



## Management Discussion and Analysis (“MD&A”) For the years ended December 31, 2010 and 2009

The following Management discussion and analysis is dated March 23, 2011 and is a review of the financial results of HSE Integrated Ltd. (“HSE”, “We”, “Our”, or the “Corporation”) for the fiscal years ended December 31, 2010 and 2009. This MD&A should be read in conjunction with HSE’s other documents filed on SEDAR at [www.sedar.com](http://www.sedar.com). Unless otherwise disclosed, the financial information presented in this discussion has been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”) and takes into consideration information available to Management up to March 23, 2011. Unless otherwise stated, dollar figures presented are expressed in thousands of Canadian dollars and per-share figures in dollars per weighted-average common share. The following MD&A contains forward-looking information and statements. Please refer to the end of the MD&A for the disclaimer on forward-looking statements.

### SELECTED FINANCIAL INFORMATION

	Year ended Dec. 31, 2010	Year-over-year % change	Year ended Dec. 31, 2009	Year-over-year % change	Year ended Dec. 31, 2008
Revenue	\$ 82,028	0.5%	\$ 81,601	-28.3%	\$ 113,763
Operating and materials	70,341	-3.0%	72,530	-21.7%	92,673
Operating margin	11,687	28.8%	9,071	-57.0%	21,090
Operating margin %	14.3%		11.1%		18.5%
Selling, general and administrative	7,936	-3.5%	8,226	-23.1%	10,699
Net earnings (loss)	(1,157)		(6,634)		248
Per-share basic	(0.03)		(0.18)		0.01
Per-share diluted	(0.03)		(0.18)		0.01
EBITDA <sup>(1)</sup>	\$ 3,751	343.8%	\$ 845	-91.9%	\$ 10,391
EBITDA %	4.6%		1.0%		9.1%
Total assets	\$ 49,912	-1.6%	\$ 50,722	-26.4%	\$ 68,934
Total long-term liabilities	\$ 7,906	45.6%	\$ 5,429	-69.4%	\$ 17,731

(1) See Non-GAAP Measures

## FINANCIAL REVIEW

### Overview

HSE operates in two geographic segments – Canada and the United States – providing health and safety services to industry. The Corporation offers a package of integrated asset, worker and community health and safety protection services including: onsite safety supervision; gas detection; fixed and mobile air quality monitoring; breathing equipment rentals and services; fixed and mobile firefighting and fire protection services and equipment; worker shower (decontamination) services; onsite medical services; first aid; emergency medical response; worker safety training; industrial hygiene services; and safety management.

For the 2010 fiscal year, total revenues increased 0.5% to \$82.0 million from \$81.6 million in 2009. The fiscal 2010 operating margin was \$11.7 million or 14.3% of revenues, up 28.8% from \$9.1 million or 11.1% of revenues in 2009. Selling, general and administrative expense (“SG&A”) decreased to \$7.9 million from \$8.2 million in the prior year. As a percentage of revenue, SG&A decreased from 10.1% of revenue in fiscal 2009 to 9.7% in 2010. HSE reported a loss of \$1.2 million or (\$0.03) per share for the 2010 fiscal year compared to a loss of \$6.6 million or (\$0.18) per share in 2009. EBITDA (see “Non-GAAP Measures” page 15) for the period was \$3.8 million or 4.6% of revenue in 2010, a 343.8% increase from \$0.8 million or 1.0% of revenue in 2009.

### Revenue

The Corporation provides health and safety services to customers in two main business areas: Industrial and Oilfield. The differentiation takes place primarily because of the industries served and activity drivers that affect demand.

Industrial health and safety services are those provided to all other industries and include a vast array of clients including fixed facilities that operate continuously on a year-round basis. The customers operate in a wide variety of industries and the public sector including: non-conventional upstream oil development and production (including oilsands extraction); oil and gas processing and refining; petrochemicals; pulp and paper; utilities; power generation; agriculture food and beverage; offshore operations; and diverse manufacturing industries. Industrial also includes worker safety training and safety management services. Industrial health and safety services are in most cases delivered to permanent production, manufacturing, processing facilities or other operations that operate 24/7/365.

Oilfield operations are associated exclusively with conventional upstream oil and gas activity, which is often short-term, mobile and temporary because they are related to interruptible exploration, drilling, completion and workover activities. Demand for Oilfield health and safety services is historically highly cyclical due to external factors such as commodity prices, currency exchange, capital markets, weather, and government policy. With all other factors stable, demand for Oilfield health and safety services is highly seasonal in Canada because field activity is greatly affected by weather and road access.

The Corporation tracks billings to customers by defined revenue groupings, but uses a common pool of equipment and manpower resources to provide these services. Management and administration services are provided from a common personnel pool.

The revenue for these business areas is shown below:

	Year ended Dec. 31, 2010	Year ended Dec. 31, 2009	Year-over-year % change
Industrial	\$ 47,274	\$ 54,298	-12.9%
Oilfield	34,754	27,303	27.3%
Total Revenue	\$ 82,028	\$ 81,601	0.5%
As a percentage of revenue:			
Industrial	57.6%	66.5%	
Oilfield	42.4%	33.5%	
Total Revenue	100.0%	100.0%	

During the year, the Corporation had one customer representing more than 10% of revenue (2009 – one). The Corporation had sales of \$8.5 million to the customer, mostly related to callout Oilfield health and safety services. In 2009, the Corporation had sales of \$8.9 million to a single Industrial client related to ongoing long-term industrial projects and plant turnarounds.

### **Industrial**

The Industrial health and safety services component of the Corporation's total revenue declined in 2010 due to the delay of plant shutdown and turnaround services until later years and a highly competitive operating environment. Although there was a general recovery in the industries and geographical markets in which HSE operates, services supplied to conventional and non-conventional hydrocarbon processing and extraction facilities were subject to pricing pressure that included price reductions to key clients in several markets due to lower commodity prices or project cost escalation. The oil and gas processing plant shutdown and turnaround services that typically take place during the second and third quarters in western Canada were subject to pricing pressure caused primarily by increased focus on this market by HSE competitors that in the past have predominantly serviced the Oilfield sector as more clients used price as the major procurement criteria. One significant HSE client in prior years chose to staff its shutdown and turnaround with staff personnel, a cost-reduction measure and a departure from the growing trend to outsourcing this service. Other projects were delayed into the future as a cash-conservation initiative.

Due to the factors cited above, Industrial revenue decreased \$7.0 million (12.9%) to \$47.3 million in 2010 from \$54.3 million in the prior year. Industrial health and safety services comprised 57.6% of total revenues, down from 66.5% in 2009.

On a regional basis, Industrial revenues varied. Revenue in the oilsands region of northeastern Alberta declined primarily due to pricing pressure and increased competition. The rest of western Canada remained stable. Central Canada grew sharply in 2010 while Atlantic Canada declined primarily because of the re-pricing of a major industrial contract. HSE's operation in the industrial midwest of the United States enjoyed substantial growth.

## **Oilfield**

Oilfield revenues in the 2010 fiscal year increased by 27.3% in 2010 compared to 2009. This significant year-over-year increase is due to higher overall activity levels in western Canada in the conventional upstream, or “wellhead”, sector of the oil and gas industry: oil and natural gas well exploration, drilling, completion and workover operations in the Western Canadian Sedimentary Basin and the southern United States. The factors behind this recovery include stable oil prices, improved development economics in Alberta due to a revised royalty regime, increased well stimulation (hydraulic fracturing) activities requiring worker and asset protection, and a trend towards deeper wells requiring more drilling days. This increased the number of days on which medical services may be required, or the likelihood that sour gas may be encountered (whether or not the target reservoir is sour), requiring breathing air and gas detection services.

Besides an increase in overall activity, there has been a major shift in the type of drilling being undertaken. According to figures provided by the Canadian Association of Oilwell Drilling Contractors (“CAODC”), from 1992 to 2008 about 70% of the total wells drilled had natural gas as the target. This included safety intensive “sour gas” containing hydrogen sulphide. Due to a North American glut in natural gas supplies caused by the successful development of shale gas, gas prices are much lower than they have been in recent years. This has caused a reduction in natural gas production and development expenditures.

However, the application of extended-reach horizontal drilling and multi-stage fracturing – and assisted by attractive royalty fiscal regimes in all four western provinces – has caused the E&P companies to increasingly focus their spending on oil. For the 2010 calendar year the CAODC reported that 48.0% or 6,250 of 13,575 wells drilled had oil as the target, a 105.3% increase from 3,176 or 34.0% of the 9,342 total wells drilled in calendar 2009. The increase in total drilling and oilwell drilling was particularly significant in the fourth quarter, a period in which a disproportionate amount of the total 2010 drilling took place. In the last three months of the 2010 fiscal year 5,352 wells were drilled, an increase of 207.1% from 1,743 in 2009. The number of wells that had oil as a target increased to 2,608, 161.8% higher than 996 in 2009.

In the United States, Boots & Coots HSE Services LLC (“BCHSE”), the Corporation’s venture with Boots & Coots Services (a division of Halliburton), contributed \$1.5 million to revenue in 2010 compared to \$0.5 million in the same period of 2009. BCHSE continues to gain customer acceptance as a capable provider of worker and asset protection services.

## **Operating and Materials Expense and Operating Margin**

Operating and materials expense consists of costs directly attributable to the delivery of health and safety services to customers. These include: wages and benefits for field employees and contractors; equipment rentals and leases; field service center property costs; transportation; fuel; consumables; equipment repairs and maintenance; and field office administration including field sales.

Operating and materials expense for the year ended December 31, 2010 declined to \$70.3 million or 85.8% of revenue compared to \$72.5 million or 88.8% of revenue in 2009. Operating margin for the year increased to \$11.7 million (14.3% of revenue) in 2010 from \$9.1 million (11.1 % of revenue) in 2009.

The increase in operating margin is due to a significant improvement in the profitability of the Corporation’s U.S. operations, rigorous control over all expenses, the impact of higher-margin Oilfield health and safety services because of increased equipment rentals, and a full year of the positive financial impact of the cost-reduction initiatives undertaken in the first half of 2009. This improvement was achieved despite the removal of salaried employee pay reductions in 2010 brought in to offset the impact of the recession in 2009.

The provision for doubtful accounts receivable was \$1.1 million (5.7% of trade accounts receivable) at the end of the year compared to \$1.3 million or 7.2% of trade accounts receivable at December 31, 2009.

## **Selling, General and Administrative Expense**

Selling, general and administrative (“SG&A”) expense consists of costs not directly attributable to the delivery of services to customers. These include executive management; corporate head-office functions and support services; administrative personnel; corporate sales and marketing costs; liability insurance; professional fees; and investor-relations expenses.

SG&A for the year ended December 31, 2010 totaled \$7.9 million (9.7% of revenue), down from \$8.2 million (10.1% of revenue) in the prior year. This improvement was achieved despite the removal of salaried employee pay reductions in 2010. The Corporation continues to work diligently to minimize SG&A expenses without impairing financial performance.

Included in SG&A expenses for 2010 is \$0.7 million related to the Corporation’s transition to the International Financial Reporting Standards (“IFRS”) with which HSE was required to comply at the beginning of the 2011 fiscal year. Contained in

2009 SG&A expenses is \$0.5 million (\$0.3 million in the first quarter of the year and \$0.2 million in the second quarter) related to cost-reduction initiatives undertaken by the Corporation in response to the global recession and commodity price collapse and a commensurate decline in overall demand for HSE's services.

## **EBITDA and Net Earnings**

EBITDA (see "Non-GAAP Measures") in the 2010 fiscal year increased 343.8% to \$3.8 million from \$0.8 million in 2009. The significant EBITDA increase was due to several factors including increased revenue, reduced operating expense, and reduced SG&A.

Total amortization for the year was \$5.7 million, down from \$6.7 million in 2009. Property and equipment amortization decreased to \$5.2 million in 2010 compared to \$6.2 million in the prior year. HSE pursued a cautious strategy on capital spending to maintain a strong balance sheet and to ensure the recovery was underway and the rate of return on invested capital going forward would justify the investment. Amortization of intangible assets was constant at \$0.5 million in 2010 and 2009.

Stock-based compensation for the year was \$0.2 million (2009 – \$0.3 million). The year-over-year decline is due to a reduction in the number of outstanding unvested options. Deferred share unit ("DSU") expense for the year was \$0.02 million (2009 - \$0.1 million), due to most directors taking their fees in the form of DSUs offset by the redemption of DSUs by directors retiring from the Board.

Interest on long-term debt and other interest and bank charges decreased slightly to \$0.49 million in 2010 from \$0.54 million in 2009. Debt declined in 2010 as scheduled principal debt payments totaling \$0.7 million were made in the second half of 2010. Offsetting this, interest rates on the Corporation's variable-rate bank debt increased year over year due to increases in prime lending rates and to a higher adjustment to prime under the Corporation's debt facility entered into in April 2010.

For the year ended December 31, 2010, the gain on disposal of property and equipment was \$0.1 million with proceeds on sale of \$0.6 million. This compared to a loss on disposal of \$0.3 million on proceeds of \$0.9 million in 2009. In both years, the amount includes amortization of a deferred gain on sale/leaseback of real estate assets as discussed in the 2008 annual MD&A (\$0.1 million – 2010; \$0.1 million – 2009). Asset divestitures consisted of retirement of vehicles replaced through the Corporation's fleet management program.

At year end 2009, the Corporation reviewed its long-lived assets to determine whether changes in the business climate indicated that future cash flows generated by the long-lived assets would be sufficient to recover their carrying value. As part of the impairment review, Management identified certain assets that were disposed of subsequent to year end at a point significantly before the end of their previously estimated useful lives. The disposal of these assets confirmed that their carrying values exceeded the amounts recoverable from them and accordingly an impairment loss of \$1.6 million was recorded with respect to these assets. In 2010, Management performed a test for impairment of long-lived assets. Based on Management's assessment, no impairment of long-lived assets existed at December 31, 2010.

At December 31, 2010 the Corporation reversed a liability for contingent consideration related to an acquisition in 2006 as the period over which the consideration could be earned had expired. This resulted in a gain of \$0.8 million that has been recorded as income.

HSE had a \$0.6 million income tax recovery for the year versus an income tax recovery of \$2.0 million for 2009. The change can be attributed primarily to the decrease in taxable income between years.

Net loss for the year was \$1.2 million or (\$0.03) per share versus \$6.6 million or (\$0.18) per share in 2009. The year-over-year decline was due to improvements in revenue, increased EBITDA, reduced amortization charges, and overall reductions in operating costs as described above.

## **Fourth Quarter 2010 Results Versus Fourth Quarter 2009**

In the fourth quarter of 2010, total revenues were \$22.4 million, an increase of \$3.3 million (17.4%) over revenues of \$19.1 million for the same period in 2009. Revenue from Oilfield health and safety services increased by \$3.8 million (58.3%) over the same period last year. Offsetting this was a decrease in Industrial revenues of \$0.5 million (3.9%) from 2009 to 2010.

Operating expenses increased by \$2.1 million to \$18.6 million from \$16.5 million in the fourth quarter of 2009. However, as a percentage of revenue, operating costs declined to 83.2% of revenue from 86.5% of revenue in Q4 2009. Operating cost changes reflect the increase in activity year over year. Operating-margin improvements are due partly to increases in Oilfield activity that typically have a higher proportion of higher-margin equipment rental revenue, as well as ongoing cost-containment activities.

SG&A decreased to \$2.0 million (8.9% of revenue) in the fourth quarter of 2010, from \$2.1 million (10.9% of revenue) in 2009. While there was some gain in the reduction of legal fees related to an unsolicited takeover bid in 2009, this was to some degree diminished by reversing the salaried staff wage cuts instituted in 2009 to help offset the impact of the recession.

EBITDA increased by 246.0% from \$0.5 million in Q4 2009 to \$1.7 million in the fourth quarter of 2010. The increase in EBITDA was due to a significant increase in Oilfield revenue, which has a larger proportion of high-margin equipment rentals than Industrial. The Corporation had a profit of \$0.7 million in the fourth quarter of 2010 versus a loss of \$2.2 million in the fourth quarter of 2009.

## Fourth Quarter 2010 Results Versus Third Quarter 2010

In the fourth quarter of 2010, total revenues were \$22.4 million, a 10.2% increase over revenues of \$20.3 million for the third quarter. Revenues from Oilfield health and safety services increased by \$1.4 million over the third quarter of 2010 as the year-over-year increase in Oilfield activity continued. Industrial health and safety revenues increased by \$0.6 million from \$11.4 million in the third quarter to \$12.0 million in the fourth quarter. This indicates a trend towards overall revenue recovery because the third quarter traditionally experiences more activity as plant shutdown and turnaround services usually take place prior to the onset of winter.

Operating expenses increased by \$1.6 million from \$17.1 million to \$18.7 million for the fourth quarter reflecting higher sales. However, operating margin increased to 16.8% from 15.8% in Q3 2010 because of higher sales volumes and a higher percentage of work from the higher-margin Oilfield business segment.

SG&A remained consistent with the third quarter at \$2.0 million, but declined as a percentage of revenue to 9.1% from 10.0%.

## Liquidity and Capital Resources

The Corporation's principal sources of capital are cash flows from operations, borrowings under an established credit facility with its senior lender, convertible debentures, and equity financing.

The Corporation, through the conduct of its operations, has undertaken certain contractual obligations as noted in the following table:

Years ended December 31	2011	2012	2013	2014	2015	Total
Capital lease obligations	\$ 111	\$ 15	\$ 2	\$ –	\$ –	128
Vehicle and equipment operating leases	2,146	952	146	8	–	3,252
Rental facilities	3,383	3,135	2,705	2,301	1,809	13,333
Long-term debt <sup>(1)</sup>	1,304	1,304	1,304	2,361	–	6,273
Total contractual obligations	\$ 6,944	\$ 5,406	\$ 4,157	\$ 4,670	\$ 1,809	\$ 22,986

(1) Principal portion only

### Liquidity

At December 31, 2010, the Corporation had cash on hand of \$1.5 million.

On April 27, 2010 the Corporation entered into a \$15.0 million credit facility with a regional financial institution. The facility consists of a \$10.0 million operating revolving loan facility for general operating purposes and a \$5.0 million non-revolving reducing loan facility. The two facilities were used to retire the \$5.3 million of bank debt with another lender that existed at the time.

The \$5.0 million non-revolving term facility is repayable in monthly payments of \$109 starting July 1, 2010. The facility is payable in full 48 months after initial drawdown. The operating facility is renewable annually and is margined to accounts receivable. Both facilities bear interest at prime plus a fixed percentage. A standby fee is also required on any unused portion of the operating facility. Both facilities are subject to certain covenants including a working-capital covenant, a debt-to-equity covenant, a fixed-charge-coverage ratio, and other positive and negative covenants. The facilities are collateralized under a general security agreement that includes accounts receivable and property and equipment.

HSE was compliant with all debt covenants at December 31, 2010. As at December 31, 2010, the total outstanding on the term-loan facility was \$4.3 million, of which \$1.3 million was current. During the year the Corporation made scheduled principal long-term debt payments of \$0.7 million. At the end of the fourth quarter, there were no draw amounts against the Corporation's \$10.0 million revolving operating facility.

The Corporation's existing long-term debt agreements contain a clause to address the transition of accounting standards to IFRS. Although there is a risk that the Corporation's financial reporting under IFRS could result in a breach of an existing financial covenant, the Corporation expects that it will be able to amend the existing long-term debt agreements to make any changes covenant neutral, however no absolute assurances can be made in this regard.

On November 9, 2010 HSE announced the issue of up to \$2.0 million in Subordinated Secured Convertible Debentures (the "Debentures"). The Debentures mature on January 15, 2014 and bear interest at 10.0% per annum, payable quarterly in arrears on April 15, July 15, October 15 and January 15 in each year beginning April 15, 2011.

On December 21, 2010, HSE completed the first closing with total proceeds of \$1.9 million. On January 18, 2011, HSE completed the final closing with proceeds of an additional \$0.1 million. The proceeds of the offering will be used to fund part of the Corporation's 2011 capital program.

The Debentures consist of both debt and equity components that are presented separately in the Corporation's consolidated balance sheet. The debt component is measured by calculating the present value of both the quarterly interest obligations and the principal payment due at maturity, using the rate of interest that would have been applicable to a non-convertible debt instrument of comparable term and risk at the date of issue. The residual portion of the Debenture proceeds is allocated to equity. As a result, the debt component of the Debentures is less than the principal amount that would be paid at maturity, assuming no conversion occurs. The discount to face value of the debt component presented on the consolidated balance sheet will be accreted using the effective-interest method over the term of Debenture.

The equity component represents the difference between the face value of the Debentures (\$1.9 million) and the value assigned to the debt component of the Debentures at the date of issue as described above. This equity component amount will remain constant over the term of the Debentures unless a conversion occurs. If Debentures are converted into common shares, a proportionate amount of both the debt and equity components will be transferred to share capital. Interest and accretion expense on the Debentures is included within interest on long-term debt in the consolidated statements of loss

#### ***Provision for Conversion***

The Debentures are convertible at the holder's option into common shares ("Shares") of the Corporation at a conversion price of \$0.50 per Share (the "Conversion Price") at any time prior to the close of business on the earlier of the business day prior to the maturity date and the business day immediately preceding the date fixed for redemption of the Debentures, subject to adjustments in certain events including dividend protection for the declaration of dividends outside of the normal course. Holders converting their Debentures will receive accrued and unpaid interest thereon to the date of conversion. The ability to convert the Debentures would cease immediately prior to a "Change of Control" as defined in the offering document. In the event Debentures are converted prior to maturity, the difference between the carrying amount of such Debentures and their face value would be charged to interest expense.

#### ***Provision for Redemption***

The Debentures will not be redeemable before January 15, 2012 except in the event of the satisfaction of certain conditions after a Change of Control has occurred. On and after January 15, 2012 and prior to January 15, 2013, provided that the current market price (as calculated pursuant to the indenture) of the Shares is at least 133% of the conversion price, the Debentures may be redeemed at the option of the Corporation in whole or in part from time to time at a redemption price equal to their principal amount plus accrued and unpaid interest thereon up to (but excluding) the redemption date. On and after January 15, 2013 and prior to the maturity date, the Debentures may be redeemed at the option of the Corporation in whole or in part from time to time at a redemption price equal to 105% of their principal amount plus accrued and unpaid interest thereon up to (but excluding) the redemption date. If HSE wishes to redeem any Debentures, it must provide not more than 60 or fewer than 40 days prior notice of redemption.

Notwithstanding the foregoing, in the event of a Change of Control, the Debentures will be redeemable at the Corporation's option, in whole or in part, at a price equal to 125% of the principal amount thereof plus accrued and unpaid interest for the first two years; thereafter, this amount will decline by 1.5% per month.

### ***Cash Provided by Operations***

Cash provided by operations in the year was \$2.1 million in 2010 compared to \$6.7 million in 2009. Improved revenue levels during the year resulted in higher operating cash flow excluding changes in working capital. This was offset by a reduction in cash provided by changes in non-cash working capital related to receivables of \$0.7 million in 2010 compared to an increase in cash provided by changes in non-cash working capital of \$5.5 million in 2009. Changes in both years were primarily due to changes in receivables and payables. Receivables and payables both increased year over year due to the higher activity levels in the fourth quarter. Days-sales-outstanding (“DSO”) remained relatively constant at 74 days at December 31, 2010 compared to 76 days at December 31, 2009.

### ***Cash Provided by (Used in) Financing and Investing***

As described above, during 2010 the Corporation negotiated a new \$15.0 million credit facility with a regional lender, which it used to pay out the facility that was outstanding at the end of 2009. During the year, the Corporation made payments totaling \$0.7 million against this facility. As well, the Corporation issued convertible debentures for proceeds of \$1.9 million.

During the year the Corporation made scheduled debt reductions of \$0.3 million towards capital leases.

Purchases of property and equipment for the year amounted to \$2.3 million, the majority of which was revenue-generating health safety services rental equipment. Proceeds from the disposal of property and equipment were \$0.6 million.

### **Working Capital**

At December 31, 2010, the Corporation had working capital (not including current portions of long-term debt obligations and deferred gains) of \$15.8 million. This compares to \$14.1 million December 31, 2009. The increase from December 31, 2009 is a result of cash received from the convertible debenture as described above, combined with activity-related increases in accounts receivable and accounts payable and accrued liabilities.

### **Outlook**

In the first quarter of 2009 the economic world in which HSE operated had radically changed due to the collapse of the commodities and world capital markets, as well as the introduction of punitive new royalty policies by the Government of Alberta. HSE spent the remainder of 2009 reducing costs in every possible manner while maintaining the core delivery capacity of the company in terms of personnel, equipment, and field service locations. HSE’s primary focus in 2009 was cutting costs, paying down debt, and finding a way to again achieve positive cash flow from operations. This was achieved in the second half of the year after significant cost cutting and restructuring.

One year ago at this time HSE was cautiously optimistic that the recovery was underway. However, the Corporation’s client base were cautious about the speed at which they resumed spending. Many of the clients delayed projects pending stabilization of oil prices and capital markets, and confirmation of positive and permanent adjustments to Alberta’s new royalty framework. Alberta confirmed its new royalty structure in May of 2010.

Early in the third quarter of last year we saw a gradual but consistent increase in spending in multiple markets and industries. This continued throughout the year. The rig count began to climb as the combination of stable oil prices, new technology, and an improved royalty regime caused E&P company clients to resume spending in western Canada. Oilsands construction projects resumed. Some plant maintenance activity that had been delayed in 2009 was undertaken in the third and fourth quarters of 2010. The Corporation’s financial performance in the fourth quarter of the 2010 fiscal year showed that for the first time in two years, HSE had returned to more traditional levels of EBITDA and operating margins that it had enjoyed in the 2005 through 2008 period.

With 2011 well underway, the Corporation’s clients have been more willing to provide guidance about the amount of upcoming work and projects requiring HSE’s services for the first time since 2008. At the time of writing, HSE’s “order book” – measured by plant shutdowns and turnaround projects awarded to HSE and other contracts in which HSE is engaged 24/7/365 – is higher than the same time last year.

In a people-driven service business like health and safety, managing HSE’s labour force is a major commitment. Two years ago the Corporation was dealing with shrinking its human resources to fit the business. One year ago the challenge was keeping HSE’s core team busy and engaged. In 2011 a preoccupation of HSE’s Management and the HR team is finding enough trained, qualified and motivated personnel to do all the upcoming work. This is one problem everyone at HSE is excited to help solve.

## ***Industrial***

The major change for the Industrial health and safety services portion of HSE's business in 2011 is a sharp increase in client demand in multiple markets, particularly for plant shutdown and maintenance services. It is difficult to discern whether the Corporation is being asked to do work that wasn't done during the recession; whether the focus on price in the past is being replaced by a focus on quality; or whether clients are simply planning their maintenance activities well in advance. Regardless, the amount of work that HSE has scheduled for late Q1 and the subsequent three quarters in the current fiscal year is greater than at this time last year.

The order book is in all markets from field hydrocarbon processing facilities in northwest Alberta, to oilsands plants in northeast Alberta, to processing plants in multiple industries in Ontario and the U.S. midwest, to refineries in Atlantic Canada.

HSE's chosen position in the Industrial safety market is that of quality and capacity, not price. HSE is not and will never be the lowest-cost provider of these services. The Corporation is focused on national standards, consistent operating procedures, trained personnel, quality equipment, and the capacity to take on larger projects and expand ongoing assignments as required. The Corporation has lost work in the past two years on price. However, Management's view is that HSE's key stakeholders – employees, clients, and capital providers – will be better served by taking on work that improves profits rather than by working on unprofitable jobs simply because they are available.

HSE's clients' focus on quality health and safety services appears to have improved since the economic recovery, resuming a trend towards outsourced expert health and safety services that had been growing for 20 years and was only interrupted by the severe economic recession of 2009 and the first half of 2010.

In 2011 HSE assembled its first formal Business Development ("BD") group to focus on expanding its client base for Industrial health and safety services. A core strength of HSE is its capacity, diversity of services, and delivery footprint, particularly in the major hydrocarbon processing, refining, and distribution centers of Fort McMurray and Fort Saskatchewan/Edmonton in Alberta; Sarnia and Hamilton in Ontario; Dartmouth, Saint John and St. John's in Atlantic Canada; and the industrial midwest of the U.S. through a location in Taylor, Michigan. The BD team has been focusing on plant owners and operators, engineering, procurement and construction companies; and maintenance contractors with operations in one or more of these locations.

In the first quarter of 2011 HSE was awarded a five-year national contract for four facilities in the above-noted locations. A condition of this contract was that HSE not disclose the name of the client, however, the precedent has been set. The next customer to embrace this "single-source" concept will also recognize that, until HSE was created, safety services were either delivered internally or by several contractors in different geographical markets. Such contractors are, by nature, unable to offer the same national standards of quality, service, and price that HSE delivers.

Securing single-client national contracts in multiple locations has been the foundation of HSE's strategic plan for the past six years. The recession of 2009 was a major setback in executing this strategy. However, with the recovery underway and a major national contract in hand, HSE believes the Industrial side of its business is back on the path to growth.

In 2011 HSE will be expanding into the new business area of safety consulting, whereby the Corporation will provide expert safety supervisors to projects on a contract basis. While HSE has done some work in this area in the past, the Corporation formalized its expansion into this business with the January 2011 acquisition of Taylored Safety Services Inc. ("Taylored") of Halifax. Having clients seek contract safety supervisors is an extension of two trends: outsourcing of safety expertise to an expert third party; and a growing emphasis on quality safety supervision for all types of safety-intensive operations. Taylored provides HSE with domain expertise in safety consulting by formalizing the requirements for qualified safety personnel, creates a database of safety consultants available on a project basis, and formalizes an internal career path for HSE personnel that wish to apply their training and job experience to more lucrative and rewarding careers.

## ***Oilfield***

The Oilfield component of HSE's business is where the Corporation started and was the dominant business area for many years. However, this segment peaked in terms of revenue in 2006 and declined every year until 2009. This decline is due in part to reduced drilling activity levels in western Canada. It is also due to greater competition caused by increased equipment capacity by competitors, who believed that demand for these services would continue to grow.

Nevertheless, the signals for increased business are the strongest they have been since before the recession. In fiscal 2010 the Corporation enjoyed its first year-over-year growth as revenues increased 27.5% from \$27.3 million to \$34.8 million. The momentum increased in the fourth quarter as revenues increased 58.3% to \$10.4 million from \$6.6 million in the prior year. Based on the 207.1% increase in total wells drilled in Q4 from 1,743 in 2009 to 5,352 in 2010, total spending in this

area has increased to a new level. Record drilling rights sales in Alberta in 2010 will likely perpetuate this level of activity through 2011. The Corporation believes that in 2011 Oilfield revenues will be higher again than in 2010.

There are several elements driving this new level of activity that appear sustainable. The price of oil has remained relatively stable at \$US 90 per barrel. Alberta's new royalty regime introduced in the second quarter of 2010 is said to be stable for the foreseeable future. The application of new drilling techniques involving extended-reach horizontal wells and multi-stage fracturing drilled into previously uneconomic but extensive oil-bearing reservoirs appears to have created a new and sustainable source of reserve and production growth for HSE's E&P company clients.

The trend in drilling for western Canada for 2011 and beyond is a move from numerous vertical shallow wells for natural gas and oil, to longer, deeper, complex and expensive horizontal wells. While the total number of wells drilled has likely declined on a permanent basis, total spending on conventional oil and gas is approaching levels similar to those in 2005 based on data published by ARC Financial on February 7, 2011. ARC estimates that in 2011 total spending on conventional oil and gas in western Canada will be \$33.8 billion, down from \$34.8 billion in 2005.

Natural gas prices remain a challenge. The realignment of North American gas markets to higher volumes and lower prices has been caused by the development of shale gas resources in places that did not previously yield commercial quantities of natural gas. Extensive drilling in the United States in the face of rising production and flat demand has further exacerbated the gas glut and flattened prices. However, in recent months the number of rigs drilling for natural gas has declined, which will eventually bring supply and demand closer to balance. Also promising are long-term markets for natural gas to further replace coal for electricity generation.

Any increase in gas prices and gas drilling will further enhance the opportunities for HSE's Oilfield health and safety services.

HSE is participating in this new type of drilling in several areas. Extensive hydraulic fracturing during completion uses acid or hydrocarbon frac fluids, which has increased demand for the Corporation's fire and shower protection units. Every rig operating more than 40 minutes from a hospital emergency ward requires onsite first aid, a core HSE service. While the target reservoirs may not contain poisonous sour gas, the deeper a well is drilled, the more likely it is that the wellbore will pass through a sour-gas-bearing reservoir. This has increased demand for HSE's air quality monitoring and breathing protection services, both key components of the Corporation's suite of health and safety services.

The impact on HSE's traditional Oilfield service locations has been positive and appears sustainable. These include: Weyburn, Brooks, Sylvan Lake, Whitecourt, and Grande Prairie. The only major year-over-year decline on a station basis was in Fort St. John. The growth in activity in this area has been primarily driven by shale gas plays such as the Montney and Horn River. While these plays still look promising for the future, clients have reduced expenditures in these areas due to continued low natural gas prices.

### **United States**

HSE has reported segmented financial information for its two U.S. operations: CRS Technologies Inc. ("CRS"), which operates from Taylor, Michigan (a suburb of Detroit), and Boots & Coots HSE Services LLC ("BCHSE"), which operates from a head office in Houston, Texas. Both locations enjoyed growth in 2010. On a consolidated basis revenues for 2010 were \$4.3 million or about 5% of total revenue. This was an increase of 152.8% from \$1.7 million in the 2009 fiscal year.

In 2008 HSE entered into a partnership with Boots & Coots Services, a division of Halliburton, to supply Oilfield health and safety services to upstream oil and gas clients in the continental United States. In early 2009, HSE's new BCHSE business unit began operations in West Texas. BCHSE struggled through 2009 as it tried to introduce a new service to a shrinking market. However, the long-term opportunity remained positive, so HSE stayed with the investment. In the second quarter of 2010 BCHSE turned cash-flow positive, a trend that continued through the rest of the year.

In the second quarter of 2010 the Macondo blowout in the Gulf of Mexico occurred. This was a major disaster for the U.S. upstream oil and gas industry, and caused E&P company clients to re-examine their procedures to ensure that they were operating in a safe and secure manner. In the second quarter of 2010 Boots & Coots, Inc., formerly an independent company, was acquired by Halliburton.

The outcome of the two events is a renewed interest in worker, asset, and community protection by BCHSE clients, and a new corporate partner for HSE: Halliburton. This company has vastly expanded resources in terms of clients and delivery footprint. In January the Board of Directors of BCHSE re-affirmed their commitment to the BCHSE business unit and approved a \$0.8 million rental equipment expansion budget for 2011. BCHSE has a compelling service offering to clients: a trusted brand in Boots & Coots; new equipment designed by HSE; and expert safety capability and management through the

personnel seconded to BCHSE by HSE in Canada. Going forward, the Corporation believes that BCHSE will be a positive contributor to revenues and cash flow.

The Taylor, Michigan location was part of an acquisition in Sarnia, Ontario in 2005. It has always been a modest performer and a contributor to cash flow but has never really broken through in a meaningful way considering the density of heavy, safety-intensive industry that exists in Michigan and nearby states such as Illinois, Ohio, New Jersey, and New York. HSE has stayed with this market because it has the characteristics of a profitable long-term growth opportunity. Many of the industries served in the U.S. industrial midwest remain depressed. This forces facility operators to be cost-conscious, which includes contracting health and safety services to third parties. As a mature market, it is also competitive with numerous suppliers.

Nevertheless, this market is not a drain on HSE's overall performance and it enjoyed its best financial performance ever in 2010. Many of the clients are in the petroleum industry operating refineries and petrochemical plants. They, too, will be affected by the overall trend to enhance worker, asset, and community protection after the Macondo blowout in the Gulf of Mexico. Many of the clients that operate hydrocarbon-processing facilities are also drilling offshore in the Gulf of Mexico, and will be reviewing their health and safety procedures and commitments. For this reason, in 2011 HSE will stay the course and continue to deliver quality services at fair prices while augmenting sales and marketing efforts to grow the business.

## Quarterly Results

	2010				2009			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Revenue	\$ 22,422	\$ 20,349	\$ 18,350	\$ 20,907	\$ 19,090	\$ 20,544	\$ 19,566	\$ 22,401
Net earnings (loss)	683	(397)	(1,235)	(208)	(2,178)	(722)	(1,928)	(1,806)
EBITDA <sup>(1)</sup>	1,717	1,192	(380)	1,222	496	1,016	(451)	(216)
Income (loss) per share – basic and diluted	\$ 0.02	\$ (0.01)	\$ (0.03)	\$ (0.01)	\$ (0.06)	\$ (0.02)	\$ (0.05)	\$ (0.05)

(1) See Non-GAAP Measures

HSE's business has two offsetting seasonal components. Revenue for Oilfield health and safety services is historically highest in first and fourth quarters and lowest in the second quarter because this sector uses equipment that can only access well locations during certain times of the year, and because of the effects of weather on field activity. Industrial revenue includes a mix of year-round contracts and "turnarounds" – scheduled major maintenance projects and repair activities on client facilities. These turnarounds tend to be scheduled during the second and third quarters to avoid the possibility of adverse effects from freezing weather. As a result, Industrial revenue tends to be highest in the second and third quarters.

Revenue by quarter for the last eight quarters is as follows:

	2010				2009			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Industrial	\$ 12,040	\$ 11,384	\$ 11,926	\$ 11,924	\$ 12,533	\$ 14,375	\$ 15,249	\$ 12,141
Oilfield	10,382	8,965	6,424	8,983	6,557	6,169	4,317	10,260
Total revenue	\$ 22,422	\$ 20,349	\$ 18,350	\$ 20,907	\$ 19,090	\$ 20,544	\$ 19,566	\$ 22,401

## Related-Party Transactions

During the year, the Corporation had the following transactions with related parties all of which are measured at exchange amounts.

- In 2010, the Corporation paid rent and property taxes of \$0.3 million (2009 - \$0.3 million) for a regional office to a corporation related to a Director of the Corporation.

- In 2010, the Corporation also paid rent and property taxes of \$0.3 million (2009 – \$0.3 million) for a regional office to a corporation controlled by a senior manager of the Corporation.
- In 2010, the Corporation paid \$0.3 million (2009 – \$0) for supplies and commissions to a corporation related to a Director of the Corporation pursuant to terms of an agreement that pre-dates the directorship. Of this amount \$0.1 million is included in accounts payable at year end.
- A placement of \$0.3 million convertible debentures to related parties for the year ended December 31, 2010.

## **Critical Accounting Policies and Estimates**

HSE prepares its consolidated financial statements in accordance with Canadian generally accepted accounting principles. In doing so, Management is required to make various estimates and judgments in determining the reported amounts of assets, liabilities, revenues, and expenses, as well as the disclosure of commitments and contingencies. Management bases its estimates and judgments on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Estimates and assumptions are reviewed periodically, and actual results may differ from those estimates under different assumptions or conditions. Management must use its judgment related to uncertainties in order to make these estimates and assumptions.

The accounting policies and estimates believed to require the most difficult, subjective or complex judgments, and which are material to the Corporation's financial reporting results are as follows:

### ***Allowance for Doubtful Accounts Receivable***

The Corporation assesses its accounts receivable through a continuous process of reviewing its receivables both on an individual-customer basis and on an overall basis. The review includes assessment of current-aging status of customers, historical collection experience, financial condition of customers, industry economic trends, and other factors at least monthly. Based on the review, allowances for specific customers are determined. The process involves a high degree of judgment and can frequently involve significant dollar amounts. Accordingly, the Corporation's financial position, results of operations, and cash flows can be affected by adjustments to the allowance when actual write-offs differ from estimates.

### ***Impairment of Long-Lived Assets***

The Corporation evaluates potential impairment of property and equipment and intangible assets with finite lives when indicators of impairment are present. Estimates of undiscounted future net cash flows to be derived from the long-lived assets over their remaining estimated useful lives, as well as any salvage values are calculated and compared to the carrying value of the long-lived assets to determine whether the assets are deemed to be impaired. Parts of HSE's business are cyclical in nature and the estimate of future cash flows requires the use of assumptions and judgment. Periods of prolonged down cycles in the industry could have a significant impact on the carrying value of these assets and may result in impairment charges.

### ***Amortization of Property and Equipment***

Property and equipment is recorded at cost less accumulated amortization. The useful lives of the depreciable assets are based on historical experience and judgment of Management. This judgment includes an assessment of expected utilization, job-mix assumptions and preventative-maintenance programs. Although Management believes that the estimated useful lives and salvage values are reasonable, there can be no certainty that the reduction in depreciable asset values over time matches amortization expense using estimated useful lives. If amortization estimates are not correct, the Corporation may record a disproportionate amount of gains or losses on disposition of these assets. Management believes their estimates of useful lives to be materially correct.

### ***Future Income Tax Liabilities***

The Corporation follows the liability method of accounting for income taxes. Under this method, future income taxes are recorded for the effect of any differences between the accounting and income tax basis of an asset or liability using the substantively enacted tax rates. The Corporation establishes valuation allowances to reduce future income tax assets when Management believes it is more likely than not that some or all of a future tax asset will not be realized. Estimates of future taxable income are considered in assessing the utilization of available tax losses. Changes in circumstances and assumptions may require changes to valuation allowances associated with the Corporation's future tax assets.

## Financial and Other Instruments

The Corporation's financial instruments include cash and cash equivalents, accounts receivable, bank indebtedness, accounts payable and accrued liabilities, long-term debt, and debentures. The carrying value of these instruments approximates their fair value either because of their short maturities or because the interest rates to which they are subject approximate market rates.

The Corporation is exposed to the following risks from its financial instruments:

- Credit risk
- Liquidity risk
- Market risk

These risks, and the Corporation's method of mitigating the risks, are described below:

### ***Credit Risk***

Credit risk is the risk of financial loss to the Corporation if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the Corporation's receivables from customers. The maximum credit exposure associated with trade accounts receivable is the carrying value.

The Corporation's accounts receivable are due from customers in a variety of industries including a significant proportion with customers operating in the energy and manufacturing industries. The ability of customers within the energy industry to pay the Corporation is partially affected by fluctuations in the price they receive for various hydrocarbon products.

The Corporation follows a credit policy under which the Corporation reviews each new customer individually for credit worthiness before the Corporation's standard payment and delivery terms and conditions are offered. The Corporation's review includes external ratings, where available, and trade references. Customers that fail to meet the Corporation's credit worthiness criteria may transact with the Corporation only on a prepayment basis. On an ongoing basis, the Corporation also reviews the payment patterns of its existing customers and the customers' continued credit worthiness.

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. Standard payment terms are net 30. However, these may be varied by agreements with particular customers. As well, industry practices, particularly within the upstream oil and gas industry, allow for payment terms of up to 60 days.

The allowance for doubtful accounts is the Corporation's best estimate of the amount of probable credit losses in the Corporation's existing accounts receivable. The Corporation determines the allowance by reviewing individual accounts past due for collectability, historical write-off experience adjusted for changes in both general and industry-specific economic conditions, and overall account aging. The Corporation reviews its allowance for doubtful accounts on an ongoing basis, but at least monthly.

### ***Liquidity Risk***

Liquidity risk is the risk that the Corporation will not be able to meet its financial obligations as they fall due. The Corporation requires liquidity to meet financial obligations as they come due and to fund its operating and investing activities. The Corporation's contractual financial liabilities include interest payments, trade and other payables, income taxes payable, a revolving operating line of credit, a non-revolving term-debt facility, a convertible debenture and capital leases for equipment, and property and equipment.

HSE manages its liquidity risk by ensuring, to the extent possible, that it has access to funding sources at competitive rates to meet its liabilities when due, under both normal and distressed conditions without unacceptable losses or risking damage to the Corporation's reputation. The Corporation generally uses operating cash flow to provide liquidity to meet its financial obligations. As a result, the Corporation is exposed to a loss of liquidity if its customers delay their payments beyond the levels that they have in the past. To mitigate this, the Corporation has projected its operating cash flows under different scenarios with respect to receivables aging to determine the effect on operating cash inflows. The Corporation monitors its receivables collections to ensure that, if collections are delayed, there are sufficient operating funds available to meet its financial obligations. As well, the Corporation has access to undrawn operating lines of credit of \$10.0 million to fund operations. These credit lines are renewable annually and are margined to accounts receivable. HSE believes it has sufficient funding through these sources to meet its obligations as they come due.

## ***Market Risk***

Market risk is the risk that changes in market prices of financial assets and liabilities, including foreign exchange rates, interest rates, and equity prices, will affect the Corporation's financial position, results of operations, and cash flows.

HSE is exposed to currency risk on U.S.-dollar denominated financial assets and liabilities. The Corporation adjusts the reported amounts of foreign-currency denominated financial assets and liabilities to their Canadian-dollar equivalent at each balance sheet date. For amounts held directly by the Corporation, any related foreign exchange gains and/or losses are recognized in the consolidated statement of earnings. For amounts held by the Corporation's self-sustaining foreign operations, the amount is included in other comprehensive income. At December 31, 2010 the extent of this exposure was not material.

HSE is exposed to interest-rate risk on its prime-based revolving operating facility and its non-revolving reducing loan facility. Based on amounts outstanding at December 31, 2010 a 1% increase in the average prime interest rate for the year would cost the Corporation \$0.04 million in additional interest expense.

## **Business Risks**

The activities the Corporation undertakes involve a number of risks and uncertainties, some of which are: economic and market events including disruptions in international credit markets and reductions in macroeconomic activity; business cyclicality within the industries in which HSE's customers operate; competitive conditions including pricing pressures; risks of customer credit default; deterioration in the financial condition of financial institutions and insurance companies with which HSE deals; availability of financing at competitive rates; changes in foreign exchange rates and interest rates; and litigation and contingencies. Additional risks and uncertainties that the Corporation may be unaware of, or that were determined to be immaterial, may also become important factors that affect the Corporation. Further details regarding specific risks that may affect the Corporation are provided below:

### ***Business Cyclicality***

The demand for HSE's Oilfield services is highly dependent upon the level of expenditures made by oil and gas companies on exploration, development and production activities. These expenditures are in turn affected by a number of factors:

- The price received by HSE's customers for crude oil and natural gas directly impacts their cash flow available to purchase the Corporation's services. Fluctuations in crude oil and natural gas prices can produce periods of high and low demand for the Corporation's services. Alternatively, a number of factors that are beyond the control of HSE's customers, including weather, geopolitical conditions, and the strength of the global economy, may reduce demand for their products, which in turn will reduce the price they receive.
- Since crude oil and natural gas prices are normally denominated in U.S. currency, fluctuations in the Canadian-dollar exchange rate relative to the U.S. dollar can also affect the cash flow available to the Corporation's customers to purchase its services.
- Exploration, development and production activity levels within particular markets are influenced by factors including royalties, regulatory and taxation changes, weather, and access to pipeline capacity.
- Changes in equity-and debt-financing markets independent of any individual company's circumstances may reduce access to capital that is used to fund exploration, development, and production activities.

These fluctuations in activity can cause cyclical demand swings in the Corporation's activity levels and operating results.

The demand for HSE's Industrial services is exposed to business cycles and contraction risks in the oil and gas industry and other industrial sectors such as forestry, pulp and paper, automotive, manufacturing, mineral extraction, and other segments of the economy that could experience reduced demand or significant fluctuations of the market value of their finished goods. As well, a significant portion of the Corporation's Industrial services are provided to customers in the non-conventional upstream oil and gas industry, including oilsands extraction. These customers are exposed to similar risks with respect to crude oil pricing as customers for whom HSE provides Oilfield services.

### ***Availability of Qualified Staff***

The Corporation's ability to provide reliable service is dependent upon attracting and retaining skilled employees. The demand for workers with particular skills used by the Corporation is high and the supply remains limited.

### ***Competitive Conditions***

The Corporation's main competitor is its own customer base. There is a risk, typically under distressed economic conditions, that customers may elect to use their own personnel to perform services that HSE currently provides. The Corporation attempts to mitigate this risk by providing with staff with more training and safety-service experience than the customer is able to provide on its own.

While no one competitor in Canada provides the full suite of services that the Corporation provides, HSE has competitors in each area of service that we provide. These competitors are typically privately owned, regionally based companies that provide a specialized set of services. These competitors may provide pricing pressure that may affect our margins and market position within particular lines of business. The Corporation attempts to mitigate this risk by providing an integrated suite of services that our competitors cannot provide, and by distinguishing ourselves through higher levels of service and expertise.

Recently, a larger private-equity-financed U.S. safety services provider commenced operations in Canada. While this provider is currently restricting its activities to providing Industrial safety services within a small portion of the industries and geographic locations in which the Corporation provides services, there is a risk that this competitor may begin to market its services to a wider array of customers and locations. As discussed above, Management is of the view that this may provide an opportunity for additional business for the Corporation as customers may be more likely to outsource safety services work when there is more than one provider available.

### ***Customer Credit***

HSE generally invoices its customers in arrears for its services. Because of this, the Corporation is subject to the risk that its customers may delay payment of its invoices through a variety of means, or fail to pay the invoice at all. Changes in economic conditions, either in general or within a particular industry, may increase this risk.

### ***Customer Dependence***

The Corporation has ongoing contracts or master service agreements with a variety of customers. For certain customers the volume of revenue generated approaches or exceeds 10% of the Corporation's total revenue on a quarterly or annual basis. While there is no indication that any of these customers are likely to change safety service providers, if a contract were cancelled and the Corporation were unable to replace the business with other existing or new customers, the Corporation's revenue, operating results and cash flows would be adversely affected. The Corporation attempts to mitigate this risk by providing an integrated suite of services that are not available from a single competitor, by providing access to our services on a country-wide basis, and by distinguishing itself through higher levels of service and expertise.

### ***Customer and Government Safety Requirements***

All companies are required to track and publish safety statistics. Certain customers require that their vendors maintain specific minimum standards with respect to safety in order to provide services as an accredited vendor. There is a risk that, if the Corporation's safety statistics fall below an acceptable level, it would not be allowed to provide services to these customers. If this occurred, the Corporation's revenues and profit levels would be adversely affected.

As well there is a risk that customer safety requirements and government regulations or legislation may change either as part of an ongoing review process, or in reaction to specific events such as the Macondo blowout in the Gulf of Mexico. While changes in these requirements may provide opportunities to provide health and safety personnel and equipment to the Corporation's customers in order to address new requirements, these changes may also pose the following risks to the Corporation. First, there is a risk that additional expenses may need to be incurred to refit equipment or provide additional training to staff. There is no guarantee that these costs could be passed on to customers and, as a result, the Corporation's profits may suffer if unanticipated changes are made. Second, there is a risk that additional regulations could make an activity or line of business unprofitable for our customers. This could cause them to exit the activity causing a reduction in the Corporation's revenues as customer activity decreases.

The Corporation mitigates these risks by ensuring that its field personnel are trained to levels that meet or exceed "best-practices" levels and that its equipment meets any requirements specified by the equipment manufacturer. The Corporation's industry technical specialists monitor industry sources to keep the Corporation apprised of potential changes to regulations. As well, the Corporation maintains a comprehensive internal safety program including regular senior management and Board of Directors review of safety results, the use of standardized "best-practices" procedures for all work performed, and specific procedures that require that all incidents be investigated to determine root causes of the incident and to recommend what, if any, changes to the Corporation's procedures are necessary to prevent recurrence.

### ***Availability of Financing***

Historically, the Corporation has funded the growth of its operations and its acquisitions from bank debt, share issues, and convertible debentures, in addition to cash generated from operations. Continued access to bank debt at competitive rates requires that the Corporation meet various financial and non-financial covenants. There is no certainty HSE will continue to be able to obtain sufficient financing at competitive rates. The Corporation's ability to grow as planned may be limited if sources of competitively priced financing are unavailable.

### ***Foreign-Exchange Exposure***

HSE's consolidated financial statements are presented in Canadian dollars, but include the results of its U.S. subsidiaries for which the functional currency is the U.S. dollar. Changes in the U.S.-dollar exchange rate versus the Canadian-dollar rate may have material effects on net income and other comprehensive income reported by the Corporation's U.S. subsidiaries.

### ***Litigation and Contingencies***

In the ordinary course of business activities, the Corporation may be contingently liable for litigation and claims with customers, suppliers, former employees and third parties. Management believes that adequate provisions have been recorded in the accounts where required. Although it may not be possible to accurately estimate the extent of potential costs and losses, if any, Management believes that the ultimate resolution of such contingencies would not have a material adverse effect on the financial position of the Corporation.

## **International Financial Reporting Standards**

On February 13, 2008, the Canadian Accounting Standards Board ("AcSB") confirmed the requirement for all publicly accountable enterprises to adopt International Financial Reporting Standards ("IFRS") for fiscal years beginning on or after January 1, 2011. Effective January 1, 2011 HSE is required to report its interim and annual financial statements in accordance with IFRS including comparative information for the 2010 period with an opening balance sheet dated January 1, 2010 ("Transition Date").

HSE commenced a process to transition from current Canadian GAAP to IFRS. A project team led by Finance was established. Representatives from other areas of HSE participate as required. A Steering Committee comprised of HSE Executives monitors the IFRS project on a monthly basis. Regular reporting to the Audit Committee and the Board of Directors on the status of the IFRS project was also implemented.

HSE developed a project plan that consisted of three major phases: initial assessment, detailed assessment and design, and implementation.

Initial assessment – This phase involved performing a high-level impact assessment to identify the areas that would be affected by the transition to IFRS. As a result of these procedures, the potentially impacted areas were identified as high, medium, and low impact. The level of impact was determined based on the relative significance of the account balance and the nature of the differences between current HSE accounting policies and the accounting policies required by IFRS.

Detailed assessment and design – This phase involved the identification of changes required to existing accounting policies, information systems, and business processes, together with an analysis of policy alternatives allowed under IFRS and the development of a template for IFRS financial statements and notes.

Implementation – This phase includes execution of changes to information systems and business processes, completing authorization processes to formally approve recommended accounting policy changes, completion of the opening balance sheet and training programs for the finance group and other areas of the company as required. HSE is implementing the identified changes to business processes, financial systems, accounting policies, disclosure controls and procedures and internal controls over financial reporting.

IFRS requires significantly more disclosures than current Canadian GAAP for certain standards. IFRS also requires, in certain instances, different presentation on the financial statements. HSE believes it has performed an appropriate level of analysis in selecting its IFRS accounting policies; however, actual quantitative results may reveal additional impacts that were not anticipated.

The Corporation is required to meet various financial covenants included in its credit facility. These covenants will likely be affected by the required IFRS transition. A clause is included in the credit agreement allowing for a period of time to renegotiate any covenants affected by the IFRS transition.

Most adjustments required on transition to IFRS will be made, retrospectively, against retained earnings on the opening January 1, 2010 balance sheet. However, IFRS 1 “First Time Adoption of International Financial Reporting Standards” provides entities adopting IFRS for the first time with a number of optional exemptions and mandatory exceptions, in certain areas to the general requirement for full retrospective application of IFRS.

Described below are the changes to the consolidated financial statements that HSE believes will be the most significant in transitioning to IFRS. The list below should not be regarded as a complete list of changes that HSE will be required or may elect to make.

### ***IFRS Optional Exemptions***

1. Business combinations – IFRS 1 provides the option to apply IFRS 3 “Business Combinations”, retrospectively for all business combinations from a particular pre-transition date elected by the Corporation or prospectively from the transition date. The Corporation has elected not to retrospectively apply IFRS 3 to business combinations that occurred prior to the Transition Date and such business combinations have not been restated.
2. Share-based payments – IFRS 1 provides companies with an optional exemption not to apply IFRS 2 “Share-Based Payments” to equity-settled share-based payments granted after November 7, 2002 that vested before the transition date. The Corporation has elected to take this exemption and has not restated its historical share-based payments that were granted after November 7, 2002 and vested prior to January 1, 2010.
3. Currency translation differences – Retrospective application of IFRS would require the Corporation to determine cumulative currency translation differences in accordance with IAS 21 “The Effects of Changes in Foreign Exchange Rates” from the date a subsidiary was acquired. IFRS 1 allows cumulative translation gains or losses to be reset to zero at transition date. The Corporation has elected to reset all cumulative translation gains and losses to zero in the opening retained earnings at the transition date.

### ***IFRS Mandatory Exceptions***

1. Estimates – Hindsight has not been used to create or revise estimates. The estimates made previously by the Corporation under Canadian GAAP were not revised for the application of IFRS except where necessary to reflect any differences in accounting policies.
2. Non-controlling interests – The Corporation has applied IAS 27 “Consolidated and Separate Financial Statements” prospectively from the date of transition, such that total comprehensive income is attributed to the owners of the parent and to the non-controlling interests. The non-controlling interest at January 1, 2010 will be zero.

### ***Leases – IAS 17***

HSE currently leases certain light vehicles, office equipment, and land and buildings.

Under Canadian GAAP, a lease is classified as a finance lease if it transfers substantially all of the risks and rewards relating to ownership to the lessee. All other leases are operating leases. Although the qualitative criteria of operating and finance leases are similar under Canadian GAAP and IFRS, Canadian GAAP contains quantitative thresholds to be applied in the lease classification test.

IFRS does not provide any quantitative thresholds that need to be met when determining the classification of a lease. Under IFRS, a lease is classified as a finance lease when the lease meets the qualitative criteria specified in IAS 17 “Leases”. These criteria include: provisions allowing or requiring the transfer of ownership of the asset to the lessee by the end of the lease term; lease agreements where the lease term is for the major part of the economic life of the asset even if title is not transferred; leases where the leased assets are of a specialized nature; and provisions specifying that, where a lessee can cancel the lease, the lessor’s losses associated with the cancellation are borne by the lessee.

Under IFRS, the Corporation expects that its light vehicle leases will be treated as finance leases. At January 1, 2010, the net book value of property and equipment is expected to increase by approximately \$7.1 million, lease liabilities will increase by approximately \$5.5 million, and opening deficit will decrease by approximately \$1.6 million (approximately \$1.2 million net of tax). Operating expenses will decrease approximately \$2.2 million to \$2.8 million per year depending upon the number of leases, interest expense will increase approximately \$0.1 million to \$0.3 million per year, and depreciation will increase by approximately \$1.5 million to \$2.0 million per year.

### ***Impairment of Assets – IAS 36***

HSE is required to apply IAS 36 “Impairment of Assets” on the January 1, 2010 Transition Date. At Transition Date, HSE had property and equipment and definite life intangibles.

There are several recognition and measurement differences between Canadian GAAP and IFRS regarding the impairment of assets. Unlike Canadian GAAP where there is no single accounting standard that deals with impairment, IAS 36 specifically addresses the issues relating to the impairment of assets. IAS 36 applies to both tangible and intangible assets, including goodwill.

Canadian GAAP impairment testing first compares the asset-carrying values with undiscounted future cash flows to determine whether impairment exists. If the carrying amount exceeds the undiscounted future cash flows, an impairment is deemed to exist and the carrying value is written down to estimated fair value. IFRS uses a one-step approach for both testing for and measurement of impairment, with carrying values compared directly to the higher of fair value less costs to sell and value-in-use (calculated using discounted cash flows).

Fair value less costs to sell is the amount obtainable from the sale of an asset or cash generating unit in an arm’s-length transaction between knowledgeable, willing parties less costs of disposal. Value- in-use is the present value of the future cash flows expected to be derived from the continuing use of an asset and from its ultimate disposal or from a cash-generating unit.

Under IFRS, property and equipment and definite life intangibles are tested for impairment at the asset or cash-generating-unit (“CGU”) level. A CGU is the smallest group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. HSE has identified its “Canada” and “USA” operating segments as its cash-generating units.

A significant difference between IFRS and Canadian GAAP stems from the application of a discount rate to future cash flows. Under IFRS, the estimated future cash flows used in calculating value-in-use are discounted using the rate that reflects the market’s assessment of risks specific to the asset or cash-generating unit. Under Canadian GAAP, the estimated future cash flows are not discounted. Due to the discounting of cash flows, it is more difficult to pass the impairment test under IFRS than under Canadian GAAP.

A significant factor in determining whether HSE had impaired assets at January 1, 2010 was the fact that the carrying value of its net assets exceeded its market capitalization. The recoverable amount was based on fair value less costs to sell, and as a result HSE expects to recognize an impairment loss to property and equipment and definite life intangibles of approximately \$7.0 million and an equivalent pre-tax increase to opening deficit (approximately \$5.0 million net of tax). Depreciation expense will decrease by approximately \$1.0 to \$1.2 million per year. IAS 36 requires that impairment losses be first applied against goodwill, and then to other assets on a pro-rata basis.

At the end of each reporting period HSE will be required to assess whether there is any indication that an impairment loss recognized in prior periods for an asset other than goodwill or a cash generating unit may no longer exist or may have decreased. An impairment loss can only be reversed to the extent that it does not increase the asset’s carry amount above the carrying amount that would have been determined for the asset had no impairment loss been recognized in previous reporting periods.

### ***Property, Plant and Equipment – IAS 16***

Under IFRS, property and equipment is required to be componentized and depreciated separately if significant components within an asset have different economic lives. If an asset has incurred a capital repair, the equivalent net book value of the part of the asset repaired is required to be derecognized. In the absence of specific criteria to define “significant”, Management uses its judgment in determining which costs are significant in relation to the property and equipment.

HSE believes that the componentization of required assets under IFRS will result in a decrease of approximately \$0.3 million in net book value of property and equipment to the balance sheet at January 1, 2010, with a corresponding increase in opening deficit (approximately \$0.2 million net of tax).

### ***Provisions, Contingent Liabilities and Contingent Assets – IAS 37***

Under IFRS, if a corporation has onerous contracts, the present obligation under the contract must be recognized and measured as a provision. An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under the contract. Provisions are discounted where amounts are material.

As part of a prior acquisition, HSE assumed a long-term operating lease for a building. The building is not required for HSE operations at this time and is not currently subleased. HSE has identified this lease as an onerous contract. HSE expects to record approximately \$2.0 to \$2.2 million as a provision at January 1, 2010 with a corresponding increase to opening deficit (approximately \$1.6 million net of tax). On an annual basis HSE expects operating expense to decrease by approximately \$0.2 million per year.

## **Internal Control Over Financial Reporting**

### ***Disclosure Controls and Procedures***

An evaluation was performed under the supervision and with participation of the Corporation's Management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), of the effectiveness of the design and operation of the Corporation's disclosure controls and procedures as defined in National Instrument 52-109. Based on that evaluation, the Corporation's Management, including the CEO and CFO, concluded that the Corporation's disclosure controls and procedures were designed to provide a reasonable level of assurance over disclosure of material information, and are effective as at December 31, 2010.

### ***Management's Report on Internal Control Over Financial Reporting***

The Corporation's Management, including the CEO and CFO, have assessed and evaluated the design and effectiveness of the Corporation's internal control over financial reporting as defined in National Instrument 52-109 as at December 31, 2010. In making this assessment, the Corporation used the criteria established by the Committee of Sponsoring Organizations ("COSO") in the "Internal Control – Integrated Framework". The Corporation's assessment included documentation, evaluation, and testing of its internal controls over financial reporting. Based on that evaluation, the Corporation's Management, including the CEO and CFO, concluded that the Corporation's internal controls over financial reporting are effective and provide reasonable assurance regarding the reliability of the Corporation's financial reporting and its preparation of financial statements for external purposes in accordance with Canadian generally accepted accounting principles, as at December 31, 2010.

Internal control over financial reporting, no matter how well designed, has inherent limitations. Therefore, internal control over financial reporting determined to be effective can provide only reasonable assurance with respect to financial statement preparation and may not prevent or detect all misstatements.

### ***Changes in Internal Controls Over Financial Reporting During 2010***

There have been no significant changes in the Corporation's internal control over financial reporting during the year ended December 31, 2010 that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

## **Common Shares and Convertible Debentures Outstanding**

At December 31, 2010 and March 23, 2011, 37,575,675 common shares of HSE were outstanding. At December 31, 2010, the Corporation had options outstanding to issue 2,279,165 shares at a weighted-average exercise price of \$1.24 per share. Of these options, 1,154,479 were exercisable. At March 23, 2011 there were 2,195,000 options outstanding at a weighted average price of \$1.19 per share. Of these options, 1,070,814 were exercisable.

At December 31, 2010 the Corporation had \$1.925 million of convertible debentures outstanding that were convertible to 3.85 million shares based on the applicable conversion price. At March 23, 2011 there were \$2.0 million of convertible debentures outstanding that were convertible to 4.0 million shares at the applicable conversion price.

## **Non-GAAP Measures**

This report makes reference to EBITDA, a measure that is not recognized under generally accepted accounting principles. Management believes that, in addition to net earnings, EBITDA is a useful supplementary measure. EBITDA provides investors with an indication of earnings before provisions for interest and bank charges, taxes, amortization, foreign exchange gains or losses, gains or losses on the disposal of property and equipment, and the non-cash effect of stock-based compensation expense. Investors should be cautioned that EBITDA should not be construed as an alternative to net earnings determined by GAAP as an indication of the Corporation's performance. HSE's method of calculating EBITDA may differ from that of other companies' and, accordingly, may not be comparable to measures used by other companies.

## EBITDA Calculation

Years ended December 31	2010	2009	2008
Net earnings (loss)	\$ (1,157)	\$ (6,634)	\$ 248
Add (deduct):			
Amortization	5,680	6,699	7,265
Impairment of property and equipment	–	1,641	–
Impairment of goodwill and intangible assets	–	–	100
Stock-based compensation	210	293	408
Interest and bank charges	487	544	1,116
Foreign exchange gain	(4)	–	(31)
(Gain) loss on disposal of property and equipment	(102)	311	648
Expiry of contingent consideration liability	(810)	–	–
Income tax	(553)	(2,009)	637
<b>EBITDA</b>	<b>\$ 3,751</b>	<b>\$ 845</b>	<b>\$ 10,391</b>

## Quarterly EBITDA Calculation

	2010				2009			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Net earnings (loss)	\$ 683	\$ (397)	\$ (1,235)	\$ (208)	\$ (2,178)	\$ (722)	\$ (1,928)	\$ (1,806)
Add (deduct):								
Amortization	1,355	1,359	1,396	1,570	1,618	1,650	1,692	1,739
Impairment of property and equipment	–	–	–	–	1,641	–	–	–
Impairment of goodwill and intangible assets	–	–	–	–	–	–	–	–
Stock-based compensation	56	26	87	41	43	101	99	50
Interest and bank charges	155	74	140	118	135	140	120	149
Foreign exchange loss (gain)	–	2	(1)	(5)	(8)	(3)	12	(1)
(Gain) loss on disposal of property and equipment	290	213	(218)	(387)	57	35	126	93
Expiry of contingent consideration liability	(810)	–	–	–	–	–	–	–
Income taxes	(12)	(85)	(549)	93	(812)	(185)	(572)	(440)
<b>EBITDA</b>	<b>\$ 1,717</b>	<b>\$ 1,192</b>	<b>\$ (380)</b>	<b>\$ 1,222</b>	<b>\$ 496</b>	<b>\$ 1,016</b>	<b>\$ (451)</b>	<b>\$ (216)</b>

## Forward-Looking Statements

Certain statements in this MD&A constitute forward-looking information and statements (collectively “forward-looking statements”) within the meaning of applicable securities laws. These forward-looking statements concern, among other things, the Corporation’s prospects, expected revenues, expenses, profits, financial position, strategic direction and growth initiatives, all of which involve known and unknown risks, uncertainties and other factors that may cause actual results, performance or achievements of the Corporation to be materially different from any future results, performance or achievements expressed or

implied by such forward-looking statements. When used in this MD&A, such forward-looking statements use such words as expect, anticipate, estimate, believe, may, will, would, could, might, intend, plan, continue, ongoing, project, objective, should, and other similar terms and phrases. This forward-looking information reflects the Corporation's current expectations regarding future events and operating performance based on assumptions and analyses made by the Corporation based on its experience and an assessment of current conditions, known trends, expected future developments and other factors that Management believe to be appropriate under the circumstances. These forward-looking statements include among others:

- At the time of writing, the Corporation's "order book" – measured by plant shutdown and turnaround projects awarded to HSE and other contracts in which HSE is engaged 24/7/365 – is higher than the same time last year. (page 7)
- In 2011 a preoccupation of HSE's Management and HR team is finding enough trained, qualified and motivated personnel to do all the upcoming work. This is one problem everyone at HSE is excited to help solve. (page 7)
- Regardless, the amount of work that HSE has scheduled for late Q1 and the subsequent three quarters in the current fiscal year is greater than at this time last year. The "order book" is in all markets from field hydrocarbon processing facilities in northwest Alberta, to oilsands plants in northeast Alberta, to processing plants in multiple industries in Ontario and the U.S. midwest, to refineries in Atlantic Canada. (page 8)
- HSE's clients' focus on quality health and safety services appears to have improved since the economic recovery, resuming a trend towards outsourced expert health and safety services that had been growing for 20 years and was only interrupted by the severe economic recession of 2009 and the first half of 2010. (page 8)
- In the first quarter of 2011 HSE was awarded a five-year national contract for four facilities in the above-noted locations. A condition of this contract was that HSE not disclose the name of the client, however, the precedent has been set. The next customer to embrace this "single-source" concept will also recognize that, until HSE was created, safety services were either delivered internally or by several contractors in different geographical markets. Such contractors are, by nature, unable to offer the same national standards of quality, service and price that HSE delivers. (page 8)
- Securing single-client national contracts in multiple locations has been the foundation of HSE's strategic plan for the past six years. The recession of 2009 was a major setback in executing this strategy. However, with the recovery underway and a major national contract in hand, HSE believes the Industrial side of its business is back on the path to growth. (page 8)
- In 2011 HSE will be expanding into the new business area of safety consulting, whereby the Corporation will provide expert safety supervisors to projects on a contract basis. While HSE has done some work in this area in the past, the Corporation formalized its expansion into this business with the January 2011 acquisition of Taylored Safety Services Inc. ("Taylored") of Halifax. Having clients seek contract safety supervisors is an extension of two trends: outsourcing of safety expertise to an expert third party; and a growing emphasis on quality safety supervision for all types of safety-intensive operations. Taylored provides HSE with domain expertise in safety consulting by formalizing the requirements for qualified safety personnel, creates a database of safety consultants available on a project basis, and formalizes an internal career path for HSE personnel that wish to apply their training and job experience to more lucrative and rewarding careers. (page 8)
- Record drilling rights sales in Alberta in 2010 will likely perpetuate this level of activity through 2011. The Corporation believes that in 2011 Oilfield revenues will be higher than they were in 2010. (page 9)
- The application of new drilling techniques involving extended-reach horizontal wells and multi-stage fracturing drilled into previously uneconomic but extensive oil-bearing reservoirs appears to have created a new and sustainable source of reserve and production growth for HSE's E&P company clients. (page 9)
- The outcome of two events (the Macondo blowout in the Gulf of Mexico and the acquisition of Boots & Coots, Inc. by Halliburton) is a renewed interest in worker, asset, and community protection by BCHSE clients, and a new corporate partner for HSE: Halliburton. This company has vastly expanded resources in terms of clients and delivery footprint. In January the Board of Directors of BCHSE reaffirmed their commitment to the BCHSE business unit and approved a \$0.8 million rental equipment expansion budget for 2011. BCHSE has a compelling service offering to clients: a trusted brand in Boots & Coots; new equipment designed by HSE; and expert safety capability and management through the personnel seconded to BCHSE by HSE in Canada. Going forward, the Corporation believes that BCHSE will be a positive contributor to revenues and cash flow. (pages 9-10)
- Many of the clients that operate hydrocarbon-processing facilities are also drilling offshore in the Gulf of Mexico, and will be reviewing their health and safety procedures and commitments. For this reason, in 2011 HSE will stay the course and continue to deliver quality services at fair prices while augmenting sales and marketing efforts to grow the business. (page 10)

The forward-looking statements contained in this MD&A reflect several material factors, expectations and assumptions including, without limitation: economic conditions within Canada and the United States, both in general and within specific industries; demand for the Corporation's services by customers in various industries and geographic locations; pricing levels for the Corporation's services; commodity prices; foreign currency exchange rates; interest rates; access to financing; the Corporation's future operating results and financial condition; and competition within particular markets or for particular services.

Forward-looking statements involve significant risks and uncertainties and should not be read as a guarantee of future performance or results, and will not necessarily be an accurate indication of whether or not such results will be achieved. A number of factors could cause actual results to differ materially from the results discussed in the forward-looking statements including, but not limited to, the factors discussed above and other risk factors discussed herein and listed from time to time in the Corporation's reports and public disclosure documents including its annual report, annual information form and other filings with securities commissions in Canada as reported under the Corporation's profile at [www.sedar.com](http://www.sedar.com).

The Corporation cautions that the foregoing list of assumptions, risks and uncertainties is not exhaustive. The forward-looking statements contained in this MD&A speak only as of the date of this MD&A, and the Corporation assumes no obligation to publicly update or revise them to reflect new events or circumstances, except as may be required pursuant to applicable laws.

### **Additional Information**

Additional information relating to HSE is available under the Corporation's profile on the SEDAR website at [www.sedar.com](http://www.sedar.com) and [www.hseintegrated.com](http://www.hseintegrated.com).