

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
FOR THE THREE AND NINE MONTH PERIOD ENDED SEPTEMBER 30, 2008**

November 18, 2008 / *The following Discussion and Analysis should be read in conjunction with the unaudited interim consolidated financial statements and related notes for the three and nine months ended September 30, 2008, and the audited consolidated financial statements for the year ended December 31, 2007, the accompanying notes, and management's discussion and analysis for the year then ended. The unaudited interim financial statements for the three and nine months ended September 30, 2008 and the audited consolidated financial statements for the year ended December 31, 2007 have been prepared in accordance with Canadian generally accepted accounting principles. Additional information about Napier Environmental Technologies Inc. ("Napier" or the "Company"), including Napier's Annual Information Form, dated March 25, 2008, is available on the System for Electronic Document Analysis and Retrieval ("SEDAR") at [www.sedar.com](http://www.sedar.com). All dollar amounts, unless otherwise specified, are expressed in Canadian dollars. This MD&A has been prepared by management and reviewed by Napier's Board of Directors.*

**Results of Operations**

Overview

For the nine months ended September 30, 2008 we recorded a net income of \$3,241,265 (\$0.02 per common share) as compared to a net loss of \$1,065,203 (\$0.01 per common share) for the same period in 2007. For the three months ended September 30, 2008, we recorded a net income of \$3,891,106 (\$0.03 per common share) as compared to net loss of \$478,349 (\$0.00 per common share) for the same period in 2007.

The increased net income in the three months ended September 30, 2008 is primarily due to the proceeds of \$5,150,000 from the sale of intellectual property ("IP") to Freeworld Coatings Global (JSE: FWD) ("Freeworld") together with an option granting Freeworld the rights to the North American sales, marketing and manufacturing operations of Napier. Of these proceeds, \$4,650,000 has been received and the balance of \$500,000 is being held in escrow, to be released over the next two years.

Should Freeworld exercise its option to proceed with the operations within North America, Napier will receive further proceeds for inventory, machinery and goodwill for certain customers outside of North America. If Freeworld does not exercise its option with respect to the North American sales, marketing and manufacturing operations of Napier, the IP for North America will be transferred back to Napier in return for a refund of the deposit of \$100,000 to Freeworld.

Sales

Sales for the three months ended September 30, 2008 were \$642,600 compared to \$720,823 for the same period in 2007. Sales for the nine months ended September 30, 2008 were \$1,786,380 compared to \$2,381,643 for the same period in 2007. The decrease in sales of \$78,223 and \$595,263 for the respective three and nine month periods ended September 30, 2008 resulted from the combination of a number of factors varying from external forces such as foreign exchange, weather and a downturn in the US economy. It is important to note that despite a decrease in overall sales, we earned royalty revenue during the year which has no associated costs.

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### Cost of Sales

Cost of sales for the three month period ended September 30, 2008 was \$507,055 (78.9% of sales) compared to \$646,556 (89.7% of sales) for the same period in 2007. Cost of sales for the nine month period ended September 30, 2008 was \$1,576,660 (88.3% of sales) compared to \$1,904,485 (80.0% of sales) for the same period in 2007. The decrease in cost of sales of 17.2% for the nine month periods ended September 30, 2008 is consistent with the corresponding decrease in sales during the period of 25.0%. The decreased level of production requires a higher absorption of fixed costs resulting in a lower gross margin percentage.

### Expenses

General and administrative expenses increased to \$1,284,513 for the three months ended September 30, 2008 as compared to \$205,602 for the same period in 2007, an increase of \$1,078,911. For the nine months ended September 30, 2008, general and administrative expenses increased to \$1,735,044 from \$663,482 for the comparative period in 2007, an increase of \$1,071,562. The increase in costs for the nine month period is primarily attributable to the bonus accrual related to the compensation agreement and legal fees related to the sale of intellectual property.

Selling expenses for the three months and nine months ended September 30, 2008 were \$72,261 and \$221,717 as compared to \$205,405 and \$601,206 for the same periods in 2007. The decrease of \$133,144 for the three month period ended September 30, 2008 and \$379,489 for the nine month period ended September 30, 2008 is a result of an overall reduction of expenses within the sales and marketing area.

Interest and finance costs decreased from \$101,507 to \$85,051 for the three months ended September 30, 2008 as compared to the same period in 2007. The decrease of \$16,456 is entirely attributable to the decrease in interest rates, loan advances and average outstanding balances over the comparative period.

Research and development costs for the three months ended September 30, 2008 were \$29,173 as compared to \$36,812 for the same period in 2007 and \$117,607 for the nine months ended September 30, 2008 as compared to \$112,629 for the same period in 2007. While reducing costs where possible, our emphasis on research and development has remained a priority. Research and development costs are important to maintaining product quality and integrity.

### Summary of Quarterly Results

The following table sets forth selected consolidated financial information for each of our last eight quarters. The table has been derived from our unaudited interim consolidated financial statements for those periods and is stated in thousands of dollars except for the earnings (loss) per share figures. These results are not necessarily indicative of results for future periods and should not be used or relied upon to predict our future performance.

(in thousands \$ except per share data)

|   | Sept 30<br>2008 | June 30<br>2008 | March 31<br>2008 | Dec 31<br>2007 | Sept 30<br>2007 | June 30<br>2007 | March 31<br>2007 | Dec 31<br>2006 |
|---|-----------------|-----------------|------------------|----------------|-----------------|-----------------|------------------|----------------|
| Sales   | 643             | 746             | 398              | 177            | 721             | 1,183           | 477              | 321            |
| Operating income (loss) before<br>other items | (1,335)         | (486)           | (336)            | (633)          | (475)           | (216)           | (503)            | (552)          |
| Net income (loss)                             | 3,891           | (348)           | (302)            | (757)          | (478)           | (88)            | (499)            | (540)          |
| Earnings (loss) per share,<br>Basic           | 0.030           | (0.003)         | (0.002)          | (0.006)        | (0.004)         | (0.001)         | (0.005)          | (0.005)        |
| Fully diluted                                 | 0.030           | (0.003)         | (0.002)          | (0.006)        | (0.004)         | (0.001)         | (0.005)          | (0.005)        |

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### **Liquidity and Capital Resources**

At September 30, 2008, our cash on hand was \$143,094 as compared to \$4,413 at December 31, 2007.

At September 30, 2008, we had accounts receivable of \$422,680 as compared to \$240,990 at December 31, 2007. The increase is the result of the cyclical nature of our business, with increasing sales peaking in the summer months.

### **Transactions with Related Parties**

We have entered into a management services agreement (the "Management Services Agreement") and a sublease (the "Sublease") with I.C.T.C. Holdings Corporation ("I.C.T.C."), a company that is controlled by Anthony Traub, Napier's Chairman, CFO and Secretary, and Steve Balmer, Napier's President and Chief Operating Officer.

Pursuant to the Management Services Agreement, effective September 1, 2005, we reimburse or charge I.C.T.C. for certain costs incurred. We pay or receive a variable monthly amount under this agreement based on the actual costs incurred. For the three and nine months ended September 30, 2008, Napier experienced a recovery through this agreement for services performed for I.C.T.C. in the amount of \$15,837 and \$50,010 respectively (2007 charge: \$39,510 and \$130,997) for services under this agreement.

The Company has subleased half of its leased premises to I.C.T.C. at 720 Eaton Way, Delta, British Columbia. The Sublease commenced on November 1, 2005 and is based on half of the financial exposure of Napier under its lease commitment. The sublease is in effect until the end of Napier's lease commitment with its landlord, January 31, 2010.

Effective July 1, 2006 the Company's chairman accepted a revised compensation agreement resulting in nominal annual compensation in return for a bonus based on the net income of the Company. This bonus is cumulative and payable at the lesser of 75% of net income or the cumulative bonus entitlement. To the extent that the bonus is not paid on an annual basis, an additional 15% will be added to it and compounded annually. During the three months ended September 30, 2008, the Company earned net income and accordingly became obligated to this bonus in the amount of \$952,876. This amount has been accrued in these financial statements; however, remains unpaid.

Anthony Traub controls 6408753 Canada Corporation and Steve Balmer controls 6408788 Canada Corp., the companies that have collectively completed two separate financing transactions consisting of term loans totaling \$1,500,000 and revolving loans up to the aggregate amount of \$3,500,000. Total interest charged by these companies in respect of these loans during the three and nine months ended September 30, 2008 was \$85,051 and \$293,035 respectively (2007: \$101,507 and \$292,733).

### **Outstanding Share Data**

There are currently 129,921,742 common shares (the "**Common Shares**") of Napier issued and outstanding. In addition, there are currently options outstanding to purchase 2,013,000 Common Shares at prices between \$0.04 and \$0.15 per share, expiring between February 2, 2009 and May 31, 2012.

### **Critical Accounting Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles requires that we 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 to be reasonable under the existing circumstances. New events or additional information may result in the revision of these estimates over time. Significant accounting policies are described in Note 3 of the annual audited financial statements. The following discussion outlines what we believe 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. We regularly review the age of the accounts receivable in detail by customer and follow up on delinquent accounts directly with the customer. Based on discussions with the customer, independent credit reports and past collection history, we 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 Napier 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 with comparable assets, technological obsolescence and asset utilization. If our estimates of useful lives of assets are incorrect, we could experience increased or decreased charges to depreciation and amortization in the future.

#### *Income Taxes*

We follow 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 basis. 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.

The determination of the income tax assets and liabilities is an inherently complex process requiring the interpretation of continually changing regulations and making certain judgments. While income tax filings are subject to audits and reassessments, we believe the tax assets have been adequately provided. However, changes in the interpretations or judgments may result in increases or decreases to Napier's future income tax asset.

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Based on our loss history, we do not have, at this time, reasonable assurance of sufficient taxable income and a valuation allowance has been made equal to the full value of the future income tax assets.

### **Risk Factors**

Significant risks and uncertainties that face our business are common to other manufacturers operating in an international economy in the industrial and consumer sectors. We 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 our day to day operations. To minimize some of these risks going forward, we continue to nurture relationships with key customers and suppliers. Open, honest and straightforward communication has retained their loyalty and continued commitment to Napier. Our business is seasonal with the third and fourth quarters delivering a lower level of sales than the first and second quarters. Efforts to offset this seasonality are underway by targeting less seasonal businesses. On July 14, 2005, we successfully renegotiated Napier's unsecured debt obligations. While the reduction of its unsecured debt obligations and additional financing should assist us in the future, our continued existence is dependent upon Napier's ability to restore and maintain profitable operations and to receive continued support from our lenders.

Our risk factors are discussed in detail in the "Management's Discussion and Analysis" section of our 2007 annual financial statements and in our Annual Information Form dated March 25, 2008 and remain substantially unchanged. Both of these documents are available at [www.sedar.com](http://www.sedar.com).

### **Cautionary Note Regarding Forward-Looking Statements**

This MD&A contains forward looking statements that are subject to a number of known and unknown risks, uncertainties and other factors that may cause actual results to differ materially from those anticipated in Napier's forward-looking statements. Such factors include, among others, Freeworld decide that they are not able to use the IP, make no further payments and forfeit the IP, risks related to future sales, the going concern status of Napier, historical losses and cash flow, the future need for capital and uncertainty of additional financing being available, the potential dilution to shareholders, the historical lack of dividend payments, competition, dependence on key personnel, dependence on key customers, weather, seasonality and economic cycles, the availability of raw materials, the retail industry and the influence of economic conditions and consumer behavior, 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 Napier's annual information form dated March 25, 2008 and filed with the British Columbia and Ontario securities commissions which can be found on SEDAR at [www.sedar.com](http://www.sedar.com). Although Napier has attempted to identify important factors that could cause actual 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.

*"Steve Balmer"*

Steve Balmer  
President and Chief Operating Officer  
November 18, 2008