

## CONDENSED NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

Hammond Power Solutions Inc. (the "Company"), is a public company, traded on the Toronto Stock Exchange and is incorporated under the Ontario Business Corporations Act.

The following notes should be read in conjunction with our 2005 Notes to Consolidated Financial Statements contained in the 2005 Annual report for the Company.

### 1. Significant accounting policies:

The Consolidated Financial Statements have been prepared in accordance with Canadian generally accepted accounting principles and reflect the following policies:

#### (a) Basis of presentation:

The Consolidated Financial Statements include the accounts of Hammond Power Solutions Inc., and its wholly-owned subsidiaries, Hammond Power Solutions Inc., and Hammond Power Solutions, S.A. de C.V. All inter-company transactions and balances have been eliminated.

#### (b) Translation of foreign currencies:

The Company's continuing operations located in the United States and Mexico are deemed to be integrated foreign operations and, therefore, their financial statements are translated using the temporal method. Under this method, all asset, liability, revenue, and expense items are translated at the exchange rate in effect at the transaction date. At the balance sheet dates, monetary assets and liabilities are adjusted to reflect the quarter end exchange rate. The gain or loss resulting from translation is included in the determination of income for the current period.

#### (c) Revenue recognition:

Revenue from sales of products is recognized when title passes to customers, which is generally at the time goods are shipped.

#### (d) Inventories:

Inventories are valued at the lower of first-in, first-out cost and market, with market defined as net realizable value for finished goods and work-in-process and replacement cost for raw materials.

#### (e) Long-term investments:

The investment in Moloney Electric Inc. (45%), is accounted for using the equity method. Under the equity method, the original cost of the shares is adjusted for the Company's share of post-acquisition earnings or losses less dividends received.

The investments in the co-tenancy of Glen Ewing Properties (50%) and in 1159714 Ontario Inc. (50%), the rental property investments, are accounted for using the proportionate consolidation method whereby the Company's proportionate share of the assets, liabilities, and the related revenues and expenses of the co-tenancy and rental property is included in the Consolidated Financial Statements.

#### (f) Property, plant, and equipment:

Property, plant, and equipment are stated at cost less accumulated amortization. Property, plant, and equipment under capital leases are initially recorded at the present value of the minimum lease payments at the inception of the lease.

#### (g) Income taxes:

The Company provides for income taxes under the asset and liability method. Under the asset and liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying value of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantive enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment.

#### (h) Deferred financing costs:

Deferred finance costs represent the unamortized cost of financing arrangements. Amortization is provided on a straight-line basis over the term of the related debt.

#### (i) Measurement uncertainty:

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from these estimates.

#### (j) Surplus property held for sale:

The investment in properties is stated at the lower of the carrying amount and the estimated net realizable value. The final realized value will be dependent on the state of the real estate market and the approval of the residential rezoning. The proposed plan is in compliance with the Official Plan of the Region of Halton.

#### (k) Share capital:

Authorized:

Unlimited number of special shares, discretionary dividends, non voting, redeemable, and retractable.

Unlimited number of Class A subordinate voting shares.

Unlimited number of Class B common shares with four votes per share, convertible into Class A subordinate voting shares on a one-for-one basis. Annual dividends on the Class B common shares may not exceed the annual dividends on the Class A subordinate voting shares.

Issued:	(dollars in thousands)
8,657,000 Class A shares	\$ 10,606
2,778,300 Class B common shares	7
11,435,300 Total Class A and B shares	\$ 10,613

#### (l) Stock-based compensation:

The Company has a stock-based compensation plan. The Company accounts for all stock-based payments using the fair value based method, in accordance with CICA Handbook Section 3870 – Stock-based compensation and other stock-based payments.

Under the fair value based method, compensation cost for physically settled stock options and direct awards of stock is measured at fair value at the grant date. Compensation cost is recognized in earnings on a straight-line basis over the relevant vesting period. The counterpart is recognized in contributed surplus. Upon exercise of a stock option, share capital is recorded at the sum of the proceeds received and the related amount of contributed surplus.

## CORPORATE INFORMATION

### Directors

- \* William G. Hammond, Chairman & CEO
- \* F. Al Raftis, President & Director
- \* † Donald H. MacAdam, Director
- \* † Zoltan D. Simo, Director
- \* † Douglas V. Baldwin, Director

- \* Corporate Governance Committee
- † Audit and Compensation Committee

### Officers

- William G. Hammond, Chairman & CEO
- F. Al Raftis, President & Director
- Chris R. Huether, Corporate Secretary & CFO

### Corporate Head Office

595 Southgate Drive  
Guelph, Ontario, Canada  
N1G 3W6

### Stock Exchange Listing

Toronto Stock Exchange (TSX)  
Trading Symbol: HPS.A

### Investor Relations

Contacts:

- William G. Hammond, Chairman & CEO
- Chris R. Huether, Corporate Secretary & CFO

Tel: 519-822-2441

Email: [ir@hammondpowersolutions.com](mailto:ir@hammondpowersolutions.com)

### Web Site

[www.hammondpowersolutions.com](http://www.hammondpowersolutions.com)

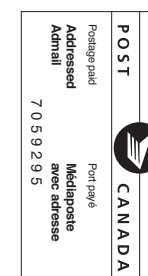
Hammond Power Solutions Inc.  
595 Southgate Drive  
Guelph, Ontario N1G 3W6



Hammond Power  
Solutions Inc.

2006 Q2

Three months ended July 1, 2006



## LETTER TO SHAREHOLDERS

We are pleased to report our Second Quarter 2006 financial results to our shareholders.

Sales and profits have continued to grow, fuelled by a strong global demand for resources as well as the continuing investment in public and private infrastructure. This marks the sixth consecutive quarter of improved financial performance.

Much of our growth is coming from OEM manufacturers of equipment and systems that are used in the extraction of oil and gas, as well as the mining of metal ores all around the world. The strong momentum of global growth has also fuelled the investment and expansion of manufacturing equipment and capacity in Asia and North America. We have also experienced accelerating market penetration of the U.S. and Canadian distributor channels. In response to this growth, we are judiciously adding capacity at our plants as well as looking for an appropriate acquisition that would expand our manufacturing capabilities and increase our market share.

Although our bookings and backlogs are at historically high levels, we are mindful of the continuing economic and business challenges facing our industry. These include the negative impact of a high Canadian Dollar on our domestic plants and customers, as well as the ongoing cost volatility of many of the materials used in the manufacture of transformers. Furthermore, we must respect the concerns of those business professionals who feel that the U.S. economy may slow within the next 18 to 24 months, even though we are not seeing this from our customer base at the current time.

We will not become complacent, but will continue to manage the business conservatively, to market our strengths, expand the company's leadership position, and to take advantage of all of the profitable opportunities in our strategic markets, while at the same time focusing on reducing our costs, enhancing profitability, and reducing our debt.



William G. Hammond  
Chairman and Chief Executive Officer

## CONSOLIDATED STATEMENT OF INCOME AND RETAINED EARNINGS

(unaudited) (dollars in thousands, except per share amounts)

	Quarter Ending		6 Months Ending	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Sales	\$ 32,020	\$ 24,673	\$ 61,735	\$ 46,736
Cost of Sales	23,670	18,187	45,760	34,208
Gross Margin	8,350	6,486	15,975	12,528
Selling, general, & administrative	5,697	4,935	11,198	9,504
Earnings from operations	2,653	1,551	4,777	3,024
Other income and expense:				
Interest expense	163	402	351	725
Gain on sale of fixed assets	–	374	–	374
Co-tenancy expense	60	35	120	95
Share of (income) loss in equity and rental property investment	(52)	(26)	(103)	52
Income before income taxes	2,482	1,514	4,409	2,526
Income tax expense	1,144	580	1,899	1,060
Net Earnings	1,338	934	2,510	1,466
Retained earnings, beginning of period	13,382	8,885	12,210	8,353
Retained earnings, end of period	\$ 14,720	\$ 9,819	\$ 14,720	\$ 9,819
Earnings per share for the period				
Basic	\$ 0.12	\$ 0.08	\$ 0.22	\$ 0.13
Diluted	\$ 0.12	\$ 0.08	\$ 0.22	\$ 0.13
EBITDA	\$ 3,236	\$ 2,582	\$ 5,941	\$ 4,565

### Disclosure

In the opinion of management, these unaudited financial statements are prepared in accordance with Canadian generally accepted accounting principles ("GAAP") and use the same accounting policies used in the preparation of the Company's annual financial statements. These interim statements and notes have not been independently reviewed by the external auditors and should be read in conjunction with the December 31, 2005, Notes to Consolidated Financial Statements.

### Segment Sales

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

## CONSOLIDATED STATEMENT OF CASH FLOWS

(unaudited) (dollars in thousands)

	Quarter Ending		6 Months Ending	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Cash provided by (used in):				
Operations:				
Net earnings	\$ 1,338	\$ 934	\$ 2,510	\$ 1,466
Add (deduct) items not involving cash:				
Amortization of property, plant, and equipment	468	449	936	935
Amortization of finance, start-up, and pre-production costs	123	217	245	379
Equity (income) loss on long-term investment	(52)	(26)	(103)	52
Gain on sale of fixed assets	–	(374)	–	(374)
Unrealized (gain) loss on forward foreign exchange contracts	(24)	21	35	139
	1,853	1,221	3,623	2,597
Change in noncash operating working capital	(785)	(1,521)	(3,695)	(3,679)
Cash provided by (used in) operations	1,068	(300)	(72)	(1,082)
Financing:				
Finance costs	–	–	–	(25)
Bank operating lines (decrease) increase	(87)	377	1,684	1,727
Proceeds of long-term debt	–	–	–	–
Repayment of long-term debt	(176)	(1,669)	(338)	(1,910)
Cash (used in) provided by financing activities	(263)	(1,292)	1,346	(208)
Investments:				
Repayment of notes receivable	40	–	40	–
Proceeds on disposal of property, plant, and equipment	–	1,779	–	1,779
Issue of common shares	–	113	–	113
Additions to property, plant, and equipment	(666)	(331)	(1,303)	(646)
Cash (used in) provided by investment activities	(626)	1,561	(1,263)	1,246
Increase (decrease) in cash	179	(31)	11	(44)
Cash, beginning of period	85	105	253	118
Cash, end of period	\$ 264	\$ 74	\$ 264	\$ 74

## MANAGEMENT'S DISCUSSION & ANALYSIS SECOND QUARTER 2006

### OVERVIEW

Hammond Power Solutions Inc. ("HPS" or the "Company"), is a North American leader for the design and manufacture of custom electrical engineered magnetics, as well as a leading manufacturer of standard electrical dry-type transformers. Advanced engineering capabilities, high quality products, and fast responsive service to customers' needs have established the Company as a technical and innovative leader in the electrical and electronic industries. The Company has manufacturing plants in Canada, the United States, and Mexico.

The following is Management's Discussion and Analysis of the Company's consolidated operating results for the quarter ended July 1, 2006, and should be read in conjunction with the notes to the Consolidated Financial Statements of the Company, contained in our 2005 Annual Report, which have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). All amounts in this report are expressed in Canadian dollars unless otherwise noted. Additional information relating to the Company may be found on SEDAR's website at [www.sedar.com](http://www.sedar.com).

### SALES

Sales for the quarter ended July 1, 2006, were \$32,020,000, up \$7,347,000 or 29.8%, from the comparative quarter last year, and were \$2,305,000 or 7.8%, higher than Quarter 1, 2006, and increased 32.1% year-to-date, finishing at \$61,735,000, compared to \$46,736,000 last year. Sales in the United States were \$21,377,000, an increase of \$4,465,000 or 26.4%, from Quarter 2, 2005, and up \$1,073,000 or 5.3%, from Quarter 1, 2006. Year-to-date sales in the United States were \$41,681,000, an increase of \$9,753,000 or 30.5%, compared to \$31,928,000 last year-to-date.

U.S. sales, stated in U.S. dollars, continue to rise, up \$5,464,000 or 40.2%, from Quarter 2, 2005, and were higher by \$1,469,000 or 8.3%, from Quarter 1, 2006, and also increased \$10,805,000 or 41.8% year-to-date, finishing at \$36,633,000, as compared to \$25,828,000. Canadian sales were \$10,642,000

for the quarter, showing solid growth over Quarter 2, 2005, of \$2,881,000 or 37.1%, and were up 13.1% from Quarter 1, 2006, and year-to-date sales were \$20,740,000, an increase of \$5,932,000 or 40.0%, as compared to sales of \$14,808,000 last year.

Geographically in the quarter, U.S.-based sales accounted for 66.8% of our total sales, while 33.2% of the sales were derived in Canada.

The Company's focus on its strategic target markets, the successful execution of its sales growth strategies, and the positive effects of solid market conditions in both the U.S. and Canadian electrical industries are the key elements to our sixth consecutive quarter-over-quarter sales increases. The robustness of these current market conditions is evidenced by our higher booking rates, growing sales, elevated backlog, and strong financial performance. The North American electrical Distributor, drive systems, MRO (machine repair and overhaul), mining equipment, and oil and gas pumping markets in both Canada and the United States all showed double-digit growth in the quarter, as compared to Quarter 2, 2005.

HPS will continue to direct its efforts towards the production of premium quality transformers, evolving product breadth, and competitive custom engineered designs. These strategies provide the footprint that will lead to the further expansion of our organic sales and new customer growth. We expect that this, combined with our market channel growth and our manufacturing agility, will generate future sales opportunities and sustain our revenue and profitability trends.

### **ORDER BOOKINGS AND BACKLOG**

The healthy electrical industry market conditions observed in Quarter 2, 2006, and our sales expansion initiatives collectively produced extremely strong bookings rates again this quarter. These factors were vital in our ability to deliver a 15.4% increase in bookings over the same quarter last year, and a 35.0% increase compared on a year-to-date basis. By channel, booking rates were up 14.7% on a direct basis, and up 15.5% through our distributor channel as compared to Quarter 2, 2005. This escalation in booking rates resulted in a backlog rise of 37.4% from the same quarter last year despite the significant sales growth in Quarter 2, 2006.

### **GROSS MARGINS**

Quarter 2, 2006, gross margin dollars further increased as a result of our sales levels, compounded with selling price increases and a favourable product mix. Gross margin rates finished at 26.1%, versus 26.3% in Quarter 2, 2005, or a negligible decline of 0.2%. The Company is very pleased with its margin rate performance despite the eroding effects the stronger Canadian dollar had on gross margin rates on Canadian manufactured products sold in the United States, competitive selling price pressures, and by rising copper and electrical grain oriented steel commodity costs. This strain on margins has resulted in a small decline in year-to-date gross margin rates which were 25.9%, versus 26.8% last year. Margins were augmented through the material procurement initiatives and our ability to maximize margin rates through short lead-time order opportunities.

HPS is steadfast in its goal to attack these margin rate deterrents through market growth, providing value-added product designs, manufacturing agility, market specific selling price increases, and aggressive cost reduction initiatives. The beneficial impact that higher manufacturing throughput has on our fixed factory cost structures and improvements in resource utilization will support margin rate stability going forward.

The Company is cognizant of the external factors that margin rates are subject to, and is determined and confident that its strategies will deliver desired gross margin rates going forward.

### **SELLING, GENERAL, & ADMINISTRATIVE EXPENSES**

Total selling, general, and administrative ("SG&A") expenses amounted to \$5,697,000 in Quarter 2, 2006, versus \$4,935,000 in Quarter 2, 2005, an increase of \$762,000 or 15.4%, and were \$11,198,000 year-to-date, versus \$9,504,000 in 2005, an increase of \$1,694,000 or 17.8%. As a percentage of sales, SG&A expenses decreased from 20.0% in Quarter 2, 2005, to 17.8% in Quarter 2, 2006, an improvement of 2.2%, and also declined 2.2% year-to-date, finishing at 18.1% in 2006, compared to 20.3% in 2005. Although there is a natural rise in freight costs and sales commission expense from the increased sales volumes and foreign exchange losses, we were able to reduce our SG&A expenses as a percent of sales, through controlled expense management and the impact of healthier sales volumes. SG&A expenses

are also reflective of foreign currency exchange losses of \$112,000 in the quarter, as compared to a foreign currency exchange loss of \$189,000 in Quarter 2, 2005, and were \$419,000 year-to-date, compared to \$206,000 in 2005.

### **EARNINGS FROM OPERATIONS**

The Company is pleased with the steady advances made in earnings from operations. This is evidenced by our Quarter 2, 2006 results, which were up \$1,102,000, or 71.0%, from the same quarter last year, finishing at \$2,653,000 in the quarter, as compared to \$1,551,000 in Quarter 2, 2005. Earnings from operations were \$4,777,000 on a year-to-date basis, up \$1,753,000 or 58%, from the \$3,024,000 for the same period last year. Sales from market expansion, sales mix, targeted selling price increases, cost reduction initiatives, and higher manufacturing throughput, were all contributors to this gain in earnings from operations.

### **INTEREST EXPENSE**

The interest expense for the quarter ended July 1, 2006, amounted to \$163,000, compared to \$402,000 in Quarter 2, 2005, a decrease of \$239,000 or 59.5%, and was \$351,000 year-to-date, versus \$725,000 last year. The decrease of interest expense for the quarter, was as a result of a 33.6% reduction in total bank indebtedness, and lower interest rates, as compared to the same quarter last year. Interest expense as a percent of sales has also dropped significantly, finishing at 0.5% in the quarter, as compared to 1.6% in Quarter 2, 2005, and dropped 1.0% year-to-date, finishing at 0.6%, compared to 1.6% in 2005.

### **CO-TENANCY EXPENSE**

The property at 2 Glen Road, Georgetown, Ontario, is owned equally as a co-tenancy agreement with Hammond Manufacturing Company Limited, and expenses in respect to the property are shared equally. Ongoing legal and consulting fees pertaining to the Glen Road site were \$60,000 for Quarter 2, 2006, compared to \$35,000 in Quarter 2, 2005, and \$120,000 year-to-date, versus \$95,000 last year.

### **EQUITY INVESTMENT – MOLONEY ELECTRIC INC.**

Hammond Power Solutions Inc., holds a 45% equity ownership in Moloney Electric Inc. Our investment in Moloney Electric Inc., accounted for using the equity method, resulted in a noncash profit of \$60,000 for the quarter ended July 1, 2006, compared to a noncash profit of \$35,000 for the quarter ended July 2, 2005, and year-to-date was \$103,000, versus a loss of \$52,000. Moloney Electric Inc., continues to have success at expanding its sales and margin rates during the year.

Profitability was positively affected by sales growth and targeted selling price increases, despite the constant challenge faced from the unprecedented rise in the raw material cost of steel and copper and competitor selling price pressures.

### **INCOME TAXES**

Due to the increase in profitability, the quarter income tax expense was \$1,144,000, as compared to \$580,000 in Quarter 2, 2005, and was \$1,899,000 year-to-date, versus \$1,060,000 last year. The current future tax assets and liabilities consist mainly of reserves and allowances, and are related to current assets and liabilities, which are not deductible against current year earnings. The long-term future tax assets and liabilities relate to temporary differences resulting from losses carried forward, capital leases (the lease payments are expensed for tax purposes), foreign exchange losses (recognized for tax purposes only on the actual debt repayments), and the difference between net book value and underpreciated capital cost of capital assets.

### **NET EARNINGS**

As a result of increased sales and higher margin dollars, net earnings for Quarter 2, 2006, grew by \$404,000 or 43.3%, concluding at \$1,338,000, compared to \$934,000 in Quarter 2, 2005, and were up \$1,044,000 or 71.2%, finishing at \$2,510,000 year-to-date, versus \$1,466,000 last year.

EBITDA (earnings before interest, taxes, depreciation, and amortization) for Quarter 2, 2006, was \$3,236,000, versus \$2,582,000 in Quarter 2, 2005, an increase of \$654,000 or 25.3%, and year-to-date was \$5,941,000, versus \$4,565,000, an increase of \$1,376,000 or 30.1%. Although there is not a standard definition of this term, the Company uses EBITDA as a non-GAAP financial measure as one of its indicators of operational profitability.

EBITDA is calculated as outlined in the following table:

	Quarter 2 2006	Quarter 2 2005	YTD 2006	YTD 2005
Net earnings	\$ 1,338,000	\$ 934,000	\$ 2,510,000	\$ 1,466,000
Add:				
Interest Expense	\$ 163,000	\$ 402,000	\$ 351,000	\$ 725,000
Income Tax Expense	\$ 1,144,000	\$ 580,000	\$ 1,899,000	\$ 1,060,000
Depreciation and Amortization	\$ 591,000	\$ 666,000	\$ 1,181,000	\$ 1,314,000
<b>EBITDA</b>	<b>\$ 3,236,000</b>	<b>\$ 2,582,000</b>	<b>\$ 5,941,000</b>	<b>\$ 4,565,000</b>

## CAPITAL RESOURCES AND LIQUIDITY

Cash provided by operations for Quarter 2, 2006, was \$1,068,000, versus cash used in operations of \$300,000 in Quarter 2, 2005, a decreased usage of \$1,368,000. Cash used by operations year-to-date was \$72,000, versus \$1,082,000 in 2005, an improvement in cash provided by operations of \$1,010,000.

Working capital requirements to support our sales growth resulted in increased accounts receivable (+\$1,168,000) and inventory (+\$850,000), which was partially offset by a rise in accounts payable and accruals (-\$665,000) from Quarter 1, 2006.

Capital expenditures were \$666,000 this quarter, up \$335,000 or 101%, compared to \$331,000 for Quarter 2, 2005, and increased 102% or \$657,000 year-to-date, finishing at \$1,303,000, compared to \$646,000 in 2005. The capital investment was utilized in the areas of manufacturing capacity expansion, productivity improvement projects, and information technology infrastructure.

Cash used in financing activities resulted from financing costs and repayment of long-term debt of \$176,000 in Quarter 2, 2006, and \$338,000 year-to-date, compared to \$1,669,000 for the same quarter last year, and \$1,910,000 year-to-date 2005. When comparing cash used in financing activities between years, please note that in the second Quarter of 2005, HPS completed the sale of our Baraboo, Wisconsin property yielding a cash infusion to the Company of which the net proceeds of this sale were used to retire \$1,500,000 of long-term debt.

Bank operating lines decreased by \$87,000 in Quarter 2, 2006, as compared to an increase of \$377,000 in Quarter 2, 2005, due to increases in noncash operating working capital, long-term debt repayment, and capital expenditures.

Overall bank operating lines of credit and long-term debt, net of cash balances dropped to \$6,802,000 as at July 1, 2006, a decrease of \$3,444,000 or 33.6%, as compared to a balance of \$10,246,000 as at July 2, 2005.

All scheduled payments of principal and interest have been made by the Company on the applicable due dates.

All bank covenants have been met as at July 1, 2006.

## CONTINGENT LIABILITIES

The Company has two properties for which there are contingent liabilities.

### Moloney Properties (1159714 Ontario Inc.):

The Company and Hammond Manufacturing Company Limited each own 50% of the shares of 1159714 Ontario Inc., which in turn owns the property at 213 Sterling Road, Toronto, occupied by Moloney Electric Inc. ("MEI"). The property has mineral oil contamination as well as some PCB contamination although the source of such contamination (except for a spill in 1993 by MEI) has not been determined. The contamination does not result from the normal operations of the Company. It appears to pre-date the Company's ownership. The source or sources may include adjoining properties. As indirect owner and occupier, the Company and Hammond Manufacturing Company Limited may, without admitting any liability, have some responsibility to participate in the remediation of the property and adjacent properties. In this regard, the Company received a complaint in 1994 from Toronto Hydro, as an adjoining owner, to the effect that mineral oil and possibly PCB contaminants may have migrated

to its property, which is an inactive substation. The Company has worked in conjunction with the Ministry of the Environment and with Toronto Hydro to remediate the properties. MEI and 1159714 Ontario Inc., completed additional field-sampling in 2005 pursuant to a joint order to further delineate the nature and extent of potential contamination. The results are consistent with previous investigations. Meetings with Toronto Hydro are contemplated to discuss further remediation activities. No determination as to the specifics of remediation has been made but the recovery period is expected to take several years.

#### **Glen Ewing Properties:**

The property at 2 Glen Road, Georgetown, Ontario, is owned equally as a co-tenant with Hammond Manufacturing Company Limited, and any expenses or liabilities in respect of the property have been agreed to be shared equally. In January 2002, the two owners were served with a statement of claim by an adjoining industrial property owner, in which the plaintiff has claimed damages in the amount of \$8,000,000 for negligence, breach of warranty, and other matters relating to alleged environmental contamination of the property. The Company intends to vigorously defend the action if it proceeds. In 2004, the Company and Hammond Manufacturing Company Limited served a counter-claim against the plaintiff in the amount of \$8,000,000. Both claims, by agreement between the parties, are in abeyance. At this time, no determination of potential liability or costs has been made. The contamination does not result from the normal operations of the Company. The parties, under the direction of the Ministry of the Environment, are in the process of undertaking a coordinated and shared investigation of the condition of the property and remediation options.

Other than the above sites, management is not aware of any unusual or significant issues. Expenditures will be recorded as appropriate when environmental remediation is probable, and the costs can be reasonably estimated in accordance with generally accepted accounting principles.

Management is not aware of any other contingent liabilities.

## **RISK FACTORS**

As with most businesses, Hammond Power Solutions Inc., is subject to a number of marketplace, industry, and economic related business risks, which could have some material impact on our operating results.

These risks include:

- The cyclical effects and unprecedented upward market cost pressures of copper commodity and electrical grain oriented steel pricing and supply;
- A significant, unexpected change in the global demand for resources;
- The unpredictability and volatility of the Canadian dollar;
- Rising interest rates; and
- Competition.

The Company continuously works to minimize the negative impact of these risks and strengthen its position through diversification of its core business, market channel expansion, geographic diversity of its operations, and hedging strategies.

## **STRATEGIC OUTLOOK**

As evidenced in our Quarter 2, 2006 report, both the Canadian and the U.S. economies continue to perform well. We are anticipating continued global economy strength throughout the balance of the year as the Canadian and U.S. resource based markets continue with increased capital spending on new equipment and infrastructure.

We remain cautious yet determined that we will sustain profit rates through selling price increases as well as further productivity gains, sales growth from new product development, and market share penetration.

Management is committed to the achievement of its market growth goals, to the execution of its strategic and operational initiatives, to ensuring the Company is well capitalized, and is determined that Hammond Power Solutions Inc., will deliver consistently strong financial performance.

## SELECTED ANNUAL AND QUARTERLY FINANCIAL INFORMATION

The information contained in the following table presents the historic audited annual financial information as at December 31, and the unaudited financial information for the previous eight quarters up to, and including, the Second Quarter of 2006. The quarterly information has been extracted from our unaudited consolidated financial statements which, in the opinion of management, are prepared in accordance with Canadian generally accepted accounting principles.

### ANNUAL INFORMATION

(dollars in thousands, except per share amounts)

	2002	2003	2004	2005
Sales	\$ 75,170	\$ 73,408	\$ 81,349	\$ 98,896
Earnings from operations	1,298	209	4,627	7,231
EBITDA	3,797	2,152	6,361	9,789
Net earnings (loss) for the year	(168)	(875)	1,449	3,857
Total assets	45,978	41,821	40,760	45,260
Total liabilities	27,723	24,441	21,907	22,242
Total debt	17,268	14,395	10,387	5,463
Cash provided from operations	3,768	3,514	5,042	4,280
Basic earnings (loss) per share	\$ (0.01)	\$ (0.08)	\$ 0.13	\$ 0.34
Diluted earnings (loss) per share	\$ (0.01)	\$ (0.08)	\$ 0.13	\$ 0.34

### QUARTERLY INFORMATION

(dollars in thousands, except per share amounts)

	2004		2005				2006	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Sales	\$ 20,918	\$ 20,494	\$ 22,063	\$ 24,673	\$ 24,678	\$ 27,482	\$ 29,715	\$ 32,020
Earnings from operations	1,546	1,392	1,472	1,552	1,719	2,488	2,124	2,653
EBITDA	2,037	1,526	1,982	2,583	2,359	2,865	2,705	3,236
Net earnings	582	391	532	934	957	1,434	1,172	1,338
Total assets	41,341	40,760	42,192	43,978	42,458	45,260	47,164	49,361
Total liabilities	22,903	21,907	22,807	23,546	21,069	22,242	22,974	23,833
Total debt	12,119	10,387	11,509	10,246	7,985	5,463	7,240	6,802
Cash provided (used) by operations from operations	2,616	2,018	(782)	(300)	2,454	2,908	(1,140)	1,068
Basic earnings per share	\$ 0.05	\$ 0.04	\$ 0.05	\$ 0.08	\$ 0.08	\$ 0.13	\$ 0.10	\$ 0.12
Diluted earnings per share	\$ 0.05	\$ 0.04	\$ 0.05	\$ 0.08	\$ 0.08	\$ 0.13	\$ 0.10	\$ 0.12

## CONSOLIDATED BALANCE SHEET

(unaudited) (dollars in thousands)

	As at	
	July 1, 2006	Dec. 31, 2005
<b>ASSETS</b>		
Current assets:		
Cash	\$ 264	\$ 253
Accounts receivable	19,193	16,847
Inventories	14,325	12,658
Prepaid expenses	325	337
Unrealized gain on forward exchange contracts	24	59
Income taxes receivable	43	74
Future income taxes	448	465
	<b>34,622</b>	<b>30,693</b>
Property, plant, and equipment	9,886	9,519
Investment in properties	1,044	1,044
Long-term investments	1,785	1,722
Notes receivable	1,674	1,674
Deferred finance, start-up, and pre-production costs	230	474
Future income taxes	120	134
	<b>\$ 49,361</b>	<b>\$ 45,260</b>
<b>LIABILITIES &amp; SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Bank operating lines of credit	\$ 3,695	\$ 2,011
Accounts payable and accrued charges	14,892	14,593
Income taxes payable	957	1,011
Current portion of long-term debt	648	651
Future income taxes	3	3
	<b>20,195</b>	<b>18,269</b>
Accrued pension benefit obligation	80	84
Long-term debt	2,723	3,054
Future income taxes	835	835
Shareholders' equity:		
Share capital	10,613	10,613
Contributed surplus	195	195
Retained earnings	14,720	12,210
	<b>25,528</b>	<b>23,018</b>
	<b>\$ 49,361</b>	<b>\$ 45,260</b>