Napier Environmental Technologies Inc.

<u>AMENDED</u> MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE YEAR ENDED DECEMBER 31, 2004

Napier Environmental Technologies Inc. (the "**Company**" or "**Napier**") is a manufacturer and distributor of effective, safe and environmentally benign chemicals for stripping paints and coatings, surface preparation and wood restoration and protection. These products are cost effective, safe and easy to use, and are formulated and designed to be environmentally benign which is important given today's environmental awareness. Napier distributes products both domestically and internationally through a network of distribution channels in the "Industrial" and "Consumer" markets.

Primary industrial uses for Napier's products are paint stripping, concrete etching, rust or adhesive removal, asbestos removal and containment, and lead abatement. The products are applied to a range of surfaces including metal, concrete, and wood. Typical surface preparation applications include aircraft, industrial plants, ships, bridges, storage tanks, oil refineries, railcars, concrete floors, and buildings. In the industry there is limited reliance on a particular market sector due to the diversity of product application. Market demand for the products is highly project driven. As well, most applications occur outdoors, so weather plays a major factor. Government spending on projects also has an impact on demand. Napier products have not yet been introduced and adopted for all possible applications.

Consumer uses for Napier's products are similar to industrial uses, with the main difference being a smaller scale of project. Demand on the consumer side has historically been weighted towards wood restoration, wood coatings and some specialty cleaning products. Historically, products for some of the industrial uses were not available to the consumer due to the complexity and sophistication of tools required for application. Napier has developed a line of products for consumers that overcame these application complexities and consumers now have access to a range of products that was previously only available to industrial users. As a result, Napier has been successful in securing private label business from some of the world's largest paint and coatings producers who have recognized Napier's unique formulas and have leveraged their respective distribution abilities to position many of Napier's products onto major retailers' shelves.

Competitive alternatives to Napier's product offerings include products that are not environmentally benign and other surface preparation methods, including sand blasting. On the wood coatings side, there are a number of competitive products, yet this is a small portion of the Company's overall business. No one competitor offers the same range of products or has the same level of global product acceptance as Napier. Competitors tend to be found on a regional or national level and in some instances are tied to one market sector such as aviation. Napier's competitive advantage is that the products are environmentally benign, cost effective, safe and easy to use. A number of the products are patented and supported by competent Research and Development expertise.

Shareholder value for this industry is generated through global distribution and product diversity and acceptance. Napier's vision is to be the global leader in surface preparation and wood restoration products. Distribution channels, product profitability, product development, brand awareness, infrastructure and working capital will drive performance. Napier continues to optimize capabilities and resources in each of these areas.

This Management's Discussion and Analysis ("**MD&A**") for the year ended December 31, 2004 has been prepared to give shareholders and other stakeholders an assessment of what the Company achieved last year as well as an indication of initiatives underway and planned for this year to improve shareholder value. This MD&A should be read in conjunction with the audited consolidated financial statements of the Company, the notes thereto and the Auditors' Report thereon for the years ended December 31, 2004 and December 31, 2003.

Overview

2004 was a year fraught with challenges for the Company. Napier's financial position was compromised by a combination of high costs and low sales volumes that resulted in negative cash flow, precipitating Napier to file a Notice of Intention to File a Proposal pursuant to the *Bankruptcy and Insolvency Act* (Canada). A key objective for the year was to increase shareholder value by generating positive cash flow. Napier did not achieve this objective, however, the Company did put into place a number of strategic initiatives required for future preservation. Changes were made at a strategic level in distribution channels, market sectors, product lines and marketing. As each area was addressed, both the management structure and team were re-positioned to bring the right people in to do the right jobs. A Chief Restructuring Officer was appointed in the fall of 2004. Under the guidance of this Chief Restructuring Officer, Napier's strategies were re-thought which resulted in operating costs being mitigated and distribution channels rationalized. The results of this effort attracted several new investor prospects to the Company. On July 14, 2005, one such investor group, which is a successful player in other sectors of the coatings industry, took a financial interest in and has recapitalized Napier. While it will take some time to restore Napier's sales and profits, management sees a clear strategy for success evolving. Management expects that this strategy will leverage Napier's technology and the investor group's distribution model, in order to reshape the Company and to posture it for future growth and prosperity.

Historically, Napier's practice has been to market and distribute products exclusively through an extensive network of in-house and external sales representatives selling direct to individual paint and hardware companies. To optimize Napier's distribution channel strategy, the Company has broadened this network to partner with manufacturers and distributors of complimentary products with existing extensive distribution networks. This has led to changes in Napier's distribution agreements with national and international paint companies. These companies will market and distribute Napier products and in some instances they will market such products within their own controlled brand.

The new marketing and distribution agreements have given Napier's technology a much wider acceptance in the marketplace and, therefore, should, over time, improve sales. Napier has been successful in branding products for ICI Paints and PPG Industries, Inc., increasing shelf space at such retailers as The Home Depot, Lowe's and Wal*Mart.

Results of Operations

The financial results for the year ended December 31, 2004 reflect the impact of the Company's strategic positioning and transition. Private label business grew by 80% and International sales grew by 26%. Overall, sales expectations were not met and sales declined by 4.0%. From a strategic perspective, a rationalization of the customer base was required, but the resulting sales shortfall was not accounted for in the Company's initial sales planning. To some degree, the sales expectation shortfall was also due to weak execution. Risks beyond the Company's control such as weather and economic factors, including a weakening in the US dollar, also contributed to the Company's reduced sales. Further, certain large customers of the Company reorganized and for a time did not place orders for the Company's products as they focused solely on their own products, while others simply sold less than expected.

By the end of the third quarter, the Company did not have sufficient working capital to meet its obligations as they became due resulting in the Company filing a Notice of Intention to File a Proposal subject to the Bankruptcy and Insolvency Act on November 3, 2004.

Sales

Sales in 2004 decreased by $0.3 million (2003 - $1.1 million) or 4% (2003 – 14%) to $6.7 million in 2004.

Geographically, 2004 sales in the US and Internationally remained at the same level as in 2003 and domestic sales dropped by 10.5%. Consumer and industrial sales declined by 5.1% and 2.8%, respectively.

Gross Profit

Gross margins declined to 36% compared to 39% in the previous year due to product mix and a write down of obsolete inventory. Consistent with the reduced sales level, gross profit was $0.4 million (2003 - $0.6 million) or 13% (2003 – 18%) lower than the 2003 level of $2.7 million.

Selling and Marketing Expenses

Selling and marketing expenses at $2.2 million were reduced from $2.5 million in 2003. Salaries and wages expense were reduced by $0.3 million or 28%, and travel and entertainment expenses were reduced by $0.1 million or 24%. Increases in expenses were for consulting and other fees related to the Company's continuing launch of a new retail line of Removall products. Bad debt expense increased from a recovery of $0.1 million in 2003 to an expense of $0.1 million in 2004.

General and Administrative Expenses

General and administrative expenses in 2004 increased by $0.7 million primarily due to increased expenses for consulting, financing and professional fees pursuant to the restructuring initiative undertaken by the Company in the second half of 2004. The item that affected this increase the most was financing costs that rose from $0.2 million to $0.5 million primarily due to the increased costs pursuant to the loans and the accretion of the interest with respect to the convertible debentures.

Other Items

Other items were taken from a net expense of $0.2 million to a net income of $0.1 million. This reversal from expense to income was primarily generated from the sale of a formula for a non-strategic product for proceeds of $166,250.

Net Loss

The Company's net loss for the year was $2.3 million as compared to a net loss of $1.8 million in 2003. The increased loss is primarily attributable to the significant initiative to restructure the Company.

Selected Financial Information

The following table sets forth selected consolidated financial information for each of the three most recently completed years ended December 31, 2004 (audited; in millions of dollars, except the loss per share figures). It has been prepared in accordance with Canadian generally accepted accounting principles and should be read in conjunction with the audited consolidated financial statements of the Company, the notes thereto and the Auditors' Report thereon for the years ended December 31, 2004, 2003 and 2002, respectively.

	December 31		
	2004	**2003**	**2002**
Sales…………………………………...................	6.7	7.0	8.1
Gross profit……………………………................	2.4	2.7	3.3
Operating loss……………………………………….	(2.4)	(1.6)	(1.0)
Net loss……………………………………………….	(2.3)	(1.8)	(1.2)
Loss per share, basic and fully-diluted………………….	(0.05)	(0.04)	(0.03)
Total assets…………………………………………	1.9	2.7	3.6
Long-term financial liabilities………………………	0.0	0.4	0.1

Summary of Quarterly Results

The following table sets forth selected consolidated financial information for each of the eight most recently completed quarters ended December 31, 2004 (unaudited; in millions of dollars, except the earnings (loss) per share figures):

	2004				2003			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Sales…………………………………..	1.6	2.6	1.7	0.8	1.5	2.6	1.8	1.0
Operating income (loss)……………..	(0.4)	(0.1)	(0.6)	(1.4)	(0.3)	0.1	(0.5)	(0.8)
Net income (loss) for the period…….	(0.2)	(0.1)	(0.7)	(1.2)	(0.4)	0.0	(0.6)	(0.9)
Earnings (loss) per share, basic and fully-diluted…………	(0.01)	0.00	(0.01)	(0.03)	(0.01)	0.00	(0.01)	(0.02)

Fourth quarter sales were down by $0.3 million to $0.8 million being the poorest quarter within the fiscal period; however, consistent with historic Company trends and industry expectations. Year over year sales declined in the fourth quarter by 27% reflecting the effect of the restructuring process that commenced in the quarter. Net income declined by $0.3 million which reflects the poor sales results and restructuring costs during the quarter that the Company did not encounter in 2003.

Critical Accounting Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates and assumptions are developed based on the best available information and are believed by management to be reasonable under the existing circumstances. New events or additional information may result in the revision of these estimates over time. The Company's significant accounting policies are described in Note 2 of the financial statements. The following discussion outlines what management believes to be the most critical accounting policies involving the use of significant estimates and assumptions.

Accounts Receivable, Allowance for Doubtful Accounts and Product Returns

The allowance for doubtful accounts is based on historical trends. The Company regularly reviews the age of the accounts receivable in detail by customer and follows up delinquent accounts directly with the customer. Based on discussions with the customer, independent credit rating reports and past collection history, the Company will estimate an appropriate allowance for doubtful accounts. A significant portion of sales is to a number of large customers with higher quality credit. This subjects the Company to a greater exposure to any one particular customer. If the estimate of the allowance is understated, this could result in a charge to earnings in the future, should the account ultimately not be collectable. Over the past two years, bad debt expense as a percentage of sales were 1.5% in 2004 and a recovery of 1.6% in 2003. The allowance for doubtful accounts at the end of the year is $111,000 or 1.7% of sales.

The provision for product returns is estimated based on historic experience for particular products and customers taking into account among other things, obsolescence, age and demand. During 2004 product returns have represented about 1.2% of sales. The products return provision at the end of the year is 1.2% of sales. The product return provision at the end of the year takes into account new accounting recommendations described in "Accounting Policy Change" below. If the estimate for product returns is understated, this could result in a charge to future earnings should the actual experience for returns be greater than estimated.

Property, Plant and Equipment/Depreciation and Amortization

The estimated useful lives of assets are determined based on historical experience for comparable assets, technological obsolescence and asset utilization. If the Company's estimated useful lives of assets were incorrect, the Company could experience increased or decreased charges to depreciation and amortization in the future.

Income Taxes

The Company follows the liability method of accounting for income taxes whereby future income taxes are recognized based on the differences between the carrying amounts of assets and liabilities reported in the financial statements and their respective tax bases. Future income tax assets are comprised of temporary differences between the carrying amount and the tax basis of assets and liabilities as well as tax losses carried forward. In valuing the future income tax assets, consideration is given to the timing of reversal of the temporary differences, the tax rate enacted for the reversal period and the results of future operations. The value of future tax assets is based on the likelihood of realization of future taxable income against which the tax losses can be applied. Based on the Company's loss history management does not have, at this time, reasonable assurance of sufficient taxable income and a valuation allowance has been made equal to the full value to the future income tax assets.

The determination of the income tax assets and liabilities is an inherently complex process requiring management to interpret continually changing regulations and to make certain judgments. While income tax filings are subject to audits and reassessments, management believes the tax assets have been adequately provided. However, changes in the interpretations or judgments may result in increase or decrease in the Company's future income tax asset.

Accounting Policy Change

Revenue Recognition

The Company follows the new accounting recommendations for revenue recognition. Under the new guidelines reasonable assurance regarding the measurement of the consideration for the sale of goods must exist. This measurement is to take into account the extent to which goods may be returned or sales may be cancelled. If a contract is cancelable, the sales price can only be determined and therefore revenue can be recognized at the time the cancellation expires. If the sales transaction allows product to be returned then there can be no assurance that the sales consideration is fixed and therefore the revenue should not be recorded. At the time of the sale, management is therefore required to provide an estimate for the value of future returns. The Company has recorded an allowance for product returns as outlined above.

Liquidity and Capital Resources

As of December 31, 2004, the Company's working capital was approximately negative $2.3 million.

Subsequent to the year-end, on July 14, 2005, the Company completed a financing arrangement with a private equity group in the principal amount of $5.0 million, $3.0 million of which was used to eliminate all debt and liabilities of the Company. The balance of $2.0 million is available for working capital purposes. A portion of the loans consist of $1.5 million of term debt due over five years and immediately removes the negative working capital that has plagued Napier for years. As a condition to this financing, this private equity group has been provided with representation on the Company's board of directors through two of its nominees.

Initiatives and Progress

Optimize Distribution Channels and Target Market Sectors

After an extensive review of the Company's regional distributors and representatives across North America and Europe, Napier took steps to eliminate under-performers and identify more effective representation. To that end, Napier has agreements with a number of regional distributors in the United

States. These partnerships brought sales success in 2004 and management expects their sales to continue to grow in 2005.

Build the Team

As the Company grows and implements strategic initiatives, its plans and strategies are increasingly geared to growth in specific markets and targeted customers. This change required not only a change in strategic thinking but also a change in culture, including clear objectives and goals coupled with well-defined responsibilities and accountabilities. During 2004, Napier continued to assemble a team that embraced this new culture and is eager to move the Company forward.

Management Outlook

A new management team, with prior experience in the paint coatings industry, took control of the Company in July 2005. This group has experience with a wide variety of Napier's current customers and distribution channels. Furthermore, it is the view of the new management team that the Napier products can be more widely distributed with added support in sales and marketing. The previous focus had been largely driven by financial constraints. These former constraints have caused Napier to abandon some mature and consistent business. The entrepreneurial approach that will be employed by this new management will leverage many years of experience in the coatings industry, from contacts at the various major paint companies and retailers, to retail sales and marketing experience in coatings and consumer products. These appear to have been one of the major ingredients missing in the past.

The money that has been injected into Napier is from senior management of the Company and not from a third party. This commitment is a show of support to the shareholders that there is a strong belief that Napier has value and much to offer their stakeholders. This type of commitment should be positive for investors and others that are considering Napier as a long-term investment.

In specific markets, Napier products are known as an effective and safe means to strip asbestos and lead paint and are receiving enquiries from major US contractors. Napier's products and technology have been featured on "This Old House" several times in the last number of months.

Napier does not plan to exit existing business. Having said this, it is likely that Napier will identify non-core products within the current and planned distribution channels, and consider licensing its unique technology that will provide revenue streams that have already been burdened by development and marketing costs. These initiatives should improve the overall margins of the Company. Napier is not aware of any planned significant reorganization by key customers. However, experience tells management that there will be hurdles or obstacles and usual business risks to overcome in 2005. The most important is to ensure that the Company has sufficient working capital to meet its operating needs. If the Company achieves its sales targets, this new financing should be adequate to enable Napier to gradually build the foundation to start generating positive net income.

In 2005, an initiative is being implemented to reduce operating costs within all areas of the business.

Governance and Management

On July 14, 2005, Steve Balmer was appointed as President of the Company and Anthony Traub was appointed as Secretary of the Company. These gentlemen have a 34-year cumulative experience in the coatings industry and, in addition to their general operational management, they possess specific expertise in sales and marketing, and finance. Management feels that the synergies with their existing businesses in this industry should positively impact Napier's success in the future.

Financial Management

Once again, to the extent that the Company is able, it has factored a stronger Canadian dollar into pricing for US customers.

The Company's adequacy of working capital is a key to its success. The Company now has adequate working capital to grow its business.

Risk Factors

Management believes that the strong customer relationships in place form a foundation for sales, however, risks inherent to the business as outlined below could result in sales shortfalls. The Company will continue to monitor the sales and working capital level and when appropriate, consider alternative methods of financing, including other forms of structured financing and equity. In light of the changing financial markets, there can be no assurance that these forms of funding will be possible at times required or desired by the Company. Management continually addresses such business risks in a methodical and rational manner.

Other significant risks and uncertainties that face the Company are common to other manufacturers operating in an international economy in the industrial and consumer sectors. The Company must deal with business risks associated with product infringement, technological change, increased market penetration into established supply lines, locating and penetrating new markets, foreign currency fluctuations, unavailable raw materials, and economic conditions affecting large or potential customers and suppliers, to name a few of the normal but significant factors affecting the Company's day to day business. To minimize some of these risks going forward, the Company continues to nurture its relationships with key customers and suppliers. Open, honest and straightforward communication has retained their loyalty and continued commitment to Napier.

Napier's business is seasonal with the first and last quarters delivering a lower level of sales than the second and third. Efforts to offset this seasonality are underway by targeting less seasonal businesses, such as the consumer "Removall Line", and export sales south of the equator, which would allow the Company to take advantage of peak seasons opposite to those north of the equator. Management expects that the results for 2005 will continue to reflect this seasonality although to a lesser extent.

Subsequent to year-end, on July 14, 2005, the Company settled its secured, preferred and unsecured debt obligations. While the reduction of its unsecured debt obligations and additional financing should assist the Company in the future, the Company's continued existence is dependent upon its ability to restore and maintain profitable operations and to receive continued support from its lenders.

Cautionary Note Regarding Forward-Looking Statements

This MD&A contains "forward-looking statements" within the meaning of the United States Private Securities Litigation Reform Act of 1995. In certain cases, forward-looking statements can be identified by the use of words such as "plans", "expects" or "does not expect", "is expected", "budget", "scheduled", "estimates", "forecasts", "intends", "anticipates" or "does not anticipate", or "believes", or variations of such words and phrases or state that certain actions, events or results "may", "could", "would", "might" or "will be taken", "occur" or "be achieved". Forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. Such factors include, among others, risks related to the going concern status of the Company, historical losses and cash flows, the future need for capital and the uncertainty of additional financing, the current cease trade orders, the possible de-listing from the Toronto Stock Exchange, dilution to shareholders, the volatility of the market price of the common shares, dividend policy, competition, dependence on key personnel, dependence on key customers, weather, seasonality and economic cycles, raw materials, the retail industry, exchange rate fluctuations and conflicts of interest. For further details regarding such risk factors, see the section entitled "Description of the Business — Risk Factors" in the Company's annual information form dated August 26, 2005 and filed with the British Columbia and Ontario securities commissions and the Toronto Stock Exchange which can be found on SEDAR at www.sedar.com. Although the Company has attempted to identify important factors that could cause actual actions, events or results to differ materially from those described in forward-looking statements, there may be other factors that cause actions, events or results not to be as anticipated, estimated or intended. There can be no assurance that forward-looking statements will prove to be accurate, as actual results and future events could differ materially from those anticipated in such statements. Accordingly, readers should not place undue reliance on forward-looking statements.

Outstanding Share Data

There are currently 47,768,042 common shares (the "**Common Shares**") of the Company issued and outstanding. In addition, there are currently outstanding options to purchase up to 1,184,000 Common Shares and warrants to purchase up to 2,917,120 Common Shares.

Additional Information

Additional information relating to the Company can be found on SEDAR at www.sedar.com.

This MD&A has been prepared by management and reviewed by the Company's Board of Directors.

"Steve Balmer"
Steve Balmer
President
August 16, 2005 (as amended August 26, 2005)