

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

*This Management's Discussion and Analysis of the results of operations and financial condition for the years ended December 31, 2004 and December 31, 2003 was prepared as at February 10, 2005 and should be read in conjunction with the Consolidated Financial Statements and accompanying notes. Additional information relating to The Westaim Corporation is available on SEDAR at [www.sedar.com](http://www.sedar.com) and the Company's website at [www.westaim.com](http://www.westaim.com).*

### **DESCRIPTION OF THE BUSINESS**

The Westaim Corporation (the "Company") develops, commercializes and launches high potential technologies into the fast growing sectors of the economy. The Company's portfolio of business opportunities includes flat panel displays, anti-microbial wound care products and pharmaceutical products.

The Company's strategy is to develop the independent technical, operating and marketing and sales capabilities of its technology investments through the early years of product introduction and commercialization with the objective of taking these technologies public through initial public offerings. Management recognizes that, in circumstances where it lacks technical or marketing expertise or the necessary capital to complete development of a product, it may be in the Company's best interests to pursue commercialization through joint venture arrangements, strategic alliances, licensing, or selling its technology.

### **CONSOLIDATED RESULTS**

#### *OVERVIEW*

For the year ended December 31, 2004, the Company reported a net loss of \$25.2 million compared to a net loss of \$35.4 million in 2003. The loss from continuing operations was \$28.7 million in 2004 compared to \$37.8 million in 2003. The Company reported income from discontinued operations of \$3.6 million in 2004 compared to income from discontinued operations of \$2.4 million in 2003. Revenues from continuing operations for the year ended December 31, 2004 were \$32.2 million compared to \$17.3 million in 2003.

The basic and diluted net loss per common share was \$0.30 in 2004 compared to \$0.45 in 2003. The basic and diluted net loss per common share from continuing operations was \$0.34 in 2004 and \$0.48 in 2003. The weighted average number of common shares outstanding was 84.1 million and 78.0 million in 2004 and 2003 respectively.

On January 29, 2004, the Company sold its Ambeon business segment ("Ambeon") for proceeds of \$33.4 million. As a result, this business has been accounted for as a discontinued operation in 2003.

Continuing operations reflect the results of the Company's subsidiaries, Nucryst Pharmaceuticals Corp. ("Nucryst") and iFire Technology Inc. ("iFire"). Revenues increased 86.5% in 2004 reflecting higher milestone revenue, royalty payments and manufacturing revenue earned from Nucryst's wound care products.

## CONSOLIDATED RESULTS

### OVERVIEW (continued)

A comparison of operating costs from continuing operations in 2004 compared to the prior year is as follows:

(\$millions)	2004	% of Revenue	2003	% of Revenue
Manufacturing	\$ 8.7	26.9%	\$ 5.9	34.4%
Selling, general and administrative	5.3	16.6%	3.8	22.1%
Research and development	35.5	110.1%	25.9	149.7%
Depreciation and amortization	5.7	17.7%	5.0	28.9%
	\$ 55.2		\$ 40.6	

The increase in manufacturing costs reflects higher sales of wound care products at Nucryst. Manufacturing costs measured as a percent of revenue, before milestone payments, have improved by 4.6 percentage points as a result of increased volume, product mix and operating efficiencies. The increase in selling and administration costs primarily reflects the cost of strategic analysis of future pharmaceutical applications for Nucryst's nanocrystalline silver technology. The increase in research and development expenses reflects higher spending at iFire compared to 2003 and increased expenditures relating to development of pharmaceutical products at Nucryst, discussed below. iFire also benefited from \$5.2 million in funding from Technology Partnerships Canada ("TPC") in 2003. All eligible research and development expenditures qualify for a 20% tax credit that can be utilized when the Company reaches a taxable position. No development costs were capitalized in 2004 and 2003.

Corporate expenses for the year ended December 31, 2004 were \$7.4 million, down from \$9.6 million in 2003, reflecting the impact of non-recurring costs in 2003 relating to a corporate reorganization and an initiative of the Board of Directors to maximize shareholder value.

Interest and foreign exchange income of \$1.8 million in 2004 was significantly higher than the \$0.7 million reported in 2003. This change reflects foreign exchange losses reported in 2003 resulting from a strengthening Canadian dollar, partially offset by lower interest income in 2004 resulting from lower average interest rates in 2004. Loss on disposal of assets reflects losses on the disposal of assets no longer in use, primarily at iFire.

Future income tax expense, a non-cash item in continuing operations, was \$Nil in 2004 compared to \$4.7 million in 2003. The reduction in the tax amount in 2004 reflects the impact of the sale of Ambeon.

The net loss in the fourth quarter of 2004 of \$10.6 million was \$7.3 million lower than the same period in 2003. This improvement primarily reflects better operating results of \$2.0 million at Nucryst in 2004 and future income tax expenses of \$4.5 million in the fourth quarter of 2003.

### OPERATIONS

#### Performance Measures

As a developer of new technologies, the Company uses financial and technical performance measures to track corporate performance. The Company develops comprehensive long-range plans and annual plans for each business segment with a view to maximizing long-term shareholder value. The success of each business unit is measured on its ability to achieve performance milestones within a specified timeframe. These milestones generally relate to specific research and development targets. Given the uncertainty surrounding developing new technologies, these milestones are reviewed and updated on a regular basis during the year. Financial milestones are also set and

## CONSOLIDATED RESULTS

### *OPERATIONS (continued)*

measured. Financial performance may relate to sales activity for commercial products or the achievement of results within operating expense and capital budget targets.

### *Continuing Operations*

The Company's business plans, and related measurements of performance against plan, are designed to ensure that the Company's capital and human resources are focused on maximizing return on investment.

The Company's operations are organized into two high-potential emerging technology businesses – iFire and Nucrust. The Company's primary strategy is to invest in the independent technical, research, operating, and marketing and sales capabilities of each of its technology investments, through the early years of product development, introduction and commercialization.

### ◆ *iFire Operations*

iFire, based in Toronto, Ontario, has developed a proprietary flat panel display with solid state, thick-film dielectric electroluminescent ("TDEL") technology with primary application in the fast-growing large screen TV market. For 30 to 39-inch screens, the Company believes that in high-volume production, iFire™ displays will have a 30% to 50% cost advantage over other flat panel technologies due to TDEL's simpler structure, less complex manufacturing methods and fewer processing steps compared with liquid crystal displays ("LCD") and plasma display panels ("PDP"). Unlike other flat panel technologies, the iFire™ displays do not contain gases (as with PDP), liquids (as with LCD) or vacuum (as with the cathode ray tube), making it inherently rugged and less susceptible to shock, vibration and breakage. TDEL technology's solid state structure and thick-film manufacturing process also make an iFire™ display less sensitive to cleanroom contamination that is associated with PDP and LCD, resulting in lower capital investment, higher manufacturing yield and reduced production cost. In addition, iFire™ displays feature full colour, rapid video response, unrestricted viewing angles and a wide operating temperature range.

In 2004, iFire continued to improve performance on its prototype 17-inch and 34-inch displays using its simplified flat panel manufacturing process, Colour-By-Blue™. iFire continues to make further technical improvements to its displays as measured in colour, brightness, lifetime and electronics. In the second quarter of 2004, iFire demonstrated a high-definition 34-inch prototype flat panel television to industry peers at the annual Society for Information Display conference. In the third quarter of 2004, iFire began construction of a \$46 million pilot production plant at its Toronto facility. Pilot production of 34-inch displays is expected to commence in late 2005.

In March 2003, iFire entered into a non-exclusive joint development agreement with Dai Nippon Printing Co., Ltd. ("DNP") of Japan for commercial production of mid-30-inch screen size flat panel television modules. Under the terms of the agreement, DNP is utilizing its flat panel production line in Kashiwa, Japan for developing front-end manufacturing processes for iFire's TDEL technology, including the substrate preparation and the fabrication of the row electrodes and thick-film dielectric layer. Back-end processes such as the deposition of phosphors, column electrodes and colour correction layers, as well as electronics assembly, are being performed by iFire at its facility in Toronto.

In January 2004, iFire entered into a Yen 1.08 billion (approximately \$13 million) loan agreement with DNP to partially fund the construction of a pilot production facility in Toronto. It is the expectation of iFire that the financing relationship will be rolled into an expanded commercial agreement as the technology moves through pilot phase and into commercial production. As at December 31, 2004, Yen 408.2 million (\$4.8 million) has been drawn on this loan facility.

## CONSOLIDATED RESULTS

### *OPERATIONS (continued)*

In 2002, iFire entered into a non-exclusive technology collaboration agreement with Sanyo Electric Company Ltd. ("Sanyo") to provide research and development expertise to iFire. As part of this agreement, Sanyo provides funding to iFire for certain research and development projects. This funding is accounted for as a reduction in research and development expenses and amounted to \$1.3 million in 2004 and \$1.4 million in 2003. Total funding is expected to amount to US \$3.8 million over 4 years.

The pilot manufacturing facility currently under construction is being partially funded through the loan agreement signed in January 2004 with DNP. Remaining capital costs for the pilot production plant will be funded through further partnership agreements or internal Company resources. Pilot manufacturing is the first step toward volume production which is planned for early 2007 in conjunction with industry partners.

In 2001, iFire entered into a research and development contribution agreement with the Government of Canada through Technology Partnerships Canada ("TPC"). Under the agreement, TPC agreed to contribute 28.371% of eligible research and development costs and related capital expenditures incurred by iFire to a maximum of \$30 million. In exchange, iFire agreed to pay a royalty to TPC equal to 1.065% of eventual commercial sales of the technology under development. In addition, TPC received warrants to purchase common shares of iFire, representing approximately 0.5% of the current outstanding common shares of iFire. Contributions from TPC were recorded as a reduction of the cost of the applicable capital asset or credited to the statement of operations of iFire, as determined by the nature of the expenditure being funded. Under this arrangement, in 2003 iFire received \$6.0 million, the final balance of the total \$30 million funding.

The impact of the TPC funding on the operating results of the iFire business segment is summarized below:

(\$millions)	Operating Expenses			Capital Expenditures		
	2004	2003	2002	2004	2003	2002
Expenses – iFire	\$ 27.9	\$ 26.2	\$ 29.2	\$ 18.6	\$ 9.2	\$ 3.9
TPC funding	–	5.2	8.0	–	0.8	1.0
Net expenses – iFire	\$ 27.9	\$ 21.0	\$ 21.2	\$ 18.6	\$ 8.4	\$ 2.9

In 2000, iFire entered into a strategic partnership with TDK Corporation ("TDK"). The transaction included the purchase of a 2.5% equity investment in iFire, an up-front license fee of \$11.8 million for the non-exclusive right to use iFire's proprietary technology to manufacture flat panel displays under 12-inches in size and ongoing royalty payments on future sales of displays manufactured by TDK using iFire technology. In 2004, TDK made a strategic decision to discontinue investment in the commercialization of small graphic displays using iFire technology and in December 2004, the license agreement was terminated. iFire repurchased the shares owned by TDK for nominal consideration and Westaim purchased substantially all of the TDK-developed intellectual property related to the technology for \$3.0 million.

#### ◆ *iFire Financial Results*

The net loss of iFire for the year ended December 31, 2004 was \$27.9 million compared to \$20.1 million in 2003. Revenues were \$Nil in 2004 compared to \$0.9 million in 2003 as final deferred revenues were recognized from the licensing agreement with TDK. Total expenses for research and development including depreciation, and before TPC funding, were \$27.9 million in 2004 compared to \$26.2 million in 2003. Approximately 50% of iFire's expenses arise from salaries and wages of research and development staff.

## CONSOLIDATED RESULTS

### *OPERATIONS (continued)*

Capital spending amounted to \$18.6 million in 2004 compared to \$9.2 million (before TPC funding) in 2003. This increase primarily related to the commencement of construction of the pilot manufacturing facility.

As at December 31, 2004, iFire had drawn down Yen 408.2 million (\$4.8 million) on the DNP loan facility. The remaining availability on this facility of Yen 671.8 million (approximately \$8.2 million) will be drawn down throughout 2005 with the principal and interest payable on June 30, 2006.

#### ◆ *iFire Outlook*

The 2005 outlook for iFire is to see increases in research and development expenditures before depreciation of approximately 30% compared to 2004, reflecting the commencement of pilot manufacturing and capital expenditure investments in the range of \$30 million relating to the pilot manufacturing facility. iFire intends to pursue a strategy of developing relationships with major international electronics companies with a view to jointly exploiting the commercialization of large format display products and sharing in the future development and capital costs of a large scale manufacturing facility.

#### ◆ *Nucryst Operations*

Nucryst researches, develops and commercializes wound care products and pharmaceutical products based on its noble metal nanocrystalline technology.

Wound Care Products – Acticoat™ Burn Dressings and Acticoat 7™ Antimicrobial Dressings, targeting the burn and chronic wound markets, were developed and sold by Nucryst until May 2001 when a series of agreements were completed with Smith & Nephew plc ("Smith & Nephew") under which Smith & Nephew acquired an exclusive global license to the Nucryst antimicrobial coating technology for wounds, together with Nucryst's U.S. and Canada Acticoat™ burn dressing business. Nucryst continues to manufacture Acticoat™ products for Smith & Nephew and receives revenue plus royalty payments and milestone payments based on Smith & Nephew's global sales. To the end of 2004, Nucryst had earned US \$14.0 million of a potential US \$56.5 million in milestone payments. The two companies are collaborating to develop the technology for the introduction of new products for chronic and serious wounds.

Nucryst's wound care earnings continued to grow in 2004 as indicated in the table below. Revenue from licensing and manufacturing in 2004 was \$18.9 million compared to \$11.6 million in 2003. Total sales to end users of Acticoat™ products has increased by approximately 50% year-over-year in each of the past three years with Smith & Nephew now selling Acticoat™ products in 30 countries. Manufacturing costs as a percentage of operating revenue, excluding milestones, improved 4.6 percentage points to 48.3% in 2004 compared to 52.9% in 2003, primarily as a result of increased volume, lower raw material costs, product mix and operating efficiencies.

Cash flow generated from the wound care products of Nucryst will continue to be used to partially fund the significant cash requirements related to the development of pharmaceutical products.

Pharmaceutical Products – When used commercially on Acticoat™ dressings, Nucryst's proprietary nanocrystalline silver coatings have proven safe for use by humans and have demonstrated their efficacy as a barrier to infection. Nucryst is now planning to develop drugs based on customized formulations of its patented nanocrystalline technology. Nucryst's Rx nanocrystals appear to have two very important therapeutic effects: broad-spectrum antimicrobial activity and anti-inflammatory activity. This dual activity could be useful for treating a wide range of diseases. Pre-clinical work by Nucryst has pointed to two broad areas: dermatological and respiratory diseases. In both these areas, the Company sees new product opportunities.

## CONSOLIDATED RESULTS

### *OPERATIONS (continued)*

In 2003, Nucryst filed an Investigational New Drug ("IND") application with the US Food and Drug Administration ("FDA") for its first dermatology drug, NPI 32101, a topical form of Nucryst's proprietary silver Rx nanocrystals and completed Phase 1 clinical studies. In September 2004, Nucryst announced the results of the Phase 2a clinical study of NPI 32101 in a cream formulation in patients with mild to moderate atopic dermatitis. This double-blind, randomized, placebo-controlled study in 224 adult patients involved 23 clinical sites across the United States. Patients were treated twice daily for a six-week period with one of two concentrations of NPI 32101, 0.5% and 1.0%, in a cream formulation or with the vehicle alone. The purpose of the study was to evaluate the safety and effectiveness of topical NPI 32101 in improving the signs and symptoms of atopic dermatitis.

Efficacy in this study was assessed using three commonly-used statistical methods. Using the intent-to-treat analysis (including all randomized patients who had at least one post-treatment efficacy assessment) with last observation carried forward method, statistical significance was not met in investigator overall assessment of disease improvement. However, statistical significance was achieved with 1.0% NPI 32101 compared to vehicle using intent-to-treat patients who completed six weeks of treatment method (i.e. without last observation carried forward data imputation method). In addition, in patients who completed the study in accordance with the protocol (the per protocol completers method), statistical significance was achieved with 1.0% NPI 32101. NPI 32101 was well tolerated and there were no serious adverse events. Any adverse events reported were not unusual for a topical drug and did not occur with a greater statistical frequency than was observed in the vehicle group. For example, application site reactions occurred in 11.4%, 10.3% and 15.7% in the vehicle, 0.5% and 1.0% creams, respectively. Additional studies will continue to be conducted to more fully understand the safety profile of NPI 32101.

Findings in this study provided Nucryst with important guidance to optimize the product, protocol and study design for future clinical trials. Using information obtained from these results, Nucryst plans to design and conduct additional clinical studies in order to prepare for the next Phase 2 clinical trial and the larger Phase 3 clinical trials of NPI 32101. Phase 3 trials, which involve hundreds of patients in numerous clinical centers, normally take a year or more to complete. If favorable results are achieved, Nucryst anticipates submitting a New Drug Application to the FDA in the 2009 timeframe.

Nucryst's pharmaceutical expenses increased by 41.6% from 2003 to 2004 reflecting the increased costs relating to research on dermatological pharmaceuticals and the initial clinical trials.

### ◆ *Nucryst Financial Results*

Nucryst's net income for the year ended December 31, 2004 was \$6.1 million compared to a loss of \$2.0 million in 2003. Revenues for the year ended December 31, 2004 were \$31.9 million compared to \$16.2 million in the prior year. Revenues in 2004 benefited from two milestone payments totaling \$13.0 million (US \$10.0 million) from Smith & Nephew relating to the achievement of two sales targets in 2004. Revenues in 2003 benefited from a one-time payment of \$4.6 million (US \$3.0 million) from Smith & Nephew following the achievement of a regulatory milestone.

## CONSOLIDATED RESULTS

### OPERATIONS (continued)

The financial results of Nucryst are as follows:

	2004	2003	2002
Wound care product related revenue	\$ 18.9	\$ 11.6	\$ 8.3
Milestone revenue	13.0	4.6	–
<b>Total wound care revenue</b>	<b>\$ 31.9</b>	<b>\$ 16.2</b>	<b>\$ 8.3</b>
Wound care contribution	\$ 20.0	\$ 7.8	\$ 0.4
Pharmaceutical product development costs (including general and administrative expenses)	(13.9)	(9.8)	(7.4)
<b>Nucryst income (loss)</b>	<b>\$ 6.1</b>	<b>\$ (2.0)</b>	<b>\$ (7.0)</b>

Capital spending totaled \$4.2 million in 2004 compared to \$1.8 million in 2003 and in both years related primarily to the addition of manufacturing capacity of Acticoat™ products in Fort Saskatchewan, Alberta. The success of the Acticoat™ product line has resulted in the need to further increase production capacity at Nucryst's Fort Saskatchewan facility. Nucryst is currently adding a production line to this facility which will be operational by the end of 2005 and will increase capacity by approximately 65%. The total cost of this capital project is approximately \$7.1 million. The Company anticipates that additional expansion may be required in 2006 to meet projected sales growth. Nucryst's administration and pharmaceutical research activities are primarily based in Wakefield, Massachusetts, and manufacturing operations are located in Fort Saskatchewan.

#### ◆ *Nucryst Outlook*

The outlook for Nucryst is for continued growth in licensing and manufacturing revenues as markets for Acticoat™ wound care products are expanded in the United States, Europe and other markets by Smith & Nephew. Increases in these revenues will be offset by lower milestone revenue. Two milestone payments were received in 2004, while one is expected to be earned in 2005. Research and development expenditures will increase in 2005 as Nucryst expands clinical and pre-clinical research into the pharmaceutical attributes of its noble metal nanocrystalline technology. As a result, Nucryst is expected to have net operating losses in 2005.

#### *Discontinued Operations*

##### ◆ *Ambeon*

On January 29, 2004, the Company sold its Ambeon division for net proceeds of \$33.4 million. The completion of the sale to a strategic buyer represented an opportunity to enhance the Company's value and to focus resources on the Company's two high potential technologies, iFire and Nucryst.

Under new Canadian Generally Accepted Accounting Principles ("GAAP") introduced in 2003, all expected future losses and estimated shutdown and asset disposal costs relating to discontinued operations are no longer accrued, but are reported in the period in which they occur. As a result, the gain from the sale of Ambeon of \$5.4 million was reported in the first quarter of 2004 and discontinued operations costs totaling \$1.9 million relating to the restructuring of the Company as a result of the sale of Ambeon were reported in the quarters in which they occurred in 2004. Future costs related to the sale of Ambeon are expected to be nominal. In accordance with GAAP, all Ambeon assets were reported as current assets available for sale at December 31, 2003.

## **CONSOLIDATED RESULTS**

### *OPERATIONS (continued)*

Ambeon had operations in Fort Saskatchewan, Alberta and the United Kingdom, and developed, manufactured and sold coating materials and products for customers in the aerospace, electronics, catalyst and other markets. The segment earnings from Ambeon operations for the year ended December 31, 2003 were \$3.0 million on revenue of \$30.1 million. Capital spending totaled \$1.7 million in 2003.

#### ◆ *Coinage Division and Ethylene Coatings business*

In May 2002, the Company announced its intention to close its Coinage division and its Ethylene Coatings business. As a result, these businesses were accounted for as discontinued operations. Operations in the Coinage Division were discontinued in July 2002 and operations in the Ethylene Coatings business were discontinued in February 2003. The manufacturing warehouse and office facility of the Ethylene Coatings business is reported as a long-term asset available for sale in the Company's consolidated financial statements.

All expected future losses from these businesses were included in the net loss from discontinued operations recorded in 2002. The remaining accrued liabilities relating to these businesses amounted to \$0.8 million at December 31, 2004 compared to \$1.3 million at December 31, 2003. Details of the financial impact of discontinued operations are disclosed in Note 3 to the 2004 Audited Consolidated Financial Statements.

## **INVESTMENTS**

The carrying value of the Company's investments at December 31, 2004 of \$0.5 million has not changed from December 31, 2003. It is Management's belief that the realizable value of these investments exceeds their current carrying value.

## **INVENTORY**

The Company's inventories were \$3.6 million at December 31, 2004 compared to \$2.6 million at December 31, 2003. This inventory is related primarily to Nucryst's operations and represents raw materials, work in progress and finished goods of its wound care products.

## **LIQUIDITY AND CAPITAL RESOURCES**

The Company's business plans are developed to ensure research and development costs do not overextend the Company's financial resources. The Company's 2005 business plan indicates that the Company will have sufficient cash and short-term investments to fund its pharmaceutical product developments at Nucryst and flat screen commercialization plans at iFire.

At December 31, 2004, the Company had cash, cash equivalents and short-term investments of \$101.1 million compared to \$68.1 million at December 31, 2003. This improvement in liquidity of \$33.0 million is primarily the result of financing initiatives discussed below, including the sale of Ambeon in January 2004, the common share offering in August 2004, and the DNP loan funding in November 2004. These three initiatives provided approximately \$83.3 million in cash to the Company. Cash used in continuing operations amounted to \$21.5 million compared to \$24.7 million in 2003, reflecting stronger results at Nucryst. Discontinued operations used \$1.8 million compared to providing cash of \$3.2 million in 2003. 2003 discontinued operations included the operating results of the Ambeon division.

## **LIQUIDITY AND CAPITAL RESOURCES (continued)**

The sale of Ambeon in January 2004 provided the Company with immediate proceeds of \$30.6 million. A further \$2.8 million from the Ambeon sale is held in escrow and will be released as certain conditions are met in 2005 and 2006.

On August 4, 2004, the Company completed a \$50.0 million common share offering. A total of 14,705,883 new common shares were issued at a price of \$3.40 per share. Four members of the Company's Board of Directors purchased 4,852,942 shares under the offering. Net proceeds after fees and expenses amounted to \$47.8 million. The net proceeds of this offering are being used to finance the construction of the iFire flat panel display pilot production facility.

Capital expenditures for continuing operations of \$23.4 million in 2004 were \$13.0 million higher than the same period in 2003. As discussed earlier, the Company commenced major capital projects in both iFire and Nucrust. In relation to these projects, the Company has outstanding purchase commitments amounting to approximately \$18.0 million as at December 31, 2004. Capital expenditures in 2006 could increase to as much as \$200 million if iFire constructs a large scale flat screen production facility.

## **DIVIDENDS**

No dividends were paid in 2004 or 2003. The Company's current policy is to retain its cash reserves to finance capital projects and business growth.

## **CRITICAL ACCOUNTING POLICIES**

The Company's accounting policies are disclosed in Note 2 to the 2004 Audited Consolidated Financial Statements.

The Company has established detailed policies and control procedures that are intended to ensure that Management judgments and estimates are well controlled, independently reviewed and consistently applied from period to period. The following are key policies that may impact the Company's financial condition and results from operations and that require significant judgments by Management. Management believes that its estimates for determining the valuation of the Company's assets and liabilities are appropriate.

**Research and Development Costs** – Development costs are capitalized once the Company has determined that commercialization criteria concerning the product or process have been met. The Company reviews the progress of research and development initiatives on a regular basis and has determined that, in 2004 and 2003, no development costs should be deferred and amortized.

**Site Restoration Costs** – Future site restoration costs have been estimated by qualified employees of the Company taking into consideration the anticipated method and extent of the remediation consistent with regulatory requirements, industry practices, current technology and possible uses of the site. Provision details are based on cost estimates provided by independent consultants. Significant judgment is required in the determination of these provisions and the Company takes a conservative approach in not accruing potential recoveries from third parties where indemnifications are in place. It is the Company's view that where remediation costs will be incurred many years into the future, third party recoveries cannot be estimated with certainty. Revisions to cost estimates and the recovery of actual remediation costs could result in material changes to the provision in future periods. Also see "Environmental Matters".

Effective January 1, 2004, the Company adopted Section 3110 "Asset Retirement Obligations" of the Canadian Institute of Chartered Accountants ("CICA") Handbook which addresses the financial accounting and reporting obligations associated with the retirement of tangible, long-lived assets and their associated net retirement costs.

## **CRITICAL ACCOUNTING POLICIES (continued)**

Under the new Section, an asset retirement obligation is recognized at its fair value in the period in which it is incurred. Asset retirement costs are capitalized as part of the carrying amount of the long-lived asset and a related amortization expense is recognized in future periods. Implementation of CICA 3110 did not have an impact on the Company's results from operations or its financial position as the assets subject to these new rules have been sold or written down to nominal value.

**Income Taxes** – The provision for income taxes is calculated based on the expected tax treatment of transactions recorded in the consolidated financial statements. In determining the provision for income taxes and, in particular, any future tax asset, the Company interprets tax legislation in a variety of jurisdictions and makes assumptions about the timing and certainty of the reversal of the future tax assets. Changes to these interpretations could have a material effect on income tax provisions in future periods.

**Stock Based Compensation** – Canadian GAAP requires that effective January 1, 2004, the fair value method of accounting for stock options be recognized in the financial statements. It provides for alternate methods of implementation and the Company has elected to apply the provisions retroactively with restatement of prior years. As a result, the cumulative compensation cost of options issued during 2002, using the Black-Scholes option pricing model, was charged to deficit with a corresponding increase to contributed surplus at January 1, 2003. Quarterly results for 2003 were restated to reflect the expense related to options issued in 2002 and 2003. The Company has determined that electing this method of applying the new rules had the most conservative impact on its financial results.

For U.S. GAAP, the Company will continue to measure compensation expense using the intrinsic value based methodology for stock options granted to directors and employees and provide pro forma disclosure of compensation expense for all outstanding options issued by the Company as if the fair value methodology had been applied.

## **CHANGES IN ACCOUNTING POLICIES IN 2005**

**Variable Interest Entities** – The Company will adopt the "CICA" guidelines on the consolidation of variable interest entities (VIEs) on January 1, 2005. VIEs include entities where the equity invested is considered insufficient to finance the entity's activities. Under this new guideline, the Company will be required to consolidate VIEs if the investments held in these entities and/or the relationships with them result in the Company being exposed to a majority of their expected losses, being able to benefit from a majority of their expected residual returns, or both, based on a calculation outlined by the standard setters. The Company does not expect that the implementation of this guideline will have an impact on its operating results or financial position.

## **ENTERPRISE RISK MANAGEMENT**

The Company invests in new technologies with the objective of providing leadership, strategy and capital to commercialize the technology as quickly as possible. There is significant risk that the technology may not be commercialized in a timely or cost-effective manner or that it may not be accepted by the marketplace. The Company reduces this risk by investing in multiple technologies and product lines but these risks could have a material adverse impact on the Company's business prospects, financial condition, and results from operations.

## **ENTERPRISE RISK MANAGEMENT (continued)**

### *RISKS AND UNCERTAINTIES*

*Westaim may be unable to develop commercially viable products.*

Some of the Company's products, such as iFire's flat panel television displays, are still in the developmental stage. The Company will likely continue to incur significant research and development costs before any of these products are commercially viable, and there is no assurance that any of its products will ever reach this stage or that the Company will achieve the level of market penetration that it expects. Some or all of the technological obstacles that will need to be overcome in order to make these products commercially viable may prove to be insurmountable.

Some of the Company's proposed products, such as medical devices and pharmaceutical products, will require regulatory approval before the Company is allowed to sell them. The Company expects the regulatory approval process to be lengthy and expensive and the Company will have the burden of proving that its products are safe and effective or that, if satisfied, would cause its products to become prohibitively expensive. There is no assurance that the Company will ever obtain regulatory approval to sell any of its proposed products, or that the conditions imposed by regulators will be satisfactory to the Company. Regulatory requirements imposed on its products could limit the Company's ability to test, manufacture and commercialize its products.

*If Westaim fails to raise the capital necessary to fund its operations, it may be unable to advance the development and commercialization of its technologies.*

A commitment of substantial resources by the Company and its collaborators to conduct research and development, construct pilot or large scale manufacturing facilities and conduct clinical studies will be required to successfully commercialize products under development. The Company completed a \$50.0 million common share offering in 2004 and believes that its current financial position is strong. Nevertheless, the Company believes that the flat panel television display, medical products and pharmaceuticals businesses, may grow extremely rapidly and the Company may not be able to raise additional capital at the time it is needed to complete product development and build manufacturing facilities. Additional capital may be required to fund operations, fund clinical studies, continue the research and development of product candidates, commercialize products and construct pilot and full scale manufacturing facilities. If the Company is unable to raise additional funds when required, it may be necessary to delay, reduce or eliminate some or all of its development programs.

*The commercial potential of the Company's products depends upon certain issues regarding pricing, production costs and medical reimbursement.*

The Company's ability to commercialize iFire's flat-screen technology successfully will depend in part on its ability to price its products at a point that will generate consumer demand, while allowing for an adequate profit margin. The Company believes that its product can be produced at costs lower than other flat-screen technologies but there is no assurance that there will be consumer demand for the iFire product or that competing products will not be developed and priced below the prices required by iFire to be profitable. There is no assurance that the Company's present cost estimates for its manufacturing facilities will be valid at the time that those facilities are constructed.

The Company's ability to commercialize its pharmaceutical products successfully will depend in part on the extent to which reimbursement for the cost of such products and related treatments will be available from government health administration authorities, private health insurers and other organizations and there can be no assurance that adequate third party coverage will be available for the Company to realize an appropriate return on its investment in product development.

## ENTERPRISE RISK MANAGEMENT

### *RISKS AND UNCERTAINTIES (continued)*

*Westaim's success is dependent upon its ability to form partnerships to develop and sell its products.*

The Company's ability to successfully develop, manufacture and market its current and proposed products will depend, to a large extent, on its ability to form partnerships or joint ventures with established corporations or other collaborators. Except as described elsewhere in this document, the Company has not yet entered into any material partnerships or joint ventures for the development or marketing of these products, nor will it necessarily be able to do so in the future. The Company may be unable to find suitable partners or form a partnership or joint venture on terms that are beneficial. If the Company does enter into a partnership or joint venture, it may suffer losses if the partner becomes insolvent or otherwise fails to meet its obligations to the Company.

*Westaim's products may become technologically obsolete.*

The Company competes, and intends to compete, in markets that are characterized by rapid adaptation to technological change. These markets include, but are not limited to, the medical devices, pharmaceuticals and flat-screen television monitor markets. The Company's current and future products may be quickly rendered obsolete and unmarketable. The Company will need to continually develop new products and enhance existing products to keep pace with evolving technologies, customer preferences and industry standards.

*Westaim is developing products for highly competitive markets.*

The Company faces, and will face, competition from a number of other companies including major domestic and international companies which have substantially greater financial, technical, marketing, sales, distribution and other resources. Many of these competitors may also have greater name or brand recognition. The Company's competitors may produce more technologically-advanced products, at a lower cost, than the Company is capable of producing. Competition may cause the Company to lose market share and may reduce profit margins on any products that it is able to sell.

*Westaim may be unable to protect its intellectual property.*

In order to succeed, the Company will need to prevent its intellectual property from being misappropriated by third parties. To protect its intellectual property, the Company relies primarily on its confidentiality agreements, physical security at research and manufacturing facilities, as well as the copyright, trade secret, trademark and patent laws of Canada, the United States, and other countries in which the Company conducts, or will conduct, business. The laws of other countries may not protect intellectual property rights to the same extent as the laws of Canada and the United States and, in any event, the methods that the Company has chosen may fail to adequately prevent misappropriation of its intellectual property.

The Company cannot provide assurance that it will succeed in obtaining new patents; that it will be able to enforce existing patents against third parties; or that existing patents will not be successfully challenged by third parties.

Even if the Company is able to prevent the misappropriation of intellectual property, others may independently and legally develop technologies that are substantially equivalent or superior.

*Westaim may become involved in expensive intellectual property or product liability litigation.*

The Company may be required to commence litigation to enforce its intellectual property rights. Others may claim that it has infringed upon their intellectual property rights and commence litigation against the Company. The

## ENTERPRISE RISK MANAGEMENT

### *RISKS AND UNCERTAINTIES (continued)*

Company believes that it will be subject to an increasing number of infringement claims as it begins to produce more products in more industries.

Some of the Company's existing and proposed products, such as its medical devices and pharmaceuticals, are part of a class of product that is particularly vulnerable to product liability litigation for a number of reasons:

- these types of products are extremely complex and the Company may fail to discover product faults, despite its best efforts to do so;
- these types of products will interact with very complex biological and man-made systems and the Company's products may interact with these systems in harmful ways that it was unable to anticipate, despite its best efforts to do so; and
- because these products may be used by a large number of people, if the Company's products do cause harm, it may be exposed to a large number of claims for damages.

The Company has tried to protect itself against product liability litigation by including limitation of liability provisions in some of its sales agreements. There is no assurance, however, that existing or future limitation of liability provisions will be sufficient to protect the Company in all circumstances, nor can the Company provide assurance that any of these provisions will be held to be enforceable by the Courts.

The Company believes that it has obtained sufficient product liability insurance coverage to protect it against claims. However, the wording of its insurance policies may exclude some claims. Furthermore, the Company cannot provide assurance that its insurance limits will be sufficient, nor can it ensure that it will be able to acquire satisfactory insurance in the future.

*Westaim may be unable to retain the required highly skilled people.*

The Company's technology businesses are dependent upon the talents and knowledge of certain key individuals in each of the businesses. The marketplace for people with these skills is highly competitive, and the Company may not be able to retain a sufficient number of people with the skills that it requires. The Company provides competitive remuneration and incentives for the retention of key personnel.

*Westaim is subject to certain risks because of the international character of its business.*

The Company estimates that sales to international customers accounted for over 90% of its net sales in the fiscal year ended December 31, 2004 and the Company anticipates that international sales will continue to represent a material portion of net sales in the future. International sales are subject to inherent risks, including variations in local economies, fluctuating exchange rates, greater difficulty in the collection of accounts receivable, changes in tariffs and other trade barriers, adverse foreign tax consequences and burdens of complying with a variety of foreign laws. The Company may also encounter exchange rate risk in the event international sales are denominated in a currency other than Canadian dollars.

The Company's financial results are reported in Canadian dollars. A significant portion of the Company's revenue and expenses, as well as accounts payable, accounts receivable and other balance sheet items, are frequently denominated in currencies other than the Canadian dollar, primarily in United States dollars. Fluctuations in the exchange rate between these other currencies and the Canadian dollar could reduce the Company's reported revenue, increase the Company's costs or give rise to a charge related to foreign currency translation, all of which could adversely affect operating results.

## **ENTERPRISE RISK MANAGEMENT**

### *RISKS AND UNCERTAINTIES (continued)*

#### *Volatility of Share Price*

Market prices for securities of companies developing new technologies are generally volatile. Factors such as announcements of technological innovations, new commercial products, patents, the development of proprietary rights, results of clinical trials, regulatory actions, publications, quarterly financial results, the Company's financial position, public concern over the safety of biotechnology, future sales of shares by the Company or by our current shareholders, and other factors, could have a significant effect on the market price and volatility of the Company's common shares.

The price of the common shares may be volatile even though there have been no material changes in the Company's business or finances. In the past, securities class action litigation has often been brought against companies that experience volatility in the market price of their securities. Moreover, market prices for stocks of technology companies frequently reach levels that bear no relationship to the operating performance of such companies. These market prices generally are not sustainable and are subject to wide variations. Whether or not meritorious, litigation brought against the Company could result in substantial costs, divert management's attention and resources and harm the Company's financial condition and results of operations.

## **ENVIRONMENTAL MATTERS**

The Company's operations are subject to extensive federal, provincial and municipal environmental statutes and regulations, including those relating to air emissions, wastewater discharges, contaminated soil and groundwater, and the handling and disposal of hazardous substances and wastes.

The Company's operations in Toronto are conducted under an environmental operating approval from the Ontario Ministry of Environment. The Company's operations in Wakefield, Massachusetts are conducted under various state and federal permits.

The Company operates under a "best management practices program" called Safety and Environment Management Practices ("SEMP") which incorporates both an environmental management system and an occupational health and safety management system. This program is regularly reviewed and updated to keep pace with or stay ahead of regulatory changes and is internally audited every year.

The provision for site restoration decreased by \$0.9 million in 2004 to \$6.7 million. The provision relates primarily to site restoration costs associated with soil and groundwater reclamation and remediation costs. The Company spent \$1.6 million in 2004, of which, \$0.5 million was recovered from a third party. The Company expects to spend only nominal amounts in future years unless a plant site is decommissioned.

## **MARKET FOR SECURITIES**

The common shares of The Westaim Corporation are listed on The Toronto Stock Exchange under the symbol WED and on NASDAQ under the symbol WEDX.

## OUTSTANDING SHARE DATA

The Company's authorized share capital consists of an unlimited number of common shares, preferred A shares and preferred B shares. As at December 31, 2004 and February 10, 2005, there were 92,828,054 common shares outstanding. There were no preferred shares outstanding at December 31, 2004 and February 10, 2005.

The Company maintains an employee and director stock option plan under which the Company may grant options for up to 10,750,000 shares of common stock of the Company at an exercise price equal to the market price of the Company's stock at the date of grant. As at December 31, 2004 and February 10, 2005, there were 4,659,600 options outstanding.

## CONTRACTUAL COMMITMENTS

(\$000)	Payments due by Period				
	Total	Less than 1 Year	1 – 3 Years	3 – 5 Years	More than 5 Years
As at December 31, 2004					
Long-term debt	\$ 4,782	\$ –	\$ 4,782	\$ –	\$ –
Capital lease obligations	–	–	–	–	–
Operating lease obligations	3,339	898	1,886	555	–
Supplier purchase obligations	25,676	25,676	–	–	–
Other long-term liabilities reflected on the Company's balance sheet	–	–	–	–	–
	\$33,797	\$26,574	\$ 6,668	\$ 555	\$ –

## MANAGEMENT'S RESPONSIBILITY

The Management of the Company is responsible for the accuracy of the information disclosed in the Management's Discussion and Analysis. Management ensures that the Company has appropriate information systems, procedures and controls to ensure that information used internally by Management and disclosed externally is complete and reliable. The interim and annual Management's Discussion and Analyses are also reviewed and approved by the Audit Committee of the Company's Board of Directors.

## SELECTED CONSOLIDATED FINANCIAL INFORMATION

The following table sets forth certain financial information for the Company for 2002 to 2004:

(\$000, except per share data)	Year Ended Dec. 31, 2004	Year Ended Dec. 31, 2003	Year Ended Dec. 31, 2002
Revenue from continuing operations	\$ 32,241	\$ 17,285	\$ 12,627
Loss from continuing operations	(28,731)	(37,800)	(39,737)
Loss per common share from continuing operations – basic and diluted	(0.34)	(0.48)	(0.51)
Net loss	(25,177)	(35,440)	(50,389)
Net loss per common share – basic and diluted	(0.30)	(0.45)	(0.65)
Total assets	172,263	144,906	184,183
Total long-term debt	4,795	–	–
Dividends declared	–	–	–

As disclosed in Note 3 to the audited consolidated financial statements, and discussed in this MD&A, the Ambeon business segment has been accounted for as a discontinued operation in 2003. Information for 2002 has been restated accordingly.

In 2002, the Company made the decision to close the Coinage Division and to divest or shut down the Ethylene Coatings business. Accordingly, the results of these operations and the cost of shutdown have been accounted for on a discontinued basis.

## SUBSEQUENT EVENTS

In January 2005, the Company completed a series of transactions whereby two inactive wholly owned subsidiary companies participated in a Plan of Arrangement with two widely held publicly traded companies. This resulted in the reorganization of the participating companies into a single company and the dilution of the Company's investment to approximately 6.0%. The company's pro rata interest in the book value of the recapitalized companies amounted to approximately \$2,200. Subsequently, the company created under the Plan of Arrangement was listed on the Toronto Stock Exchange.

The inactive subsidiaries were previously carried at a nominal value and this transaction will result in the Company recording a dilution gain of approximately \$2,200 recorded in discontinued operations in the first quarter of 2005. On February 10, 2005, the Company sold its investment for net proceeds of approximately \$11,500 and will record an additional gain on the sale of investment of approximately \$9,300 in the first quarter of 2005.

## QUARTERLY INFORMATION

	Q1	Q2	Q3	Q4
(\$000, except per share data)	2004	2004	2004	2004
Revenue from continuing operations	\$10,721	\$ 4,923	\$10,501	\$ 6,096
Loss from continuing operations	(3,178)	(12,667)	(2,487)	(10,399)
Loss per common share from continuing operations				
– basic and diluted	(0.04)	(0.16)	(0.03)	(0.11)
Net Income (Loss)	1,008	(13,071)	(2,514)	(10,600)
Net income (loss) per common share – basic and diluted	0.01	(0.17)	(0.03)	(0.11)

	Q1	Q2	Q3	Q4
(\$000, except per share data)	2003	2003	2003	2003
Revenue from continuing operations	\$ 7,638	\$ 2,683	\$ 3,370	\$ 3,594
Loss from continuing operations	(3,531)	(9,140)	(8,135)	(16,994)
Loss per common share from continuing operations				
– basic and diluted	(0.05)	(0.12)	(0.10)	(0.22)
Net loss	(1,211)	(8,280)	(8,035)	(17,914)
Net loss per common share – basic and diluted	(0.02)	(0.11)	(0.10)	(0.23)

The results of operations of the Ambeon business segment have been accounted for as discontinued operations.

Revenues, loss from continuing operations and net loss were favourably impacted by the reporting of milestone revenues in Nucryst of US \$5.0 million in the first quarter of 2004, US \$5.0 million in the third quarter of 2004, and US \$3.0 million in the first quarter of 2003.

The gain on sale of Ambeon of \$5.4 million was included in net income in the first quarter of 2004.

### *Forward-looking Statements*

This Report contains forward-looking statements including the outlook for Nucryst and iFire. The words “may”, “should”, “would”, “outlook”, “believe”, “anticipate”, “estimate”, “expect”, “intend”, “plan”, “strategy”, “project” and words and expressions of similar import are intended to identify forward-looking statements. Such forward-looking statements include but are not limited to statements concerning expected progress in the Company's technology businesses; return on the Company's technology investments; results of the Company's business plans in relation to costs and financial resources including cash; the expected tax treatment of transactions; the impact of changes in accounting policies on operating results or financial position; product development and performance; the role to be played by or the contribution expected from the present and future technology collaboration partners of iFire Technology Inc. (“iFire”); applications for and effectiveness of technology and products; future costs related to the sale of the Ambeon business; the anticipated release of escrowed cash from the sale of the Ambeon business; estimates for valuing assets and liabilities; future site restoration and remediation costs and environmental compliance costs; expected product cost advantages

of iFire, particularly in regard to existing flat panel display technologies; production capacity and yield of manufacturing facilities; production schedules; research and development costs; the expected commencement or completion dates of new facilities for iFire and Nucryst Pharmaceuticals Corp. (“Nucryst”) and resulting production capacity increases; projected dates and capital requirements for iFire pilot manufacturing of flat panel displays and production of product quality displays and panels; estimated iFire production costs and capital requirements for manufacturing facilities; sales growth; estimates and expectations regarding the start and completion of clinical trials by Nucryst; Nucryst’s development of new products, completion of associated clinical trials, and the submission of FDA applications within any particular timeframe; opportunities and demand for Nucryst’s present and future products; global sales trends for Acticoat™; Nucryst’s sales, receipt of milestone payments, revenue and profitability; and Nucryst’s deployment of cash flow to technology development for the introduction of new products. These statements are based on current expectations that are subject to risks and uncertainties, and the Company can give no assurance that these expectations are correct. Forward-looking statements are not guarantees of future performance, they involve significant risks, uncertainties and assumptions, and our actual results could differ materially from those anticipated by these forward-looking statements for various reasons generally beyond our control, including but not limited to: (i) unexpected obstacles in developing iFire or Nucryst technology, manufacturing processes and new applications; (ii) unforeseen complexities and delays associated with completing the iFire and Nucryst facility expansions, and with achieving timing targets for pilot manufacturing and the production of product quality displays and panels and the commercial introduction and sale of iFire products; (iii) patent and technical hurdles which might inhibit or delay the ability of iFire or Nucryst to develop or commercialize technologies or products; (iv) delays in receiving regulatory approvals, including from the FDA; (v) the degree to which Smith & Nephew plc succeeds in selling Acticoat™ products; (vi) general economic, market, financing, regulatory and industry developments and conditions in the industries that the Company serves, which among other things might affect the demand for electronic materials and pharmaceutical products or the ability to raise new capital or affect potential partner ability to contribute financially; (vii) the activities of our competitors and technological developments that diminish the attractiveness of our products; (viii) general industry and market conditions and growth rates; and (ix) the risks described above under “Risks and Uncertainties”. The Company disclaims any intention or obligations to revise forward-looking statements whether as a result of new information, future developments or otherwise. All forward-looking statements are expressly qualified in their entirety by this cautionary statement.