Velan Inc.

Unaudited Condensed Interim Consolidated Financial Statements

For the three-month and nine-month periods ended November 30, 2014

Velan Inc.

Condensed Interim Consolidated Statements of Financial Position

(Unaudited)
(in thousands of U.S. dollars)

As At	November 30, 2014 $	February 28, 2014 $
Assets		
Current assets		
Cash and cash equivalents	89,430	106,716
Short-term investments	318	239
Accounts receivable	123,352	128,978
Income taxes recoverable	10,519	5,465
Inventories (note 7)	208,331	224,149
Deposits and prepaid expenses	5,480	5,046
Derivative assets	94	498
	437,524	471,091
Non-current assets		
Property, plant and equipment	94,056	96,605
Intangible assets and goodwill	37,823	43,359
Deferred income taxes	10,331	11,406
Other assets	1,224	1,693
	143,434	153,063
Total assets	580,958	624,154
Liabilities		
Current liabilities		
Bank indebtedness	15,360	31,876
Short-term bank loans	1,783	916
Accounts payable and accrued liabilities	76,708	76,590
Income taxes payable	7,055	4,158
Dividend payable	1,918	1,586
Customer deposits	46,620	66,842
Provisions	9,326	8,060
Accrual for performance guarantees	31,977	33,842
Derivative liabilities	2,461	1,501
Current portion of long-term debt	9,708	10,402
	202,916	235,773
Non-current liabilities		
Long-term debt	7,123	11,685
Deferred income taxes	8,327	9,270
Other liabilities	8,105	8,307
	23,555	29,262
Total liabilities	226,471	265,035
Equity		
Equity attributable to the Subordinate and Multiple Voting shareholders		
Share capital (note 8)	76,486	76,688
Contributed surplus	6,054	6,099
Retained earnings	280,760	272,867
Accumulated other comprehensive income (loss)	(16,306)	(3,589)
	346,994	352,065
Non-controlling interest	7,493	7,054
Total equity	354,487	359,119
Total liabilities and equity	580,958	624,154

Commitments and contingencies (note 9)

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

Velan Inc.

Condensed Interim Consolidated Statements of Income (Loss)

(Unaudited)

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

	Three-month periods ended November 30		Nine-month periods ended November 30	
	2014 **$**	**2013** **$**	**2014** **$**	**2013** **$**
Sales	127,290	115,611	341,243	368,541
Cost of sales (note 7)	93,807	81,863	252,022	274,037
Gross profit	33,483	33,748	89,221	94,504
Administration costs	25,244	21,901	68,021	64,998
Other expense (income)	180	33	(36)	1,047
Operating profit (loss)	8,059	11,814	21,236	28,459
Finance income	264	244	780	603
Finance costs	638	531	1,270	1,687
Finance income (costs) – net	(374)	(287)	(490)	(1,084)
Income (Loss) before income taxes	7,685	11,527	20,746	27,375
Provision for (Recovery of) income taxes	2,521	2,688	6,101	7,026
Net income (loss) for the period	5,164	8,839	14,645	20,349
Net income (loss) attributable to:				
Subordinate Voting Shares and Multiple Voting Shares	**4,759**	**8,319**	**13,862**	**19,008**
Non-controlling interest	405	520	783	1,341
	5,164	8,839	14,645	20,349
Net income (loss) per Subordinate and Multiple Voting Share				
Basic	0.22	0.38	0.63	0.87
Diluted	0.22	0.38	0.63	0.87
Dividends declared per Subordinate and Multiple Voting Share	0.09 (CA$0.10)	0.07 (CA$0.08)	0.27 (CA$0.30)	0.23 (CA$0.24)
Total weighted average number of Subordinate and Multiple Voting Shares				
Basic	21,947,758	21,941,076	21,947,758	21,929,494
Diluted	21,961,072	21,941,076	21,959,439	21,929,494

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

Velan Inc.

Condensed Interim Consolidated Statements of Comprehensive Income (Loss)

(Unaudited)
(in thousands of U.S. dollars)

	Three-month periods ended November 30		Nine-month periods ended November 30	
	2014	**2013**	**2014**	**2013**
	$	**$**	**$**	**$**
Comprehensive income (loss)				
Net income (loss) for the period	5,164	8,839	14,645	20,349
Other comprehensive income (loss)				
Foreign currency translation adjustment on foreign operations whose functional currency is other than the reporting currency (U.S. dollar)	(8,238)	4,384	(12,975)	5,046
Comprehensive income (loss)	(3,074)	13,223	1,670	25,395
Comprehensive income (loss) attributable to:				
Subordinate Voting Shares and Multiple Voting Shares	(2,950)	12,481	1,145	23,928
Non-controlling interest	(124)	742	525	1,467
	(3,074)	13,223	1,670	25,395

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

Velan Inc.

Condensed Interim Consolidated Statements of Changes in Equity

(Unaudited)

(in thousands of U.S. dollars, excluding number of shares)

	Equity attributable to the Subordinate and Multiple Voting shareholders							
	Number of shares	Share capital	Contributed surplus	Accumulated other comprehensive income (loss)	Retained earnings	Total	Non-controlling interest	Total equity
Balance - February 28, 2014	21,958,768	76,688	6,099	(3,589)	272,867	352,065	7,054	359,119
Net income (loss) for the period	-	-	-	-	13,862	13,862	783	14,645
Other comprehensive income (loss)	-	-	-	(12,717)	-	(12,717)	(258)	(12,975)
	21,958,768	76,688	6,099	(16,306)	286,729	353,210	7,579	360,789
Effect of share-based compensation (note 8 (d))	-	-	6	-	-	6	-	6
Dividends								
Multiple Voting Shares	-	-	-	-	(4,208)	(4,208)	-	(4,208)
Subordinate Voting Shares	-	-	-	-	(1,722)	(1,722)	-	(1,722)
Non-controlling interest	-	-	-	-	-	-	(86)	(86)
Share repurchase (note 8 (c))	(18,600)	(202)	(51)	-	(39)	(292)	-	(292)
Balance - November 30, 2014	21,940,168	76,486	6,054	(16,306)	280,760	346,994	7,493	354,487
Balance - February 28, 2013	21,923,768	76,314	1,746	(8,676)	250,129	319,513	8,660	328,173
Net income (loss) for the period	-	-	-	-	19,008	19,008	1,341	20,349
Other comprehensive income (loss)	-	-	-	4,920	-	4,920	126	5,046
	21,923,768	76,314	1,746	(3,756)	269,137	343,441	10,127	353,568
Effect of share-based compensation (note 8 (d))	-	-	19	-	-	19	-	19
Shares issued under Share Option Plan (note 8 (d))	35,000	374	-	-	-	374	-	374
Dividends								
Multiple Voting Shares	-	-	-	-	(3,617)	(3,617)	-	(3,617)
Subordinate Voting Shares	-	-	-	-	(1,456)	(1,456)	-	(1,456)
Non-controlling interest	-	-	-	-	-	-	(103)	(103)
Acquisition of non-controlling interest	-	-	4,330	(1,137)	-	3,193	(3,193)	-
Balance - November 30, 2013	21,958,768	76,688	6,095	(4,893)	264,064	341,954	6,831	348,785

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

Velan Inc.

Condensed Interim Consolidated Statements of Cash Flow

(Unaudited)
(in thousands of U.S. dollars)

	Three-month periods ended November 30		Nine-month periods ended November 30	
	2014 **$**	**2013** **$**	**2014** **$**	**2013** **$**
Cash flows from				
Operating activities				
Net income for the period	5,164	8,839	14,645	20,349
Adjustments to reconcile net income to cash provided by operating activities (note 10)	6,125	2,580	13,511	10,831
Changes in non-cash working capital items (note 11)	(3,231)	27,210	(3,447)	30,894
Cash provided (used) by operating activities	8,058	38,629	24,709	62,074
Investing activities				
Short-term investments	490	455	(79)	(1,778)
Additions to property, plant and equipment	(4,543)	(6,493)	(10,263)	(14,691)
Additions to intangible assets	(107)	(60)	(400)	(265)
Proceeds on disposal of property, plant and equipment, and intangible assets	32	-	160	87
Net change in other assets	288	(81)	455	(9)
Cash provided (used) by investing activities	(3,840)	(6,179)	(10,127)	(16,656)
Financing activities				
Dividends paid to Subordinate and Multiple Voting shareholders	(1,978)	(1,700)	(5,598)	(5,122)
Dividends paid to non-controlling interest	(86)	(103)	(86)	(103)
Shares issued under Share Option Plan (note 8 (d))	-	374	-	374
Repurchase of shares (note 8(c))	(16)	-	(292)	-
Payment of proceeds payable	-	-	-	(1,960)
Short-term bank loans	296	(28)	867	(1,029)
Increase in long-term debt	-	-	-	2,654
Repayment of long-term debt	(1,468)	(1,740)	(4,867)	(6,583)
Cash provided (used) by financing activities	(3,252)	(3,197)	(9,976)	(11,769)
Effect of exchange rate differences on cash	(2,275)	1,691	(5,376)	2,656
Net change in cash during the period	(1,309)	30,944	(770)	36,305
Net cash – Beginning of the period	75,379	33,953	74,840	28,592
Net cash – End of the period	74,070	64,897	74,070	64,897
Net cash is composed of:				
Cash and cash equivalents	89,430	103,467	89,430	103,467
Bank indebtedness	(15,360)	(38,570)	(15,360)	(38,570)
	74,070	64,897	74,070	64,897
Supplementary information				
Interest received (paid)	(35)	(147)	(101)	(733)
Income taxes reimbursed (paid)	(2,717)	(1,676)	(5,403)	(2,473)

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

For the three-month and nine-month periods ended November 30, 2014

1 General information

These unaudited condensed interim financial statements represent the consolidation of the accounts of Velan Inc. (the "Company") and the entities over which it has control, its subsidiary companies and special purpose entities ("SPEs"). The Company is an international manufacturer of industrial valves and is a public company listed on the Toronto Stock Exchange under the symbol "VLN". It was incorporated under the name Velan Engineering Ltd. on December 12, 1952 and continued under the *Canada Business Corporations Act* on February 11, 1977. It changed its name to Velan Inc. on February 20, 1981. Velan Inc. maintains its registered head office at 7007 Cote de Liesse, Montreal, Quebec, Canada, H4T 1G2. The Company's ultimate parent company is Velan Holdings Co. Ltd.

These unaudited condensed interim consolidated financial statements were approved for issue by the Company's Board of Directors on January 13, 2015. The Company's auditors have not performed a review of these unaudited condensed interim consolidated financial statements.

2 Basis of preparation

These unaudited condensed interim consolidated financial statements for the three-month and nine-month periods ended November 30, 2014 have been prepared in accordance with International Financial Reporting Standards ("IFRS") in accordance with International Accounting Standard ("IAS") 34, *Interim Financial Reporting*. These unaudited condensed interim consolidated financial statements have been prepared using the same basis of presentation, accounting policies, and methods of computation as outlined in Note 2, *Summary of significant accounting policies*, in the Company's annual consolidated financial statements for the year ended February 28, 2014, which have also been prepared in accordance with IFRS. Accordingly, these unaudited condensed interim consolidated financial statements should be read in conjunction with the Company's annual consolidated financial statements for the year ended February 28, 2014.

3 Future accounting changes

Unless otherwise noted, the following revised standards are effective for annual periods beginning on or after January 1, 2015 with earlier application permitted. The Company has not yet assessed the impact of these standards or determined whether it will early adopt them.

(i) IFRS 9, *Financial Instruments*, was issued in November 2009 and addresses classification and measurement of financial assets. It replaces the multiple category and measurement models in IAS 39, *Financial Instruments: Recognition and Measurement*, for debt instruments with a new mixed measurement model having only two categories: amortized cost and fair value through profit or loss. IFRS 9 also replaces the models for measuring equity instruments. Such instruments are either recognized at fair value through profit or loss or at fair value through other comprehensive income. Where equity instruments are measured at fair value through other comprehensive income, dividends are recognized in profit or loss to the extent that they do not clearly represent a return of investment; however, other gains and losses (including impairments) associated with such instruments remain in accumulated other comprehensive income indefinitely.

Requirements for financial liabilities were added to IFRS 9 in October 2010 and they largely carried forward existing requirements in IAS 39, except that fair value changes due to credit risk for liabilities designated at fair value through profit and loss are generally recorded in other comprehensive income.

The above revisions are effective for annual periods beginning on or after January 1, 2018, with earlier application permitted.

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

The above revisions are effective for annual periods beginning on or after January 1, 2017, with earlier application permitted.

4 Estimates

The preparation of interim financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities, income and expense. Actual results may differ from these estimates.

In preparing these unaudited condensed interim consolidated financial statements, the significant judgements made by management in applying the Company's accounting policies and the key sources of estimation uncertainty were the same as those that applied to the annual consolidated financial statements for the year ended February 28, 2014.

5 Seasonality

The Company's sales are not subject to seasonality. Quarterly sales can vary greatly based on the timing of revenue recognition on large project orders.

6 Operating segment information

Consistent with the prior fiscal year, the Company reflects its results under a single reportable operating segment.

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

7 Inventories

	November 30, 2014 $	February 28, 2014 $
Raw materials	53,851	45,130
Work in process and finished parts	114,357	123,848
Finished goods	40,123	55,171
	208,331	224,149

As a result of variations in the ageing of its inventories, the Company recognized an inventory provision for the period of $2,384 (November 30, 2013 – $2,280), net of reversals of $4,544 (November 30, 2013 - $2,624)

8 Capital stock

a) Authorized – in unlimited number
Preferred Shares, issuable in series
Subordinate Voting Shares
Multiple Voting Shares (five votes per share), convertible into Subordinate Voting Shares

b) Issued

	November 30, 2014 $	February 28, 2014 $
6,373,601 Subordinate Voting Shares (February 28, 2014 – 6,392,201) (note 8 (c))	69,360	69,562
15,566,567 Multiple Voting Shares	7,126	7,126
	76,486	76,688

c) Pursuant to its Normal Course Issuer Bid, the Company is entitled to repurchase for cancellation a maximum of 100,000 of the issued Subordinate Voting Shares of the Company, representing approximately 1.57% of the issued shares of such class as at October 9, 2014, during the ensuing 12-month period ending October 21, 2015. During the nine-month period ended November 30, 2014, 18,600 Subordinate Voting Shares were purchased for a cash consideration of $292 and cancelled. During the three-month period ended November 30, 2014, 1,000 Subordinate Voting Shares were purchased for a cash consideration of $16 and cancelled. During the nine-month period ended November 30, 2013, no Subordinate Voting Shares were repurchased. The amount by which the repurchase amount is above the stated capital of the shares has been debited to contributed surplus and retained earnings.

d) The Company established a fixed share option plan (the “Share Option Plan”) in 1996, amended in fiscal 2007, to allow for the purchase of Subordinate Voting Shares by certain of its full-time employees, directors, officers and consultants.

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

The subscription price for Subordinate Voting Shares granted under options is the greater of (i) the weighted average trading price for such Subordinate Voting Shares for the five days preceding the date of grant during which the Subordinate Voting Shares were traded on the Toronto Stock Exchange ("TSX") or (ii) the trading price for the Subordinate Voting Shares on the last day the Subordinate Voting Shares were traded on the TSX immediately preceding the date of grant.

Under the Share Option Plan, the maximum number of Subordinate Voting Shares issuable from time to time is a fixed maximum percentage of 5% of the aggregate of the Multiple Voting Shares and the Subordinate Voting Shares issued and outstanding from time to time.

The granting of options is at the discretion of the Board of Directors which, at the date of grant, establishes the term and vesting period. Vesting of options generally commences 12 months after the date of grant and accrues annually over the vesting period provided there is continuous employment. The maximum term permissible is 10 years.

For the nine-month period ended November 30, 2014, a compensation cost of $6 (November 30, 2013 – $19) was recorded in the consolidated statement of income and credited to contributed surplus. For the three-month period ended November 30, 2014, no compensation cost (November 30, 2013 – $3) was recorded in the consolidated statement of income and credited to contributed surplus.

During the three-month and nine-month periods ended November 30, 2013, 35,000 options were exercised resulting in the issuance of 35,000 Subordinate Voting Shares of the Company for proceeds of $374 which were credited to share capital. No options were exercised in the corresponding periods of the current fiscal year.

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

	Number of shares	**Weighted average exercise price**	**Weighted average contractual life in months**
Outstanding – February 28, 2014	50,000	$12.78 (CA$14.15)	29.0
Exercised	-	-	-
Expired/forfeited	-	-	-
Outstanding – November 30, 2014	50,000	$12.37 (CA$14.15)	20.0
Exercisable – November 30, 2014	50,000	$12.37 (CA$14.15)	

9 Contingent liabilities

Two of the Company's U.S. subsidiaries have been named as defendants in a number of asbestos-related legal proceedings pertaining to products they formerly sold. Management believes it has a strong defence, and the subsidiaries have previously been dismissed from a number of similar cases. Because of the many uncertainties inherent in predicting the outcome of these proceedings, as well as the course of asbestos litigation in the United States, management believes that it is not possible to make an estimate of the subsidiaries' asbestos liability. Accordingly, no provision has been set up in the accounts.

During the nine-month period ended November 30, 2014, legal and related costs for these matters amounted to $4,868 (November 30, 2013 – $3,659). During the three-month period ended November 30, 2014, legal and related costs for these matters amounted to $1,945 (November 30, 2013 – $896).

Lawsuits and proceedings or claims arising from the normal course of operations are pending or threatened against the Company. Although at this time it is not possible to determine the outcome, based on the facts currently known, the Company does not believe that the ultimate outcome will have a material adverse effect on its financial position, results of operations or liquidity. No provision has been set up in the accounts.

Subsequent event

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

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

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

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

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

	Three-month periods ended November 30,		Nine-month periods ended November 30,	
	2014 $	2013 $	2014 $	2013 $
Depreciation of property, plant and equipment	3,487	3,334	10,244	9,237
Amortization of intangible assets	588	627	1,864	1,868
Deferred income taxes	233	(259)	145	(470)
Share-based compensation expense (note 8 (d))	-	3	6	19
Loss (Gain) on disposal of property, plant and equipment	8	30	137	(16)
Interest accretion on proceeds payable	-	-	-	9
Unrealized foreign exchange losses (gains)	-	(276)	-	618
Net change in derivative assets and liabilities	2,265	(1,116)	1,323	(898)
Net change in other liabilities	(456)	237	(208)	464
	6,125	2,580	13,511	10,831

11 Changes in non-cash working capital items

	Three-month periods ended November 30,		Nine-month periods ended November 30,	
	2014 $	2013 $	2014 $	2013 $
Accounts receivable	(8,852)	10,076	5,458	7,451
Inventories	10,223	577	15,344	22,500
Income taxes recoverable	(2,267)	(1,628)	(5,205)	(1,189)
Deposits and prepaid expenses	1,036	365	(447)	(7)
Accounts payable and accrued liabilities	10,809	5,199	114	(5,971)
Income taxes payable	784	1,748	2,810	4,317
Customer deposits	(15,198)	7,961	(20,828)	(2,787)
Provisions	1,799	647	1,228	1,291
Accrual for performance guarantees	(1,565)	2,265	(1,921)	5,289
	(3,231)	27,210	(3,447)	30,894

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

12 Related party transactions and balances

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

	Nine-month periods ended November 30, 2014 $	2013 $
Affiliated company owned by certain relatives of the controlling shareholder		
Purchases – Material components	1,206	1,455
Sales – Material components	67	72
Amounts charged by an affiliated company in which a relative of the controlling shareholder owns a 50% interest		
Computer consulting	12	3
Amount charged by the controlling shareholder to one of the Company's subsidiaries and certain of its executives		
Rent based on weekly usage	27	17
Amount charged by the minority shareholders of the Company's Italian subsidiary, which became a wholly-owned subsidiary on July 16, 2013		
Rent for manufacturing facilities	-	271
Interest expense on shareholder loans payable	-	33
Key management[1] compensation		
Salaries and other short-term benefits	3,186	3,006
Share-based compensation	6	19

	November 30, 2014 $	February 28, 2014 $
Accounts receivable		
Affiliated companies	37	32
Accounts payable and accrued liabilities		
Affiliated companies	116	174
Controlling shareholder	35	21

[1] Key management includes directors (executive and non-executive) and certain senior management.