertible into Subordinate Voting Shares on a 1 to 1 basis.

Management's discussion and analysis

RESULTS OF OPERATIONS – for the year ended February 28, 2015 compared to the year ended February 28, 2014 (unless otherwise noted, all amounts are in U.S. dollars and all comparisons are to the prior fiscal year)

Sales

| (millions) | Year ended February 28, 2015 | Year ended February 28, 2014 |
|------------|------------------------------------|------------------------------------|
| Sales | \$455.7 | \$489.3 |

Sales decreased by \$33.6 million or 6.9% from the prior year. The decrease in sales is primarily attributable to delays in shipments of certain large project orders from the Company's North American and German operations. The German operations were negatively impacted by delays in shipments to a large Asian project that encountered contractual issues. For the North American operations, the delays were caused by various supply chain, customer-related and internal operational issues, as discussed above.

Net bookings and backlog

| (millions) | Year ended February 28, 2015 | Year ended February 28, 2014 |
|--------------|------------------------------------|------------------------------------|
| Net bookings | \$471.4 | \$416.6 |

Net bookings, which were calculated based on actual orders received converted at average exchange rates, increased by \$54.8 million or 13.2% for the fiscal year. This increase is primarily attributable to increased bookings in the Company's French and German subsidiaries. After two years of weakness with respect to its nuclear business following the Fukushima accident, the Company's French subsidiaries secured significant orders for its nuclear valves destined primarily to customers based in Asia. The Company's German subsidiary secured a number of orders for valves destined for refining and petrochemical projects.

| (millions) | February 2015 | February 2014 | February 2013 |
|--|------------------|------------------|------------------|
| Backlog | \$437.8 | \$471.7 | \$531.0 |
| For delivery within the subsequent fiscal year | \$326.7 | \$386.7 | \$398.2 |
| For delivery beyond the subsequent fiscal year | \$111.1 | \$85.0 | \$132.8 |
| Percentage – beyond the subsequent fiscal year | 25.4% | 18.0% | 25.0% |

The Company's book-to-bill ratio was 1.03 which normally would have resulted in a \$15.7 million increase in the backlog. However, due to currency fluctuations, primarily related to the drop in the Euro against the U.S. dollar, the total backlog decreased by \$33.9 million or 7.2% since the beginning of the fiscal year, settling at \$437.8 million.

Gross profit

| (millions) | Year ended February 28, 2015 | Year ended February 28, 2014 |
|-------------------------|------------------------------------|------------------------------------|
| Gross profit | \$118.3 | \$131.1 |
| Gross profit percentage | 26.0% | 26.8% |

Gross profit decreased by \$12.8 million for the fiscal year due primarily to the decrease in sales over the course of the year. Despite this drop in sales, the gross profit percentage remained relatively stable, marginally decreasing by 0.8 percentage points from the prior year. While the Company had a greater proportion of higher margin product sales, particularly spare parts and valves without third party actuators, in the first half of the year, this trend was reversed in the second half of the year as the Company shipped a greater proportion of project orders, which generally entail lower gross margins.

Management's discussion and analysis

Administration costs

| (millions) | Year ended February 28, 2015 | Year ended February 28, 2014 |
|--------------------------|------------------------------------|------------------------------------|
| Administration costs | \$88.4 | \$87.1 |
| As a percentage of sales | 19.4% | 17.8% |

Administration costs increased by \$1.3 million or 1.5% for the fiscal year. The increase is mainly a result of increases in research and development costs in one of the Company's French subsidiaries related to new product qualifications and costs associated with the Company's ongoing asbestos litigation (see *Contingencies* section). Like many other U.S. valve manufacturers, two of the Company's U.S. subsidiaries have been named as defendants in a number of pending lawsuits brought on behalf of individuals seeking to recover damages for their alleged asbestos exposure. These lawsuits are related to products manufactured and sold in the past. Management believes that any asbestos was incorporated entirely within the product in such a way that it would not allow for any ambient asbestos during normal operation, inspection or repairs. Management strongly believes its products, which were supplied in accordance with valve industry practice and customer mandated specifications, did not contribute to any asbestos-related illness. The Company will continue to vigorously defend against these claims but given the ongoing course of asbestos litigation in the U.S. and the unpredictability of jury trials, it is not possible to make an estimate of any settlement costs and legal fees.

Net finance costs

| (millions) | Year ended February 28, 2015 | Year ended February 28, 2014 |
|-------------------|------------------------------------|------------------------------------|
| Net finance costs | \$0.6 | \$1.5 |

Net finance costs decreased by \$0.9 million for the fiscal year as the Company continued to pay down its current and long-term bank borrowings without undertaking any new debt issuances (see *Liquidity and Capital Resources* section).

Income taxes

| (in thousands, excluding percentages) | Year ended February 28, 2015 | | Year ended February 28, 2014 | |
|---|------------------------------------|-------|------------------------------------|-------|
| | \$ | % | \$ | % |
| Income before income taxes | 28,965 | 100.0 | 42,762 | 100.0 |
| Tax calculated at domestic tax rates applicable to earnings in the respective countries | 9,416 | 32.5 | 12,528 | 29.3 |
| Tax effects of: | | | | |
| Non-deductible (taxable) foreign exchange loss (gain) | 539 | 1.8 | (4) | 0.0 |
| Losses not tax effected | 874 | 3.0 | 369 | 0.9 |
| Benefit attributable to a financing structure | (1,342) | (4.6) | (1,308) | (3.1) |
| Other | 286 | 1.0 | 175 | 0.4 |
| Provision for income taxes | 9,773 | 33.7 | 11,759 | 27.5 |

Management's discussion and analysis

Net earnings¹

| (millions) | Year ended February 28, 2015 | Year ended February 28, 2014 |
|---------------------------|------------------------------------|------------------------------------|
| Net earnings ¹ | \$18.6 | \$29.4 |
| As a percentage of sales | 4.1% | 6.0% |

Net earnings¹ for the year amounted to \$18.6 million or \$0.85 per share compared to \$29.4 million or \$1.34 per share last year. The \$10.8 million decrease in net earnings¹ is primarily attributable to lower sales volume and higher non-operational administration costs, in particular an increase in costs recognized in connection with the Company's ongoing asbestos litigation (see *Contingencies* section) as well as increased research and development costs in one of the Company's French subsidiaries related to new product qualifications.

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 ended May, August, November and February (in thousands of U.S. dollars, excluding per share amounts)

| | QUARTERS ENDED | | | | | | | |
|-------------------------------------|------------------|------------------|----------------|-------------|------------------|------------------|----------------|-------------|
| | February 2015 | November 2014 | August 2014 | May 2014 | February 2014 | November 2013 | August 2013 | May 2013 |
| Sales | \$114,507 | \$127,290 | \$110,888 | \$103,065 | \$120,716 | \$115,611 | \$120,762 | \$132,168 |
| Net Earnings ¹ | 4,718 | 4,759 | 5,098 | 4,005 | 10,392 | 8,319 | 4,889 | 5,800 |
| Net earnings ¹ per share | | | | | | | | |
| - Basic | 0.22 | 0.22 | 0.23 | 0.18 | 0.47 | 0.38 | 0.23 | 0.26 |
| - Diluted | 0.22 | 0.22 | 0.23 | 0.18 | 0.47 | 0.38 | 0.23 | 0.26 |

Sales can vary from one quarter to the next due to the timing of the shipment of large project orders. Sales were higher in the quarter ended in May 2013 and November 2014 due to increased shipments of such orders, while the lower sales amounts for the quarters ended in August 2014 and May 2014 were due to delayed execution on the shipments of such orders. Net earnings¹ for the quarters ended November 2013 and February 2014 were higher due to a more efficient product mix and lower administration costs.

RESULTS OF OPERATIONS – quarter ended February 28, 2015 compared to the quarter ended February 28, 2014

(unless otherwise noted, all amounts are in U.S. dollars and all comparisons are to the fourth quarter of the prior fiscal year)

Sales

| (millions) | Three-month period ended February 28, 2015 | Three-month period ended February 28, 2014 |
|------------|---|---|
| Sales | \$114.5 | \$120.7 |

Sales decreased by \$6.2 million or 5.1% for the quarter. Despite the strong push in the quarter to execute shipments of certain large project orders, the Company was not able to match the level of execution achieved in the same quarter of the prior year, particularly in its North American operations.

¹ Net earnings refers to net income attributable to Subordinate and Multiple Voting Shares.

Management's discussion and analysis

Net bookings and backlog

| (millions) | Three-month period ended February 28, 2015 | Three-month period ended February 28, 2014 |
|--------------|---|---|
| Net bookings | \$101.1 | \$139.6 |

Net bookings, which were calculated based on actual orders received converted at average exchange rates, decreased by \$38.5 million or 27.6% for the quarter. The decrease in net bookings is primarily attributable to the fact that the prior year quarter had over \$40 million worth of orders that were booked with two large Indian energy customers, which did not repeat in the current quarter.

Gross profit

| (millions) | Three-month period ended February 28, 2015 | Three-month period ended February 28, 2014 |
|-------------------------|---|---|
| Gross profit | \$29.1 | \$36.6 |
| Gross profit percentage | 25.4% | 30.3% |

Gross profit decreased by \$7.5 million for the quarter, resulting in a decrease of 4.9 percentage points in the gross profit percentage from the prior year. This decrease was primarily attributable to a product mix with a greater proportion of sales of lower margin products, such as complex and custom manufactured project valves, as opposed to higher margin products, such as spare parts.

Administration costs

| (millions) | Three-month period ended February 28, 2015 | Three-month period ended February 28, 2014 |
|--------------------------|---|---|
| Administration costs | \$20.4 | \$22.1 |
| As a percentage of sales | 17.8% | 18.3% |

Administration costs for the quarter decreased by \$1.7 million or 7.7%. The decrease is mainly a result of lower freight costs, the securing of a research and development grant attributable to the Company's Italian operations and a decrease in costs associated with the Company's ongoing asbestos litigation (see *Contingencies* section). The fluctuation in asbestos costs is due more to the timing of settlement payments than to changes in long-term trends.

Finance costs

| (millions) | Three-month period ended February 28, 2015 | Three-month period ended February 28, 2014 |
|-------------------|---|---|
| Net finance costs | \$0.1 | \$0.4 |

Net finance costs decreased by \$0.3 million for the quarter as the Company continued to pay down its current and long-term bank borrowings without undertaking any new debt issuances (see *Liquidity and Capital Resources* section).

Management's discussion and analysis

Income taxes

| (in thousands, excluding percentages) | Three-month period ended February 28, 2015 | | Three-month period ended February 28, 2014 | |
|---|---|-------|---|-------|
| | \$ | % | \$ | % |
| Income (Loss) before income taxes | 8,219 | 100.0 | 15,387 | 100.0 |
| Tax calculated at domestic tax rates applicable to earnings in the respective countries | 3,017 | 36.7 | 4,918 | 32.0 |
| Tax effects of: | | | | |
| Non-deductible (taxable) foreign exchange loss (gain) | 293 | 3.6 | (83) | (0.5) |
| Losses not tax effected | 452 | 5.5 | - | - |
| Benefit attributable to a financing structure | (346) | (4.2) | (329) | (2.1) |
| Other | 256 | 3.1 | 227 | 1.4 |
| Provision for income taxes | 3,672 | 44.7 | 4,733 | 30.8 |

Net earnings¹

| (millions) | Three-month period ended February 28, 2015 | Three-month period ended February 28, 2014 |
|---------------------------|---|---|
| Net earnings ¹ | \$4.7 | \$10.4 |
| As a percentage of sales | 4.1% | 8.6% |

Net earnings¹ for the quarter amounted to \$4.7 million or \$0.22 per share compared to \$10.4 million or \$0.47 per share last year. The \$5.7 million decrease in net earnings¹ is primarily attributable to a lower gross profit percentage partially offset by decreased administration costs, in particular lower freight costs, the securing of a research and development grant attributable to the Company's Italian operations in the quarter and a decrease in costs associated with the Company's ongoing asbestos litigation (see *Contingencies* section).

¹ Net earnings refers to net income or loss attributable to Subordinate and Multiple Voting Shares.

Management's discussion and analysis

LIQUIDITY AND CAPITAL RESOURCES – a discussion of liquidity risk, credit facilities, cash flows and proposed transactions (unless otherwise noted, all dollar amounts are denominated in U.S. dollars)

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

| | As at February 28, 2015 | | | | |
|---|--------------------------------|------------------|---------------|---------------|----------------|
| (In thousands) | Total | Less than | 1 to 3 | 4 to 5 | After |
| | \$ | 1 year | Years | Years | 5 years |
| | | \$ | \$ | \$ | \$ |
| Long-term debt | 14,827 | 10,644 | 1,973 | 610 | 1,600 |
| Accounts payable and accrued liabilities | 70,997 | 70,997 | - | - | - |
| Customer deposits | 44,111 | 44,111 | - | - | - |
| Accrual for performance guarantees | 30,012 | 30,012 | - | - | - |
| Bank indebtedness and short-term bank loans | 17,750 | 17,750 | - | - | - |
| Derivative liabilities | 5,362 | 5,362 | - | - | - |

On February 28, 2015, the Company's order backlog was \$437.8 million and its net cash¹ plus unused credit facilities amounted to \$176.6 million, which it believes, along with future cash flows generated from operations, is sufficient to meet its financial obligations, increase its capacity, satisfy its working capital requirements, and execute on its business strategy. However, there can be no assurance that the risk of another sharp downturn in the economy will not materially adversely affect the Company's results of operations or financial condition. The Company continues to closely monitor the continued weakness of the euro currency. The Company is in compliance with all covenants related to its debt and credit facilities.

As a corollary to managing its liquidity risk the Company also monitors the financial health of its key suppliers.

Proposed transactions

The Company has not committed to any material asset or business acquisitions or dispositions, other than those already discussed in this MD&A.

¹ Non-IFRS measures – see reconciliations at the end of this report.

Management's discussion and analysis

Cash flows (unless otherwise noted, all amounts are in U.S. dollars and all comparisons are to same period in the prior fiscal year)

Net cash¹

| (millions) | February 2015 | November 2014 | February 2014 | November 2013 | February 2013 |
|-----------------------|------------------|------------------|------------------|------------------|------------------|
| Net cash ¹ | \$75.6 | \$66.7 | \$67.7 | \$59.2 | \$19.8 |

The Company's net cash¹ increased by \$8.9 million during the quarter and \$7.9 million since the beginning of the year. For both periods, net cash¹ was positively impacted by positive cash net earnings² and non-cash working capital movements.

Cash provided by operating activities

| (millions) | Fiscal Year ended February 28, 2015 | Fiscal Year ended February 28, 2014 | Three-month period ended February 28, 2015 | Three-month period ended February 28, 2014 |
|---------------------------------------|--|--|---|---|
| Cash provided by operating activities | \$49.9 | \$75.5 | \$25.2 | \$13.4 |

Cash provided by operating activities for the current fiscal year decreased by \$25.6 million when compared to last year. This decrease was principally related to lower net earnings² and non-cash working capital movements. Cash provided by operating activities for the quarter increased by \$11.8 million when compared to the prior year period. This increase was principally related to non-cash working capital movements, specifically a decrease in accounts receivable.

Accounts receivable

| (millions) | Fiscal Year ended February 28, 2015 | Fiscal Year ended February 28, 2014 | Three-month period ended February 28, 2015 | Three-month period ended February 28, 2014 |
|---|--|--|---|---|
| Accounts receivable decrease (increase) | \$23.6 | \$5.4 | \$18.1 | \$(2.0) |

Accounts receivable balances are a function of the timing of sales and cash collections. For both the current quarter and fiscal year, the accounts receivable balance decreased due to a combination of lower sales output in the respective periods coupled with increased collections of prior year accounts.

Inventories

| (millions) | Fiscal Year ended February 28, 2015 | Fiscal Year ended February 28, 2014 | Three-month period ended February 28, 2015 | Three-month period ended February 28, 2014 |
|----------------------------|--|--|---|---|
| Inventories decrease | \$20.6 | \$23.0 | \$5.2 | \$0.5 |
| Customer deposits decrease | \$22.8 | \$9.8 | \$1.9 | \$7.0 |

Inventories typically increase in times of rising backlog and order bookings and decrease when the opposite occurs. Inventories are also a function of timing between receipts and shipments. For the current quarter and fiscal year, inventories decreased as a result of the timing of purchases of raw materials for certain new orders. In order to help finance its investment in inventories, the Company, where possible, obtains customer deposits for large orders. Customer deposits decreased for the current quarter and fiscal year due to the increased proportion of shipments of certain large export project orders.

¹ Non-IFRS measures – see reconciliations at the end of this report.

² Net earnings refers to net income attributable to Subordinate and Multiple Voting Shares.

Management's discussion and analysis

Accounts payable and accrued liabilities

| (millions) | Fiscal Year ended February 28, 2015 | Fiscal Year ended February 28, 2014 | Three-month period ended February 28, 2015 | Three-month period ended February 28, 2014 |
|--|--|--|---|---|
| Accounts payable and accrued liabilities (decrease) increase | \$(5.6) | \$(1.8) | \$(5.7) | \$4.1 |

For all of the indicated periods, the fluctuations in accounts payable and accrued liabilities were primarily related to timing, particularly related to inventory.

Additions to property, plant and equipment

| (millions) | Fiscal Year ended February 28, 2015 | Fiscal Year ended February 28, 2014 | Three-month period ended February 28, 2015 | Three-month period ended February 28, 2014 |
|--|--|--|---|---|
| Additions to property, plant and equipment | \$12.8 | \$18.0 | \$2.6 | \$3.3 |

The additions to property, plant and equipment relate mainly to the Company's North American and Asian operations where it continues to invest in machinery and equipment in order to improve its manufacturing infrastructure and operational efficiency. The decrease in additions for the current quarter when compared to the prior year is due to the timing of the receipts of certain equipment. The decrease in additions for the fiscal year is due to a lower total spend for productive machinery and equipment, which comes after several years of relatively high capital expenditures.

Dividends

| (millions) | Fiscal Year ended February 28, 2015 | Fiscal Year ended February 28, 2014 | Three-month period ended February 28, 2015 | Three-month period ended February 28, 2014 |
|----------------|--|--|---|---|
| Dividends paid | \$7.5 | \$6.8 | \$1.9 | \$1.7 |

The dividends paid in the first quarter of the current fiscal year were the last payouts under the Company's prior dividend policy, namely CA\$0.08 per share per quarter. The quarterly dividend payments that were made in subsequent quarters were under the Company's current dividend policy, namely CA\$0.10 per share per quarter.

Long-term debt

| (millions) | Fiscal Year ended February 28, 2015 | Fiscal Year ended February 28, 2014 | Three-month period ended February 28, 2015 | Three-month period ended February 28, 2014 |
|-----------------------------|--|--|---|---|
| Increase in long-term debt | \$ - | \$2.7 | \$ - | \$ - |
| Repayment of long-term debt | \$6.3 | \$8.4 | \$1.5 | \$1.8 |

During the current quarter and fiscal year, the Company continued to pay down its long-term debt without undertaking any new debt issuances.

Management's discussion and analysis

Other Liabilities

| (millions) | Fiscal Year ended February 28, 2015 | Fiscal Year ended February 28, 2014 | Three-month period ended February 28, 2015 | Three-month period ended February 28, 2014 |
|-----------------------------|--|--|---|---|
| Payment of proceeds payable | \$ - | \$2.0 | \$ - | \$ - |

In accordance with the provisions of the purchase and sale agreement for ABV, the Company paid \$2.0 million to the former owners of ABV over the course of the first quarter of the prior year, which represented the final payment of the proceeds payable at the time of the acquisition.

FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

The Company's activities expose it to a variety of financial risks: market risk (including currency risk, cash flow interest rate risk and fair value 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 subsidiaries. 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 | | | |
|--|----------|---------------|--------|-----------|
| | Currency | Interest rate | Credit | Liquidity |
| Cash and cash equivalents | x | x | x | |
| Short-term investments | x | x | x | |
| Accounts receivable | x | | x | |
| Derivative assets | x | | x | |
| Bank indebtedness | x | x | | x |
| Short-term bank loans | x | x | | x |
| Accounts payable and accrued liabilities | x | | | x |
| Customer deposits | x | | | x |
| Dividend payable | x | | | x |
| Accrual for performance guarantees | x | | | x |
| Derivative liabilities | 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.

Management's discussion and analysis

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, 2015 and February 28, 2014 are as follows:

| | Range of exchange rates | | Gain (loss) | | Notional amount | |
|---|-------------------------|-------------------|---|---|---|---|
| | February 28, 2015 | February 28, 2014 | February 28, 2015 (In thousands of U.S. dollars) \$ | February 28, 2014 (In thousands of U.S. dollars) \$ | February 28, 2015 (In thousands of indicated currency) | February 28, 2014 (In thousands of indicated currency) |
| Foreign exchange forward contracts | | | | | | |
| Sell US\$ for CA\$ – 0 to 12 months | 1.09-1.26 | 1.04-1.12 | (3,047) | (1,275) | US\$49,565 | US\$43,057 |
| Sell US\$ for € – 0 to 12 months | 1.14-1.40 | 1.29-1.36 | (2,236) | 192 | US\$19,573 | US\$8,498 |
| Buy US\$ for € – 0 to 12 months | 1.12-1.27 | 1.34-1.36 | 30 | (14) | US\$1,119 | US\$483 |
| Sell US\$ for £ – 0 to 12 months | - | 1.52 | - | 130 | - | US\$1,315 |
| Sell US\$ for KW – 0 to 12 months | - | 1,070-1,075 | - | 94 | - | US\$1,348 |
| Sell € for US\$ – 0 to 12 months | 1.10-1.14 | 1.31-1.37 | (6) | (133) | €5,907 | €9,026 |
| Buy £ for US\$ – 0 to 12 months | 1.55-1.62 | 1.61-1.68 | (37) | 3 | £599 | £2,746 |
| Buy £ for € – 0 to 12 months | 0.74-0.79 | - | 78 | - | £1,982 | - |

Foreign exchange forward contracts are contracts whereby the Company has the obligation to sell or buy the currencies at the strike price. The fair value of the foreign currency instruments is recorded in the consolidated statement of income and reflects the estimated amounts the Company would have paid or received to settle these contracts as at the financial position date. Unrealized gains are recorded as derivative assets and unrealized losses as derivative liabilities on the consolidated statement of financial position.

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, which 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, accrual for performance guarantees and long-term debt, including interest payable. A hypothetical strengthening of 5.0% of the following currencies would have had the following impact for the fiscal year ended February 28, 2015:

| | Net income (loss) | Other comprehensive income (loss) |
|---|-------------------|-----------------------------------|
| Canadian dollar strengthening against the U.S. dollar | 1,083 | - |
| Euro strengthening against the U.S. dollar | 766 | - |

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 subsidiaries into the Company's reporting currency. For those subsidiaries whose functional currency is other than the reporting currency (U.S. dollar) of the Company, such exposure would impact other comprehensive income or loss.

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% change in interest rates would have no significant impact on the Company's net income or cash flows.

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.

Management's discussion and analysis

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, 2015, four (2014 – two) customers accounted for more than 5% each of its trade accounts receivable, of which one customer accounted for 10.3% (2014 – 5.4%), and the Company's ten largest customers accounted for 54.7% (2014 – 36.5%). In addition, one customer accounted for 10.9% of the Company's sales (2014 – no customers accounted for more than 10% of sales).

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 primary credit risk is limited to the carrying value of the trade accounts receivable and gains on derivative assets.

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

| (In thousands of U.S. dollars) | February 28, 2015 \$ | February 28, 2014 \$ |
|---------------------------------------|----------------------------|----------------------------|
| Current | 64,387 | 93,053 |
| Past due 0 to 30 days | 17,930 | 13,251 |
| Past due 31 to 90 days | 12,360 | 9,375 |
| Past due more than 90 days | 4,804 | 9,039 |
| | <hr/> | <hr/> |
| Less: Allowance for doubtful accounts | 99,481 899 | 124,718 917 |
| | <hr/> | <hr/> |
| Trade accounts receivable | 98,582 | 123,801 |
| Other receivables | 6,735 | 5,177 |
| | <hr/> | <hr/> |
| Total accounts receivable | 105,317 | 128,978 |

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

| (In thousands of U.S. dollars) | February 28, 2015 \$ | February 28, 2014 \$ |
|---|----------------------------|----------------------------|
| Balance – Beginning of year | 917 | 1,525 |
| Bad debt expenses | 872 | 767 |
| Recoveries of trade accounts receivable | (665) | (1,237) |
| Write-off of trade accounts receivable | (172) | (168) |
| Foreign exchange | (53) | 30 |
| | <hr/> | <hr/> |
| Balance – End of year | 899 | 917 |

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

Management's discussion and analysis

CONTINGENCIES (in thousands of U.S. dollars, 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. 846 claims were outstanding at the end of the reporting period (February 28, 2014 – 856). These claims were filed in the states of Arizona, Arkansas, California, Connecticut, Delaware, Florida, Hawaii, Illinois, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Mississippi, Missouri, New Jersey, New York, North Carolina, Oklahoma, Pennsylvania, Rhode Island, Texas, Virginia, Washington and West Virginia. During the current fiscal year, the Company resolved 439 claims (February 28, 2014 – 368) and was the subject of 429 new claims (February 28, 2014 – 460). 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. Settlement costs and legal fees related to these asbestos claims amounted to \$1,217 for the quarter (February 28, 2014 - \$1,813) and \$6,085 for the year (February 28, 2014 - \$5,472).

On December 3, 2014, San Diego Gas & Electric Company ("SDG") filed a claim against Velan Valve Corp., a wholly-owned subsidiary of the Company, in the Superior Court of the State of California, concerning high pressure valves supplied to SDG and installed at its Palomar Energy Center ("Facility"). This lawsuit alleges damages to the Facility in excess of \$9,000 related to allegedly defective valves supplied by Velan Valve Corp. The claim is for alleged strict product liability and alleged negligence. It is the Company's position that this claim is without merit. The Company intends to vigorously defend its position and will undertake all actions necessary to protect its reputation. While the Company cannot predict the final outcome of this claim, based on information currently available, the Company believes the resolution of this claim will not have a material adverse effect on its financial position, results of operations or liquidity. The Company has reported this claim to its insurance company and accrued the \$100 deductible.

OFF-BALANCE SHEET ARRANGEMENTS

The Company has entered into certain off-balance sheet arrangements. They are fully described in notes 10, 22 and 25 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

RELATED PARTY TRANSACTIONS (in thousands of U.S. 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 the Company's plants.

| | Three months ended | | Twelve months ended | |
|----------------------------------|--------------------|------------------|---------------------|------------------|
| | Feb. 28, 2015 | Feb. 28, 2014 | Feb. 28, 2015 | Feb. 28, 2014 |
| Purchases of material components | \$253 | \$434 | \$1,459 | \$1,889 |
| Sales of raw material | - | 32 | 67 | 104 |

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.

Management's discussion and analysis

- 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 the Company's marketing department.

| | Three months ended | | Twelve months ended | |
|--|--------------------|---------------|---------------------|---------------|
| | Feb. 28, 2015 | Feb. 28, 2014 | Feb. 28, 2015 | Feb. 28, 2014 |
| Software development and consulting services | \$2 | \$1 | \$14 | \$4 |

- c) One of the Company's subsidiaries and certain of its executives lease, 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 | |
|------|--------------------|---------------|---------------------|---------------|
| | Feb. 28, 2015 | Feb. 28, 2014 | Feb. 28, 2015 | Feb. 28, 2014 |
| Rent | \$- | \$8 | \$27 | \$25 |

CONTROLS AND PROCEDURES

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 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 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, 2015 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 control 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 IFRS.

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 (2013)" issued by the *Committee of Sponsoring Organizations of the Treadway Commission* ("COSO"). This evaluation was performed by the 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 CEO and the CFO concluded that the internal controls and procedures over financial reporting were appropriately designed and operating effectively as at February 28, 2015.

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.

Changes in internal control over financial reporting

The Company did not make any material changes to the design of internal control over financial reporting during the year and three-month period ended February 28, 2015 that have materially affected, or are reasonably likely to have materially affected, the Company's internal control over financial reporting.

Management's discussion and analysis

CRITICAL ACCOUNTING ESTIMATES & JUDGEMENTS

The Company's financial statements are prepared in accordance with IFRS as issued by the IASB. The Company's significant accounting policies as described in note 2 of the Company's audited consolidated financial statements are essential to understanding the Company's financial positions, results of operations 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 (see *Forward-looking information* section above). 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. There were no significant changes made to critical accounting estimates during the past two financial years.

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:

Consolidation

The Company consolidates the accounts of Juwon Special Steel Co. Ltd. in these financial statements. It was determined that the Company has substantive rights over this structured entity that are currently exercisable and for which there is no barrier, despite the fact that its percentage ownership in this entity is only 50%. These substantive rights are obtained through the shareholders' agreement signed between the Company and the non-controlling interest which gives the Company the ultimate decision right on any decision taken for which both parties in the joint arrangement are not in agreement. As per the shareholders' agreement, the Board of Directors, representing the interests of shareholders, has responsibility to establish operating decisions (including budgets), approve capital transactions and determine key management personnel remuneration. Consequently, the Company, through its rights set out in the shareholders' agreement, has substantive rights that give it the ability to direct the relevant activities of Juwon Special Steel Co. Ltd. while being exposed to variable returns. As such, it was determined that this entity should be consolidated.

Accounts receivable

The Company must report its accounts receivable at their net realizable value. This involves management judgment and requires the Company to perform continuous evaluations of their collectability 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 could impact the carrying value of the accounts receivable on the consolidated statement of financial position with a corresponding impact made to administration costs on the consolidated statement of income.

Inventories

Inventories must be valued at the lower of cost and net realizable value. A writedown of 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 demand and, in some cases, the specific risk of loss on specifically identified inventory. Any change in the assumptions used in assessing this valuation or selling costs could impact the carrying amount of the inventory on the consolidated statement of financial position with a corresponding impact made to cost of sales on the consolidated statement of income.

Provisions

Provisions must be established for possible product warranty expenses. 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. The Company estimates its exposure under these obligations based on an analysis of all identified or expected claims. Any change in the assumptions used could impact the value of the provision on the consolidated statement of financial position with a corresponding impact made to cost of sales on the consolidated statement of income.

Impairment of non-financial assets

Assets that have an indefinite life, such as goodwill, are tested annually by the Company for impairment, or more frequently if events or circumstances indicate there may be impairment. All other assets must be reviewed by the Company at the end of each reporting period in order to determine whether there is an indication of possible impairment. Any change in the assumptions used could impact the carrying amount first of any goodwill allocated to the CGU and then to the other assets of the CGU on a pro rata

Management's discussion and analysis

basis of the carrying amount of each asset in the CGU on the consolidated statement of financial position with a corresponding impact made to the consolidated statement of income.

Income taxes

The Company must estimate its income taxes in each jurisdiction in which it operates. This involves assessing the probability of using 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 balances on the consolidated statement of financial position.

ACCOUNTING STANDARDS AND AMENDMENTS ISSUED BUT NOT YET ADOPTED

Unless otherwise noted, the following revised standards are effective for annual periods beginning on or after January 1, 2016 with earlier application permitted. The Company has not yet assessed the impact of these standards or determined whether it will early adopt them.

- (i) In July 2014, the IASB issued IFRS 9, *Financial Instruments*. The IASB has previously published versions of IFRS 9 that introduced new classification and measurement requirements (in 2009 and 2010) and a new hedge accounting model (in 2013). The July 2014 publication represents the final version of the Standard, replaces earlier versions of IFRS 9 and substantially completes the IASB's project to replace IAS 39, *Financial Instruments: Recognition and Measurement*.

This standard replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has only three classification categories: amortized cost and fair value through other comprehensive income and fair value through profit or loss. The basis of classification depends on the entity's business model and the contractual cash flow characteristics of the financial asset or liability. The standard introduces a new, expected loss impairment model that will require more timely recognition of expected credit losses. Specifically, the new Standard requires entities to account for expected credit losses from when financial instruments are first recognised and it lowers the threshold for recognition of full lifetime expected losses. The new standard also introduces a substantially-reformed model for hedge accounting with enhanced disclosures about risk management activity and aligns hedge accounting more closely with risk management. The new standard is effective for annual periods beginning on or after January 1, 2018 with early adoption permitted.

- (ii) IFRS 15, *Revenue from Contracts with Customers*, was issued in May 2014 and specifies how and when revenue will be recognized as well as requiring the provision of more informative and relevant disclosures. Its core principle is that an entity will recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This core principle is delivered in a five-step model framework: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the entity satisfies a performance obligation. IFRS 15 replaces IAS 11, *Construction contracts*, IAS 18, *Revenue*, IFRIC 13, *Customer Loyalty Programmes*, IFRIC 15, *Agreements for the Construction of Real Estate*, IFRIC 18, *Transfers of Assets from Customers*, and SIC-31, *Revenue - Barter Transactions Involving Advertising Services*.

The IASB has decided to propose to defer the effective date of IFRS 15 from its current effective date of January 1, 2017 to annual periods beginning on or after January 1, 2018, with earlier application permitted.

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 or market. 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, such as the current downturn in the oil and gas industry, will not have a significant adverse effect on the Company's sales.

Management's discussion and analysis

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 that 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.

Backlog

The Company's order backlog consists of sales orders that are considered firm. It is also an indication of future sales revenues. However, there can be no assurance that subsequent cancellations or scope adjustments will not occur, that the order backlog will ultimately result in earnings, or when the related revenues and earnings from such order backlog will be recognized.

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.

Foreign currency exchange risks

Due to the geographic mix of the Company's customers and its operations, the Company is exposed to foreign currency exchange risk. The Company enters into simple foreign currency forward contracts in order to manage a portion of its net exposure to foreign currencies. Such forward contracts contain an inherent credit risk related to default on obligations by the counterparty, which the company mitigates by entering into contracts with sound financial institutions that it anticipates will satisfy their obligations. Risk related to currency fluctuations could have a material adverse effect on the Company's results of operations and its financial position.

Interest rate risk

A portion of the Company's liabilities consist of debt instruments that bear interest at variable rates. As such, the Company is exposed to the risk of interest rate fluctuations. This risk could have an adverse effect on the Company's results of 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. 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 that 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 due to more stringent terms and conditions. Although contract terms may vary from customer to customer, production delays and other performance issues may call for liquidated damages or other penalties in case of non-performance or warranty issues due to the more stringent terms and conditions of such contracts.

Management's discussion and analysis

Political and economic risks associated with international sales and operations

Since the Company sells and manufactures its products worldwide, the business 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.

Force majeure events

Force majeure events are unforeseeable events or circumstances that occur beyond the control of the Company. Such events include but are not limited to political unrest, war, terrorism, strikes, riots, and crime, as well as seismic or severe weather related events such as earthquakes, hurricanes, tsunamis, tornadoes, ice storms, flooding and volcanic eruptions. The risk of occurrence of a force majeure event is unpredictable and may result in delays or cancellations of orders and deliveries to customers, delays in the receipt of materials from suppliers, damage to facilities or equipment, personal injury or fatality, and possible legal liability.

Asbestos litigation

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 defense related to certain products that may have contained an internal component containing asbestos. Although it is defending these allegations vigorously, there can be no assurance that the Company will prevail. Unfavorable rulings, judgments or settlement terms could have a material adverse impact on the Company's business, financial condition, results of operations and cash flows.

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 comprehensive general liability insurance coverage which it considers to generally be in accordance with industry practice, such insurance does not cover certain categories of claims (such as ongoing asbestos claims) to which the Company is subject. Comprehensive general liability premiums have also increased significantly during the last several years. Accordingly, the Company cannot be certain that comprehensive general liability insurance coverage will continue to be available to it at a reasonable cost, or, if available, would be adequate to cover its liabilities.

Health and safety risk

The Company is committed to providing all employees, contractors, and visitors to its premises with a healthy and safe work environment. The Company has implemented a program throughout its operations with policies and procedures that must be followed to ensure that it meets all applicable health and safety laws, regulations, and standards. The Company recognizes that a lack of a strong health and safety program may expose it to lost production time, penalties and lawsuits, and may impact future orders as customers may take into account the Company's health and safety record when awarding sales contracts.

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.

Controls over disclosures and financial reporting

In accordance with National Instrument 52-109, the CEO and the CFO of the Company are responsible for designing, maintaining, and evaluating the effectiveness of disclosure controls and procedures. The CEO and the 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 IFRS. 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.

Control of the Company

Velan Holding Co. Ltd. (the "Controlling Shareholder") owns 15,566,567 Multiple Voting Shares representing, in the aggregate, approximately 92.4% of the voting interests in the Company. Voting control enables the Controlling Shareholder to determine all matters requiring shareholder approval. The Controlling Shareholder has advised the Company that the disposition of the shares requires the consent of certain Velan family members and controlled entities.

Management's discussion and analysis

The Controlling Shareholder effectively has sufficient voting power to prevent a change in control of the Company, which may negatively affect the price and liquidity of the Subordinated Voting Shares. 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 negatively 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 international laws

Due to the international nature of its operations, the Company is subject to differing systems of laws and regulations which are often complex and differ from one country to the next. Such laws and regulations include but are not limited to anti-bribery legislation, export and customs controls, foreign currency exchange controls, transfer pricing regulations and economic sanctions imposed by governmental authorities. Failure to comply with such laws could negatively impact earnings and may result in criminal, civil and administrative legal sanctions. The Company has implemented policies and procedures to effect compliance with these laws by its employees and representatives.

Non-controlling interest

The Company's operations in China and Taiwan, and certain of its operations in France and Korea are undertaken with partners that are classified as non-controlling interest. The success of these operations depends on the satisfactory performance of such partners in their obligations. The failure of such partners to perform their obligations could impose additional financial and performance obligations on the Company that could negatively impact its earnings and financial condition.

Business acquisitions

The success of a business acquisition depends in part upon the integration of the acquired business through such tasks as the realization of synergies, elimination of cost duplication, information systems integration, and establishment of controls and procedures. The inability to adequately integrate an acquired business in a timely manner might result in lost business opportunities, higher than expected integration costs and departures of key personnel, all of which could have a negative impact on earnings.

Management's discussion and analysis

RECONCILIATIONS OF NON-IFRS MEASURES

In this MD&A and other sections of the 2015 Annual Report, the Company presented measures of performance or financial condition which are not defined under IFRS ("non-IFRS 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 IFRS. Reconciliations of these amounts can be found below.

| Net cash | Fiscal year ended Feb. 28, 2015 | Fiscal year ended Feb. 28, 2014 | Fiscal year ended Feb. 28, 2013 | Fiscal year ended Feb. 29, 2012 | Fiscal year ended Feb. 28, 2011 |
|--|--|--|--|--|--|
| (in thousands) | | | | | |
| Cash and cash equivalents | 99,578 | 106,716 | 77,172 | 65,414 | 119,996 |
| Short-term investments | 847 | 239 | 398 | 4,954 | 87 |
| Bank indebtedness | (15,616) | (31,876) | (48,580) | (32,438) | (5,634) |
| Short-term bank loans | (2,134) | (916) | (2,284) | (858) | (822) |
| Current portion of long-term bank borrowings | (7,063) | (6,402) | (6,919) | (1,696) | (603) |
| | <u>75,612</u> | <u>67,761</u> | <u>19,787</u> | <u>35,376</u> | <u>113,024</u> |

| Adjusted net operating results | Fiscal year ended Feb. 28, 2015 | Fiscal year ended Feb. 28, 2014 | Fiscal year ended Feb. 28, 2013 | Fiscal year ended Feb. 29, 2012 | Fiscal year ended Feb. 28, 2011 |
|--|--|--|--|--|--|
| (in thousands) | | | | | |
| Net income attributable to Subordinate Voting Shares and Multiple Voting Shares | 18,580 | 29,400 | 6,169 | 7,892 | 21,224 |
| <u>Adjustments for:</u> | | | | | |
| Goodwill impairment loss | - | - | 11,700 | - | - |
| Interest accretion on ABV proceeds payable | - | 9 | 663 | 946 | - |
| Fair value adjustment for ABV proceeds payable | - | - | (2,444) | (2,230) | - |
| Unrealized foreign exchange gain on ABV proceeds payable | - | - | (407) | (978) | - |
| | <u>18,580</u> | <u>29,409</u> | <u>15,681</u> | <u>5,630</u> | <u>21,224</u> |

Velan Inc.

Consolidated Financial Statements
For the years ended February 28, 2015 and 2014



May 19, 2015

Independent Auditor's Report

To the Shareholders of Velan Inc.

We have audited the accompanying consolidated financial statements of Velan Inc. and its subsidiaries, which comprise the consolidated statements of financial position as at February 28, 2015 and February 28, 2014 and the consolidated statements of income, comprehensive income (loss), changes in equity and cash flows for the years then ended, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

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

Auditor's responsibility

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

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

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"PwC" refers to PricewaterhouseCoopers LLP/s.r.l./s.e.n.c.r.l., an Ontario limited liability partnership.



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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Velan Inc. and its subsidiaries as at February 28, 2015 and February 28, 2014 and their financial performance and their cash flows for the years then ended in accordance with International Financial Reporting Standards.

PricewaterhouseCoopers LLP¹

¹ CPA auditor, CA, public accountancy permit No. A123642

Velan Inc.

Consolidated Statements of Financial Position

(in thousands of U.S. dollars)

| | As at February 28, 2015 \$ | As at February 28, 2014 \$ |
|--|-------------------------------------|-------------------------------------|
| Assets | | |
| Current assets | | |
| Cash and cash equivalents | 99,578 | 106,716 |
| Short-term investments | 847 | 239 |
| Accounts receivable | 105,335 | 128,978 |
| Income taxes recoverable | 5,472 | 5,465 |
| Inventories (note 5) | 203,557 | 224,149 |
| Deposits and prepaid expenses | 5,326 | 5,046 |
| Derivative assets | 144 | 498 |
| | <u>420,259</u> | <u>471,091</u> |
| Non-current assets | | |
| Property, plant and equipment (notes 7 and 12) | 91,285 | 96,605 |
| Intangible assets and goodwill (note 8) | 33,576 | 43,359 |
| Deferred income taxes (note 20) | 12,392 | 11,406 |
| Other assets | 1,116 | 1,693 |
| | <u>138,369</u> | <u>153,063</u> |
| Total assets | <u>558,628</u> | <u>624,154</u> |
| Liabilities | | |
| Current liabilities | | |
| Bank indebtedness (note 10) | 15,616 | 31,876 |
| Short-term bank loans | 2,134 | 916 |
| Accounts payable and accrued liabilities (note 9) | 70,997 | 76,590 |
| Income taxes payable | 3,961 | 4,158 |
| Dividend payable | 1,755 | 1,586 |
| Customer deposits | 44,111 | 66,842 |
| Provisions (note 11) | 7,874 | 8,060 |
| Accrual for performance guarantees | 30,012 | 33,842 |
| Derivative liabilities | 5,362 | 1,501 |
| Current portion of long-term debt (note 12) | 10,644 | 10,402 |
| | <u>192,466</u> | <u>235,773</u> |
| Non-current liabilities | | |
| Long-term debt (note 12) | 4,183 | 11,685 |
| Deferred income taxes (note 20) | 8,349 | 9,270 |
| Other liabilities | 8,537 | 8,307 |
| | <u>21,069</u> | <u>29,262</u> |
| Total liabilities | <u>213,535</u> | <u>265,035</u> |
| Equity | | |
| Equity attributable to Subordinate and Multiple Voting shareholders | | |
| Share capital (note 13) | 76,475 | 76,688 |
| Contributed surplus | 6,064 | 6,099 |
| Retained earnings | 283,724 | 272,867 |
| Accumulated other comprehensive loss | (27,652) | (3,589) |
| | <u>338,611</u> | <u>352,065</u> |
| Non-controlling interest (note 6) | 6,482 | 7,054 |
| Total equity | <u>345,093</u> | <u>359,119</u> |
| Total liabilities and equity | <u>558,628</u> | <u>624,154</u> |
| Commitments and contingencies (note 22) | | |

The accompanying notes are an integral part of these consolidated financial statements.

Approved by the Board of Directors



T.C. Velan, Director

Velan Inc.

Consolidated Statements of Income

For the years ended February 28, 2015 and 2014

(in thousands of U.S. dollars, excluding per share amounts)

| | 2015 \$ | 2014 \$ |
|---|------------------------|------------------------|
| Sales (notes 14 and 24) | 455,750 | 489,257 |
| Cost of sales (notes 5, 14, 15 and 19) | 337,467 | 358,111 |
| Gross profit | 118,283 | 131,146 |
| Administration costs (notes 16 and 19) | 88,391 | 87,143 |
| Other costs (income) | 337 | (269) |
| Operating profit | 29,555 | 44,272 |
| Finance income | 1,067 | 859 |
| Finance costs | 1,657 | 2,369 |
| Finance costs – net | (590) | (1,510) |
| Income before income taxes | 28,965 | 42,762 |
| Income taxes (note 20) | 9,773 | 11,759 |
| Net income for the year | 19,192 | 31,003 |
| Net income attributable to: | | |
| Subordinate Voting Shares and Multiple Voting Shares | 18,580 | 29,400 |
| Non-controlling interest | 612 | 1,603 |
| | 19,192 | 31,003 |
| Earnings per share (note 21) | | |
| Basic | 0.85 | 1.34 |
| Diluted | 0.85 | 1.34 |
| Dividends declared per Subordinate and Multiple Voting Share | 0.36 (CA\$0.40) | 0.31 (CA\$0.32) |

The accompanying notes are an integral part of these consolidated financial statements.

Velan Inc.

Consolidated Statements of Comprehensive Income (Loss)

For the years ended February 28, 2015 and 2014
(in thousands of U.S. dollars)

| | 2015 | 2014 |
|--|----------------|---------------|
| | \$ | \$ |
| Comprehensive income (loss) | | |
| Net income for the year | 19,192 | 31,003 |
| Other comprehensive income (loss) | | |
| Foreign currency translation adjustment on foreign operations whose functional currency is other than the reporting currency (U.S. dollar) | (24,850) | 6,311 |
| Foreign currency translation adjustment realized on the liquidation of a subsidiary whose functional currency is other than the reporting currency (U.S. dollar) | 636 | - |
| Comprehensive income (loss) | <u>(5,022)</u> | <u>37,314</u> |
| Comprehensive income (loss) attributable to: | | |
| Subordinate Voting Shares and Multiple Voting Shares | (5,483) | 35,624 |
| Non-controlling interest | 461 | 1,690 |
| | <u>(5,022)</u> | <u>37,314</u> |

The accompanying notes are an integral part of these consolidated financial statements.

Velan Inc.

Consolidated Statements of Changes in Equity

For the years ended February 28, 2015 and 2014
(in thousands of U.S. dollars)

| | Equity attributable to Subordinate and Multiple Voting shareholders | | | | | | Total equity |
|---|---|---------------------|---|-------------------|----------|--------------------------|--------------|
| | Share capital | Contributed surplus | Accumulated other comprehensive income (loss) | Retained earnings | Total | Non-controlling interest | |
| Balance - February 28, 2013 | 76,314 | 1,746 | (8,676) | 250,129 | 319,513 | 8,660 | 328,173 |
| Net income for the year | - | - | - | 29,400 | 29,400 | 1,603 | 31,003 |
| Other comprehensive income | - | - | 6,224 | - | 6,224 | 87 | 6,311 |
| | 76,314 | 1,746 | (2,452) | 279,529 | 355,137 | 10,350 | 365,487 |
| Effect of share-based compensation (note 13(d)) | - | 23 | - | - | 23 | - | 23 |
| Shares issued under Share Option Plan (note 13(d)) | 374 | - | - | - | 374 | - | 374 |
| Dividends | | | | | | | |
| Multiple Voting Shares | - | - | - | (4,760) | (4,760) | - | (4,760) |
| Subordinate Voting Shares | - | - | - | (1,902) | (1,902) | - | (1,902) |
| Non-controlling interest | - | - | - | - | - | (103) | (103) |
| Acquisition of non-controlling interest (note 6(d)) | - | 4,330 | (1,137) | - | 3,193 | (3,193) | - |
| Balance - February 28, 2014 | 76,688 | 6,099 | (3,589) | 272,867 | 352,065 | 7,054 | 359,119 |
| Net income for the year | - | - | - | 18,580 | 18,580 | 612 | 19,192 |
| Other comprehensive loss | - | - | (24,063) | - | (24,063) | (151) | (24,214) |
| | 76,688 | 6,099 | (27,652) | 291,447 | 346,582 | 7,515 | 354,097 |
| Effect of share-based compensation (note 13(d)) | - | 15 | - | - | 15 | - | 15 |
| Dividends | | | | | | | |
| Multiple Voting Shares | - | - | - | (5,447) | (5,447) | - | (5,447) |
| Subordinate Voting Shares | - | - | - | (2,233) | (2,233) | - | (2,233) |
| Non-controlling interest | - | - | - | - | - | (1,033) | (1,033) |
| Share repurchase (note 13(c)) | (213) | (50) | - | (43) | (306) | - | (306) |
| Balance - February 28, 2015 | 76,475 | 6,064 | (27,652) | 283,724 | 338,611 | 6,482 | 345,093 |

The accompanying notes are an integral part of these consolidated financial statements.

Velan Inc.

Consolidated Statements of Cash Flow

For the years ended February 28, 2015 and 2014
(in thousands of dollars)

| | 2015 | 2014 |
|--|-----------------|-----------------|
| | \$ | \$ |
| Cash flows from | | |
| Operating activities | | |
| Net income for the year | 19,192 | 31,003 |
| Adjustments to reconcile net income to cash provided by operating activities (note 27) | 19,445 | 15,890 |
| Changes in non-cash working capital items (note 28) | 11,279 | 28,566 |
| Cash provided by operating activities | <u>49,916</u> | <u>75,459</u> |
| Investing activities | | |
| Short-term investments | (608) | 159 |
| Additions to property, plant and equipment | (12,822) | (17,953) |
| Additions to intangible assets | (400) | (397) |
| Proceeds on disposal of property, plant and equipment, and intangible assets | 160 | 396 |
| Net change in other assets | 576 | 44 |
| Cash used in investing activities | <u>(13,094)</u> | <u>(17,751)</u> |
| Financing activities | | |
| Dividends paid to Subordinate and Multiple Voting shareholders | (7,511) | (6,777) |
| Dividends paid to non-controlling interest | (1,033) | (103) |
| Shares issued under Share Option Plan (note 13(d)) | - | 374 |
| Repurchase of shares (note 13(c)) | (306) | - |
| Payment of proceeds payable | - | (1,960) |
| Short-term bank loans | 1,218 | (1,368) |
| Increase in long-term debt | - | 2,654 |
| Repayment of long-term debt | (6,326) | (8,430) |
| Cash used by financing activities | <u>(13,958)</u> | <u>(15,610)</u> |
| Effect of exchange rate differences on cash | <u>(13,742)</u> | <u>4,150</u> |
| Net change in cash during the year | 9,122 | 46,248 |
| Net cash – Beginning of the year | <u>74,840</u> | <u>28,592</u> |
| Net cash – End of the year | <u>83,962</u> | <u>74,840</u> |
| Net cash is composed of: | | |
| Cash and cash equivalents | 99,578 | 106,716 |
| Bank indebtedness | (15,616) | (31,876) |
| | <u>83,962</u> | <u>74,840</u> |
| Supplementary information | | |
| Interest paid | (117) | (1,062) |
| Income taxes paid | (9,357) | (3,946) |

The accompanying notes are an integral part of these consolidated financial statements.

Velan Inc.

Notes to the Consolidated Financial Statements

For the years ended February 28, 2015 and 2014

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

1 General information and basis of preparation

These consolidated financial statements represent the consolidation of the accounts of Velan Inc. (the “Company”) and its subsidiaries. The Company is an international manufacturer of industrial valves.

The Company is a public company listed on the Toronto Stock Exchange under the symbol “VLN”. It was incorporated under the name Velan Engineering Ltd. on December 12, 1952 and continued under the *Canada Business Corporations Act* on February 11, 1977. It changed its name to Velan Inc. on February 20, 1981. Velan Inc. maintains its registered head office at 7007 Côte de Liesse, Montréal, Quebec, Canada, H4T 1G2. The Company’s ultimate parent company is Velan Holdings Co. Ltd.

The Company’s consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board (“IASB”).

These consolidated financial statements were approved by the Company’s Board of Directors on May 19, 2015.

2 Summary of significant accounting policies

Functional and presentation currency

Functional currency is defined as the currency of the primary economic environment in which an entity operates. Indicators for determining an entity’s functional currency are broken down into primary and secondary indicators.

Primary indicators include:

- the currency of sales and cash inflows;
- the currency of the country having primary influence over sales prices; and
- the currency of expenses and cash outflows.

Primary indicators receive more weight than secondary indicators. If a functional currency can be determined based on the primary indicators, the secondary indicators are not considered.

The functional and presentation currency of the Company is the U.S. dollar.

Consolidation

These financial statements represent the consolidation of the accounts of the Company and its subsidiaries. Control exists when the Company is exposed to, or has rights to, variable returns from its involvement with an investee, including a structured entity, and has the ability to affect those returns through its power to direct the activities of an investee. Subsidiaries are fully consolidated from the date control has been transferred to the Company and deconsolidated from the date control ceases.

All subsidiaries prepare their financial statements at the same reporting date as the Company except for Velan Valvac Manufacturing Co. Ltd., 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.

Foreign currency transactions and balances

The Company and its subsidiaries translate foreign currency transactions and balances into their functional currency. Foreign currency is defined as any currency that is different from an individual entity’s functional currency.

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Monetary assets and liabilities in foreign currencies are translated at year-end exchange rates. Non-monetary assets are translated at rates prevailing at the transaction dates. Revenue and expenses in foreign currencies are translated at weekly average rates throughout the year. Gains and losses arising on translation are included in the consolidated statement of income for the year.

Translation of accounts of foreign subsidiaries

The financial statements of the Company's foreign subsidiaries whose functional currency is not the U.S. dollar are translated into U.S. dollars for reporting purposes. All assets and liabilities are translated at year-end rates, and revenue and expenses at the average rate for the period. Resulting gains and losses are included in other comprehensive income (loss) 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 assets. The Company's financial liabilities comprise mainly bank indebtedness, short-term bank loans, accounts payable and accrued liabilities, customer deposits, dividend payable, accrual for performance guarantees, long-term debt and derivative liabilities.

The Company recognizes a financial instrument on its consolidated statement of financial position 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 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, available-for-sale assets, held-to-maturity investments, loans and receivables 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.

Held for trading

Financial instruments classified as held for trading are carried at fair value at each statement of financial position date with the changes in fair value recorded in the consolidated statement of income in the period in which these changes arise. The Company has classified its derivative financial instruments as held for trading.

Loans and receivables, held-to-maturity investments 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 income over the expected life of the instrument. Cash and cash equivalents, short-term investments and accounts receivable are classified as loans and receivables. Bank indebtedness, short-term bank loans, accounts payable and accrued liabilities, customer deposits, dividend payable, accrual for performance guarantees and long-term debt, including interest payable, are classified as other financial liabilities, all of which are measured at amortized cost.

Velan Inc.

Notes to the Consolidated Financial Statements

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(in thousands of U.S. dollars, excluding number of shares and per share amounts)

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 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 through profit or loss. These embedded derivatives are classified as held for trading.

The Company and its subsidiaries 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 statement of financial position, gains are recorded as derivative assets and losses are recorded as derivative liabilities.

Transaction costs are expensed when incurred.

Fair value

Estimated fair values for financial instruments are designed to approximate amounts at which the instruments could be exchanged in a current arm’s-length transaction between knowledgeable willing parties. The fair value of derivative instruments is determined using valuation techniques.

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.

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 and associated costs 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 products. 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 products, and some products are sold with volume discounts. Sales are recorded based on the price specified in the sales contract, net of

Velan Inc.

Notes to the Consolidated Financial Statements

For the years ended February 28, 2015 and 2014

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

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.

Cash and cash equivalents

Cash and cash equivalents include cash on 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 consolidated statement of financial position. Interest is earned on cash and cash equivalents at rates ranging from 0% to 3.5% on an annual basis. Interest is paid on bank indebtedness at rates ranging from 0.4% to 5.0%.

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 2.0% to 8.0%.

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 principally using 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) work in process, finished parts and finished goods using the raw material cost described in (a) plus applicable direct labour and manufacturing overhead.

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. The writedown may be reversed if the circumstances which caused it no longer exist.

Property, plant and equipment

Property, plant and equipment are valued at acquisition or manufacturing costs less any related government assistance, accumulated depreciation 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. Borrowing costs directly attributable to the acquisition, construction or production of assets that necessarily take a substantial period of time to be ready for their intended use are added to the cost of those assets, until such time as those assets are ready for their intended use.

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Notes to the Consolidated Financial Statements

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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 a replaced part is expensed as the parts are used. All other repairs and maintenance are charged to the consolidated statement of income during the period in which they are incurred.

Depreciation of assets commences when the assets are ready for their intended use. The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at the end of each reporting period. Changes in expected useful life or the expected pattern of consumption of future economic benefits embodied in the asset are accounted for by changing the depreciation period or method, as appropriate, and treated on a prospective basis as a change in estimate.

Depreciation on the property, plant and equipment is determined principally using the following methods and annual rates or terms:

| | Method | Rate/Term |
|--|-------------------|------------------|
| Buildings | Declining balance | 4% to 5% |
| Machinery and equipment and furniture and fixtures | Declining balance | 10% to 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.

Intangible assets

Purchased intangible assets relate primarily to patents, products, designs, customer lists, non-compete agreements and computer software. Internally generated intangible assets relate to development costs. Research and development costs are expensed as incurred unless the development costs meet the criteria for deferral. As at February 28, 2014 and February 28, 2013, the Company had not capitalized any development costs.

Amortization expense is recognized in the consolidated statement of income in the expense category consistent with the function of the intangible asset. The assets' useful lives are reviewed, and adjusted if appropriate, at the end of each reporting period or more frequently if events or circumstances occur that would indicate a change in useful life. Changes in expected useful life or the expected pattern of consumption of future economic benefits embodied in the asset are accounted for by changing the amortization period or method, as appropriate, and treated on a prospective basis as a change in estimate. Amortization is determined principally using the following methods and terms:

| | Method | Term |
|-------------------------------|---------------|--------------|
| Patents, products and designs | Straight-line | 15 years |
| Customer lists | Straight-line | 10 years |
| Non-compete agreements | Straight-line | 5 years |
| Computer software | Straight-line | 1 to 3 years |

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Notes to the Consolidated Financial Statements

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Government assistance

The Company receives assistance in the form of investment tax credits (“ITCs”). ITCs 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.

Impairment of non-financial assets

Assets that have an indefinite life (e.g. goodwill or indefinite life intangible assets) are not subject to amortization and are tested annually for impairment, or more frequently if events or circumstances indicate there may be impairment.

All other long-lived assets must be reviewed at the end of each reporting period in order to determine whether there is an indication of possible impairment.

For the purposes of impairment testing, assets are grouped at the lowest levels for which there are separately identifiable cash flows. A cash-generating unit (“CGU”) is the smallest group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. If an indication of impairment exists, the recoverable amount of the CGU is estimated in order to determine the extent of the impairment loss, if any. An impairment loss is recognized for the amount by which the asset’s carrying amount exceeds its recoverable amount. If the recoverable amount of the CGU is less than the carrying amount, the impairment loss is allocated first to reduce the carrying amount of any goodwill allocated to the CGU and then to the other assets of the CGU on a pro rata basis of the carrying amount of each asset in the CGU. The recoverable amount is the greater of an asset’s or CGU’s fair value less costs of disposal and its value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

Goodwill is allocated to CGUs for the purpose of impairment testing based on the level at which it is monitored by management. The allocation is made to those CGUs that are expected to benefit from the business combination in which the goodwill arose.

Non-current and non-financial assets, other than goodwill, that have previously suffered an impairment loss are reviewed for possible reversal of the impairment at each reporting date.

Income taxes

The provision for income taxes for the year comprises current and deferred taxes. Taxes are recognized in the consolidated statement of income, except to the extent that it relates to items recognized in other comprehensive income or directly in equity, in which case the taxes are recognized in other comprehensive income or equity, respectively.

Current income taxes

The current income taxes charge is calculated on the basis of the tax laws enacted or substantively enacted at the statement of financial position date in the countries where the Company generates taxable income. When an asset is transferred between entities within the consolidated group, the difference between the tax rates of the two entities is recognized as a tax expense in the period in which the transfer occurs. Current taxes payable is recognized for any

Velan Inc.

Notes to the Consolidated Financial Statements

For the years ended February 28, 2015 and 2014

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

taxes payable in the current period. Current tax liabilities are recognized for current taxes to the extent that they remain unpaid for current and prior periods.

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. Uncertain income tax provisions are recorded when probable and are recorded at the Company's best estimate of the amount.

Deferred income taxes

Deferred income taxes are 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 deferred income taxes are not accounted for if they arise 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. Deferred income taxes are determined using tax rates and laws that have been enacted or substantively enacted by the statement of financial position date and are expected to apply when the related deferred income tax asset is realized or the deferred income tax liability is settled. Deferred 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 used. Deferred income tax assets are reviewed at each statement of financial position date and amended to the extent that it is no longer probable that the related tax benefit will be realized.

Deferred income taxes are provided on temporary differences arising on investments in subsidiaries, 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.

Current income tax assets and liabilities are offset when the Company has a legally enforceable right to offset the recognized amounts and intends either to settle on a net basis or to realize the asset and settle the liability simultaneously. Normally, the Company would only have a legally enforceable right to set off a current tax asset against a current tax liability when they relate to income taxes levied by the same taxation authority and the taxation authority permits the Company to make or receive a single net payment. Deferred income tax assets and liabilities are offset when the Company has a legally enforceable right to set off current income tax assets against current income tax liabilities and deferred income tax assets and liabilities related to income taxes levied by the same taxation authority on either: (1) the same taxable entity; or (2) different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realize assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred income tax liabilities or assets are expected to be settled or recovered.

Provisions

Provisions are recognized when the Company has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of resources will be required to settle the obligation, and the amount has been reliably estimated. Provisions are not recognized for costs that need to be incurred to operate in the future or expected future operating losses.

Provisions are measured at the present value of the expenditures required to settle the obligation using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the obligation.

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Accrual for performance guarantees

Accrual for performance guarantees arise for possible late delivery and other contractual non-compliance penalties or liquidated damages. It is recognized when the Company has a present legal or constructive obligation as a result of a past event, and the amount has been reliably estimated. Accrual for performance guarantees is not recognized for costs that need to be incurred to operate in the future or expected future operating losses.

Accrual for performance guarantees is measured at the present value of the expenditures required to settle the obligation using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the obligation.

Leases

Leases are classified as either finance or operating leases. Leases that transfer substantially all of the risks and rewards of ownership of the asset to the Company are accounted for as finance leases. Finance leases are capitalized at the commencement of the lease at the lower of the fair value of the leased asset and the present value of the minimum lease payments. Assets acquired under a finance lease are depreciated over the shorter of the period of expected use on the same basis as other similar assets and the lease term.

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Rental payments under operating leases are expensed in the consolidated statement of income on a straight-line basis over the term of the lease.

Share-based compensation plans

Grants under the Company's share-based compensation plans are accounted for in accordance with the fair value based method of accounting. The Company operates a share-based compensation plan under which it 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, with a corresponding increase to contributed surplus. 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. Vesting typically occurs one-third per year over three years from the grant date. This non-market performance condition is factored into the estimate of the number of options expected to vest. If 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, together with the amount recorded in contributed surplus, net of any directly attributable transaction costs, are recorded in share capital.

Critical accounting estimates and judgment

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

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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. There were no significant changes made to critical accounting estimates during the past two fiscal years.

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 fiscal year are addressed below.

Consolidation

The Company consolidates the accounts of Juwon Special Steel Co. Ltd. in these financial statements. It was determined that the Company has substantive rights over this structured entity that are currently exercisable and for which there is no barrier, despite the fact that its percentage ownership in this entity is only 50%. These substantive rights are obtained through the shareholders' agreement signed between the Company and the non-controlling interest which gives the Company the ultimate decision right on any decision taken for which both parties in the joint arrangement are not in agreement. As per the shareholders' agreement, the Board of Directors, representing the interests of shareholders, has responsibility to establish operating decisions (including budgets), approve capital transactions and determine key management personnel remuneration. Consequently, the Company, through its rights set out in the shareholders' agreement, has substantive rights that give it the ability to direct the relevant activities of Juwon Special Steel Co. Ltd. while being exposed to variable returns. As such, it was determined that this entity should be consolidated.

Accounts receivable

The Company must report its accounts receivable at their net realizable value. This involves management judgment and requires the Company to perform continuous evaluations of their collectability 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 could impact the carrying value of the accounts receivable on the consolidated statement of financial position with a corresponding impact made to administration costs on the consolidated statement of income.

Inventories

Inventories must be valued at the lower of cost and net realizable value. A writedown of 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 demand and, in some cases, the specific risk of loss on specifically identified inventory. Any change in the assumptions used in assessing this valuation or selling costs could impact the carrying amount of the inventory on the consolidated statement of financial position with a corresponding impact made to cost of sales on the consolidated statement of income.

Provisions

Provisions must be established for possible product warranty expenses. 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. The Company estimates its exposure under these obligations based on an analysis of all identified or expected claims. Any change in the assumptions used could impact the value of the provision on the consolidated

Velan Inc.

Notes to the Consolidated Financial Statements

For the years ended February 28, 2015 and 2014

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

statement of financial position with a corresponding impact made to cost of sales on the consolidated statement of income.

Impairment of non-financial assets

Assets that have an indefinite life, such as goodwill, are tested annually by the Company for impairment, or more frequently if events or circumstances indicate there may be impairment. All other assets must be reviewed by the Company at the end of each reporting period in order to determine whether there is an indication of possible impairment. Any change in the assumptions used could impact the carrying amount first of any goodwill allocated to the CGU and then to the other assets of the CGU on a pro rata basis of the carrying amount of each asset in the CGU on the consolidated statement of financial position with a corresponding impact made to the consolidated statement of income.

Income taxes

The Company must estimate its income taxes in each jurisdiction in which it operates. This involves assessing the probability of using 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 balances on the consolidated statement of financial position.

3 Accounting standards and amendments issued but not yet adopted

Unless otherwise noted, the following revised standards are effective for annual periods beginning on or after January 1, 2016 with earlier application permitted. The Company has not yet assessed the impact of these standards or determined whether it will early adopt them.

- (i) In July 2014, the IASB issued IFRS 9, *Financial Instruments*. The IASB has previously published versions of IFRS 9 that introduced new classification and measurement requirements (in 2009 and 2010) and a new hedge accounting model (in 2013). The July 2014 publication represents the final version of the Standard, replaces earlier versions of IFRS 9 and substantially completes the IASB's project to replace IAS 39, *Financial Instruments: Recognition and Measurement*.

This standard replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has only three classification categories: amortized cost and fair value through other comprehensive income and fair value through profit or loss. The basis of classification depends on the entity's business model and the contractual cash flow characteristics of the financial asset or liability. The standard introduces a new, expected loss impairment model that will require more timely recognition of expected credit losses. Specifically, the new Standard requires entities to account for expected credit losses from when financial instruments are first recognised and it lowers the threshold for recognition of full lifetime expected losses. The new standard also introduces a substantially-reformed model for hedge accounting with enhanced disclosures about risk management activity and aligns hedge accounting more closely with risk management. The new standard is effective for annual periods beginning on or after January 1, 2018 with early adoption permitted.

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- (ii) IFRS 15, *Revenue from Contracts with Customers*, was issued in May 2014 and specifies how and when revenue will be recognized as well as requiring the provision of more informative and relevant disclosures. Its core principle is that an entity will recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This core principle is delivered in a five-step model framework: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the entity satisfies a performance obligation. IFRS 15 replaces IAS 11, *Construction contracts*, IAS 18, *Revenue*, IFRIC 13, *Customer Loyalty Programmes*, IFRIC 15, *Agreements for the Construction of Real Estate*, IFRIC 18, *Transfers of Assets from Customers*, and SIC-31, *Revenue - Barter Transactions Involving Advertising Services*.

The IASB has decided to propose to defer the effective date of IFRS 15 from its current effective date of January 1, 2017 to annual periods beginning on or after January 1, 2018, with earlier application permitted.

4 Goodwill impairment analysis

Impairment test at July 16, 2013

On July 16, 2013, the Company acquired the remaining 30% of its then 70%-owned Italian subsidiary, Velan ABV S.p.A. ("ABV") (see note 6(d)), which management considered to be a triggering event to test the carrying value of the ABV assets for impairment.

The recoverable amount was determined based on the fair value less costs of disposal approach using a discounted cash flow model. The significant key assumptions included forecasted cash flows based on updated financial plans prepared by management covering a five-year period taking into consideration the following assumptions and trends:

- Expected earnings before interest, taxes, depreciation and amortization as a percentage of sales for the CGU of 8.3% in 2014, 11.8% in 2015, 14.4% in 2016, 16% in 2017 and 19% in 2018.
- Expected working capital cash absorption ratio for the CGU of 19% of annual incremental sales increases.
- Expected annual capital expenditure needs for the CGU of \$500 in 2014, 2015 and 2016, and \$1,000 thereafter.

The discounted cash flow model was established using a discount rate of 19% and a terminal growth rate of 2%.

Although the business process integration was still underway, management did not believe that the long-term outlook for the business had changed at the time of this impairment test. As a result, and following the impairment test performed at that date where the recoverable amount exceeded the carrying amount of \$13,991 by \$1,313, no impairment was recorded at July 16, 2013 with respect to the carrying amount of the goodwill associated with the CGU related to the Company's ABV subsidiary.

The following table provides a sensitivity analysis of the Company's recoverable amount of the goodwill associated with the CGU related to its ABV subsidiary for the period assuming a one percentage point increase of the selected variables below. Note that this sensitivity analysis assumes that all other assumptions and trends remain constant for each independent variable.

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| | Decrease (Increase) in recoverable amount \$ |
|--|---|
| Increase in expected EBITDA as a percentage of sales | (4,519) |
| Increase in discount rate | 2,755 |
| Increase in terminal growth rate | (1,594) |

A one percentage point decrease of the selected variables below, assuming all other assumptions and trends remain constant for each independent variable, would have the following impact on the recoverable amount of the goodwill associated with the CGU related to its ABV subsidiary:

| | Decrease (Increase) in recoverable amount \$ |
|--|---|
| Decrease in expected EBITDA as a percentage of sales | 4,833 |
| Decrease in discount rate | (3,114) |
| Decrease in terminal growth rate | 1,417 |

Summarized below is the amount by which each key assumption must change, after incorporating consequential effects of the change on the other variables used to measure the recoverable amount, in order for the CGU's recoverable amount to be equal to its carrying amount:

- Decrease of 0.3% in the expected EBITDA as a percentage of sales for the CGU for each referenced year.
- Increase in working capital cash absorption ratio for the CGU from 19% to 22.5% of annual incremental sales increases.
- Increase in expected discount rate from 19% to 19.5%.
- Decrease of expected terminal growth rate from 2% to 1.1%.

Impairment test at February 28, 2014

Despite the above impairment test triggered on July 16, 2013, the Company continued to carry out its annual impairment testing at its year-end date. In the context of its annual impairment testing at year-end, the Company completed its impairment analysis and assessed the recoverability of the assets allocated to its various CGUs. The Company calculated the recoverable amounts of its CGUs using valuation methods which were consistent with those used in prior years.

As a result of the impairment analysis, the Company determined that the recoverable amount exceeded the carrying amount of the goodwill associated with the CGU related to its ABV subsidiary of \$14,602 by \$1,274 and, accordingly, no goodwill impairment loss was recorded at February 28, 2014.

The recoverable amount was determined based on the fair value less costs of disposal approach using a discounted cash flow model. The significant key assumptions included forecasted cash flows based on updated financial plans prepared by management covering a five-year period taking into consideration the following assumptions and trends:

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- Expected EBITDA as a percentage of sales for the CGU of 7% in 2015, 11.8% in 2016, 19.6% in 2017, 19.3% in 2018 and 19.2% in 2019.
- Expected working capital cash absorption ratio for the CGU of 19% of annual incremental sales increases.
- Expected annual capital expenditure needs for the CGU of \$500 in 2015, 2016 and 2017, and \$1,000 thereafter.

The discounted cash flow model was established using a discount rate of 18.5% and a terminal growth rate of 2%.

Management based its selection of assumptions upon its assessment of the ability of the restructured CGU to return to its pre-acquisition levels of growth and profitability, as well as its evaluation of the longer term potential of its key end-user markets, particularly upstream oil and gas flow control. The acquisition of the non-controlling interest and the hiring of key senior management personnel were also factored into its assessments of the ABV subsidiary. The margin assumptions used were also generally comparable to those obtained in its other similar European project manufacturing operations.

The following table provides a sensitivity analysis of the Company's recoverable amount of the goodwill associated with the CGU related to its ABV subsidiary for the period assuming a one percentage point increase of the selected variables below. Note that this sensitivity analysis assumes that all other assumptions and trends remain constant for each independent variable.

| | Decrease (Increase) in recoverable amount \$ |
|--|---|
| Increase in expected EBITDA as a percentage of sales | (4,224) |
| Increase in discount rate | 2,678 |
| Increase in terminal growth rate | (1,864) |

A one percentage point decrease of the selected variables below, assuming all other assumptions and trends remain constant for each independent variable, would have the following impact on the recoverable amount of the goodwill associated with the CGU related to its ABV subsidiary:

| | Decrease (Increase) in recoverable amount \$ |
|--|---|
| Decrease in expected EBITDA as a percentage of sales | 4,339 |
| Decrease in discount rate | (3,036) |
| Decrease in terminal growth rate | 1,651 |

Summarized below is the amount by which each key assumption must change, after incorporating consequential effects of the change on the other variables used to measure the recoverable amount, in order for the CGU's recoverable amount to be equal to its carrying amount:

- Decrease of 0.3% in the expected EBITDA as a percentage of sales for the CGU for each referenced year.

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- Increase in working capital cash absorption ratio for the CGU from 19% to 23% of annual incremental sales increases.
- Increase in expected discount rate from 18.5% to 19%.
- Decrease of expected terminal growth rate from 2% to 1.2%.

The Company also tested for impairment the carrying amount of the goodwill associated with the CGU related to its French subsidiary, Velan S.A.S., and determined that the recoverable amount significantly exceeded the carrying amount of \$10,736 by \$39,408. Accordingly, no goodwill impairment loss was recorded for this CGU at February 28, 2014.

The recoverable amount was determined based on the fair value less costs of disposal approach using a discounted cash flow model. The significant key assumptions included forecasted cash flows based on updated financial plans prepared by management covering a three-year period taking into consideration the following assumptions and trends:

- Expected EBITDA as a percentage of sales for the CGU of 14.6% in 2015, 12.5% in 2016 and 13.1% in 2017.
- Expected working capital cash absorption ratio for the CGU of 19% of annual incremental sales increases.
- Expected annual capital expenditure needs for the CGU of \$2,600 in 2015, 2016 and 2017.

The discounted cash flow model was established using a discount rate of 15.0% and a terminal growth rate of 2%.

Management based its selection of assumptions upon its assessment of the ability of the CGU to deliver on its past levels of growth and profitability based on its current backlog of orders, as well as its evaluation of the longer term potential of its key end-user markets, particularly nuclear power and cryogenics. The margin assumptions used were in line with actual margins generated by the CGU in prior years.

Impairment test at February 28, 2015

In the context of its annual impairment testing, the Company completed its impairment analysis and assessed the recoverability of the assets allocated to its various CGUs. The Company calculated the recoverable amounts of its CGUs using valuation methods which were consistent with those used in prior years.

As a result of the impairment analysis, the Company determined that the recoverable amount exceeded the carrying amount of the goodwill associated with the CGU related to its ABV subsidiary of \$11,882 by \$1,720 and, accordingly, no goodwill impairment loss was recorded at February 28, 2015.

The recoverable amount was determined based on the fair value less costs of disposal approach using a discounted cash flow model. The significant key assumptions included forecasted cash flows based on updated financial plans prepared by management covering a five-year period taking into consideration the following assumptions and trends:

- Expected EBITDA as a percentage of sales for the CGU of 11.2% in 2016, 11.4% in 2017, 18.4% in 2018, 18.2% in 2019 and 18.2% in 2020.
- Expected working capital cash absorption ratio for the CGU of 19% of annual incremental sales increases.
- Expected annual capital expenditure needs for the CGU of \$562 in 2016, 2017 and 2018, and \$1,124 thereafter.

The discounted cash flow model was established using a discount rate of 18.5% and a terminal growth rate of 2%.

Management based its selection of assumptions upon its assessment of the ability of the restructured CGU to return to its pre-acquisition levels of growth and profitability, as well as its evaluation of the longer term potential of its key

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end-user markets, particularly upstream oil and gas flow control. The margin assumptions used were also generally comparable to those obtained in its other similar European project manufacturing operations.

The following table provides a sensitivity analysis of the Company's recoverable amount of the goodwill associated with the CGU related to its ABV subsidiary for the period assuming a one percentage point increase of the selected variables below. Note that this sensitivity analysis assumes that all other assumptions and trends remain constant for each independent variable.

| | Decrease (Increase) in recoverable amount \$ |
|--|---|
| Increase in expected EBITDA as a percentage of sales | (3,693) |
| Increase in discount rate | 2,094 |
| Increase in terminal growth rate | (1,456) |

A one percentage point decrease of the selected variables below, assuming all other assumptions and trends remain constant for each independent variable, would have the following impact on the recoverable amount of the goodwill associated with the CGU related to its ABV subsidiary:

| | Decrease (Increase) in recoverable amount \$ |
|--|---|
| Decrease in expected EBITDA as a percentage of sales | 3,623 |
| Decrease in discount rate | (2,373) |
| Decrease in terminal growth rate | 1,290 |

Summarized below is the amount by which each key assumption must change, after incorporating consequential effects of the change on the other variables used to measure the recoverable amount, in order for the CGU's recoverable amount to be equal to its carrying amount:

- Decrease of 0.5% in the expected EBITDA as a percentage of sales for the CGU for each referenced year.
- Increase in working capital cash absorption ratio for the CGU from 19% to 21.8% of annual incremental sales increases.
- Increase in expected discount rate from 18.5% to 19.3%.
- Decrease of expected terminal growth rate from 2% to 0.6%.

The Company also tested for impairment the carrying amount of the goodwill associated with the CGU related to its French subsidiary, Velan S.A.S., and determined that the recoverable amount significantly exceeded the carrying amount of \$8,736 by \$44,908. Accordingly, no goodwill impairment loss was recorded for this CGU at February 28, 2015.

The recoverable amount was determined based on the fair value less costs of disposal approach using a discounted cash flow model. The significant key assumptions included forecasted cash flows based on updated financial plans

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prepared by management covering a three-year period taking into consideration the following assumptions and trends:

- Expected EBITDA as a percentage of sales for the CGU of 15% in 2016, 2017 and 2018.
- Expected working capital cash absorption ratio for the CGU of 19% of annual incremental sales increases.
- Expected annual capital expenditure needs for the CGU of \$2,248 in 2016, 2017 and 2018.

The discounted cash flow model was established using a discount rate of 15.0% and a terminal growth rate of 2%.

Management based its selection of assumptions upon its assessment of the ability of the CGU to deliver on its past levels of growth and profitability based on its current backlog of orders, as well as its evaluation of the longer term potential of its key end-user markets, particularly nuclear power and cryogenics. The margin assumptions used were in line with actual margins generated by the CGU in prior years.

5 Inventories

| | As at February 28, 2015 \$ | As at February 28, 2014 \$ |
|------------------------------------|-------------------------------------|-------------------------------------|
| Raw materials | 54,910 | 45,130 |
| Work in process and finished parts | 103,805 | 123,848 |
| Finished goods | 44,842 | 55,171 |
| | <u>203,557</u> | <u>224,149</u> |

As a result of variations in the ageing of its inventories, the Company recognized a net additional inventory provision for the year of \$727 (2014 – \$3,245), including reversals of \$7,894 (2014 – \$5,892).

The net book value of inventories pledged as security under the Company's credit facilities amounted to \$1,837 (2014 – \$5,382).

6 Subsidiaries and transactions with non-controlling interests

a) Interest in subsidiaries

Set out below are the Company's principal subsidiaries at February 28, 2015. Unless otherwise stated, the subsidiaries have share capital consisting solely of ordinary shares, which are held directly by the Company, and the proportion of ownership interests held equals the voting rights held by the Company. The country of incorporation or registration is also their principal place of business.

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| Name of entity | Functional Currency | Country of incorporation | % of ownership interest held by the Company | | % of ownership interest held by the non-controlling interests | | Principal Activities |
|-------------------------------------|---------------------|--------------------------|---|------|---|------|----------------------|
| | | | 2015 | 2014 | 2015 | 2014 | |
| Velan Valve Corp. | U.S. Dollar | U.S.A. | 100 | 100 | - | - | Valve Manufacture |
| Velan Ltd. | U.S. Dollar | Korea | 100 | 100 | - | - | Valve Manufacture |
| Juwon Special Steel Co. Ltd. | Korean Won | Korea | 50 | 50 | 50 | 50 | Foundry |
| Velan Valvulas Industrias, Lda. | Euro | Portugal | 100 | 100 | - | - | Valve Manufacture |
| Velan Valves Limited | British Pound | U.K. | 100 | 100 | - | - | Valve Manufacture |
| Velan S.A.S. | Euro | France | 100 | 100 | - | - | Valve Manufacture |
| Segault S.A.S. | Euro | France | 75 | 75 | 25 | 25 | Valve Manufacture |
| Velan GmbH | Euro | Germany | 100 | 100 | - | - | Valve Distribution |
| Velan ABV S.p.A. | Euro | Italy | 100 | 100 | - | - | Valve Manufacture |
| Velan Valvac Manufacturing Co. Ltd. | U.S. Dollar | Taiwan | 75 | 75 | 25 | 25 | Valve Manufacture |
| Velan Valve (Suzhou) Co. Ltd. | U.S. Dollar | China | 85 | 85 | 15 | 15 | Valve Manufacture |
| Velan Valves India Private Limited | Indian Rupee | India | 100 | 100 | - | - | Valve Manufacture |

b) Significant restrictions

Cash and short-term investments held in certain Asian countries are subject to local exchange control regulations. These regulations provide for restrictions on exporting capital from those countries, other than through normal dividends. However, such restrictions do not have a significant impact on the Company's operations and treasury management as less than 2% of the Company's cash and short-term investments are subject to such restrictions. The total amount of cash and short-term investments subject to such restrictions was \$1,678 (2014 – \$1,454).

c) Non-controlling interests

Set out below is summarized financial information for each subsidiary company and structured entity that has non-controlling interests that are material to the Company and for which the non-controlling interest is recognized as equity rather than as a liability (see note 12(j)). The amounts disclosed for each subsidiary are before intercompany eliminations.

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| <i>Summarized statement of financial position</i> As at February 28, | Juwon Special Steel Co. Ltd. | | Velan Valvac Manufacturing Co. Ltd. | | Velan ABV S.p.A. | |
|---|------------------------------|---------------|--|--------------|------------------|----------|
| | 2015 | 2014 | 2015 | 2014 | 2015 | 2014 |
| | \$ | \$ | \$ | \$ | \$ | \$ |
| Current assets | 10,149 | 10,745 | 4,775 | 4,796 | - | - |
| Current liabilities | 4,203 | 2,810 | 1,200 | 1,481 | - | - |
| Current net assets | 5,946 | 7,935 | 3,575 | 3,315 | - | - |
| Non-current assets | 4,929 | 4,693 | 1,874 | 1,923 | - | - |
| Non-current liabilities | 1,585 | 2,511 | 170 | 173 | - | - |
| Non-current net assets | 3,344 | 2,182 | 1,704 | 1,750 | - | - |
| Net assets | 9,290 | 10,117 | 5,279 | 5,065 | - | - |
| Accumulated non- controlling interest | 4,935 | 5,531 | 1,547 | 1,523 | - | - |

| <i>Summarized statement of comprehensive income</i> | Juwon Special Steel Co. Ltd. | | Velan Valvac Manufacturing Co. Ltd. | | Velan ABV S.p.A. | |
|---|---------------------------------|--------------|---|------------|------------------|------------|
| | 2015 | 2014 | 2015 | 2014 | 2015 | 2014 |
| | \$ | \$ | \$ | \$ | \$ | \$ |
| Sales | 21,734 | 20,079 | 7,757 | 10,008 | - | 16,247 |
| Net income (loss) for the year | 1,368 | 1,234 | 559 | 552 | - | 108 |
| Other comprehensive income (loss) | (302) | 172 | - | - | - | - |
| Total comprehensive income (loss) for the year | 1,066 | 1,406 | 559 | 552 | - | 108 |
| Net income (loss) allocated to non-controlling interest | 684 | 617 | 140 | 138 | - | 33 |
| Dividends paid to non-controlling interest | 947 | - | 86 | 103 | - | - |

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| <i>Summarized statement of cash flows</i> | Juwon Special Steel | | Velan Valvac | | Velan ABV S.p.A. | |
|---|---------------------|--------------|-------------------|-----------|------------------|--------------|
| | Co. Ltd. | | Manufacturing Co. | | | |
| | 2015 | 2014 | 2015 | 2014 | 2015 | 2014 |
| | \$ | \$ | \$ | \$ | \$ | \$ |
| Cash flows from operating activities | 1,995 | 1,615 | 1,373 | 485 | - | 2,810 |
| Cash flows from investing activities | (848) | (224) | (46) | (37) | - | (438) |
| Cash flows from financing activities | (1,895) | 973 | (349) | (409) | - | (57) |
| Net increase (decrease) in cash and cash equivalents | (748) | 2,364 | 978 | 39 | - | 2,315 |

The summarized statements of comprehensive income and cash flows above include the results of Velan ABV S.p.A. for the 2014 fiscal year only for the period beginning March 1, 2013 and ending July 16, 2013, the date at which the Company acquired this subsidiary company's non-controlling interest (see note 6(d)). It is for this reason that the summarized statement of financial position above excludes the financial information for Velan ABV S.p.A. for the 2015 and 2014 fiscal years.

d) Transactions with non-controlling interests

As a result of losses sustained in prior periods, the Company's Italian subsidiary, ABV, was required to recapitalize its share structure. Through the recapitalization, the existing share capital of ABV was cancelled. New shares were issued solely to the Company through the conversion of existing shareholder loans from the Company to ABV. In addition, the existing shareholder loans payable to the non-controlling interest of ABV amounting to \$1,403 (€1,071) were repaid through the recapitalization process. As a result of the recapitalization, the Company acquired the remaining 30% of ABV to become its 100% shareholder as of July 16, 2013.

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7 Property, plant and equipment

| | Land | Buildings | Machinery & equipment | Furniture & fixtures | Data processing equipment | Rolling stock | Leasehold improvements | Total |
|-------------------------------------|--------|-----------|-----------------------|----------------------|---------------------------|---------------|------------------------|-----------|
| | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ |
| At February 28, 2013 | | | | | | | | |
| Cost | 11,907 | 50,964 | 136,462 | 7,960 | 4,875 | 2,584 | 2,897 | 217,649 |
| Accumulated depreciation | - | (21,157) | (94,014) | (5,389) | (3,658) | (1,593) | (1,208) | (127,019) |
| | 11,907 | 29,807 | 42,448 | 2,571 | 1,217 | 991 | 1,689 | 90,630 |
| Year ended February 28, 2014 | | | | | | | | |
| Beginning balance | 11,907 | 29,807 | 42,448 | 2,571 | 1,217 | 991 | 1,689 | 90,630 |
| Additions | 271 | 1,878 | 12,855 | 903 | 1,043 | 389 | 614 | 17,953 |
| Disposals | - | (2) | 153 | (116) | (3) | (52) | (52) | (72) |
| Depreciation | - | (1,720) | (8,416) | (665) | (750) | (400) | (290) | (12,241) |
| Exchange differences | (17) | (453) | (263) | 594 | 5 | 18 | 451 | 335 |
| | 12,161 | 29,510 | 46,777 | 3,287 | 1,512 | 946 | 2,412 | 96,605 |
| At February 28, 2014 | | | | | | | | |
| Cost | 12,161 | 52,486 | 145,907 | 10,622 | 5,879 | 2,922 | 4,356 | 234,333 |
| Accumulated depreciation | - | (22,976) | (99,130) | (7,334) | (4,367) | (1,976) | (1,945) | (137,728) |
| | 12,161 | 29,510 | 46,777 | 3,288 | 1,512 | 946 | 2,411 | 96,605 |
| Year ended February 28, 2015 | | | | | | | | |
| Beginning balance | 12,161 | 29,510 | 46,777 | 3,288 | 1,512 | 946 | 2,411 | 96,605 |
| Additions | 3 | 1,251 | 9,496 | 469 | 1,118 | 363 | 122 | 12,822 |
| Disposals | - | - | (264) | (15) | - | (16) | - | (295) |
| Depreciation | - | (1,761) | (9,907) | (578) | (815) | (386) | (302) | (13,749) |
| Exchange differences | (490) | (958) | (1,191) | (926) | (63) | (59) | (411) | (4,098) |
| | 11,674 | 28,042 | 44,911 | 2,238 | 1,752 | 848 | 1,820 | 91,285 |
| At February 28, 2015 | | | | | | | | |
| Cost | 11,674 | 51,139 | 146,247 | 8,388 | 6,740 | 2,866 | 3,694 | 230,748 |
| Accumulated depreciation | - | (23,097) | (101,336) | (6,150) | (4,988) | (2,018) | (1,874) | (139,463) |
| | 11,674 | 28,042 | 44,911 | 2,238 | 1,752 | 848 | 1,820 | 91,285 |

Depreciation expense of \$13,749 (2014 – \$12,241) is included in the consolidated statement of income: \$12,196 (2014 – \$10,865) in ‘cost of sales’ and \$1,553 (2014 – \$1,376) in ‘administration costs’.

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8 Intangible assets and goodwill

| | Goodwill | Computer software | Patents, products & designs | Customer lists | Non-competitive agreements | Other | Total |
|-------------------------------------|----------|-------------------|-----------------------------|----------------|----------------------------|---------|----------|
| At February 28, 2013 | | | | | | | |
| Cost | 24,080 | 6,953 | 13,720 | 7,067 | 784 | 2,175 | 54,779 |
| Accumulated amortization | - | (5,661) | (2,238) | (1,297) | (288) | (2,101) | (11,585) |
| | 24,080 | 1,292 | 11,482 | 5,770 | 496 | 74 | 43,194 |
| Year ended February 28, 2014 | | | | | | | |
| Beginning balance | 24,080 | 1,292 | 11,482 | 5,770 | 496 | 74 | 43,194 |
| Additions | - | 390 | - | - | - | 7 | 397 |
| Disposals and transfers | - | 44 | 3 | - | - | (73) | (26) |
| Amortization | - | (753) | (889) | (720) | (160) | (3) | (2,525) |
| Exchange differences | 1,342 | 52 | 606 | 296 | 23 | - | 2,319 |
| | 25,422 | 1,025 | 11,202 | 5,346 | 359 | 5 | 43,359 |
| At February 28, 2014 | | | | | | | |
| Cost | 25,422 | 7,611 | 14,485 | 7,461 | 829 | 1,091 | 56,899 |
| Accumulated amortization | - | (6,586) | (3,283) | (2,115) | (470) | (1,086) | (13,540) |
| | 25,422 | 1,025 | 11,202 | 5,346 | 359 | 5 | 43,359 |
| Year ended February 28, 2015 | | | | | | | |
| Beginning balance | 25,422 | 1,025 | 11,202 | 5,346 | 359 | 5 | 43,359 |
| Additions | - | 384 | 13 | - | - | 3 | 400 |
| Disposals and transfers | - | (19) | - | - | - | - | (19) |
| Amortization | - | (650) | (866) | (699) | (155) | (4) | (2,374) |
| Exchange differences | (4,736) | (130) | (1,975) | (903) | (46) | - | (7,790) |
| | 20,686 | 610 | 8,374 | 3,744 | 158 | 4 | 33,576 |
| At February 28, 2015 | | | | | | | |
| Cost | 20,686 | 7,343 | 11,805 | 6,072 | 675 | 890 | 47,471 |
| Accumulated amortization | - | (6,733) | (3,431) | (2,328) | (517) | (886) | (13,895) |
| | 20,686 | 610 | 8,374 | 3,744 | 158 | 4 | 33,576 |

Amortization expense of \$2,374 (2014 – \$2,525) is included in the consolidated statement of income: \$1,890 (2014 – \$1,992) in ‘cost of sales’ and \$484 (2014 – \$533) in ‘administration costs’.

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Notes to the Consolidated Financial Statements

For the years ended February 28, 2015 and 2014

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9 Accounts payable and accrued liabilities

| | As at February 28, 2015 \$ | As at February 28, 2014 \$ |
|------------------------|-------------------------------------|-------------------------------------|
| Trade accounts payable | 26,868 | 31,410 |
| Accrued liabilities | 41,018 | 41,712 |
| Other | 3,111 | 3,468 |
| | <u>70,997</u> | <u>76,590</u> |

10 Credit facilities

- a) The Company and its U.S. subsidiary company, Velan Valve Corp., have the following credit facilities available as at February 28, 2015:

Unsecured

Credit facilities available

\$87,983 (CA\$85,000 and US\$20,000) (2014 – \$96,756
(CA\$85,000 and US\$20,000)) (note 25)

Borrowing rates

Prime to prime + 0.75%

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.

As at February 28, 2015, an amount of \$9,435 (2014 – \$21,699) was drawn against these unsecured credit facilities in the form of demand operating lines of credit and bank overdrafts. An additional \$12,377 (2014 – \$7,881) was drawn against these unsecured credit facilities in the form of letters of credit and letters of guarantee.

In addition to the unsecured credit facilities above, the Company maintains a facility with Export Development Canada of \$40,000 for letters of credit and letters of guarantee. As at February 28, 2015, \$9,476 (2014 – \$8,862) was drawn against this facility.

Velan Inc.

Notes to the Consolidated Financial Statements

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- b) Foreign subsidiaries and structured entities have the following credit facilities available as at February 28, 2015:

Secured by corporate guarantees

| Credit facilities available | Borrowing rates |
|--|--|
| Foreign subsidiaries \$60,749 (€45,172; £2,000; KW4,018,400; INR200,000) (2014 – \$66,489 (€40,822; £2,000; KW4,691,250; CNY5,633; INR90,000)) (note 25) | 0.54% to 10.50% (2014 – 0.75% to 7.65%) |
| Foreign structured entities \$5,070 (KW5,590,000) (2014 – \$6,184 (KW6,600,000)) (note 25) | 3.11% to 5.00% (2014 – 3.11% to 5.00%) |

The above credit facilities are available by way of demand operating lines of credit, bank loans, guarantees, letters of credit and foreign exchange forward contracts. The majority of these credit facilities have variable borrowing rates based on LIBOR, EURIBOR, KORIBOR, EONIA or prime rate. The borrowing rates listed above are the rates in effect as at February 28, 2015 and February 28, 2014. 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 \$8,233 (2014 – \$21,602).

As at February 28, 2015, an amount of \$6,181 (2014 – \$11,092) was drawn against these secured credit facilities in the form of demand operating lines of credit and bank overdrafts. An additional \$4,867 (2014 – \$1,473) was drawn against these secured credit facilities in the form of letters of credit and letters of guarantee.

11 Provisions

| | As at February 28, 2015 \$ | As at February 28, 2014 \$ |
|-----------------------------|-------------------------------------|-------------------------------------|
| Balance – Beginning of year | 8,060 | 6,345 |
| Additional provisions | 3,618 | 2,969 |
| Used during the year | (2,211) | (1,628) |
| Exchange differences | (1,593) | 374 |
| Balance – End of year | <u>7,874</u> | <u>8,060</u> |

The Company's provisions consist entirely of warranties. The Company offers various warranties to the purchasers of its valves. Management estimates the related provision for future warranty claims based on historical warranty claim information, as well as recent trends that might suggest that past cost information may differ from future claims. Factors that could impact the estimated claim information include the success of the Company's productivity and quality initiatives, as well as parts and labour costs.

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Notes to the Consolidated Financial Statements

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12 Long-term debt

| | As at February 28, 2015 \$ | As at February 28, 2014 \$ |
|--|-------------------------------------|-------------------------------------|
| The Company | | |
| Unsecured bank loan (note 12(a)) | 6,667 | 12,000 |
| French subsidiary | | |
| Unsecured bank loan (€68; 2014 – €166) (note 12(b)) | 76 | 230 |
| Secured bank loan (€84; 2014 – €134) (note 12(c)) | 94 | 185 |
| Secured bank loan (nil; 2014 – €342) | - | 472 |
| Italian subsidiary | | |
| Unsecured bank loan (€662; 2014 – €757) (note 12(d)) | 744 | 1,046 |
| Unsecured bank loan (€629; 2014 – €707) (note 12(e)) | 707 | 977 |
| Unsecured state bank loan (€371; 2014 – €439) (note 12(f)) | 417 | 605 |
| Korean structured entity | | |
| Secured bank loan (KW22,800; 2014 – KW24,000) (note 12(g)) | 21 | 22 |
| Secured bank loan (KW900,000; 2014 – 900,000) (note 12(h)) | 816 | 843 |
| Unsecured bank loan (KW500,000; 2014 – 500,000) (note 12(i)) | 454 | 469 |
| Other (note 12(j)) | 4,831 | 5,241 |
| | <hr/> | <hr/> |
| | 14,827 | 22,087 |
| Less: Current portion | 10,644 | 10,402 |
| | <hr/> | <hr/> |
| | 4,183 | 11,685 |
| | <hr/> | <hr/> |

a) Unsecured bank loan

The unsecured bank loan of \$6,667 bears interest at 2.74% and is repayable in monthly instalments of \$444, expiring in 2016.

b) Unsecured bank loan

The unsecured bank loan of \$76 (€68) bears interest at 2.6% and is repayable in quarterly instalments of \$29, expiring in 2016

c) Secured bank loan

The secured bank loan of \$94 (€84) bears interest at 2.7% and is repayable in monthly instalments of \$8, expiring in 2016. Certain machinery and equipment are pledged as collateral for this loan.

d) Unsecured bank loan

The unsecured bank loan of \$744 (€662) bears interest at 2.91% and is repayable in monthly instalments, expiring in 2021.

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e) Unsecured bank loan

The unsecured bank loan of \$707 (€629) bears interest at 4.90% and is repayable in monthly instalments, expiring in 2021.

f) Unsecured state bank loan

The unsecured state bank loan of \$417 (€371) is non-interest bearing and is repayable in semi-annual instalments, expiring in 2020.

g) Secured Bank Loan

The secured bank loan of \$21 (KW22,800) bears interest at 1.50% and is repayable in 2020. Certain land, a building, and certain machinery and equipment are pledged as collateral for this loan.

h) Secured Bank Loan

The secured bank loan of \$816 (KW900,000) bears interest at 3.10% and is repayable in 2015. Certain land, a building, and certain machinery and equipment are pledged as collateral for this loan.

i) Unsecured Bank Loan

The unsecured bank loan of \$454 (KW500,000) bears interest at 3.39% and is repayable in 2015.

j) Included in Other is an amount of \$3,580 (€3,185) (2014 – \$4,049 (€2,931)) 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 non-controlling interest. The liability is initially recognized as the non-controlling interest's share of the net identifiable assets of the subsidiary or structured entity. 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 income.

k) The following is a schedule of future debt payments:

| | \$ |
|-------------------|---------------|
| February 29, 2016 | 10,644 |
| February 28, 2017 | 1,675 |
| February 28, 2018 | 298 |
| February 28, 2019 | 303 |
| February 28, 2020 | 307 |
| Subsequent years | <u>1,600</u> |
| | <u>14,827</u> |

The aggregate net book value of the assets pledged as collateral under long-term debt agreements amounted to \$2,742 (2014 – \$3,217).

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

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Notes to the Consolidated Financial Statements

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13 Share capital

- 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

| | As at February 28, 2015 \$ | As at February 28, 2014 \$ |
|--|-------------------------------------|-------------------------------------|
| 6,372,601 Subordinate Voting Shares (February 28, 2014 – 6,392,201) (notes 13(c) and (d)) | 69,349 | 69,562 |
| 15,566,567 Multiple Voting Shares | 7,126 | 7,126 |
| | <u>76,475</u> | <u>76,688</u> |

- c) Pursuant to its Normal Course Issuer Bid, the Company is entitled to repurchase for cancellation a maximum of 100,000 of the issued Subordinate Voting Shares of the Company, representing approximately 1.57% of the issued shares of such class as at October 9, 2014, during the ensuing 12-month period ending October 21, 2015. During the year ended February 28, 2015, 19,600 Subordinate Voting Shares were purchased for a cash consideration of \$306 and cancelled. During the year ended February 28, 2014, no Subordinate Voting Shares were repurchased. The amount by which the repurchase amount is above the stated capital of the shares has been debited to contributed surplus and retained earnings.
- 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.

Under the Share Option Plan, the maximum number of Subordinate Voting Shares issuable from time to time 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 12 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.

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Notes to the Consolidated Financial Statements

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A compensation cost of \$15 (2014 – \$23) was recorded in the consolidated statement of income and credited to contributed surplus.

During the fiscal year ended February 28, 2014, 35,000 options were exercised resulting in the issuance of 35,000 Subordinate Voting Shares of the Company for proceeds of \$374 which were credited to share capital. No options were exercised in the current fiscal year.

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

| | Number of shares | Weighted average exercise price | Weighted average contractual life in months |
|---------------------------------|---------------------|---------------------------------|---|
| Outstanding – February 28, 2013 | 180,000 | \$11.51 (CA\$11.88) | 16.8 |
| Exercised | (35,000) | \$10.70 (CA\$11.00) | - |
| Expired/forfeited | (95,000) | \$10.70 (CA\$11.00) | - |
| Outstanding – February 28, 2014 | 50,000 | \$12.78 (CA\$14.15) | 29.0 |
| Exercisable – February 28, 2014 | 33,334 | \$12.78 (CA\$14.15) | |
| Outstanding – February 28, 2014 | 50,000 | \$12.78 (CA\$14.15) | 29.0 |
| Issued | 100,000 | \$16.43 (CA\$20.88) | 60.0 |
| Outstanding – February 28, 2015 | 150,000 | \$14.91 (CA\$18.64) | 45.0 |
| Exercisable – February 28, 2015 | 50,000 | \$11.32 (CA\$14.15) | |

14 Foreign exchange

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 fiscal year are included in sales and cost of sales and amounted to:

| | 2015 \$ | 2014 \$ |
|---------------|------------|------------|
| Sales | 2,074 | (250) |
| Cost of sales | (8,937) | (907) |

Velan Inc.

Notes to the Consolidated Financial Statements

For the years ended February 28, 2015 and 2014

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15 Cost of sales

| | 2015 | 2014 |
|--|----------------|----------------|
| | \$ | \$ |
| Change in inventories of finished goods and work in progress | 18,850 | 15,364 |
| Raw materials and consumables used | 163,407 | 190,382 |
| Employee expenses, excluding scientific research investment tax credits (note 17) | 93,713 | 96,608 |
| Depreciation and amortization (note 19) | 14,086 | 12,857 |
| Movement in inventory provision – net (note 5) | 727 | 3,245 |
| Foreign exchange loss (note 14) | 8,937 | 907 |
| Other production overhead costs | 37,747 | 38,748 |
| | <u>337,467</u> | <u>358,111</u> |

16 Administration costs

| | 2015 | 2014 |
|--|---------------|---------------|
| | \$ | \$ |
| Employee expenses, excluding scientific research investment tax credits (note 17) | 44,575 | 43,310 |
| Scientific research investment tax credits (notes 17 and 18) | (3,815) | (4,028) |
| Commissions | 7,921 | 7,095 |
| Freight to customers | 4,635 | 6,411 |
| Professional fees | 10,958 | 11,929 |
| Movement in allowance for doubtful accounts (note 25) | 35 | (638) |
| Depreciation and amortization (note 19) | 2,037 | 1,909 |
| Other | 22,045 | 21,155 |
| | <u>88,391</u> | <u>87,143</u> |

17 Employee expenses

| | 2015 | 2014 |
|--|----------------|----------------|
| | \$ | \$ |
| Wages and salaries | 99,173 | 99,518 |
| Social security costs | 32,460 | 33,936 |
| Scientific research investment tax credits (note 18) | (3,815) | (4,028) |
| Share-based compensation (note 13(d)) | 15 | 23 |
| Other | 6,640 | 6,441 |
| | <u>134,473</u> | <u>135,890</u> |

Velan Inc.

Notes to the Consolidated Financial Statements

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18 Research and development expenses

Research and development expenses are included in cost of sales and administration costs and consist of the following:

| | 2015 \$ | 2014 \$ |
|--|----------------|----------------|
| Research and development expenditures | 9,231 | 8,844 |
| Less: Scientific research and development investment tax credits | <u>(3,815)</u> | <u>(4,028)</u> |
| | <u>5,416</u> | <u>4,816</u> |

19 Depreciation and amortization costs

Depreciation and amortization costs are included in cost of sales and administration costs and consist of the following:

| | 2015 \$ | 2014 \$ |
|---|---------------|---------------|
| Depreciation of property, plant and equipment | 13,749 | 12,241 |
| Amortization of intangible assets | <u>2,374</u> | <u>2,525</u> |
| | <u>16,123</u> | <u>14,766</u> |

20 Income taxes

| | 2015 \$ | 2014 \$ |
|---|----------------|---------------|
| Current taxes: | | |
| Current tax on profits for the year | 11,470 | 10,289 |
| Adjustments in respect of prior years | <u>209</u> | <u>349</u> |
| | 11,679 | 10,638 |
| Deferred taxes: | | |
| Origination and reversal of temporary differences | <u>(1,906)</u> | <u>1,121</u> |
| Income tax expense | <u>9,773</u> | <u>11,759</u> |

The taxes on the Company's income before taxes differ from the amount that would arise using the statutory tax rates applicable to income of the consolidated entities as follows:

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| | 2015 \$ | 2014 \$ |
|---|--------------|---------------|
| Income before tax at statutory rate of 26.90% (2014 – 26.90%) | 7,792 | 11,503 |
| Tax effects of: | | |
| Difference in statutory tax rates in foreign jurisdictions | 1,624 | 1,025 |
| Non-deductible (taxable) foreign exchange loss (gain) | 539 | (4) |
| Losses not tax effected | 874 | 369 |
| Benefit attributable to a financing structure | (1,342) | (1,309) |
| Other | 286 | 175 |
| Income tax expense | <u>9,773</u> | <u>11,759</u> |

The analysis of deferred tax assets and deferred tax liabilities is as follows:

| | 2015 \$ | 2014 \$ |
|--|--------------|--------------|
| Deferred income tax assets: | | |
| To be realized after more than 12 months | 7,502 | 6,465 |
| To be realized within 12 months | 4,890 | 4,941 |
| Deferred income tax liabilities: | | |
| To be realized after more than 12 months | (8,199) | (7,772) |
| To be realized within 12 months | (150) | (1,498) |
| Net deferred income tax asset | <u>4,043</u> | <u>2,136</u> |

The movement of the net deferred income tax asset account is as follows:

| | 2015 \$ | 2014 \$ |
|--|--------------|--------------|
| Balance – Beginning of year | 2,136 | 3,191 |
| Recovery (Provision) to consolidated statement of income | 1,906 | (1,121) |
| Exchange differences | 1 | 66 |
| Balance – End of year | <u>4,043</u> | <u>2,136</u> |

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

| | 2015 | 2014 |
|--|--------------|--------------|
| | \$ | \$ |
| Property, plant and equipment | (4,858) | (3,832) |
| Intangible assets | (3,798) | (5,254) |
| Non-deductible provisions and reserves | 5,675 | 3,491 |
| Investment tax credits | (930) | (909) |
| Inventories | 6,378 | 4,324 |
| Non-capital loss carryforwards | 2,479 | 2,399 |
| Other | (903) | 1,917 |
| | <u>4,043</u> | <u>2,136</u> |

The Company did not recognize deferred income tax assets of \$1,664 (2014 – \$606) in respect of non-capital losses amounting to \$5,707 (2014 – \$1,782) that can be carried forward to reduce taxable income in future years. These losses expire between 2021 and indefinitely.

The Company did not recognize deferred income tax assets of \$276 (2014 – \$276) in respect of capital losses amounting to \$2,051 (2014 – \$2,051) that can be carried forward indefinitely against future taxable capital gains.

Deferred tax liabilities of \$6,967 (2014 – \$7,009) have not been recognized for the withholding tax and other taxes that would be payable on the unremitted earnings of certain subsidiaries. Such amounts are not expected to reverse in the foreseeable future. Unremitted earnings as at February 28, 2015 totalled \$304,098 (2014 – \$292,798).

21 Earnings per share

a) Basic

Basic earnings per share is calculated by dividing the net income attributable to the Subordinate and Multiple Voting shareholders by the weighted average number of Subordinate and Multiple Voting Shares outstanding during the year.

| | 2015 | 2014 |
|---|-------------------|-------------------|
| Net income attributable to Subordinate and Multiple Voting shareholders | \$18,580 | \$29,400 |
| Weighted average number of Subordinate and Multiple Voting Shares outstanding | <u>21,947,725</u> | <u>21,936,714</u> |
| Basic earnings per share | <u>\$0.85</u> | <u>\$1.34</u> |

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b) Diluted

Diluted earnings per share is calculated by adjusting the weighted average number of Subordinate and Multiple Voting Shares outstanding to assume conversion of all dilutive potential Subordinate and Multiple Voting Shares. The Company has one category of dilutive potential Subordinate and Multiple Voting Shares: stock options. For the stock options, a calculation is done to determine the number of Subordinate and Multiple Voting Shares that could have been acquired at fair value (determined as the average market share price of the Company's outstanding Subordinate and Multiple Voting Shares for the period), based on the exercise prices attached to the stock options. The number of Subordinate and Multiple Voting Shares calculated above is compared with the number of Subordinate and Multiple Voting Shares that would have been issued assuming exercise of the stock options.

| | 2015 | 2014 |
|--|------------|------------|
| Net income attributable to Subordinate and Multiple Voting shareholders | \$18,580 | \$29,400 |
| Weighted average number of Subordinate and Multiple Voting Shares outstanding | 21,947,725 | 21,936,714 |
| Adjustments for stock options | 14,892 | - |
| Weighted average number of Subordinate and Multiple Voting Shares for diluted earnings per share | 21,962,617 | 21,936,714 |
| Diluted earnings per share | \$0.85 | \$1.34 |

22 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, 2015, the aggregate maximum value of these guarantees, if exercised, amounted to \$65,873 (2014 – \$73,934). The guarantees expire as follows:

| | \$ |
|-------------------|---------------|
| February 29, 2016 | 26,742 |
| February 28, 2017 | 16,110 |
| February 28, 2018 | 10,655 |
| February 28, 2019 | 11,807 |
| February 29, 2020 | 393 |
| Subsequent years | 166 |
| | <u>65,873</u> |

- b) The Company has outstanding purchase commitments with foreign suppliers, due within one year, amounting to \$8,722 (2014 – \$4,452), which are covered by letters of credit.

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- c) Future minimum payments under operating leases (related mainly to premises and machinery) are as follows:

| | \$ |
|-------------------|--------------|
| February 29, 2016 | 1,066 |
| February 28, 2017 | 890 |
| February 28, 2018 | 840 |
| February 28, 2019 | 775 |
| February 29, 2020 | 688 |
| Subsequent years | <u>690</u> |
| | <u>4,949</u> |

- d) Two of the Company's U.S. 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.

During the year ended February 28, 2015, legal and related costs for these matters amounted to \$6,085 (2014 – \$5,472).

- e) 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.

On December 3, 2014, San Diego Gas & Electric Company ("SDG") filed a claim against Velan Valve Corp., a wholly-owned subsidiary of the Company, in the Superior Court of the State of California, concerning high pressure valves supplied to SDG and installed at its Palomar Energy Center ("Facility").

This lawsuit alleges damages to the Facility in excess of \$9,000 related to allegedly defective valves supplied by Velan Valve Corp. The claim is for alleged strict product liability and alleged negligence. It is the Company's position that this claim is without merit.

The Company intends to vigorously defend its position and will undertake all actions necessary to protect its reputation. While the Company cannot predict the final outcome of this claim, based on information currently available, the Company believes the resolution of this claim will not have a material adverse effect on its financial position, results of operations or liquidity. The Company has reported this claim to its insurance company and accrued the \$100 deductible.

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23 Related party transactions

Transactions and balances with related parties occur in the normal course of business. Related party transactions and balances not otherwise disclosed separately in these consolidated financial statements are as follows:

| | 2015 | 2014 |
|---|-------|-------|
| | \$ | \$ |
| Affiliated company owned by certain relatives of controlling shareholder | | |
| Purchases – Material components | 1,459 | 1,889 |
| Sales – Material components | 67 | 104 |
| Amounts charged by an affiliated company in which a relative of the controlling shareholder owns a 50% interest | | |
| Computer consulting | 14 | 4 |
| Amount charged by the controlling shareholder to one of the Company's subsidiaries and certain of its executives | | |
| Rent based on weekly usage | 27 | 25 |
| Accounts receivable | | |
| Affiliated companies | - | 32 |
| Amount charged by minority shareholders of the Company's Italian subsidiary (up to the acquisition of the remaining 30% - note 6d)) | | |
| Rent for manufacturing facilities | - | 271 |
| Interest expense on shareholder loans payable | - | 33 |
| Accounts payable and accrued liabilities | | |
| Affiliated companies | 82 | 174 |
| Controlling shareholder | 35 | 21 |
| Key management ¹ compensation | | |
| Salaries and other short-term benefits | 4,405 | 3,841 |
| Share-based compensation | 15 | 23 |

¹ Key management includes directors (executive and non-executive) and certain members of senior management.

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24 Segment reporting

The Company reflects its results under a single reportable operating segment. The geographic distribution of its sales and assets is as follows:

February 28, 2015

| | Canada | United States | France | Italy | Other | Consolidation Adjustment | Consolidated |
|--------------------------------|---------|---------------|---------|--------|---------|--------------------------|--------------|
| | \$ | \$ | \$ | \$ | \$ | \$ | \$ |
| Sales | | | | | | | |
| Customers - | | | | | | | |
| Domestic | 37,258 | 142,930 | 54,190 | 553 | 22,237 | | 257,168 |
| Export | 91,517 | - | 49,434 | 34,935 | 22,696 | | 198,582 |
| Intercompany (export) | 83,279 | 17,230 | 144 | 3,156 | 56,022 | (159,831) | - |
| Total | 212,054 | 160,160 | 103,768 | 38,644 | 100,955 | (159,831) | 455,750 |
| Property, plant and equipment | 41,588 | 7,926 | 10,496 | 3,854 | 27,421 | - | 91,285 |
| Intangible assets and goodwill | 78 | - | 9,229 | 24,215 | 54 | - | 33,576 |
| Other identifiable assets | 245,375 | 30,633 | 132,780 | 39,964 | 110,638 | (125,623) | 433,767 |
| Total identifiable assets | 287,041 | 38,559 | 152,505 | 68,033 | 138,113 | (125,623) | 558,628 |

February 28, 2014

| | Canada | United States | France | Italy | Other | Consolidation Adjustment | Consolidated |
|--------------------------------|---------|---------------|---------|--------|---------|--------------------------|--------------|
| | \$ | \$ | \$ | \$ | \$ | \$ | \$ |
| Sales | | | | | | | |
| Customers - | | | | | | | |
| Domestic | 71,899 | 116,343 | 58,630 | 1,011 | 12,779 | | 260,662 |
| Export | 108,673 | - | 48,538 | 36,834 | 34,550 | | 228,595 |
| Intercompany (export) | 91,160 | 33,383 | 895 | 839 | 55,764 | (182,041) | - |
| Total | 271,732 | 149,726 | 108,063 | 38,684 | 103,093 | (182,041) | 489,257 |
| Property, plant and equipment | 42,365 | 8,693 | 13,612 | 5,279 | 26,663 | (7) | 96,605 |
| Intangible assets and goodwill | 169 | - | 11,522 | 31,597 | 71 | - | 43,359 |
| Other identifiable assets | 261,928 | 34,886 | 165,934 | 30,499 | 108,026 | (117,083) | 484,190 |
| Total identifiable assets | 304,462 | 43,579 | 191,068 | 67,375 | 134,760 | (117,090) | 624,154 |

25 Financial risk management

The Company's activities expose it to a variety of financial risks: market risk (including currency risk, cash flow interest rate risk and fair value 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

Velan Inc.

Notes to the Consolidated Financial Statements

For the years ended February 28, 2015 and 2014

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

responsibility of the corporate finance team in conjunction with the finance teams of the Company's subsidiaries. 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 | | | |
|--|----------|---------------|--------|-----------|
| | Market | | Credit | Liquidity |
| | Currency | Interest rate | | |
| Cash and cash equivalents | x | x | x | |
| Short-term investments | x | x | x | |
| Accounts receivable | x | | x | |
| Derivative assets | x | | x | |
| Bank indebtedness | x | x | | x |
| Short-term bank loans | x | x | | x |
| Accounts payable and accrued liabilities | x | | | x |
| Customer deposits | x | | | x |
| Dividend payable | x | | | x |
| Accrual for performance guarantees | x | | | x |
| Derivative liabilities | 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 exchange forward contracts. These derivatives are not designated as hedges for accounting purposes.

Velan Inc.

Notes to the Consolidated Financial Statements

For the years ended February 28, 2015 and 2014

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

The amounts outstanding as at February 28, 2015 and February 28, 2014 are as follows:

| | Range of exchange rates | | Gain (loss) | | Notional amount | |
|---|-------------------------|-------------------|---|---|---|---|
| | February 28, 2015 | February 28, 2014 | February 28, 2015 (In thousands of U.S. dollars) \$ | February 28, 2014 (In thousands of U.S. dollars) \$ | February 28, 2015 (In thousands of indicated currency) | February 28, 2014 (In thousands of indicated currency) |
| Foreign exchange forward contracts | | | | | | |
| Sell US\$ for CA\$ – 0 to 12 months | 1.09-1.26 | 1.04-1.12 | (3,047) | (1,275) | US\$49,565 | US\$43,057 |
| Sell US\$ for € – 0 to 12 months | 1.14-1.40 | 1.29-1.36 | (2,236) | 192 | US\$19,573 | US\$8,498 |
| Buy US\$ for € – 0 to 12 months | 1.12-1.27 | 1.34-1.36 | 30 | (14) | US\$1,119 | US\$483 |
| Sell US\$ for £ – 0 to 12 months | - | 1.52 | - | 130 | - | US\$1,315 |
| Sell US\$ for KW – 0 to 12 months | - | 1,070-1,075 | - | 94 | - | US\$1,348 |
| Sell € for US\$ – 0 to 12 months | 1.10-1.14 | 1.31-1.37 | (6) | (133) | €5,907 | €9,026 |
| Buy £ for US\$ – 0 to 12 months | 1.55-1.62 | 1.61-1.68 | (37) | 3 | £599 | £2,746 |
| Buy £ for € – 0 to 12 months | 0.74-0.79 | - | 78 | - | £1,982 | - |

Foreign exchange forward contracts are contracts whereby the Company has the obligation to sell or buy the currencies at the strike price. The fair value of the foreign currency instruments is recorded in the consolidated statement of income and reflects the estimated amounts the Company would have paid or received to settle these contracts as at the financial position date. Unrealized gains are recorded as derivative assets and unrealized losses as derivative liabilities on the consolidated statement of financial position.

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, which 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, accrual for performance guarantees and long-term debt, including interest payable. A hypothetical strengthening of 5.0% of the following currencies would have had the following impact for the fiscal year ended February 28, 2015:

| | Net income (loss) | Other comprehensive income (loss) |
|---|----------------------|---|
| Canadian dollar strengthening against the U.S. dollar | 1,083 | - |
| Euro strengthening against the U.S. dollar | 766 | - |

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 subsidiaries into the Company's reporting currency. For those subsidiaries whose functional currency is other than the reporting currency (U.S. dollar) of the Company, such exposure would impact other comprehensive income or loss.

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% change in interest rates would have no significant impact on the Company's net income or cash flows.

Velan Inc.

Notes to the Consolidated Financial Statements

For the years ended February 28, 2015 and 2014

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

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, 2015, four (2014 – two) customers accounted for more than 5% each of its trade accounts receivable, of which one customer accounted for 10.3% (2014 – 5.4%), and the Company's ten largest customers accounted for 54.7% (2014 – 36.5%). In addition, one customer accounted for 10.9% of the Company's sales (2014 – no customers accounted for more than 10% of sales).

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 primary credit risk is limited to the carrying value of the trade accounts receivable and gains on derivative assets.

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

| | As at February 28, 2015 \$ | As at February 28, 2014 \$ |
|---------------------------------------|-------------------------------------|-------------------------------------|
| Current | 64,387 | 93,053 |
| Past due 0 to 30 days | 17,930 | 13,251 |
| Past due 31 to 90 days | 12,360 | 9,375 |
| Past due more than 90 days | 4,804 | 9,039 |
| | <hr/> | <hr/> |
| | 99,481 | 124,718 |
| Less: Allowance for doubtful accounts | 899 | 917 |
| | <hr/> | <hr/> |
| Trade accounts receivable | 98,582 | 123,801 |
| Other receivables | 6,735 | 5,177 |
| | <hr/> | <hr/> |
| Total accounts receivable | 105,317 | 128,978 |

Velan Inc.

Notes to the Consolidated Financial Statements

For the years ended February 28, 2015 and 2014

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

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

| | As at February 28, 2015 \$ | As at February 28, 2014 \$ |
|---|-------------------------------------|-------------------------------------|
| Balance – Beginning of year | 917 | 1,525 |
| Bad debt expenses | 872 | 767 |
| Recoveries of trade accounts receivable | (665) | (1,237) |
| Write-off of trade accounts receivable | (172) | (168) |
| Foreign exchange | (53) | 30 |
| | <hr/> | <hr/> |
| Balance – End of year | 899 | 917 |

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.

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

| | As at February 28, 2015 | | | | |
|---|-------------------------|---------------------------|-----------------------|-----------------------|------------------------|
| | Total \$ | Less than 1 year \$ | 1 to 3 Years \$ | 4 to 5 Years \$ | After 5 years \$ |
| Long-term debt | 14,827 | 10,644 | 1,973 | 610 | 1,600 |
| Accounts payable and accrued liabilities | 70,997 | 70,997 | - | - | - |
| Customer deposits | 44,111 | 44,111 | - | - | - |
| Accrual for performance guarantees | 30,012 | 30,012 | - | - | - |
| Bank indebtedness and short-term bank loans | 17,750 | 17,750 | - | - | - |
| Derivative liabilities | 5,362 | 5,362 | - | - | - |

| | As at February 28, 2014 | | | | |
|---|-------------------------|---------------------------|-----------------------|-----------------------|------------------------|
| | Total \$ | Less than 1 year \$ | 1 to 3 Years \$ | 4 to 5 Years \$ | After 5 years \$ |
| Long-term debt | 22,087 | 10,402 | 8,987 | 739 | 1,959 |
| Accounts payable and accrued liabilities | 76,590 | 76,590 | - | - | - |
| Customer deposits | 66,842 | 66,842 | - | - | - |
| Accrual for performance guarantees | 33,842 | 33,842 | - | - | - |
| Bank indebtedness and short-term bank loans | 32,792 | 32,792 | - | - | - |
| Derivative liabilities | 1,501 | 1,501 | - | - | - |

Velan Inc.

Notes to the Consolidated Financial Statements

For the years ended February 28, 2015 and 2014

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

Fair value of financial instruments

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 on the consolidated statements of financial position are as follows:

| | As at February 28, 2015 | | | |
|---|--------------------------------|----------------|----------------|----------------|
| Financial position classification and nature | Total | Level 1 | Level 2 | Level 3 |
| | \$ | \$ | \$ | \$ |
| Assets | | | | |
| Derivative assets | 144 | - | 144 | - |
| Liabilities | | | | |
| Derivative liabilities | 5,362 | - | 5,362 | - |

| | As at February 28, 2014 | | | |
|---|--------------------------------|----------------|----------------|----------------|
| Financial position classification and nature | Total | Level 1 | Level 2 | Level 3 |
| | \$ | \$ | \$ | \$ |
| Assets | | | | |
| Derivative assets | 498 | - | 498 | - |
| Liabilities | | | | |
| Derivative liabilities | 1,501 | - | 1,501 | - |

Fair value measurements of the Company's derivative assets and liabilities 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. The carrying value of the Company's financial instruments is considered to approximate fair value, unless otherwise indicated.

Velan Inc.

Notes to the Consolidated Financial Statements

For the years ended February 28, 2015 and 2014

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

26 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 leveraging.

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 equity.

The total debt-to-equity ratio was as follows:

| | As at February 28, 2015 \$ | As at February 28, 2014 \$ |
|-----------------------------------|-------------------------------------|-------------------------------------|
| Bank indebtedness | 15,616 | 31,876 |
| Short-term bank loans | 2,134 | 916 |
| Current portion of long-term debt | 10,644 | 10,402 |
| Long-term debt | 4,183 | 11,685 |
| Total debt | 32,577 | 54,879 |
| Equity | 345,093 | 359,119 |
| Total debt-to-equity ratio | 9.4% | 15.3% |

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 reporting 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 the Consolidated Financial Statements

For the years ended February 28, 2015 and 2014

(in thousands of U.S. dollars, excluding number of shares and per share amounts)

27 Adjustments to reconcile net income to cash provided from operating activities

| | 2015 | 2014 |
|---|---------|--------|
| | \$ | \$ |
| Depreciation of property, plant and equipment | 13,749 | 12,241 |
| Amortization of intangible assets | 2,374 | 2,525 |
| Deferred income taxes | (1,906) | 1,121 |
| Share-based compensation expense | 15 | 23 |
| Loss (Gain) on disposal of property, plant and equipment | 139 | (296) |
| Interest accretion on proceeds payable | - | 9 |
| Realized foreign exchange loss on liquidation of subsidiary | 636 | - |
| Net change in derivative assets and liabilities | 4,208 | (37) |
| Net change in other liabilities | 230 | 304 |
| | <hr/> | <hr/> |
| | 19,445 | 15,890 |
| | <hr/> | <hr/> |

28 Changes in non-cash working capital items

| | 2015 | 2014 |
|--|----------|---------|
| | \$ | \$ |
| Accounts receivable | 23,602 | 5,443 |
| Inventories | 20,557 | 23,033 |
| Income taxes recoverable | (7) | 2,226 |
| Deposits and prepaid expenses | (280) | 1,011 |
| Accounts payable and accrued liabilities | (5,603) | (1,825) |
| Income tax payable | (197) | 1,339 |
| Customer deposits | (22,770) | (9,754) |
| Provisions | (186) | 1,730 |
| Accrual for performance guarantees | (3,837) | 5,363 |
| | <hr/> | <hr/> |
| | 11,279 | 28,566 |
| | <hr/> | <hr/> |

Directors and officers

Corporate directors

| | |
|----------------|-------------------------------|
| A. K. Velan | Founder and Chairman Emeritus |
| T. Velan | Chairman of the Board |
| W. Sheffield | Lead Director |
| P. Velan | Director |
| R. Velan | Director |
| C. Hooper | Director |
| J. Latendresse | Director |
| K. MacKinnon | Director |

Corporate officers

| | |
|----------------|--|
| T. Velan | Chief Executive Officer |
| Y. Leduc | President |
| I. Velan | Executive Vice-President |
| W. Maar | Executive Vice-President, International Sales and Overseas Operations |
| J. Ball | Chief Financial Officer |
| S. Cherlet | Chief Operations Officer |
| 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 |
| P. Lee | Vice-President, Sales - United States (Eastern Division) |
| G. Perez | Vice-President, Engineering |
| C. Pogue | Vice-President, Sales - United States (Western Division) |
| G. Sabourin | Vice-President, Treasurer and Financial Systems |
| A. Smith | Vice-President, Procurement and Overseas Manufacturing |
| R. Sossoyan | Vice-President, Global Financial Reporting |
| N. Tarfa | Vice-President, Materials and Process Technologies |
| D. Velan | Vice-President, Marketing |
| R. Velan | Vice-President, Sales Administration (North America) |
| G. Zarifah | Vice-President, Global Capital Investments and Production Technology |

Shareholder information

Head office

7007 Cote de Liesse
Montreal, Quebec, Canada H4T 1G2

Website

www.velan.com

Investor relations

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

Auditors

PricewaterhouseCoopers LLP

Transfer agent

CST Trust Company

Shares outstanding as at February 28, 2015

6,372,601 Subordinate Voting Shares
15,566,567 Multiple Voting Shares

Listing

Symbol: VLN

Price range

High CA \$21.94
Low CA \$15.17

Closing on February 28, 2015: CA \$19.00

Annual meeting

The Annual Meeting of Shareholders will be held July 9, 2015,
at 3:00 p.m. in the Grand Salon of the:
Saint James Club
1145 Union Avenue
Montreal, Quebec, Canada H3B 3C2

Velan worldwide

Head Office



Montreal, QC, Canada
Velan Inc.

An extensive global network

- 17 production facilities
- 5 plants in North America
- 6 plants in Europe
- 6 plants in Asia
- 5 stocking and distribution centers
- Hundreds of distributors worldwide
- Over 60 service shops worldwide

Manufacturing - North America

Plant 1



Montreal, QC, Canada
Velan Inc.

Plant 2 and 7



Montreal, QC, Canada
Velan Inc.

Plant 4 and 6



Granby, QC, Canada
Velan Inc.

Plant 5



Montreal, QC, Canada
Velan Inc.

Plant 3



Williston, VT, USA
Velan Valve Corp.

Manufacturing - Europe

Plant



Lyon, France
Velan SAS

Plant



Mennecy, France
Segault SA

Plant



Leicester, United Kingdom
Velan Valves Ltd.

Plant



Lisbon, Portugal
Velan Valvulas Industriais, Lda.

Plant 1



Lucca, Italy
Velan ABV S.p.A

Plant 2



Lucca, Italy
Velan ABV S.p.A

Manufacturing - Asia

Plant 1



Ansan City, South Korea
Velan Ltd.

Plant 2



Ansan City, South Korea
Velan Ltd.

Plant 3



Ansan City, South Korea
Velan Ltd.

Plant



Taichung, Taiwan
Velan-Valvac

Plant



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

Plant



Coimbatore, India
Velan Valves India Private Ltd.

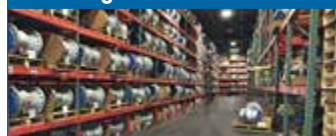
Distribution centers

Stocking and distribution



Willich, Germany
Velan GmbH

Stocking and distribution



Granby, QC, Canada
VelCAN

Stocking and distribution



Benicia, CA, U.S.A.
VelCAL

Stocking and distribution



Marietta, GA, U.S.A.
VelEAST

Stocking and distribution



Houston, TX, U.S.A.
VelTEX

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