Velan Inc.

Unaudited Condensed Interim Consolidated Financial Statements
For the three-month and six-month periods ended August 31, 2016

Velan Inc.

Condensed Interim Consolidated Statements of Financial Position

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

As At	August 31, 2016 $	February 29, 2016 $
Assets		
Current assets		
Cash and cash equivalents	89,872	89,368
Short-term investments	1,769	3,225
Accounts receivable	103,107	119,569
Income taxes recoverable	9,116	5,674
Inventories (note 7)	175,860	162,523
Deposits and prepaid expenses	5,012	3,586
Derivative assets	1,279	1,598
	386,015	385,543
Non-current assets		
Property, plant and equipment	94,322	95,257
Intangible assets and goodwill	19,968	20,352
Deferred income taxes	14,486	13,537
Other assets	807	938
	129,583	130,084
Total assets	515,598	515,627
Liabilities		
Current liabilities		
Bank indebtedness	6,996	5,028
Short-term bank loans	1,344	1,319
Accounts payable and accrued liabilities	53,305	62,943
Income taxes payable	4,357	5,746
Dividend payable	1,658	1,606
Customer deposits	39,351	28,123
Provisions	9,647	9,333
Accrual for performance guarantees	29,350	30,563
Derivative liabilities	930	2,945
Current portion of long-term debt	6,575	7,978
	153,513	155,584
Non-current liabilities		
Long-term debt	13,744	14,471
Deferred income taxes	3,280	3,408
Other liabilities	9,903	9,045
	26,927	26,924
Total liabilities	180,440	182,508
Equity		
Equity attributable to the Subordinate and Multiple Voting shareholders		
Share capital (note 8)	74,217	74,345
Contributed surplus	5,979	5,941
Retained earnings	279,523	280,380
Accumulated other comprehensive income (loss)	(30,526)	(33,089)
	329,193	327,577
Non-controlling interest	5,965	5,542
Total equity	335,158	333,119
Total liabilities and equity	515,598	515,627

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 August 31		Six-month periods ended August 31	
	2016 **$**	**2015** **$**	**2016** **$**	**2015** **$**
Sales	71,137	111,558	148,546	214,737
Cost of sales (note 7)	51,897	84,877	110,641	164,539
Gross profit	19,240	26,681	37,905	50,198
Administration costs	17,032	19,889	35,798	39,070
Other expense (income)	309	(6)	202	9
Operating profit (loss)	1,899	6,798	1,905	11,119
Finance income	215	244	480	500
Finance costs	132	265	257	567
Finance income (costs) – net	83	(21)	223	(67)
Income (Loss) before income taxes	1,982	6,777	2,128	11,052
Provision for (Recovery of) income taxes	102	1,680	(326)	2,524
Net income (loss) for the period	1,880	5,097	2,454	8,528
Net income (loss) attributable to:				
Subordinate Voting Shares and Multiple Voting Shares	**2,001**	**4,749**	**2,529**	**7,856**
Non-controlling interest	(121)	348	(75)	672
	1,880	5,097	2,454	8,528
Net income (loss) per Subordinate and Multiple Voting Share				
Basic	0.10	0.22	0.12	0.36
Diluted	0.10	0.22	0.12	0.36
Dividends declared per Subordinate and Multiple Voting Share	0.07 (CA$0.10)	0.08 (CA$0.10)	0.15 (CA$0.20)	0.16 (CA$0.20)
Total weighted average number of Subordinate and Multiple Voting Shares				
Basic	21,731,871	21,875,203	21,729,924	21,886,645
Diluted	21,736,983	21,875,203	21,735,703	21,886,645

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 August 31		Six-month periods ended August 31	
	2016 $	2015 $	2016 $	2015 $
Comprehensive income (loss)				
Net income (loss) for the period	1,880	5,097	2,454	8,528
Other comprehensive income (loss)				
Foreign currency translation adjustment on foreign operations whose functional currency is other than the reporting currency (U.S. dollar)	(56)	1,354	3,061	(1,688)
Comprehensive income (loss)	1,824	6,451	5,515	6,840
Comprehensive income (loss) attributable to:				
Subordinate Voting Shares and Multiple Voting Shares	1,640	6,416	5,092	6,528
Non-controlling interest	184	35	423	312
	1,824	6,451	5,515	6,840

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 29, 2016	21,737,135	74,345	5,941	(33,089)	280,380	327,577	5,542	333,119
Net income (loss) for the period	-	-	-	-	2,529	2,529	(75)	2,454
Other comprehensive income (loss)	-	-	-	2,563	-	2,563	498	3,061
	21,737,135	74,345	5,941	(30,526)	282,909	332,669	5,965	338,634
Effect of share-based compensation (note 8 (d))	-	-	38	-	-	38	-	38
Share repurchase (note 8 (c))	(11,800)	(128)	-	-	(31)	(159)	-	(159)
Dividends								
Multiple Voting Shares	-	-	-	-	(2,402)	(2,402)	-	(2,402)
Subordinate Voting Shares	-	-	-	-	(953)	(953)	-	(953)
Balance - August 31, 2016	21,725,335	74,217	5,979	(30,526)	279,523	329,193	5,965	335,158
Balance - February 28, 2015	21,939,168	76,475	6,064	(27,652)	283,724	338,611	6,482	345,093
Net income (loss) for the period	-	-	-	-	7,856	7,856	672	8,528
Other comprehensive income (loss)	-	-	-	(1,328)	-	(1,328)	(360)	(1,688)
	21,939,168	76,475	6,064	(28,980)	291,580	345,139	6,794	351,933
Effect of share-based compensation (note 8 (d))	-	-	52	-	-	52	-	52
Shares issued under Share Option Plan (note 8 (d))	14,267	227	(227)	-	-	-	-	-
Share repurchase (note 8 (c))	(89,300)	(973)	-	-	(253)	(1,226)	-	(1,226)
Acquisition of non-controlling interest	-	-	-	-	-	-	(890)	(890)
Dividends								
Multiple Voting Shares	-	-	-	-	(2,495)	(2,495)	-	(2,495)
Subordinate Voting Shares	-	-	-	-	(932)	(932)	-	(932)
Non-controlling interest	-	-	-	-	-	-	(139)	(139)
Balance - August 31, 2015	21,864,135	75,729	5,889	(28,980)	287,900	340,538	5,765	346,303

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 August 31		Six-month periods ended August 31	
	2016 **$**	**2015** **$**	**2016** **$**	**2015** **$**
Cash flows from				
Operating activities				
Net income for the period	1,880	5,097	2,454	8,528
Adjustments to reconcile net income to cash provided by operating activities (note 10)	4,752	4,331	5,259	5,407
Changes in non-cash working capital items (note 11)	(13,539)	(3,566)	(1,734)	(16,409)
Cash provided (used) by operating activities	(6,907)	5,862	5,979	(2,474)
Investing activities				
Short-term investments	299	(43)	1,456	(817)
Additions to property, plant and equipment	(1,937)	(2,549)	(3,273)	(4,126)
Additions to intangible assets	(10)	(22)	(60)	(127)
Proceeds on disposal of property, plant and equipment, and intangible assets	46	73	179	90
Acquisition of non-controlling interest	-	(890)	-	(890)
Net change in other assets	(29)	(845)	133	(508)
Cash provided (used) by investing activities	(1,631)	(4,276)	(1,565)	(6,378)
Financing activities				
Dividends paid to Subordinate and Multiple Voting shareholders	(1,697)	(1,777)	(3,303)	(3,520)
Dividends paid to non-controlling interest	-	(139)	-	(139)
Repurchase of shares (note 8 (c))	(159)	(1,171)	(159)	(1,226)
Short-term bank loans	152	(63)	25	(628)
Increase in long-term debt	-	6,009	-	6,009
Repayment of long-term debt	(1,311)	(2,800)	(3,272)	(4,224)
Cash provided (used) by financing activities	(3,015)	59	(6,709)	(3,728)
Effect of exchange rate differences on cash	(581)	2,374	831	862
Net change in cash during the period	(12,134)	4,019	(1,464)	(11,718)
Net cash – Beginning of the period	95,010	68,225	84,340	83,962
Net cash – End of the period	82,876	72,244	82,876	72,244
Net cash is composed of:				
Cash and cash equivalents	89,872	87,541	89,872	87,541
Bank indebtedness	(6,996)	(15,297)	(6,996)	(15,297)
	82,876	72,244	82,876	72,244
Supplementary information				
Interest received (paid)	112	(4)	224	1
Income taxes reimbursed (paid)	(1,285)	(1,981)	(3,205)	(3,849)

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

For the three-month and six-month periods ended August 31, 2016

1 General information

These unaudited condensed interim financial statements represent the consolidation of the accounts of Velan Inc. (the "Company") and its subsidiaries. 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 October 13, 2016. 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 six-month periods ended August 31, 2016 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 29, 2016, 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 29, 2016.

3 Future accounting changes

The Company has not yet assessed the impact of the following new and revised standards or determined whether it will early adopt them.

(i) In July 2014, the IASB issued IFRS 9, *Financial Instruments*. The IASB has previously published versions of IFRS 9 that introduced new classification and measurement requirements (in 2009 and 2010) and a new hedge accounting model (in 2013). The July 2014 publication represents the final version of the Standard, replaces earlier versions of IFRS 9 and substantially completes the IASB's project to replace IAS 39, *Financial Instruments: Recognition and Measurement*.

This standard replaces the current multiple classification and measurement models for financial assets and liabilities with a single model that has only three classification categories: amortized cost and fair value through other comprehensive income and fair value through profit or loss. The basis of classification depends on the entity's business model and the contractual cash flow characteristics of the financial asset or liability. The standard introduces a new, expected loss impairment model that will require more timely recognition of expected credit losses. Specifically, the new Standard requires entities to account for expected credit losses from when financial instruments are first recognised and it lowers the threshold for recognition of full lifetime expected losses. The new standard also introduces a substantially-reformed model for hedge accounting with enhanced disclosures about risk management activity and aligns hedge accounting more closely with risk management. The new standard is effective for annual periods beginning on or after January 1, 2018 with earlier adoption 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 new standard is effective for annual periods beginning on or after January 1, 2018 with earlier adoption permitted.

(iii) In January 2016, the IASB issued IFRS 16, *Leases*, which sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract. It eliminates the classification of leases as either operating leases or finance leases and introduces a single lessee accounting model. It also substantially carries forward the lessor accounting requirements. Accordingly, a lessor continues to classify its leases as operating leases or finance leases, and to account for those two types of leases differently. IFRS 16 replaces IAS 17, *Leases*, IFRIC 4, *Determining whether an Arrangement contains a Lease*, SIC-15, *Operating Leases – Incentives*, and SIC-27, *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*. The new standard is effective for annual periods beginning on or after January 1, 2019 with earlier adoption permitted only if IFRS 15 is early adopted.

(iv) On January 29, 2016, the IASB published amendments to IAS 7, *Statement of Cash Flows*. The amendments are intended to clarify IAS 7 to improve information provided to users of financial statements about an entity's financing activities. The revised standard is effective for annual periods beginning on or after January 1, 2017 with earlier adoption 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 29, 2016.

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

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.

7 Inventories

	August 31, 2016 $	**February 29, 2016 $**
Raw materials	33,812	37,899
Work in process and finished parts	101,008	86,000
Finished goods	41,040	38,624
	175,860	162,523

As a result of variations in the ageing of its inventories, the Company recognized an inventory provision for the period of $1,739 (August 31, 2015 – $1,246), net of reversals of $4,539 (August 31, 2015 - $2,902)

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

	August 31, 2016 $	**February 29, 2016 $**
6,158,768 Subordinate Voting Shares (February 29, 2016 – 6,170,568) (notes 8 (c) and 8(d))	67,091	67,219
15,566,567 Multiple Voting Shares	7,126	7,126
	74,217	74,345

c) Pursuant to its Normal Course Issuer Bid, the Company is entitled to repurchase for cancellation a maximum of 314,878 of the issued Subordinate Voting Shares of the Company, representing approximately 5% of the issued shares of such class as at October 14, 2015, during the ensuing 12-month period ending October 21, 2016. During the six-month period ended August 31, 2016, 11,800 (August 31, 2015 – 89,300) Subordinate Voting Shares were purchased for a cash consideration of $159 (August 31, 2015 - $1,226) and cancelled. During the three-month period ended August 31, 2016, 11,800 (August 31, 2015 – 85,900) Subordinate Voting Shares were purchased for a cash consideration of $159 (August 31, 2015 - $1,171) and cancelled. The amount by which the repurchase amount was above the stated capital of the shares has been debited to 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.

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 six-month period ended August 31, 2016, a compensation cost of $38 (August 31, 2015 – $52) was recorded in the consolidated statement of income and credited to contributed surplus. For the three-month period ended August 31, 2016, a compensation cost of $19 (August 31, 2015 – $26) was recorded in the consolidated statement of income and credited to contributed surplus.

During the six-month period ended August 31, 2015, 50,000 options were exercised using the cashless exercise option, resulting in the issuance of 14,267 Subordinate Voting Shares of the Company for nil proceeds with a stated capital of $227 which was debited to contributed surplus. No options were exercised in the corresponding period of the current fiscal year.

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

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

	Number of shares	Weighted average exercise price	Weighted average contractual life in months
Outstanding – February 29, 2016	140,000	$14.24 (CA$19.26)	50.4
Issued	-	-	-
Expired/forfeited	-	-	-
Outstanding – August 31, 2016	140,000	$14.69 (CA$19.26)	44.4
Exercisable – August 31, 2016	25,000	$15.92 (CA$20.88)	

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 six-month period ended August 31, 2016, legal and related costs for these matters amounted to $3,211 (August 31, 2015 – $2,635). During the three-month period ended August 31, 2016, legal and related costs for these matters amounted to $1,812 (August 31, 2015 – $1,684).

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.

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 accrued the $100 deductible.

(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 August 31,		Six-month periods ended August 31,	
	2016 $	2015 $	2016 $	2015 $
Depreciation of property, plant and equipment	2,888	3,392	5,759	6,539
Amortization of intangible assets	419	478	876	953
Deferred income taxes	47	201	(656)	(88)
Share-based compensation expense (note 8 (d))	19	26	38	52
Loss (Gain) on disposal of property, plant and equipment	5	76	50	64
Net change in derivative assets and liabilities	998	166	(1,676)	(2,024)
Net change in other liabilities	376	(8)	868	(89)
	4,752	4,331	5,259	5,407

11 Changes in non-cash working capital items

	Three-month periods ended August 31,		Six-month periods ended August 31,	
	2016 $	2015 $	2016 $	2015 $
Accounts receivable	516	(3,657)	16,661	(8,492)
Inventories	(7,134)	12,857	(13,176)	12,908
Income taxes recoverable	(1,429)	(1,168)	(3,400)	(3,331)
Deposits and prepaid expenses	709	38	(1,409)	(581)
Accounts payable and accrued liabilities	(8,318)	(10,890)	(9,522)	(11,442)
Income tax payable	(31)	(244)	(1,372)	290
Customer deposits	2,801	(2,849)	11,364	(7,442)
Provisions	287	1,070	318	901
Accrual for performance guarantees	(940)	1,277	(1,198)	780
	(13,539)	(3,566)	(1,734)	(16,409)

(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:

	Six-month periods ended August 31,	
	2016	**2015**
	$	**$**
Affiliated company owned by certain relatives of the controlling shareholder		
Purchases – Material components	559	489
Sales – Material components	-	9
Amount charged by the controlling shareholder to one of the Company's subsidiaries and certain of its executives		
Rent based on weekly usage	18	19
Key management[1] compensation		
Salaries and other short-term benefits	2,096	2,147
Share-based compensation	38	52

	August 31, 2016	February 29, 2016
	$	**$**
Accounts receivable		
Affiliated companies	-	9
Accounts payable and accrued liabilities		
Affiliated companies	101	85
Controlling shareholder	24	6

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