
Annual Report 2005

# *leading* innovation through *nature's vitality*

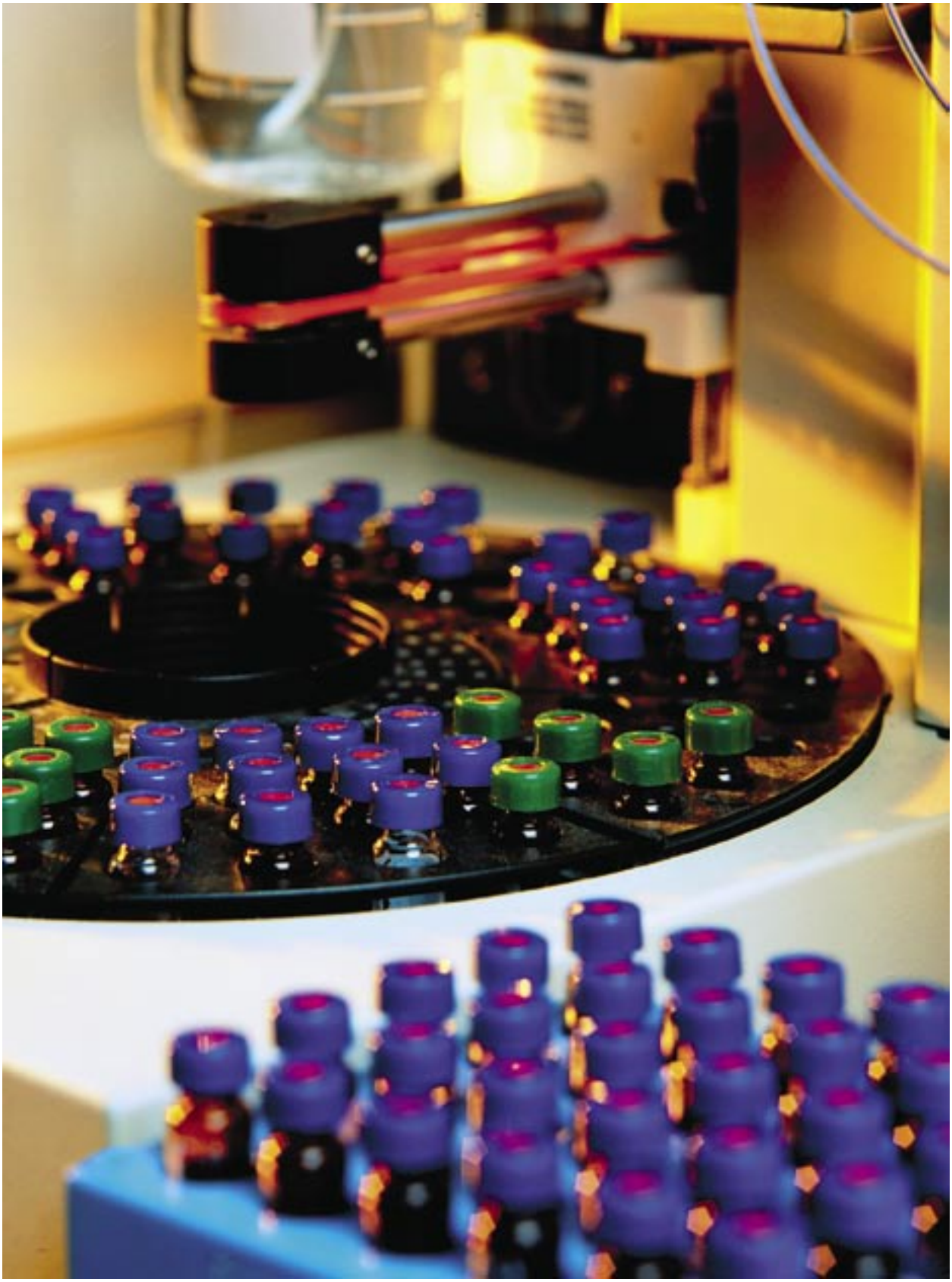
*superior*

# technology

# capturing *nature's* *vitality*


CAPRO INC.

through
*innovative*
**science**



facilitated by

*efficient*

**production**

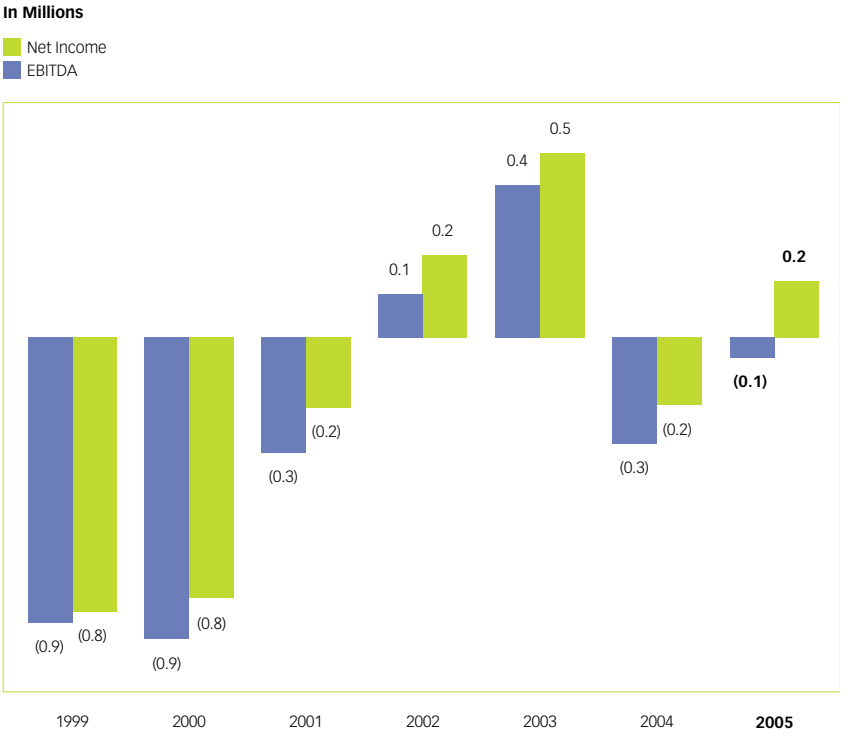
to improve *life*

# Highlights 2005

The past year has been marked with strong organic growth in accordance with our business plan and with an eye towards future development. We have identified eight key milestones achieved in 2005:

- **37%** increase in product sales
- **61%** increase in active ingredient sales
- **10%** increase in gross margins to 58%
- **$433,000** increase in EBITDA to $156,000
- **$1,000,000** increase in working capital
- **$701,000** growth in assets
- **200%** increase in manufacturing capacity
- **15** new patents filed to expand technology portfolio

# Financial Performance



# About Ceapro

Since 1997, Ceapro's focus has been to develop and commercialize new products using natural materials for the human and animal health markets. Our vision is to be a profitable company recognized for the innovation, the high quality, and the life-enhancing performance of its products. For CeaProve®, our vision is to be the global-preferred diabetes screening, diagnostic, and management test.

## "Leading Innovation Through Nature's Vitality"

### Our Mission:

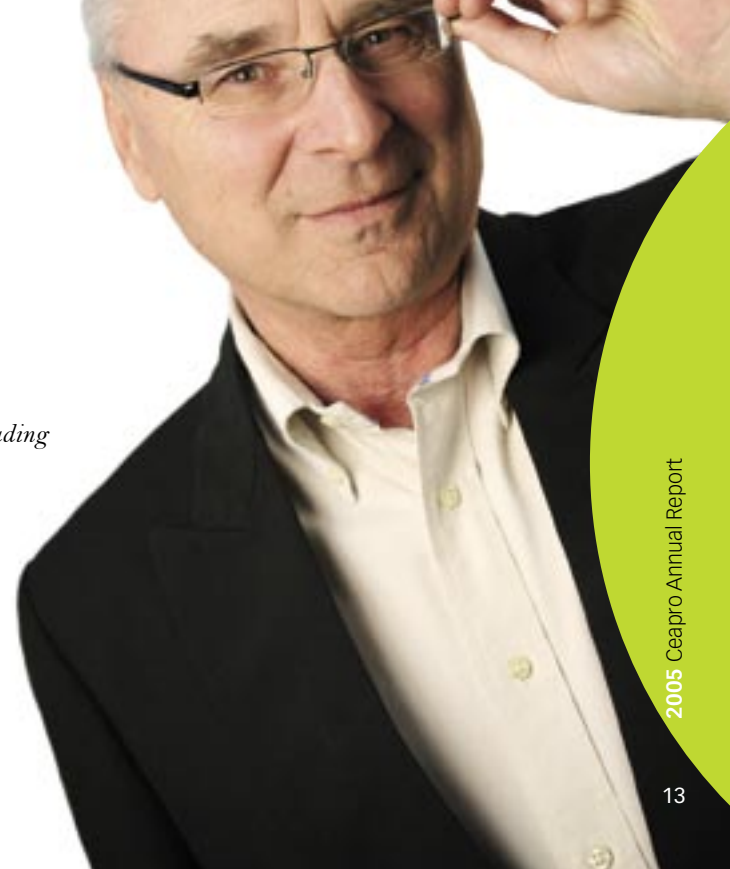
- Innovate, discover, and commercialize natural plant extracts
- Add value to our extracts by manufacturing medical and therapeutic products
- Introduce health and wellness services by employing our CeaProve® diagnostic technology

### Our Values:

- Enhancing human and animal health
- Producing the highest quality of work possible in products, science, and business
- Developing personnel through guidance, opportunities, and encouragement

*"Ceapro is focused on our core objective: commercialization of products using natural materials. Capturing Nature's vitality and leading innovation will continue to be our focus as our company grows."*

**Ken Pilip** M.Sc., P. Eng.
*Founder & Senior Advisor*



# Dear Fellow Shareholder:

Over the last twelve months, Ceapro invested in its people, its physical assets, and its technology. This investment in our future was accomplished within budget and according to our business plan. As a result 2005 was a year of strong organic growth; we will now look to accelerating growth through new partnerships and new opportunities.

## Accomplishments

Our alliances with Symrise (Active Ingredients), Brennen Medical (Beta Glucan), and Daisen (Animal Health) have stood the test of time. Collectively, these partnerships represent almost thirty years of collaboration. Now Ceapro is working hard to forge other new partnerships. These relationships will ensure that existing products and technologies will be sold in expanded territories and that new products will be placed to receive the maximum exposure and create the greatest impact.

Publication of landmark clinical studies in the *International Journal of Cosmetic Science*, a peer-reviewed scientific journal, has created strong market and customer interest in beta glucan. Building on this attention Symrise has advised Ceapro of increasing interest in beta glucan, especially in Asia. Brennen Medical reports similarly raised awareness in the wound-care market. Especially following the introduction of beta glucan-based hernia treatments by Genzyme Inc. We expect even stronger sales of active ingredient in the 2006 due to publicity and expanding markets.

Increased sales of animal health products to veterinarians in Japan was reported in the Fuji Economic 2005 Report. The report confirmed Ceapro's leadership position in OTC (over the counter) shampoo and ear cleansing products, outperforming other global competitors. We have used this data to demonstrate competitive performance benefits and market size to prospective partners in the United States; we anticipate making US market announcements later this year.

Ceapro's implementation plan for CeaProve® addresses markets in screening and monitoring, as well as in diagnosis of diabetes and the related causes of the "Metabolic Syndrome". We have reached the point of forming alliances and partnerships that will ensure market penetration in the workplace, pharmacies, clinical laboratories, and medical clinics.

## Investment for the Future

In 2005 Ceapro added personnel, intellectual property, and capital equipment to the Company. These costs are reflected in general and administrative expenses, and in research and development expenses.

Staff salaries, Board costs, and consulting fees are a major budget item for Ceapro, as with any growing biotechnology company. This expense is understandable and acceptable because Ceapro's people are a major asset. Ceapro's personnel combine years of knowledge and experience with new ideas and ingenuity to produce Ceapro's products. Ceapro's commitment to retaining exceptional people provides returns to the Company in more ways than ensuring high performance and standards of governance. In 2005 as in previous years, Ceapro's team chose to reinvest money in Ceapro; the Board, management, employees, and their families participated in the Company's financings. This confidence and degree of support provides insight into the commitment of those closely associated with the Company.

Patents figured prominently in Ceapro's activities during 2005, and will ensure protection of intellectual property essential to Ceapro's operations. Ceapro filed for 15 patents in various countries to protect new oat processing methods, beta glucan drug-delivery technology, and new CeaProve® formulations. Ceapro also concluded a nine-year challenge of another company's patent in the European Patent Office. The ruling limited the use of the challenged oat extract to a specific use in scalp treatment. In December, Ceapro commenced patent-related activities to establish a clear patent position for a new processing technology. Our latest technological advances will greatly enhance our productivity and pave the way for new partnerships in nutraceuticals.

Ceapro has increased production capacity and expanded manufacturing operations at Leduc, Alberta, which completes Phase 1 of the expansion plans announced in the 2004 Annual Report. The investment in capital equipment has already provided returns through reduced costs and higher margins, expanded volumes, and a greater diversity of products.

Phase 2 of the expansion plan began in the last quarter of 2005, as Ceapro commenced engineering and design studies for the potential expansion of manufacturing space to 4,000 square feet. The expanded area would offer space to operate continuous processes, expand production shifts, enhance production parameters, and allow streamlined production of pharmaceutical-grade active ingredients. If approved, the expansion will take place during the third quarter of 2006 and would provide Ceapro with adequate production capacity for the next three years, based on our market forecasts and business plan.

## Marketing Challenges

As an innovation-driven company, we face challenges in making the most of our technological opportunities and realizing profits resulting from technology commercialization. Our greatest challenge has been the merchandizing of the numerous products originating from our patents.

To meet this marketing challenge we have developed a successful sales and distribution model that involves forging long-term partnerships that uses our partners' sales teams and resources to access customers. This model is particularly effective when our technical and scientific staff become part of the sales process. As a result of applying this model our market for our products has grown at a rate greater than the 70% per annum over the last five years.

Now, however, to increase that growth rate we have embarked upon a new partnership strategy that extends beyond distribution. During 2005, we conducted applied research to meet our partners' specific product needs. In the future, we will increase activities in the areas of licensing and foster even closer collaborations and joint ventures.

## Financial Resources

Ceapro sells its products in US dollars but reports in Canadian dollars. As a result the foreign exchange rates have had bearing on corporate performance and profitability, so influencing share price. Comparing 2005 to 2004, the exchange rate increase had a $166,000 negative effect on Ceapro's revenues; this effect is even greater when comparing 2005 to 2003, with a $280,000 negative effect. Ceapro has neutralized the impact of the stronger Canadian dollar through increased sales, improved margins, and enhanced efficiencies.

Expansion of our CeaProve® programs required us to raise additional capital in 2005. During the year, we raised $1.6 million using a number of different financing vehicles. To protect our shareholders' investments we did not issue large numbers of shares; however, we did acquire additional performance-based debt (investments with repayments based on CeaProve® success). The cost of this capital together with the previous Royalty Interest programs will have an effect on profitability until the loans are repaid.

## Human Resources

Over the last year, Alberta-based companies have experienced serious shortages with respect to human resources. Ceapro itself has not been able to fill open positions in manufacturing and marketing, and we have had to implement measures to ensure that we are able to retain our valuable team members. We are fortunate and privileged to have an enthusiastic and dedicated workforce; Ceapro understands the need to continue to recognize and reward their work.

We recently announced the promotion of two highly-qualified and talented individuals: Shawn McMillan as Chief Financial Officer and David Fielder as Vice President Scientific Affairs. The critical role that each of these individuals plays in Ceapro today makes these appointments appropriate and an important part of Ceapro's future.

Having experienced difficulties in recruiting employees, Ceapro has relied extensively on consultants to work with management. We have supplemented to our long-term consultant base of Mike Andrews (Finance) and Cark Maunsell (Technology), with additional consulting support in marketing, communications, investor relations, business development, and engineering. While consultants come at a cost, their use gives us flexibility and time to execute our business plans, while continuing to seek the right individuals for full-time employment.

## Outlook

Ceapro's success will be based on these factors:

- We own unique technology to make exceptional products
- We have bright, knowledgeable employees
- We are partnered with the best companies in the world
- We have strong sales into major global markets

We are encouraged by strong first quarter sales and anticipate further revenue growth throughout 2006. We expect the expansion of sales to existing customers, and the introduction of new products to new customers to further increase sales of both active ingredients and veterinary therapeutic products. Ceapro expects to undertake further expansion of manufacturing capacity to meet this increased demand.

Ceapro has made strides in the development of CeaProve®, our diabetes screening product. Our strategy has reached the point of forming alliances and partnerships that will ensure market penetration in the workplace, pharmacies, clinical laboratories, and medical clinics. Ceapro expects to generate revenues from CeaProve® in 2006 once utilization commences in the newly-identified screening service markets and partners begin ordering product.

Ceapro's export sales should continue to increase despite the significant strengthening of the Canadian dollar. We remain confident that enhanced production efficiencies and expanded markets will enable us to continue to stimulate financial growth and corporate performance.

The executive and Board are positive about Ceapro's future. During the last year, we have achieved growth and set in motion activities which will ensure the sustained growth of the Company and contribute to fulfilling our mission and our realizing our vision.

**Mark Redmond**
*President & CEO*
Ceapro Inc
April 3, 2006

*Diana Shaw, Ken Pilip, and Sarah Lord*

# The Ceapro Team

Highly talented and qualified individuals are the cornerstones of Ceapro's success. We are fortunate and privileged to have an enthusiastic and dedicated workforce.

## Executive

**Mark Redmond, Ph.D.**
President & Chief Executive Officer

Since its inception, Ceapro has relied on Dr. Redmond's ingenuity and inventiveness to develop the Company. Today, he is the driver, challenger, and visionary in expanding Ceapro's business.

**Shawn McMillan, B.Comm., C.A.**
Vice President Finance and Chief Financial Officer

Appointed in 2005, Mr. McMillan is responsible for corporate and financial reporting as well as the management of all administrative departments.

**David Fielder, M.Sc.**
Vice President Scientific Affairs

Mr. Fielder joined Ceapro in 1996 and has played a major role in the discovery, conception, and commercialization of all of Ceapro's core technology. He is responsible for Ceapro's scientific developments as well as customer technical services.

## Management

**Laurie Lanuke**
Manager of Customer Service and Logistics

Ms. Lanuke manages product orders and customer inquiries and facilitates distribution of Ceapro products.

**Sarah Lord, Ph.D.**
Manager of Clinical Services

Dr. Lord is responsible for managing clinical studies and screenings for Ceapro's diabetes products.

**Ken Pilip, M.Sc., P.Eng.**
Founder and Senior Advisor

As Founder and Senior Advisor, Mr. Pilip is responsible for corporate relations and engineering design and development.

**Darrin Schmidt**
Manager of Plant Operations

With over 20 years of experience in extract production Mr. Schmidt leads Ceapro's manufacturing team.

**Diana Shaw, Ph.D.**
Manager of Business Development

Dr. Shaw focuses on product development, pre-market testing, and regulatory requirements for Ceapro's diabetes products.

# Active Ingredients

## Core Extraction Technology and Active Ingredients

Ceapro's distinct competency stems from our ability to identify and extract unique and functional materials from plants. Until recently, our focus was limited to extracts from oats; today we have expanded the application of our technology to include other plants from the Canadian north, developing the "extreme actives" brand.

Our unique extraction technology creates superior active ingredients with distinct formulation and performance advantages. Our natural approach and quality control program ensures the active ingredients are of the highest quality.

Ceapro's range of active ingredients has grown beyond beta glucan, colloidal oat extract, and oat oil to now include hydrolyzed oat protein, combinations of beta glucan with oat protein, and legume proteins from forest plants.

## Beta Glucan

Beta glucan is a polymer of glucose and functions as a key component in some plants, bacteria, and fungi to give their cells strength and structure. For humans and animals, beta glucan stimulates our cells to grow, promoting wound healing, and to produce collagen, which adds tone to skin thus removing wrinkles.

The publication in 2005 of landmark clinical studies in the *International Journal of Cosmetic Science*, has created strong market and customer interest in beta glucan.

In 2005, Ceapro increased its proprietary technology position by filing patents for methods of extracting beta glucan, as well as patents for the use of beta glucan in drug delivery and delivering oral hygiene products. The drug delivery market is projected to be worth $41billion by 2007 and is an important opportunity for Ceapro to develop in the future.

## Colloidal Oat Extract

Colloidal oat extract contains avenanthramides, a chemical found only in oats. Ceapro scientists discovered and characterized avenanthramides as having anti-histamine activity, proving avenanthramides effective in reducing itching and redness.

During 2005, the collaboration between Symrise and Ceapro resulted in the discovery that avenanthramides also block inflammation. It is expected that this new property will be valuable in the development of medical and cosmetic products.

## On the Market

Ceapro's active ingredients are products which meet the demand of today's cosmetics and personal care industries, as well as the needs of human and veterinary medicine. Our partnership strategy allows our products to be identified as key ingredients in a broad range of personal care products and medicines.

Access to global markets for cosmetics is provided by Symrise, whose sales network is supported by distribution centers in Germany, the United States, Brazil, and Singapore. Symrise's market strategy is to work with the Top 10 cosmetics companies to develop brands and inspire the innovation which creates successful products.

Brennen Medical markets three beta glucan containing wound care products across North America and Europe. GlucanPro, GlucanPro 3000, and MacroPro are used in the treatment of burns and skin-loss injuries. Genzyme, a leader in biotechnology and medical devices, has begun the worldwide marketing of beta glucan-based GlucaTex® and GlucaMesh® used in the repair of hernias.

*"Active ingredients are a core element of Ceapro's business and it is important that our distribution and marketing partners have ready and available access to our product."*

**Laurie Lanuke**
*Manager of Customer Service & Logistics*

# CeaProve®

## What is CeaProve®?

CeaProve® is a tool for the early detection and monitoring of diabetes and pre-diabetes.

CeaProve® is a standardized meal in the form of calibrated wafers made from proprietary formulations of proteins, fats, and complex carbohydrates. Once eaten the wafers elicit a temporary rise in blood glucose which may be measured with a glucose meter. This measurement indicates a person's risk for diabetes and pre-diabetes.

For individuals having diabetes or pre-diabetes, CeaProve® is an effective monitoring device to ensure that lifestyle changes and/or medications are effectively controlling their blood glucose levels.

Ceapro will supply CeaProve® to hospital laboratories and clinics, doctors' offices, pharmacies, and other professional outlets offering point-of-care testing.


## Why CeaProve®?

The prevalence of diabetes is reaching epidemic levels throughout the world. Diabetes can be a devastating disease leading to complications such as blindness, kidney failure, amputation, heart attack, and stroke. Prior to being diagnosed with diabetes, many people unknowingly live with "pre-diabetes" for as many as five to ten years before their diagnosis. CeaProve® was developed for the early detection of diabetes and pre-diabetes. An earlier diagnosis allows people to take action to prevent the full onslaught of diabetes and its complications.

## How Does CeaProve® Work?

**Step 1**: Fast overnight.
**Step 2**: Take a small blood sample (finger prick) and test the sample with a portable blood glucose meter.
**Step 3**: Consume CeaProve® wafers with a large glass of water within 10 minutes.
**Step 4**: Wait 50 minutes and take another blood sample with a portable blood glucose meter.

## Advantages of CeaProve®

**Accurate:** Clinically proven to be more accurate than a glucose drink.
**Convenient:** Can be completed at home, at work, or in the clinic within one hour with no adverse side effects.
**Accessible:** Can be used with standard blood glucose meters.
**Versatile:** Can be used for detection or monitoring.

## "Know Your Numbers"

Ceapro recently began its "Know Your Numbers" marketing campaign. The campaign promotes screening and awareness of diabetes testing in point-of-care and corporate environments.

The "Know Your Numbers" program uses CeaProve® as its core measure. Additional components assembled into the program include:

- Risk factor determination, e.g., hereditary diabetes or heart disease
- Body measurements, e.g., weight and waist size
- Blood pressure reading
- Cholesterol/lipid determination

Knowing their numbers allows individuals to assess their overall health status.

As a part of a corporate wellness program, CeaProve® provides employers with a fast and effective way to ensure employees are in good health.

We recommend that "Know Your Numbers" become an integral part of a three-step program involving:

1. A baseline CeaProve® "Know Your Numbers" health status measurement
2. An action plan to address health risks
3. A follow-up CeaProve® "Know Your Numbers" measurement to assess progress towards health

*"With CeaProve® our company is taking dramatic steps in the early detection and prevention of diabetes."*

**Sarah Lord, Ph.D.**
Manager of Clinical Programs

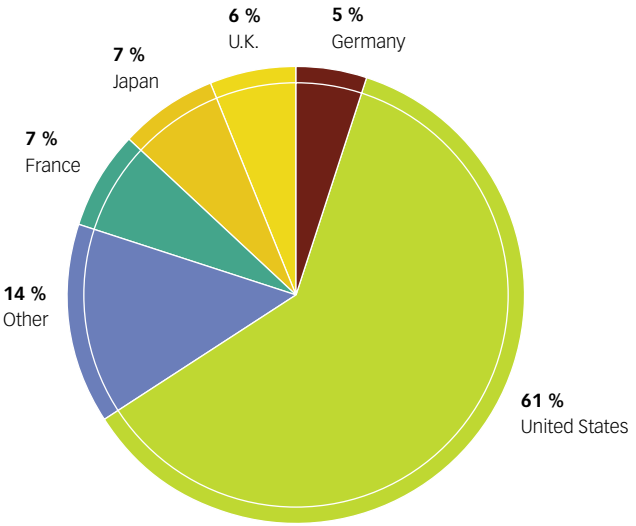
# Veterinary Therapeutic Products

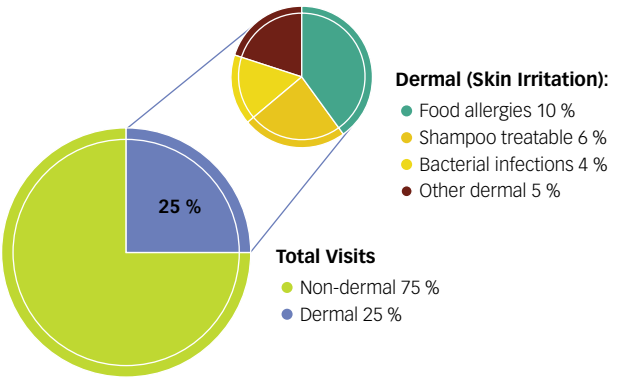
Skin problems are a major health concern in animals and are responsible for over 20% of visits to the veterinary clinic. In recognizing this issue and the potential benefits of oat extracts in promoting skin health, Ceapro conceived and commercialized its line of products for the prevention and treatment of animal skin disease.

Ceapro's current range of veterinary products is based on disease prevention: our products include Oat Shampoo, Ear Cleanser, and Dermal Complex. In 2006 we will launch our first treatment product aimed at bacterial infection.

## Market

The 2005 Fuji Economic Report (April, 2004-March, 2005 ) stated that the Dr. Redmond's Selection of dermatological products captured US$1.1 million of product sales to veterinarians. With Japan representing 7% of the global pet market, Ceapro is working to establish a network of distributors to access a potential market of US$15.5 million. Further expansion of this market may be anticipated as more products are added to the range.



## Global Animal Health Partnerships

Ceapro's veterinary products are sophisticated and technically advanced. As such, the products benefit from user education; the veterinarian is the appropriate teacher. To ensure that the veterinarian is fully informed, Ceapro is establishing a global network of specialized distributors.

**Dr. Redmond's Selection** *Japan, China, Korea, and Taiwan*

The Dr. Redmond's Selection brand has grown to be a market leader in veterinary shampoos and ear cleansers in Japan. Our 12-year relationship with Daisen Sangyo Co. Ltd. and Zenoaq has allowed us to expand our products into Asia.

**NaturOat** *Australia*

Our continued partnership with PharmTech has enabled Ceapro to deliver animal health products to the Australian market.

**Avena Sativa** *Canada*

Ceapro's strategic alliance with Aventix Animal Health Corp. in Canada has enabled the launch of our product under the Avena Sativa brand. Ceapro's ear cleanser has already established itself as a challenger to the leardership position in this sector.

**Oatderm** *United Kingdom*

In 2005, Ceapro formed a strategic alliance with Pharmavet Ltd. in the United Kingdom. Pharmavet is unique in its operation of veterinary supply and internet businesses, as well as owning veterinary practices in Wales.

# Management's Discussion & Analysis

The MD&A provides commentary on the results of operations for the years ended December 31, 2005 and 2004, financial position as at December 31, 2005 and the outlook of Ceapro Inc. ("Ceapro") based on information available as at March 28, 2006. The following information should be read in conjunction with the consolidated financial statements as at December 31, 2005, and related notes thereto, which are prepared in accordance with Canadian generally accepted accounting principles (Canadian GAAP). All comparative percentages are between the years ended December 31, 2005 and 2004 and all dollar amounts are expressed in Canadian currency, unless otherwise noted. Additional information about Ceapro can be found on SEDAR at www.sedar.com.

## Forward-looking Statements

This MD&A offers our assessment of Ceapro's future plans and operations as at March 28, 2006, and contains forward-looking statements. By their nature, forward-looking statements are subject to numerous risks and uncertainties, including those discussed below. You are cautioned that the assumptions used in the preparation of forward-looking information, although considered reasonable at the time of preparation, may prove to be imprecise and, as such, undue reliance should not be placed on forward-looking statements. Actual results, performance or achievements could differ materially from those expressed in, or implied by, these forward-looking statements. No assurance can be given that any of the events anticipated will transpire or occur, or if any of them do so, what benefits Ceapro will derive from them. We disclaim any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

## Vision, Core Business, and Strategy

Ceapro Inc. (Ceapro) is incorporated under the Canada Business Corporations Act, and its wholly-owned subsidiaries, Ceapro Technology Inc., Ceapro Veterinary Products Inc., and Ceapro Active Ingredients Inc., are incorporated under the Alberta Business Corporations Act. Ceapro is an innovation-driven biotechnology company. Our primary business activities relate to the development and commercialization of organic products for medical, cosmetic, and animal health industries using proprietary technology and natural, renewable resources.

Our products include:

- A commercial line of active ingredients, including beta glucan, avenanthramides (colloidal oat extract and Drago-Calm), oat powder, and oat oil, which are marketed to the personal care and cosmetic industry through an exclusive agreement with our distribution partner, Symrise Inc.; and

- Veterinary therapeutic products, including an oat shampoo, an ear cleanser, and a dermal complex/conditioner, which are marketed to veterinarians in Japan and Asia, through distribution agreements with Daisen Sangyo Co. Ltd., in Canada by Aventix Animal Health, and in the UK by Pharmavet Ltd.

Other products and technologies are currently in the research and development or pre-commercial stage. These new technologies include:

- CeaProve®, a diabetes test meal to identify Type 2 diabetes and pre-diabetes, to determine dosage levels for diabetes oral therapy, and to monitor the condition of pre-diabetics. We are working towards a Canadian product listing to make CeaProve® available across Canada in 2006.

- A drug-delivery platform using our beta glucan technology to deliver compounds for uses ranging from wound care and therapy, to skin care treatments that reduce the signs of aging.

- An extension to the active ingredients offering, through new protein and new cereal grain extract products; and

- An extension to the existing veterinary products line, though new therapeutic products/formulations.

Our vision is to be a global leader in developing and commercializing products for the human and animal health markets through the use of proprietary technology and renewable resources. We act as innovator, advanced processor and formulator in the development of new products. We deliver our technology to the market through distribution partnerships. Our strategic focus is:

- Increasing sales and expanding markets for active ingredients;

- Developing and marketing additional high-value proprietary therapeutic products

- Deploying CeaProve® and maximizing product utilization; and

- Advancing new technology to a partnering position.

As a knowledge-based enterprise, we will also expand and strengthen our patent portfolio and build the necessary manufacturing infrastructure to become a global biotechnology company.

Our business growth depends on our ability to access global markets through distribution partnerships. Our marketing strategy emphasizes providing technical support to our distributors and their customers to maximize the value of our technology and product utilization. Our vision and business strategy are supported by our commitment to the following core values:

- Adding value to everything that we touch;

- Enhancing the human and animal health;

- Discovering, extracting, and commercializing new, natural ingredients;

- Producing the highest quality work possible in products, science, and business; and

- Developing personnel through guidance, opportunities, and encouragement.

To support these objectives, we believe we have the requisite resources (intellectual and human capital) and the competitive advantages (partnerships) to exploit our technology. To fund our operations, we rely upon revenues generated from the sale of active ingredients and veterinary therapeutic products, and the proceeds of public and private offerings of equity securities, debentures, and other income offerings.

## Risks and Uncertainties

Biotechnology companies are subject to a number of risks and uncertainties inherent in the development of any new technology. General business risks include: uncertainty in product development and related clinical trials and validation studies; the regulatory environment, for example, delays or denial of approvals to market our products; the impact of technological change and competing technologies; the ability to protect and enforce our patent portfolio and intellectual property assets; the availability of capital to finance continued and new product development; and the ability to secure strategic partners for late stage development, marketing, and distribution of our products. To the extent possible, we pursue and implement strategies to reduce or mitigate the risks associated with our business.

As substantially all sales are export sales to two distributors, we are dependent on those distributors to maintain and expand the volume of product sales to existing and new customers.

We have exposure to risk arising from volatility in foreign exchange rates as substantially all sales of our products are denominated in US currency, while our expenses are primarily denominated in Canadian dollars. We do not currently engage in hedging or use of derivatives to reduce foreign exchange risk.

Ceapro's long-term debt has fixed interest rates over the terms of the obligations. Our exposure to interest rate and inflation risks are expected to be negligible as economic forecasts project a stable outlook for both interest rates and inflation in the near future.

Ceapro's share price is subject to equity market price risk, which may result in significant speculation and volatility of trading due to the uncertainty inherent in our business and the biotechnology industry. There is a risk that future issuance of common shares may result in material dilution of share value, which may lead to further decline in share price. The expectations of securities analysts and major investors about our financial or scientific results, the timing of such results and future prospects, could also have a significant effect on the future trading price of Ceapro's shares.

A variety of factors will affect our future growth and operating results, including the strength and demand for our products, the extent of competition in our markets, the ability to recruit and retain qualified personnel, and our ability to raise capital.

Our financial statements are prepared within a framework of GAAP selected by management and approved by our Board of Directors. The assets, liabilities, revenues, and expenses reported in our financial statements depend to varying degrees on estimates made by management. An estimate is considered a critical accounting estimate if it requires management to make assumptions about matters that are highly uncertain; and if different estimates that could have been used would have a material impact. The significant areas requiring the use of management estimates relate to amortization of property and equipment, the assumptions used in determining stock-based compensation and employee future benefit obligation. These estimates are based on historical

experience and reflect certain assumptions about the future that we believe to be both reasonable and conservative. Actual results could differ from those estimates. We continually evaluate the estimates and assumptions.

## Disclosure Controls and Procedures

Disclosure controls and procedures have been designed to provide assurance that material information relating to the Company is accumulated and communicated to the Company's management as appropriate to allow timely decisions regarding required disclosure. The Company's Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as at December 31, 2005, that the Company's disclosure controls and procedures are effective to provide reasonable assurance that material information related to the Company is made known to them by others within the Company. It should be noted that while the Company's Chief Executive Officer and Chief Financial Officer believe that the Company's disclosure controls and procedures provide a reasonable level of assurance that they are effective, they do not expect that the disclosure controls and procedures will prevent all errors or fraud. A control system, no matter how well conceived or operated, can only provide reasonable, not absolute, assurance that the objectives of the control system are met.

## Results of Operations – Years Ended December 31, 2005, 2004, and 2003

## Selected Annual Information

| **$000s except per share data** | **2005** | 2004 | 2003 |
|---|---|---|---|
| Total revenues | **2,763** | 2,420 | 2,424 |
| Net (loss) income | **(57)** | (398) | 442 |
| EBITDA | **156** | (277) | 550 |
| Basic (loss) income per share | **(0.00)** | (0.01) | 0.01 |
| Diluted (loss) income per share | **(0.00)** | (0.01) | 0.01 |
| Total assets | **2,419** | 1,718 | 1,255 |
| Total liabilities | **1,958** | 1,604 | 873 |

During 2005 there was a 61% increase in active ingredient sales leading to an overall increase of product sales of 37%.

In 2005, the net loss decreased by $341,000 resulting from an increase in revenues of $343,000. This was offset by an increase in general and administration of $150,000, higher sales and marketing of $125,000, amortization of $70,000, royalties of $45,000 and interest of $23,000.

EBITDA increased in the year by $433,000 due to an increase in product sales.

Ceapro's assets grew by $701,000 in 2005 from the result of an increase in cash and receivables offset by a reduction of inventory on hand.

The strong Canadian dollar had an impact on the revenues of Ceapro over the year. Ceapro's revenues are substantially all denominated in US currency, thus a strong Canadian dollar reduces the value of each sale. The average exchange rate on Ceapro's sales dropped 6% compared to 2004 and 11% compared to 2003. This had a substantial impact on Ceapro's gross sales. With the continual

strengthening of the Canadian dollar Ceapro has to increase actual volume of sales to sustain the Canadian equivalent.

## Revenue

| $000s | 2005 | 2004 | Change |
|---|---|---|---|
| Product sales | | | |
| Active ingredients | **2,153** | 1,338 | 61% |
| Veterinary therapeutic products | **530** | 619 | (14%) |
| | **2,683** | 1,957 | 37% |
| Royalties, licenses, and product development fees | **80** | 463 | (83%) |
| Total revenues | **2,763** | 2,420 | 14% |

### Product Sales

In 2005, active ingredient sales rose $815,000 or 61% as a result of an increase of sales of colloidal oat extract, increased sales of the new formulations of beta glucan, and new sales of oat powder. The increase in sales of active ingredients has also been part of Ceapro's continual sales efforts with both the large and mid-size personal care and cosmetic companies. Ceapro continually looks for new and innovative products to add to the current line.

Sales of veterinary therapeutic products were lower year over year due to having a one time order from Daisen of $67,000 in the third quarter of 2004, and a new distributor in Canada stocking up in 2004.

### Royalties, Licences, and Product Development Fees

Royalties, licenses, and product development fees are revenue derived from the addition of new products to existing distribution agreements, activation of new distribution agreements, and scientific and technical services provided to customers for the creation and development of new products. Revenue from royalties, licenses, and product development fees decreased by $383,000 in 2005. In 2004, Ceapro received $463,000 of product development fees upon delivery of new products to our distribution partners. No new product development fees were received in the current year. The $80,000 earned in 2005 was the final portion of the product development fees, received in 2004, upon delivery of product to the customer for testing.

## Expenses

### Cost of Goods Sold and Gross Margins

| $000s | 2005 | 2004 | Change |
|---|---|---|---|
| Sales | **2,683** | 1,957 | |
| Cost of products sold | **1,123** | 1,023 | |
| Gross margin | **1,560** | 934 | 67% |
| Gross margin % | **58%** | 48% | |

Cost of goods sold is comprised of the direct raw materials required for the specific formulation of products, as well as direct labour, quality control, packaging, and transportation costs. Aside from labour and quality control related expenses, the majority of costs are variable in relation to the volume of product produced or shipped.

For 2005, the gross margin percentage improved to 58% from 48%, as a result of the increase in product sales, and as fixed production labour costs were absorbed over the higher product sales. The higher margin also reflects the increase in efficiencies from the new equipment installed in the prior year that is realized with higher production volumes.

## General and Administration

| **$000s** | **2005** | 2004 | Change |
|---|---|---|---|
| Salaries and benefits | **314** | 265 | |
| Board of Directors compensation | **102** | 65 | |
| Investor relations | **102** | 97 | |
| Insurance | **100** | 99 | |
| Legal | **96** | 36 | |
| Other | **269** | 271 | |
| Total general and administration expenses | **983** | 833 | 18% |

General and administration expense (G&A) for 2005 increased $150,000 primarily due to an increase in legal costs of $52,000 related to patent expenses and an increase in regulatory and general legal expenses. The Board of Directors compensation increased by $37,000 as a result of the change, in the prior year, to a fee based compensation structure from a stock based compensation structure. To date the Directors have reinvested their compensation by exercising stock options and participating in private placements in Ceapro.

## Sales and Marketing

| **$000s** | **2005** | 2004 | Change |
|---|---|---|---|
| Salaries and benefits | **207** | 82 | |
| Other | **49** | 48 | |
| Total sales and marketing | **256** | 130 | 97% |

Sales and marketing expenses increased by 97% largely due to senior management and scientific personnel spending time on marketing in the current year, versus in the most of 2004 senior management and scientific personnel were required to spend significant time renewing, refreshing and reformulating existing products. The increase in sales and marketing was to drive the increase in sales, which aided in the 61% increase in active ingredient sales.

## Royalties

| $000s | 2005 | 2004 | Change |
|---|---|---|---|
| Royalty interest units | **230** | 203 | |
| AVAC Royalty | **92** | 74 | |
| Total royalties expenses | **322** | 277 | 16% |

As at December 31, 2005, royalty investors receive royalties equal to 8.31% (2004 – 8.31%) of revenues from product sales and royalty, license, and product development fees of active ingredients and veterinary therapeutic products, to a maximum of two times the amount invested. AVAC Ltd. receives royalties of up to 5% of revenues from eligible product sales, to a maximum of two times the amount invested. Royalty expense throughout 2006 will vary directly with fluctuations in product sales, royalty, license, and product development fees, product sales mix, and any new royalty interest offerings or AVAC investments that may be completed.

## Interest

| $000s | 2005 | 2004 | Change |
|---|---|---|---|
| Interest on callable debt, convertible debentures, and other | **10** | 18 | |
| Interest on long-term debt | **41** | 10 | |
| Total interest expense | **51** | 28 | 82% |

Interest expense increased $23,000 due to the increase in long term debt in 2004 which was used to fund the expansion of the company's manufacturing facility during the latter half of 2004. Total interest expense in 2005 is significantly higher than 2004, as the debt incurred for equipment financing was outstanding for the entire year in 2005 versus a portion of the year in 2004.

## Amortization

Amortization expense increased by $70,000 or 76%, as capital expenditures for manufacturing equipment acquired in the second half of 2004 are now being amortized.

# Other Income (Expenses)

## Research and Product Development

| $000s | 2005 | 2004 | Change |
|---|---|---|---|
| Salaries and benefits | **134** | 101 | |
| Product development - CeaProve® | **395** | 231 | |
| Other | **129** | 121 | |
| Research and product development expenditures | **658** | 453 | 45% |
| AVAC investment (Product Innovation) | **(100)** | - | |
| AVAC investment (CeaProve®) | **(395)** | (150) | |
| Net research and product development expenses | **163** | 303 | (53%) |

Research and product development expenses increased 45% primarily due to an increase in development and pre-market activities for CeaProve®. In 2005 Ceapro received funds under a product pre-commercialization investment agreement that was offset against CeaProve® product development charges. In 2005, $100,000 of active ingredient and animal health product development expenses were offset against funds from AVAC under the Product Innovation Investment agreement.

## Other Income (Expenses)

| $000s | 2005 | 2004 | Change |
|---|---|---|---|
| AVAC - product innovation investment | **225** | | |
| Non-operational legal and consulting expense | **-** | (124) | |
| Settlement of lawsuit | **-** | (40) | |
| Foreign exchange gains (losses) and other | **15** | 46 | |
| Total other income (expenses) | **240** | (118) | 303% |

Other income (expenses) increased in 2005, due to the receipt of $225,000 in AVAC product innovation investment for costs that were incurred in 2004. In 2004, there was an increase in legal and consulting expenses as a result of specific, one-time costs for new agreement development, partnership negotiations, and due diligence processes that were unrelated to regular operations. A stronger Canadian dollar foreign exchange rate at December 31, 2005 resulted in exchange gain due to an unrealized gain of $21,000 on US dollar bank and accounts receivables balances.

## Quarterly Information

The following selected financial information is derived from Ceapro's unaudited quarterly financial statements for each of the last eight quarters, all of which cover periods of three months.

| | | | | 2005 | | | | 2004 |
|---|---|---|---|---|---|---|---|---|
| **$000s except per share data** | **Q4** | Q3 | Q2 | Q1 | Q4 | Q3 | Q2 | Q1 |
| Total revenues | **608** | 654 | 1,032 | 469 | 469 | 414 | 975 | 561 |
| Net (loss) income | **123** | (125) | 101 | (156) | (78) | (361) | (71) | 113 |
| Basic (loss) income per share | **0.00** | (0.00) | 0.00 | (0.00) | (0.00) | (0.01) | (0.00) | 0.00 |
| Diluted (loss) income per share | **0.00** | (0.00) | 0.00 | (0.00) | (0.00) | (0.01) | (0.00) | 0.00 |

Ceapro's quarterly sales and results fluctuate due to variations in the timing of product sales. For example, a significant proportion of our annual veterinary therapeutic product sales are in the second quarter of the year.

## Liquidity and Capital Resources

We rely upon revenues generated from the sale of active ingredients and veterinary therapeutic products, the proceeds of public and private offerings of equity securities and debentures, and income offerings to support our operations.

During 2005, 666,820 stock options were exercised at prices ranging from $0.12 to $0.28. The amount credited to share capital upon exercise of the options is the cash consideration received, if applicable, plus the fair value of the options at the time they were granted (stock-based compensation).

On March 31, 2005, Ceapro completed a private placement share offering of 682,666 Units, for aggregate gross proceeds of $204,800. Each Unit was priced at $0.30 and contained one common share of Ceapro and one common share purchase warrant entitling the holder thereof to acquire one additional common share at an exercise price of $0.40 per share until September 30, 2005, and thereafter at a price of $0.60 per common share, until September 30, 2006.

On December 28, 2005, Ceapro completed a private placement that resulted in the sale of 914 units for a total of $502,700. Each unit consists of 100 common shares priced at $0.50 per share, 100 common share purchase warrants, and 100 royalty interest units at $5.00 per unit. Each warrant entitles the holder thereof to acquire one additional common share at a price of $0.55 per share for a period of six months until June 28, 2006 and thereafter at a price of $0.75 per share until December 28, 2007. The common shares issued under the private placement or upon exercise of the warrants will be subject to a hold period which will expire on April 29, 2006. Each royalty interest unit entitles the holder to a royalty equal to 0.000025% of the net proceeds received by Ceapro from the sale or license of its Active Ingredients, Animal Health Products and CeaProve® up to a maximum cumulative amount equal to $10.00 per royalty interest unit. Proceeds of $457,000 related to royalty interest units and $45,700 for common shares.

Total common shares issued and outstanding as at March 28, 2006 were 37,098,670 (2005 – 36,355,950). In addition, 3,286,795 stock options (2005 – 3,548,115) and 774,066 warrants (2005 – nil) were outstanding that are potentially convertible into an equal number of common shares at various prices. Shareholders' equity increased to $461,337 at December 31, 2005 from $114,066 at December 31, 2004.

Ceapro's working capital position improved to $1,003,000 at December 31, 2005, an improvement of $1,059,000 from December 31, 2004. Ceapro continues to pursue additional financings to fund ongoing working capital requirements, and to secure the financial resources required to support the expected increases in sales of existing products, the introduction of new products to existing and new markets, and the development of new technology.

To meet future requirements, we intend to raise additional cash through some or all of the following methods: public or private equity or debt financing, income offerings, capital leases, collaborative and licensing agreements, and joint venture or partnership financings. However, there is no assurance of obtaining additional financing through these arrangements on acceptable terms, if at all. The ability to generate new cash will depend on external factors, many beyond our control, as outlined in the Risks and Uncertainties section. Should sufficient capital not be raised, we may have to delay, reduce the scope of, eliminate, or divest one or more of our discovery, research, or development technology or programs, any of which could impair the value of the business.

## Sources and Uses of Cash

The following table outlines our sources and uses of funds during the past two years.

| **$000s except per share data** | **2005** | 2004 |
|---|---|---|
| Sources of funds | | |
| Funds generated from operations (cash flow) | **238** | (247) |
| Change in non-cash working capital items | **(666)** | 155 |
| Share capital issued, net of cost | **356** | 111 |
| Royalty interest proceeds | **457** | - |
| Change in long-term and callable debt | **(70)** | 418 |
| | **315** | 437 |
| Uses of funds | | |
| Purchase of property and equipment | **(57)** | (542) |
| Decrease in convertible debentures | **(20)** | (10) |
| Royalties payable | **104** | (37) |
| | **27** | (589) |
| Net change in cash | **342** | (152) |

## Financings and Milestones

During the year ended December 31, 2005, investors agreed to purchase additional interests in the net proceeds, if any, from the SGGF claim. At December 31, 2005, investors are entitled to 57.1% of the net proceeds, if any, from the SGGF claim, to a maximum $14,264,780.

On April 25, 2005, Ceapro received an investment commitment from AVAC Ltd. for product innovation development in the areas of Veterinary Therapeutics and Active Ingredients based on Alberta cereal by-products of an amount up to $362,250 upon completion of project objectives as outlined and agreed to by both parties. In the year ended December 31, 2005, $325,000 of this commitment has been received or was receivable as at December 31, 2005. Ceapro will pay a 2.5% royalty on certain sales to a maximum of $75,000 per quarter to a maximum of two times the amount received from AVAC. These payments will commence when the royalty payments on other AVAC agreements (dated May 13, 2002 and March 26, 2004) are fully satisfied.

In the year ended December 31, 2005, the Company received a commitment for financial assistance totaling $800,000 for pre-market activities of CeaProve® (a health and wellness product) upon completion of project objectives as outlined and agreed to by both parties. As of December 31, 2005, $510,000 of this commitment was receivable and received subsequent to year end. The Company is obligated to pay a royalty (to a maximum of one and a half times the financial assistance received) on sales generated from CeaProve® on the following basis: 0% of net sales and net sub-licensing revenues earned until royalty payments have been fully satisfied under the Investment Agreement dated March 24, 2004, and 5% thereafter until repaid to a maximum of $125,000 per quarter. No royalties were incurred or payable during the current year.

## Related Party Transactions

During 2005, $60,580 royalties were earned by employees and Directors from their investment in previous Ceapro royalty offerings. Directors and employees invested $190,250 in the sale of royalty interest units and lawsuit interests. At December 31, 2005, $13,336 of royalties were payable to employees and Directors. Included in accounts receivable at December 31, 2005 is $50,000 due from a Director for lawsuit financing. Prepaid expenses included $25,884 of Director fees paid for the term ending May 31, 2006. These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

## Legal Proceedings

On May 5, 1998, control of Ceapro's wholly-owned subsidiary, Canamino Inc. ("Canamino") was assumed by Canamino's Class B preferred shareholder, the Saskatchewan Government Growth Fund Ltd. ("SGGF") pursuant to a notice given March 30, 1998 by SGGF due to default of payment of dividends due in October, 1997, and the failure to redeem 500,000 Class B preferred shares as required under the subscription agreement. Control was gained through the assumption of 51% of the voting entitlement attached to the Class A common shares.

On March 22, 2002, Ceapro filed a Statement of Claim (subsequently amended on April 6, 2004) in the Court of Queen's Bench of Saskatchewan against the Government of Saskatchewan, Saskatchewan Government Growth Fund Management Corporation, Gary K. Benson, Janice MacKinnon, and Can-Oat Milling Products Inc. ("SGGF et al."). The action was launched to recover damages with respect to assets claimed to be seized wrongfully as a result of the Defendant's actions in 1998. With the filing in Saskatchewan, Ceapro stayed its action in the Court of Queen's Bench of Alberta. This action was originally filed in September 1999. The claim alleges that Ceapro has suffered damage for its loss of investment in Canamino and loss of reputation in the capital markets.

In 2003, Ceapro issued a bond relating to legal costs up to $305,000, which was secured by personal guarantees of the Board of Directors and the Chief Executive Officer. At December 31, 2004, document production had occurred and Examinations for Discovery of the Defendants had been concluded. The examination of Ceapro's Chief Executive Officer commenced in October 2004, continued through 2005, and resumed in into 2006 for 33 days. The examination of Ceapro's Chief Executive Officer should conclude in April 2006. The legal process will continue through the spring of 2006, moving to the pre-trial conference to be held in the last weeks of November where mandatory judicial mediation will take place.

As of March 28, 2006, it is the opinion of Ceapro's Corporate Counsel that, based on the document production to date and examinations that have transpired, the likely outcome of the case is that Ceapro will be successful. At this stage of the litigation, it is premature to quantify the damages that may be awarded at the discretion of the Court; therefore, no amount has been accrued in the financial statements with respect to this claim.

## Outlook

The initiatives undertaken during 2004 have resulted in an increase in product sales making 2005 our best revenue year in Ceapro's history. We are encouraged with first quarter 2006 sales and look forward to growing revenues throughout 2006. Ceapro incurred a minimal loss in the year of $57,000, and there was significant improvement in our EBITDA, working capital, and cash flow. The expansion of sales to existing customers, and the introduction of new products to new customers have boosted sales of active ingredients. Ceapro's export sales have continued to increase despite the significant strengthening of the Canadian dollar over the last few years.

Ceapro has made strides in the development of CeaProve®, our diabetes screening product, identifying new applications in the areas of diabetes monitoring and drug dosage determination.

During 2005 Ceapro has continued to further develop new products for our Active Ingredient and Veterinary Therapeutic lines that will support further growth as these new products enter the market place in 2006. During 2006 Ceapro will also under go an expansion of our Leduc production facilities in order to ensure that we can increase our capacity to meet the anticipated increase in sales.

Ceapro will continue to pursue additional financings to fund ongoing working capital requirements and to secure the financial resources required to support the expected increases in the volume of sales of existing products, the introduction of new products to existing and new markets, and the further development of new technology.

We intend to implement our operating plans in a measured and responsible manner. We caution that additional investments may be required to continue to grow the business and product lines and availability of these additional investments may affect the pace of growth.

## Additional Information

Additional information relating to Ceapro Inc., including a copy of our Annual Report and Proxy Circular, can be found on SEDAR at www.sedar.com.

# Management's Report

To the Shareholders of CEAPRO INC.

The accompanying consolidated financial statements of Ceapro Inc., and all information presented in this annual report, are the responsibility of Management and have been approved by the Board of Directors.

The consolidated financial statements have been prepared by Management in accordance with Canadian generally accepted accounting principles. The financial statements include some amounts that are based on the best estimates and judgments of Management. Financial information used elsewhere in the annual report is consistent with that in the financial statements.

To further the integrity and objectivity of data in the financial statements, Management of the Company has developed and maintains a system of internal controls, which Management believes will provide reasonable assurance that financial records are reliable and form a proper basis for preparation of financial statements, and that assets are properly accounted for and safeguarded.

The Board of Directors carries out its responsibility for the financial statements in the annual report principally through its Audit Committee. The Audit Committee is appointed by the Board, and all of its members are outside and unrelated Directors. The Committee meets periodically with Management and the external auditors to discuss internal controls over the financial reporting process and financial reporting issues, to make certain that each party is properly discharging its responsibilities, and to review quarterly reports, the annual report, the annual financial statements, management discussion and analysis, and the external auditors' report. The Committee reports its findings to the Board for consideration when approving the financial statements for issuance to the shareholders. The Company's auditors have full access to the Audit committee, with and without Management being present.

The financial statements have been audited by the Company's auditors, Stout & Company LLP, the external auditors, in accordance with auditing standards generally accepted in Canada on behalf of the shareholders.

Sincerely,

Signed "Mark J. Redmond, Ph. D."
President and Chief Executive Officer

Signed "Shawn P. McMillan, CA"
Corporate Controller

# Auditors' Report

To the Shareholders of CEAPRO INC.

We have audited the consolidated balance sheet of Ceapro Inc. as at December 31, 2005 and 2004, and the consolidated statements of net loss and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2005 and 2004, and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Edmonton, Canada
March 1, 2006

SIGNED "Stout & Company LLP"
Chartered Accountants

Ceapro Inc.

# Consolidated Balance Sheets

As at December 31st

| Assets | 2005 $ | 2004 $ |
|---|---|---|
| **Current Assets** | | |
| Cash | **438,045** | 96,266 |
| Accounts receivable | **982,347** | 425,160 |
| Inventories | **228,158** | 345,424 |
| Prepaid expenses and deposits | **90,761** | 66,473 |
| | **1,739,311** | 933,323 |
| Restricted cash for the purchase of property and equipment | **-** | 64,430 |
| Property and equipment (note 3) | **679,623** | 720,067 |
| | **2,418,934** | 1,717,820 |

## Liabilities and Shareholders' Equity

| | | |
|---|---|---|
| **Current Liabilities** | | |
| Account payable and accrued liabilities | **284,863** | 636,615 |
| Deferred revenue | **229,676** | 80,000 |
| Current portion of convertible debentures (note 4) | **-** | 17,510 |
| Callable debt (note 5) | **81,584** | 122,296 |
| Current portion of long-term debt (note 6) | **33,519** | 28,234 |
| Current portion of royalties payable (note 7) | **106,508** | 104,498 |
| | **736,150** | 989,153 |
| Deferred royalty revenue (note 7 (e)) | **457,000** | - |
| Long-term debt (note 6) | **436,731** | 471,766 |
| Employee future benefit obligation (note 8) | **159,946** | 76,586 |
| Royalties payable (note 7) | **167,770** | 66,249 |
| | **1,957,597** | 1,603,754 |
| **Shareholders' Equity** | | |
| Share capital (note 9 (b)) | **2,414,830** | 1,995,443 |
| Contributed surplus (note 9 (c)) | **106,888** | 121,997 |
| Deficit | **(2,060,381)** | (2,003,374) |
| | **461,337** | 114,066 |
| | **2,418,934** | 1,717,820 |

Approved on Behalf of the Board

Signed " Edward A. Taylor "
Director

Signed " David B. Harvey "
Director

*See accompanying notes

Ceapro Inc.

# Consolidated Statements of Net Loss and Deficit

Years ended December 31st

| | 2005 | 2004 |
|---|---|---|
| **Revenue** | **$** | $ |
| Sales (note 11) | **2,683,433** | 1,956,961 |
| Cost of goods sold | **1,123,606** | 1,022,831 |
| Gross margin | **1,559,827** | 934,130 |
| Royalties, licenses, and product development fees | **80,000** | 462,758 |
| | **1,639,827** | 1,396,888 |
| **Expenses** | | |
| General and administration | **982,887** | 833,346 |
| Royalties | **321,692** | 277,149 |
| Sales and marketing | **255,773** | 130,578 |
| Amortization | **161,550** | 91,962 |
| Interest on long-term debt | **41,310** | 10,662 |
| Interest on callable debt, convertible debentures, and other | **10,386** | 17,841 |
| | **1,773,598** | 1,361,538 |
| (Loss) income from operations | **(133,771)** | 35,350 |
| **Other income (expenses)** | | |
| Research and product development | **(162,833)** | (302,487) |
| Loss on disposal of property and equipment | **-** | (12,389) |
| Other income (expenses) (note 12) | **239,597** | (118,211) |
| | **76,764** | (433,087) |
| Loss before income taxes | **(57,007)** | (397,737) |
| Income Taxes (note 13) | | |
| Current | **435,143** | 654,483 |
| Reduction as a result of applying non-capital losses carried forward against the current year's taxable income | **(435,143)** | (654,483) |
| Net loss for the year | **(57,007)** | (397,737) |
| Deficit, beginning of year | **(2,003,374)** | (1,605,637) |
| Deficit, end of year | **(2,060,381)** | (2,003,374) |
| Net loss per share: (note 14) | | |
| Basic | **(0.00)** | (0.01) |
| Diluted | **(0.00)** | (0.01) |

*See accompanying notes

# Consolidated Statements of Cash Flows

Year ended December 31st

| | 2005 | 2004 |
|---|---|---|
| **Operating Activities** | **$** | $ |
| Net loss for the year | **(57,007)** | (397,737) |
| **Items not affecting cash** | | |
| Amortization | **161,550** | 91,962 |
| Loss on disposal of property and equipment | **-** | 12,389 |
| Employee future benefits obligation | **83,360** | 27,049 |
| Stock based compensation | **50,007** | 19,006 |
| | **237,910** | (247,331) |
| **Changes in Non-Cash Working Capital Items** | | |
| Accounts receivable | **(557,187)** | 88,994 |
| Inventories | **117,266** | (229,868) |
| Prepaid expenses and deposit | **(24,288)** | (36,502) |
| Accounts payable and accrued liabilities | **(351,752)** | 252,558 |
| Deferred revenue | **149,676** | 80,000 |
| | **(666,285)** | 155,182 |
| | **(428,375)** | (92,149) |
| **Investing activities** | | |
| Purchase of property and equipment | **(121,106)** | (477,230) |
| Restricted cash for the purchase of property and equipment | **64,430** | (64,430) |
| | **(56,676)** | (541,660) |
| **Financing Activities** | | |
| Repayment of long-term debt | **(29,750)** | (44,832) |
| Proceeds of long-term debt | **-** | 500,000 |
| Repayment of callable debt | **(40,712)** | (37,387) |
| Repayment of convertible debenture | **(20,000)** | (10,000) |
| Proceeds from issuance of share capital | **238,817** | 111,131 |
| Proceeds from exercise of stock options | **117,944** | - |
| Proceeds from royalty interest | **457,000** | - |
| Increase (decrease) in royalties payable | **103,531** | (37,280) |
| | **826,830** | 481,632 |
| Increase (decrease) in cash | **341,779** | (152,177) |
| Cash at beginning of year | **96,266** | 248,443 |
| Cash at the end of year | **438,045** | 96,266 |

## Supplementary information

| | | |
|---|---|---|
| Interest paid | **51,906** | 26,300 |
| Royalties paid | **218,161** | 312,502 |

*See accompanying notes

# Notes to Consolidated Financial Statements

## 1. Nature of Business Operations

Ceapro Inc. (the "Company") was incorporated under the Canada Business Corporations Act and is listed on the TSX Venture Exchange. The Company's primary business activities relate to the marketing and development of various health and wellness products and technology relating to oat extracts.

## 2. Accounting Policies

(a) Use of estimates

The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of the assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. The significant areas requiring the use of management estimates relates to amortization of property and equipment, the assumptions used in determining stock based compensation and the discount rate used in determining the employee future benefit obligation. Actual results could differ from those estimates.

(b) Principles of consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Ceapro Technology Inc., Ceapro Veterinary Products Inc., and Ceapro Active Ingredients Inc.

(c) Cash and equivalents

The Company considers cash and short term deposits with original maturities of three months or less as cash and cash equivalants.

(d) Revenue recognition

Revenue from the sale of health and wellness products is recognized as revenue at the time the products are shipped to customers.

The Canadian Institute of Chartered Accountants has issued an accounting pronouncement effective January 1, 2004 concerning the recognition of revenue (EIC-141). Based on the pronouncement, the sale of royalty interests have been recorded as deferred revenue and will be matched to future related royalty expenses.

Royalty, licenses, and product development fees are recorded in accordance with the terms of the applicable agreements.

(e) Inventories

Inventory of raw materials is valued at the lower of cost and replacement cost on a first-in, first-out basis.

Inventory of work-in-process and finished goods is valued at the lower of cost and net realizable value on an average cost basis.

(f) Property and equipment

Property and equipment are recorded at cost and are amortized over their estimated useful lives as follows:

| | |
|---|---|
| Manufacturing equipment | 20 % declining balance |
| Office equipment | 20 % declining balance |
| Computer equipment | 30 % declining balance |

(g) Research and product development expenditures

Research costs are expensed when incurred. Product development costs are also expensed when incurred unless they are are significant and meet generally accepted criteria for deferral. Costs are reduced by government grants and investment tax credits where applicable.

(h) Foreign exchange

Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at year end exchange rates and non-monetary assets at the exchange rates prevailing when the assets were acquired. Foreign currency denominated revenue and expense items are translated at the rate of exchange in effect at the time of the transaction. Foreign currency gains or losses arising on translation are included in income.

(i) Income taxes

Income taxes are accounted for by the asset and liability method whereby future tax assets and liabilities are recognized for the future tax consequences attributed to the difference between the financial statement carrying amounts of existing assets and liabilities and their respective income tax bases.

(j) Lease obligations

Leases are classified as capital or operating leases. A lease that transfers substantially all of the benefits and risks incidental to the ownership of property is classified as a capital lease. At the inception of a capital lease, an asset and an obligation are recorded at an amount equal to the lesser of the present value of the minimum lease payments and the property's fair value at the beginning of the lease. All other leases are accounted for as operating leases where in payments are expensed as incurred.

(k) Government assistance

Government assistance is periodically granted to the Company under available government incentive programs. Government assistance relating to research and development expenditures is recorded as a reduction of the expenditures when received.

(l) Investment tax credits

Investment tax credits relating to qualifying scientific research and experimental development expenditures are accrued provided there is a reasonable assurance that the credits will be realized. When recorded, the investment tax credits are accounted for as a reduction of the related expenditures.

(m) Net loss per share

Net loss per share is calculated based on the weighted average number of shares outstanding during the year. Diluted net (loss) income per share reflects the assumed conversion of all dilutive securities using the treasury stock method.

(n) Stock based compensation

Stock based compensation of employees, Directors, officers, and consultants is recorded in accordance with the fair value method.

(o) Employee future benefits

The Company accrues its obligations under an employee defined retirement benefit plan, and the related costs, net of plan assets. The cost of retirement benefits earned by employees is determined using the accumulated benefit method and management's best estimate of expected plan investment performance and retirement ages of employees. Past service costs relating to plan amendments are accured and recognized in the year the amendments occur.

(p) Impairments of long-lived assets

The Company accounts for the impairment of long-lived assets in accordance with CICA 3063 "Impairment of Long-lived Assets". In the event that facts and circumstances indicate that the carrying value of long-lived assets may be impaired, the Company performs a recoverability evaluation. If the evaluation indicates that the carrying value of the asset is not recoverable from undiscounted cash flows attributable to the asset, then an impairment loss is measured by comparing the carrying amount of the asset to its fair value.

(q) Callable debt

The Canadian Institute of Chartered Accountants has issued an accounting pronouncement concerning the classification of debt (EIC-122). Based on the pronouncement, one of the Company's loans payable is classified as a current liability since the lender has the right to demand repayment within one year.

## 3. Property and Equipment

**2005**

| | Cost ($) | Accumulated Amortization ($) | Net Book Value ($) |
|---|---|---|---|
| Manufacturing equipment | 908,142 | 308,434 | 599,708 |
| Computer and office equipment | 165,004 | 85,089 | 79,915 |
| | 1,073,146 | 393,523 | 679,623 |

**2004**

| | Cost ($) | Accumulated Amortization ($) | Net Book Value ($) |
|---|---|---|---|
| Manufacturing equipment | 799,351 | 171,622 | 627,729 |
| Computer and office equipment | 152,689 | 60,351 | 92,338 |
| | 952,040 | 231,973 | 720,067 |

## 4. Convertible Debentures

| | 2005 Series 1 to 5 $ | 2004 Series 1 to 5 $ |
|---|---|---|
| Original face value issued | **20,000** | 30,000 |
| Repaid | **(20,000)** | (10,000) |
| Remaining face value | **-** | 20,000 |
| Equity component | **-** | (2,490) |
| | **-** | 17,510 |
| Less current portion | **-** | 17,510 |
| | **-** | - |

## 5. Callable Debt

| | 2005 $ | 2004 $ |
|---|---|---|
| Loan, payable at $4,166 per month, prinicipal and interest at 8%, secured by specific manufacturing equipment (carriying value of $191,877 (2004 - $239,847)) and a general security agreement, due November 2007. | **81,584** | 122,296 |

## 6. Long-Term Debt

| | 2005 $ | 2004 $ |
|---|---|---|
| Loan, payable at $ 6,161 per month, prinicipal and interest at 8.85%, secured by a general security agreement, due January 2010. | **470,250** | 500,000 |
| Less current portion | **33,519** | 28,234 |
| | **436,731** | 471,766 |

Estimated principal payments due in the next five years are as follows:

| | $ |
|---|---|
| 2006 | 33,519 |
| 2007 | 36,608 |
| 2008 | 39,983 |
| 2009 | 43,669 |
| 2010 | 316,471 |
| | **470,250** |

## 7. Royalties Payable

| | 2005 $ | 2004 $ |
|---|---|---|
| Royalties payable pursuant to financial assistance received (note 7 (a)) | **223,694** | 131,777 |
| Royalties payable pursuant to royalty interest offering (note 7(c) and (d)) | **50,584** | 38,970 |
| | **274,278** | 170,747 |
| Less current portion | **106,508** | 104,498 |
| | **167,770** | 66,249 |

(a) In the year ended December 31, 1999, the Company received financial assistance in the amount of $164,882 for the research and development of new products, patents, and markets. The Company is obligated to pay a 5% royalty (to a maximum of two times the financial assistance received) on sales generated from products developed using these funds. The portion of this obligation paid or accrued as at December 31, 2005 was $325,166 (2004- $233,250). Pursuant to an amending agreement the terms of repayment were amended to allow all royalties accrued to December 31, 2005 to be repaid $13,981 per quarter. Royalties incurred subsequent to December 31, 2005 are to be repaid quarterly in arrears commencing with the quarter ending March 31, 2006.

(b) In the year ended December 31, 2004, the Company received a commitment for financial assistance totaling $250,000 for pre-market activities of *CeaProve*® (a health and wellness product) upon completion of project objectives as outlined and agreed to by both parties. As of December 31, 2005, $225,000 (2004 - $100,000) of this commitment has been received. The Company is obligated to pay a royalty (to a maximum of two times the financial assistance received) on sales generated from *CeaProve*® on the following basis: 0% of revenues earned to December 31, 2005, 2.5% of revenues earned to December 31, 2006, and 5% thereafter until repaid. No royalties have been incurred during the current year. The Company has repaid at December 31, 2005 $nil (2004- $nil) of this obligation. Upon completion of the repayment of the financial assistance received, the company will be required to repay $19,750 advanced during the year ended December 31, 2002. The portion of this obligation paid or accrued as at December 31, 2005 was nil (2004- nil).

(c) In the year ended December 31, 2003, the Company completed a Royalty Income Unit offering through the terms described in an Offering Memorandum. Each royalty interest has a right to receive royalties equal to 0.00001% from the sale or licensing of the Company's active ingredients and animal health products, to a maximum cumulative amount of $2.08 per unit. Proceeds from the offering were $516,348 (before related expenses) represent the sale of a 5.163% royalty interest in the Company's future sales and licensing of active ingredients and animal health products. Maximum royalties payable are two times the amount invested or $1,032,695. The portion of this obligation paid or accrued as at December 31, 2005 was $319,127 (2004- $176,277).

(d) In the year ended December 31, 2003, the Company sold a 1.418% royalty interest in the Company's future sales and licensing of active ingredients and animal health products for $141,796. At December 31, 2004, the Company sold a cumulative royalty interest of 3.142% for $314,197. Combined maximum royalties payable are two times the amount invested or $911,986. The portion of this obligation paid or accrued as at December 31, 2005 was $239,917 (2004- $152,993).

(e) On December 28, 2005, the Company sold a 2.285% royalty interest in the Company's future sales and licensing of active ingredients, animal health, and *CeaProve*® products for $457,000. Maximum royalties payable are two times the amount invested or $914,000. The profit of this obligation paid or accrued as at December 31, 2005 was nil (2004- nil).

(f) In the year ended December 31, 2005, the Company received a commitment for financial assistance totaling $362,250 for product innovation development in the area of Veterinary Therapeutics and Active Ingredients. In the year ended December 31, 2005, $225,000 of this commitment has been received and $100,000 was receivable at December 31,2005. The Company is obligated to pay a 2.5% royalty to a maximum of $75,000 per quarter (to a maximum of two times the financial assistance received) on sales generated from products developed using these funds. These payments will commence when the royalty payments on investment agreements in note 7(a) are fully satisfied. The portion of this obligation paid or accrued as at December 31, 2005 was nil.

(g) In the year ended December 31, 2005, the Company received a commitment for financial assistance totaling $800,000 for pre-market activities of *CeaProve*® (a health and wellness product) upon completion of project objectives as outlined and agreed to by both parties. As of December 31, 2005, $510,000 of this commitment has been set-up as recievable and was received subsequent to year end. The Company is obligated to pay a royalty (to a maximum of one and a half times the financial assistance received) on sales generated from *CeaProve*® on the following basis: 0% of net sales and net sub-licensing revenues earned until royalty payments have been fully satisfied under the investment agreement in note 7(b), and 5% thereafter until repaid to a maximum of $125,000 per quarter. No royalties have been incurred during the current year. The portion of this obligation paid or accrued as at December 31, 2005 was nil.

## 8. Employee Future Benefit Obligation

The Company has an unfunded non-registered, non-indexed defined retirement benefit plan for certain senior employees. The retirement benefit is two months' salary for each year they are employed by the Company.

During the current fiscal year the plan was amended to clarify the obligation and the date to which the obligations accrue. As a result, past service obligations of $53,453 were recorded in the current year.

| | 2005 $ | 2004 $ |
|---|---|---|
| **Accrued Employee Future Benefit Obligation** | | |
| Unfunded balance, beginning of year | **76,586** | 49,537 |
| Current service cost | **22,152** | 16,835 |
| Past service costs | **53,453** | - |
| Interest costs on accrued obligation | **7,755** | 10,214 |
| Unfunded balance, end of year | **159,946** | 76,586 |

Management is required to make a significant estimate regarding the discount rate used to determine the accrued employee future benefit obligation. These significant estimates are of a long-term nature, which is consistent with the nature of the employee future benefits. The discount rate used to determine the accrued benefit obligation as at December 31, 2005 was 5.58% (2004- 5.58%).

## 9. Share Capital

(a) Authorized

Unlimited number of Class A voting common shares
Unlimited number of Class B non-voting common shares

(b) Issued – Class A common shares

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | **Number of shares** | **Amount $** | Number of shares | Amount $ |
| Balance at beginning of year | **35,635,284** | **1,995,443** | 34,169,213 | 1,855,823 |
| Changes during the year | | | | |
| Equity placements | **774,066** | **238,818** | - | - |
| Exercise of options | **666,820** | **183,059** | 1,466,071 | 140,184 |
| Decrease in equity component of convertible debentures | **-** | **(2,490)** | - | (564) |
| Balance at end of year | **37,076,170** | **2,414,830** | 35,635,284 | 1,995,443 |

(c) Contributed Surplus

The following table summarizes the changes in contributed surplus:

| | 2005 $ | 2004 $ |
|---|---|---|
| Balance at beginning of year | **121,997** | 132,044 |
| Stock based compensation expense (note 9(d)) | **50,007** | 19,006 |
| Exercise of stock options | **(65,116)** | (29,053) |
| Balance at end of year | **106,888** | 121,997 |

(d) The Company has granted stock options to eligible employees, Directors, officers, and consultants under stock option plans, which vest over periods ranging from eighteen months to 4 years, and have a maximum term of five years.

The Company accounts for options granted under these plans in accordance with the fair value based method of accounting for stock based compensation. The application of the fair value based method requires the use of certain assumptions regarding the risk-free market interest rate, expected volatility of the underlying stock and life of the options. The risk-free rate used in 2003 was 4.08%, the expected volatility was 6.76% which was based on prior trading activity of the Company's shares, and the expected life of the options was 5 years. The stock based compensation expense recorded during the current year relating to options granted in 2003 was $2,104 (2004 - $19,006).

In the current year the Company granted 400,000 stock options. The application of the fair value based method requires the use of certain assumptions regarding the risk-free market interest rate, expected volatility of the underlying stock and life of the options. The risk-free rate used in 2005 was 3.40%, the expected volatility was 110% which was based on prior trading activity of the Company's shares, and the expected life of the options was 5 years. The stock based compensation expense recorded during the current year relating to options granted in 2005 was $47,903.

A summary of the status of the Company's stock options at December 31, 2005 and 2004 and changes during the years ended on those dates is as follows:

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | **Number of Options** | **Weighted Average Exercise Price $** | Number of Options | Weighted Average Exercise Price $ |
| Outstanding at beginning of year | **3,586,115** | **0.21** | 5,077,186 | 0.22 |
| Granted | **400,000** | **0.28** | - | - |
| Expired | **(32,500)** | **0.25** | (25,000) | 1.00 |
| Exercised | **(666,820)** | **0.18** | (1,466,071) | 0.22 |
| Outstanding at end of year | **3,286,795** | **0.23** | 3,586,115 | 0.21 |
| Exercisable at the end of the year | **3,081,795** | **0.19** | 3,421,115 | 0.21 |

The following table summarizes information about stock options outstanding at December 31, 2005 and 2004:

| | | **2005** | 2004 |
|---|---|---|---|
| Exercise Price $ | Year of Expiration | **Number of Options** | Number of Options |
| 0.28 | 2010 | **250,000** | - |
| 0.25 | 2008 | **1,895,792** | 2,021,600 |
| 0.17 | 2007 | **809,003** | 825,180 |
| 0.20 | 2006 | **332,000** | 344,335 |
| 0.12 | 2005 | **-** | 395,000 |
| | | **3,286,795** | 3,586,115 |

Subsequent to December 31, 2005, 22,500 Class A common shares were issued upon the exercise of stock options for aggregate proceeds of $5,625. The fair value of the options at the time they were granted of $1,069 will be transferred from contributed surplus to share capital.

(e) Warrants

A summary of the status of the Company's warrants at December 31, 2005 and 2004 and changes during the years ended on those dates is as follows:

| | **2005** | | 2004 | |
|---|---|---|---|---|
| | **Number of Warrants** | **Average Exercise price $** | Number of Warrants | Average Exercise price $ |
| Issued and outstanding at beginning of year | **-** | **-** | - | - |
| Issued | **774,066** | **0.59** | - | - |
| Issued and outstanding at end of year | **774,066** | **0.59** | | |

The following table summarizes information on warrants outstanding at December 31, 2005:

| **Exercise Price $** | **Number Outstanding** | **Expiry Date** |
|---|---|---|
| 0.60 | 682,666 | September 30, 2006 |
| 0.55* | 91,400 | December 31, 2007 |
| | 774,066 | |

* Warrants are exercisable at $0.55 until June 28, 2006 and thereafter at $0.75 until expiry.

(f) On March 31, 2005 the Company completed a private placement share offering of 682,666 Units, for aggregate gross proceeds of $204,800. Each Unit was priced at $0.30 and contained one common share of the Company and one common share purchase warrant entitling the holder thereof to acquire one additional common share at an exercise price of $0.40 per share until September 30, 2005 and there after at a price of $0.60 per common share until September 30, 2006.

(g) On December 28, 2005 the Company completed a private placement offering through the terms described in an Offering Memorandum, which resulted in gross proceeds of $502,700 (914 units at $550 per unit, net of related expense). Each unit is comprised of 100 Class A common shares of the Company ("common shares"), 100 Class A common shares purchase warrants ("warrants"), and 100 royalty interests ("royalty interests"). Each warrant entitled the holder thereof to acquire one Class A common share at an exercise price of $0.55 per share until June 28, 2006 and thereafter at a price of $0.75 per share until December 31, 2007. Each royalty interest is a right to receive royalties equal to 0.000025% of the proceeds received by the Company from the sale or licensing of its active ingredients, animal health products, and *CeaProve*®, up to a maximum cumulative amount of amount of $10.00 per unit. Proceeds of $457,000 related royalty interest units and $45,700 for common shares.

(h) During the year ended December 31, 2004 a senior employee and former employee exercised 950,000 stock options at exercise prices ranging from $0.19 to $0.25. The fair value of the options at the time they were granted of $17,077 was transferred from contributed surplus to share capital.

## 10. Contingencies and Commitments

(a) On May 5, 1998, control of the Company's wholly-owned subsidiary, Canamino Inc. ("Canamino") was assumed by Canamino's Class B preferred shareholder, the Saskatchewan Government Growth Fund Ltd. ("SGGF") pursuant to a notice given March 30, 1998 by SGGF due to default of payment of dividends due in October, 1997, and failure to redeem 500,000 Class B preferred shares as required under the subscription agreement. Control was gained through the assumption of the 51% of the voting entitlement attached to the Class A common shares.

On March 22, 2002, the Company filed a statement of claim ("the claim") (subsequently amended on April 6, 2004) with the Court of Queen's Bench of Saskatchewan. With the filing in Saskatchewan, the Company stayed its action in the Court of Queen's Bench in Alberta which was originally filed in December 1999.

In 2003, the Company issued a bond relating to legal costs up to $305,000 which was secured by guarantees of the Board of Directors and an Officer of the Company. At December 31, 2005 it is the opinion of the Company's Corporate Counsel that based on the document production to date and the examinations which have transpired, the likely outcome of the case is that the Company will be successful. At this stage of the litigation it is premature to quantify the damages which will likely be awarded at the discretion of the Court; therefore no amount has been accrued in these statements with respect to this claim.

During the year ended December 31, 2005, a Director agreed to invest $50,000 (2004 - $206,478) to purchase an interest in the net proceeds, if any, from the SGGF claim. The Company also received $225,000 (2004 - $227,500) from the sale of a 9.0% (2004 – 9.1%) interest in the net proceeds, if any, from the claim. At December 31, 2005, the Directors and investors are entitled to 57.1% (2004 – 46.1%) of the net proceeds, if any, from the SGGF claim, to a maximum of $14,264,780 (2004 - $11,514,780).

During the year ended December 31, 2005 the Company entered into an agreement with its SGGF legal counsel whereby a portion of their fees are payable on a contingency basis. At December 31, 2005 that contingency was $106,160, which will be paid from the net proceeds, if any, from the SGGF claim.

(b) On March 1, 2002 the Company received notice of a Statement of Claim filed on February 28, 2001 by a former employee. The statement alleged that the Company breached certain conditions of contract between the former employee and the Company. During the year ended December 31, 2004, the Company settled the claim for $40,000. The settlement amount is included in other income (expenses).

(c) In the normal course of operations the Company may be subject to litigation and claims from customers, suppliers and former employees. Management believes that adequate provisions have been recorded in the accounts where required. Although it is not possible to estimate the extent of potential costs, if any, management believes that the ultimate resolution of such contingencies would not have a material adverse effect on the financial position of the Company.

(d) Effective September 28, 2005, the Company modified its existing lease agreement for its office premises. The lease requires the Company to pay annual rent of $70,639 per year which includes its share of maintenance and operating costs until expiry April 30, 2006.

## 11. Sales

Substantially all sales are export sales to two distributors of the Company's products. The Company is therefore economically dependent on those distributors to maintain and expand the volume of product sales to existing and new customers.

## 12. Other Income (Expenses)

Other income (expenses) is comprised as follows:

| | **2005 $** | 2004 $ |
|---|---|---|
| Product Innovation Investment (note 7(f)) | **225,000** | - |
| Non-operational legal and consulting expenses | **-** | (123,911) |
| Settlement of lawsuit (note 10 (b)) | **-** | (40,000) |
| Foreign exchange gains (losses) | **3,920** | 23,744 |
| Other | **10,677** | 21,956 |
| | **239,597** | (118,211) |

## 13. Income Taxes

(a) Non-capital losses

The company has accumulated non-capital losses carried forward for income tax purposes of approximately $2,208,000 the benefit of which has not been reflected in these consolidated financial statements.

These losses may be applied against future taxable income within the limitations prescribed by the Income Tax Act and expire as follows:

| | $ |
|---|---|
| 2006 | 661,000 |
| 2007 | 683,000 |
| 2008 | 571,000 |
| 2015 | 293,000 |
| | **2,208,000** |

(b) Capital losses

The Company has capital losses of approximate $6,807,000, which can be carried forward indefinitely to offset future capital gains.

(c) Scientific research and experimental development (SR & ED)

The company has accumulated SR & ED expenditure pool of approximately $1,506,000, which can be carried forward indefinitely to be applied against future taxable income.

The company has accumulated SR & ED investment tax credits of approximately $194,000. These credits may be applied against future federal income taxes payable and expire as follows:

| | $ |
|---|---|
| 2006 | 38,000 |
| 2007 | 119,000 |
| 2008 | 16,000 |
| 2009 | 400 |
| 2012 | 20,600 |
| | **194,000** |

(d) Temporary differences

A future income tax asset reflects the net effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's future income tax assets are as follows:

| | **2005 $** | 2004 $ |
|---|---|---|
| **Income tax effect of deductible temporary differences** | | |
| Non-capital losses and SR & ED expenditures carried forward | **1,423,000** | 1,759,000 |
| Net capital losses carried forward | **1,144,000** | 1,144,000 |
| SR & ED investment tax credits | **194,000** | 194,000 |
| Undepreciated capital cost for tax purposes in excess of net book value | **3,123,00** | 3,030,000 |
| Deferred revenue recognized for tax purposes | **231,000** | - |
| Valuation allowance | **(6,115,000)** | (6,127,000) |
| | **-** | - |

For consolidated financial statement purposes, no future income tax asset has been recorded at December 31, 2005 and 2004 as it is not, 'more likely than not' to be realized.

(e) Income tax reconciliation

The Company's consolidated income tax position comprises tax benefits and provisions arising from the respective tax positions of its taxable entities. The Company's income tax provision differs from that calculated by applying statutory rates for the following reasons:

| | **2005 $** | 2004 $ |
|---|---|---|
| Income taxes (recovery) based on federal and provincial statutory income tax rate of 33.62 % (2004 - 33.87 %) | **(19,166)** | (134,714) |
| Tax effect of expenses that are not deductible for income tax purposes | **124,787** | 107,245 |
| Tax effect of current year non-capital losses not recognized | **98,662** | 19,982 |
| Tax effect of gain sale of technology and licences to subsidary | **-** | 661,970 |
| Tax effect of deferred revenue recognized for tax | **230,860** | |
| Income tax reduction as a result of applying non-capital losses carried forward against current year taxable income | **(435,143)** | (654,483) |
| | **-** | - |

## 14. Basic and Diluted Net Loss Per Share

The following table outlines the calculation of basic and diluted net loss per share:

| | **2005 $** | 2004 $ |
|---|---|---|
| **Numerator** | | |
| Numerator for basic and diluted net income per share: | | |
| Net (loss) income for the year | **(57,007)** | (397,737) |
| **Denominator** | | |
| Denominator for basic net income per share: | | |
| Weighted-average number of shares outstanding during the year | **36,337,657** | 34,764,478 |
| Effect of potentially dilutive securities: | | |
| Stock options | **-** | - |
| Warrants | **-** | - |
| Denominator for diluted net income per share: | | |
| Adjusted weighted-average number of shares outstanding during the year | **36,337,657** | 34,764,478 |
| Basic net loss per share | **(0.00)** | (0.01) |
| Diluted net loss per share | **(0.00)** | (0.01) |

The dilutive effect of outstanding stock options on net loss per share is based on the application of the treasury stock method. Under the treasury stock method, the proceeds from the exercise of options is assumed to be used to purchase common shares.

For the year ended December 31, 2005 and 2004, no options, warrants, or convertible debentures have been included in the calculation for net loss per share as the result would be anti-dilutive.

## 15. Related Party Transactions

Related party transactions during the years not otherwise disclosed in these consolidated financial statements are as follows:

| | **2005 $** | 2004 $ |
|---|---|---|
| Royaties earned by employees and Directors | **60,580** | 52,985 |
| Sale of royalty and lawsuit interests to employees and Directors | **190,250** | 10,000 |
| Amounts payable to employees and Directors included in royalties payable | **13,336** | 10,274 |
| Prepaid expense relating to Director fees | **25,884** | - |
| Amounts receivable from Directors included in accounts receivable | **50,000** | 206,748 |
| Reimbursement of legal fee expenses by Directors | **-** | 206,748 |

These transactions are in the normal course of operations and are measured at the exchange amount which is the amount of consideration established and agreed to by related parties.

## 16. Segmented Information

The Company operates in one industry segment, which is the active ingredient product technology industry. The majority of the revenue is derived from sales in the Americas. All the assets of the Company, which support the revenues of the Company, are also located in the Americas. The distribution of revenue by location of customer is as follows:

| | **2005 $** | 2004 $ |
|---|---|---|
| Americas | **1,827,692** | 1,035,132 |
| Other | **935,741** | 1,384,587 |
| | **2,763,433** | 2,419,719 |

## 17. Financial Instruments

The estimated fair value of cash, accounts receivable, accounts payable and accrued liabilities, callable debt, current portions of long-term debt, royalties payable, and employee future benefit obligation approximates their carrying value due to their short-term nature.

The fair value of long-term debt and royalties payable are estimated to approximate their carrying value using the Company's incremental borrowing rate or discount cash flow analysis for similar types of borrowing arrangements.

The Company operates internationally, giving rise to exposure to market risks from changes in foreign exchange rates in relation to the resulting accounts receivable and accounts payable and accrued liabilities.

It is Management's opinion that the Company is not exposed to significant interest or credit risks arising from these financial instruments.

## 18. Comparative Figures

Certain comparative figures have been reclassified to conform with financial statement presentation adopted for the current year.

# Information For Investors

## Directors
Edward Taylor, Chairman
Donald Byers
David Harvey
Donald Oborowsky
John Yewchuk
John Zupancic
Mark J. Redmond

## Officers
Mark J. Redmond, Ph. D
President and Chief Executive Officer

Shawn McMillan, CA
Chief Financial Officer and Corporate Secretary

David Fielder, M. Sc.
Vice President Scientic Affairs

## Head Office
1008 RTF University of Alberta
8308 - 114 Street
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Canada

Telephone: 1.780.421.4555
Fax: 1.780.421.1320
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Email: info@ceapro.com

## Registered Office
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10180 - 101 Street
Edmonton, AB T5J 3V5
Canada

## Auditors
Stout & Company LLP
1900 College Plaza
8215 - 112 Street
Edmonton, AB T6G 2C8
Canada

## Corporate Counsel
Fraser Milner Casgrain LLP
2900 Manulife Place
10180 - 101 Street
Edmonton, AB T5J 3V5
Canada

## Securities Counsel
Bryan & Company
2600 Manulife Place
10180 - 101 Street
Edmonton, AB T5J 3V5
Canada

## Chartered Bank
TD Canada Trust
148 Edmonton Centre
1025 - 101 Street
Edmonton, AB T5J 2Y8

## Stock Information
Listed on the TSX Venture Stock Exchange
Symbol: CZO

## Transfer Agent & Registrar
Olympia Trust Company
460 Sunlife Place
10123 - 99 Street
Edmonton, AB T5J 3H1
Canada

Telephone: 1.780.496.9713
Fax: 1.780.408.3382

## Change of Address
Registered Shareholders should notify the Company's Transfer Agent and Registrar at the address set out above.

Beneficial Owners should contact their respective brokerage firm to give notice of a change of address.

## Financial Calendar
The Company's year-end is December 31.

The Annual Report is mailed in May.
Quarterly Reports are mailed in May, August, and November.

## Equal Opportunity Employer
Ceapro Inc. is an equal opportunity employer and seeks to attract and retain the best-qualified people regardless of race, religion, national origin, gender, sexual orientation, age, or disability.