



**MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE SIX MONTHS ENDED JUNE 30, 2005**

This Management's Discussion and Analysis ("MD&A") of Napier Environmental Technologies Inc. (the "Company" or "Napier") should be read in conjunction with the unaudited consolidated financial statements of the Company and the notes thereto for the six months ended June 30, 2005.

Results of Operations

Sales for the first six months of 2005 were \$2.9 million, down \$1.3 million compared to the first six months of 2004. The sales decrease was primarily in the industrial sector of the business, down \$1.1 million from the same period last year. This significant reduction in sales was the result of the restructuring initiative undertaken by the Company. The majority of the reduction in sales was caused by the discontinuation of products with low margins, change in freight terms to the customers, reduction in the number of approved customers and the elimination of any financial terms previously accorded to customers.

Gross margin increased from 41.6% in 2004 to 43.8% in 2005. The increase in gross margin was achieved primarily through the product mix that was offered during the first six months of 2005.

In addition to increasing margins, overall expenses were reduced dramatically. Selling and marketing expenses were reduced from \$1.3 million to \$0.3 million; primarily driven by a reduction in sales, travel and consulting. General and administrative and research and product development expenses remained constant at \$0.9 million. Collectively, expenses were reduced from \$2.4 million to \$1.4 million from the same period in 2004.

Despite increased margins and reduced costs, a net loss of \$0.2 million was realized for the first six months of 2005; however, this is an improvement over a net loss of \$0.4 million for the same period in 2004.

Summary of Quarterly Results

The following table sets forth selected consolidated financial information for each of the eight most recently completed quarters ended June 30, 2005 (unaudited; in millions of dollars, except the earnings (loss) per share figures):

	<u>2005</u>		<u>2004</u>				<u>2003</u>	
	<u>Q1</u>	<u>Q2</u>	<u>Q1</u>	<u>Q2</u>	<u>Q3</u>	<u>Q4</u>	<u>Q3</u>	<u>Q4</u>
Sales.....	1.6	1.2	1.6	2.6	1.7	0.8	1.8	1.0
Operating income (loss).....	0.1	(0.2)	(0.4)	(0.1)	(0.6)	(1.4)	(0.5)	(0.8)
Net income (loss) for the period.....	0.1	(0.3)	(0.2)	(0.1)	(0.7)	(1.2)	(0.6)	(0.9)
Earnings (loss) per share, basic and fully-diluted.....	0.00	(0.01)	(0.01)	0.00	(0.01)	(0.03)	(0.01)	(0.02)

The quarterly sales results have been significantly reduced due to an intentional effort to reduce the number of customers and products during this period of reorganization by the Company.

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.

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. The product return provision at the end of the period 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

Cash remained constant at \$0.1 million while accounts receivable increased from \$0.4 million at the end of the last quarter of 2004 to \$1.0 million at the end of the second quarter of 2005.

The credit facility available to Napier was always kept current with the lender and enabled Napier to finance sales and add liquidity to its working capital to maintain the business.

Capital expenditures were curtailed to preserve cash and improve the working capital position of Napier.

In an effort to support the turnaround to profitability, Napier continued to search for financing opportunities, strategic partners or other methods of stabilizing the capital requirements of the Company.

On July 14, 2005, subsequent to June 30, 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.

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 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 during the remainder of 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.

Napier continues to focus its efforts on the distribution of its core products to the industrial and consumer markets. These sales initiatives, together with cost controls, are the key to maximizing shareholder value, which is the mandate of management.

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.

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. Management expects that the results for the remainder of 2005 will continue to reflect this seasonality.

On July 14, 2005, subsequent to the end of this second quarter, 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 26, 2005