

**Management Discussion and Analysis of Financial Condition  
and Results of Operations**

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**Forward-Looking Statements** - Statements in this report, or any document filed by Offshore Systems International Ltd. (the “Company”) with the different governing authorities, or in any other written or oral communication by or on behalf of the Company, to the extent not directly and exclusively based on historical events, constitute forward-looking statements. These statements represent the Company’s intentions, plans, expectations, and beliefs, and no assurance can be given that the results described in such statements will be achieved.

Forward-looking statements include, without limitation, statements evaluating market and general economic conditions in the following sections, and statements regarding future-oriented costs and expenditures. Investors are cautioned not to place undue reliance on these forward-looking statements, which reflect management’s analysis only as of the date thereof. These forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially. Such risks and uncertainties with respect to the Company include the effects of general economic conditions, changing foreign exchange rates and actions by government authorities, uncertainties associated with legal proceedings and negotiations, industry supply levels, competitive pricing pressures and misjudgements in the course of preparing forward-looking statements.

The Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

### **Overview**

The Company’s financial statements are prepared in accordance with generally accepted accounting principles in Canada (“Cdn GAAP”) and are presented in Canadian dollars unless otherwise indicated. All references in this report to financial information concerning the Company refer to such information in accordance with Cdn GAAP and all dollar amounts in this report are in Canadian dollars unless otherwise indicated.

The following discussion and analysis provides a review of activities, results of operations and financial condition of the Company for the fiscal quarter ended February 28, 2003 in comparison with those for the fiscal quarter ended February, 2002. This discussion should be read in conjunction with the Company’s unaudited financial statements for the fiscal quarter ending February 28, 2003, its 2002 Audited Financial Statements and the 2002 year end Management Discussion and Analysis of Financial Condition and Results of Operations.

Founded in 1977, the Company designs, develops and markets the proprietary ECPINS<sup>®</sup> line of electronic chart navigation systems for commercial and military customers. ECPINS<sup>®</sup> helps to reduce the risk of navigation-related incidents by giving bridge crews a precise, real-time display of their position, course and speed, against a background of fixed obstacles and other navigational hazards. The Company has developed a strong market position in military navigation, and has ECPINS<sup>®</sup> systems deployed with the Canadian and United States Coast Guards, the Canadian Navy, the Royal Danish Navy and the United States Navy.

At March 31, 2003, the Company has 26,087,273 common shares, 30,262 Class A preference shares - Series A and 61,244 Class B preference shares - Series 1 outstanding.

### **Results of Operations**

For the quarter ended February 28, 2003, the Company had net earnings of \$248,248, or \$.01 per share on a basic and diluted basis.

The table below presents, for the periods indicated, selected financial data of the Company expressed as a percentage of total revenues:

	<b>Three months ended February 28</b>	
	<b>2003</b>	<b>2002</b>
	<b>%</b>	<b>%</b>
<b>Revenue</b>		
Systems and system components	72.5%	77.8%
Software	5.8%	7.6%
Geomatics	19.4%	11.5%
Other	2.3%	3.1%
	<u>100.0%</u>	<u>100.0%</u>
<b>Direct costs</b>	<u>47.0%</u>	<u>48.8%</u>
<b>Gross profit</b>	<u>53.0%</u>	<u>51.2%</u>
<b>Expenses</b>		
General and administrative	19.5%	17.6%
Research and development	13.6%	10.3%
Sales and marketing	14.1%	13.2%
Amortization	2.3%	2.9%
Interest	0.0%	0.1%
Foreign exchange loss	3.8%	0.5%
Technology Partnerships Canada royalty	1.1%	7.2%
Technology Partnerships Canada contribution	(8.4%)	(5.8%)
	<u>46.0%</u>	<u>46.0%</u>
<b>Earnings from operations</b>	7.0%	5.2%
<b>Income tax recovery</b>	<u>0.0%</u>	<u>(3.0%)</u>
<b>Earnings for the period</b>	<u><u>7.0%</u></u>	<u><u>8.2%</u></u>

## Revenues

The Company's core revenue stream is derived from four sources: Systems and System Components, Software, Geomatics, and Other which includes system repairs and servicing, training and consulting. The Company's principal developed and manufactured product, the Electronic Chart Precise Integrated Navigation System ("ECPINS<sup>®</sup>"), delivers the majority of the revenue.

The Company recognizes revenue from each source in accordance with generally accepted accounting principles. Certain revenue from projects for navigation systems are recognized using the percentage of completion method of accounting, whereby revenue and profit in the period are based on the ratio of costs incurred to total estimated costs of the project for each segment of the project. Certain other systems revenues and revenues from navigation software are recognized at the time of delivery of the system to the customer or the delivery of the software and software locks to the customer if persuasive evidence exists of

an agreement with the customer, the price is fixed and determinable, collection is probable, and there are no ongoing obligations of the company to provide future services. Systems revenues under bill-and-hold arrangements, whereby revenues were recognized but goods have not been shipped, are recognized when the customer has substantial business purpose for ordering the goods on a bill-and-hold basis and the company does not retain any specific performance obligations such that the earnings are not complete. Revenues from the sale of geomatics products are recognized when the products are delivered. Revenues from projects for geomatics services are recognized using the percentage of completion method of accounting, whereby revenue and profit in the period are based on the ratio of costs incurred to total estimated costs of the project for each segment of the project. Revenues from systems components and other revenues are recorded at the time of delivery or as the services are provided.

The Company's revenue and margins can vary from period to period as a result of the level of business volumes, mix of contracts and component supply availability. The Company's contracts with its key customers generally provide a framework for its overall relationship with the customer.

Consolidated revenue for the quarter ended February 28, 2003 was \$3,563,175, compared with \$3,285,518 for the quarter ended February 28, 2002, an increase of \$277,657 or 8%. The Company's quarterly revenues are primarily affected by the level, timing and duration of customer orders and customer product delivery requirements. The main customers for the Company's products and services were the US Coast Guard, Canadian Coast Guard, Canadian Department of National Defence, Royal Danish Navy and the US Navy. Revenue from these customers accounted for 81% of the consolidated revenue for the three months ended February 28, 2003 and 96% of the consolidated revenue for the three months ended February 28, 2002.

### **Gross Profit**

The Company's gross profit increased \$205,057 to \$1,888,438 for the quarter ended February 28, 2003 from \$1,683,381 for the same quarter in 2002. Gross profit percentage increased to 53.0% for the quarter ended February 28, 2003 from 51.2% for the quarter ended February 28, 2002. The Company's quarterly gross profit is primarily affected by relative mix of value added products and services, fluctuations in materials costs, manufacturing effectiveness and efficiency and the ability to manage inventory effectively.

### **General and Administrative Expenses**

General and administrative ("G&A") expenses consist mainly of salaries and benefits of management and administrative personnel, professional fees, public company expenses, related facility costs and general administrative expenses. G&A increased \$117,296 for the quarter ended February 28, 2003 to \$694,444 from \$577,148 in comparative 2002 quarter. The increase is the result of additions to the Company's administrative support team, increased liability insurance costs and the adoption of the new stock-based compensation guidelines as required under Cdn GAAP. As a percent of revenue, G&A increased to 19.5% from 17.6% when comparing the current quarter to the same quarter last year.

### **Research and Development Expenses**

Research and development ("R&D") expenses consist mainly of salaries and benefits of software and hardware engineering personnel, sub-contractor costs and related overhead and facilities expenses. The Company continued and will continue to invest in new product development in 2003. It believes that in order to maintain its technological advantage, it must continue its strategy to fine-tune existing products and introduce new high quality products that continue to challenge and redefine the industry standards. R&D spending increased to \$483,095 (13.6% of revenue) for the current quarter compared to \$338,559 (10.3% of revenue) for the quarter ended February 28, 2002. The increased spending is the result of

additional salaries and benefits for new staff to support the additional R&D activities the Company is pursuing.

In November of 1999, the Company announced an agreement with Technology Partnerships Canada ("TPC") whereby TPC has agreed to grant financial assistance to the Company for the purpose of assisting the Company in funding its research and development activities. The maximum eligible repayable contribution is \$4,000,177 over the period to March 31, 2003. During the quarter, the Company incurred eligible costs of \$298,006 and has claimed the full amount. To February 28, 2003, the Company has claimed a total of \$3,921,292 since the start of the TPC program. Also, under the terms of the agreement, the Company is required to pay TPC a royalty based on the sales of its subsidiary Offshore Systems Ltd. To February 28, 2003, the Company has either paid or accrued for future payment \$1,105,479 in royalties for historical and estimated future sales.

### **Sales and Marketing Expenses**

Sales and marketing ("S&M") expenses consisted primarily of compensation of sales and marketing personnel, as well as expenses associated with advertising, trade shows, facilities and other expenses related to the sales and marketing of the Company's products and services. S&M expenses increased \$67,645, or 15.6%, for the quarter ended February 28, 2003 to \$501,651 (14.1% of revenue) from \$434,006 (13.2% of revenue) for the same quarter in 2002. The increase in expenses was the result of the company's increased level of business development activity relating to its expansion efforts into European and Asia-Pacific markets. These expansion efforts required the Company to hire additional S&M staff. The expansion effort targets the military agencies of Canada, NATO and other allies of Canada to increase the profile of the Company and its products.

### **Amortization**

Total amortization decreased for the quarter ended February 28, 2003 when compared to the same period in 2002. For the current quarter, amortization was \$82,565 down \$13,879 from the quarter ended February 28, 2002. The decrease reflects the final amortization of deferred chart costs in the fiscal year 2002.

### **Interest**

Interest expense decreased for the quarter ended February 28, 2003 to \$250 from \$1,745 for the quarter ended February 28, 2002 because the Company did not utilize its credit facility during the quarter.

### **Income Taxes**

Based on the information available at the time of the issue of the unaudited February 28, 2003 financial statements, the Company estimated that it has sufficiently allowed for the application of taxable earnings in future years to draw down a portion of the Company's \$4,855,787 Canadian non-capital losses carried forward. As a result of this assessment, the valuation allowance and the future tax asset did not change for the quarter ended February 28, 2003. The Company does not consider it more likely than not that the remaining future tax asset will be recovered so in accordance with Canadian GAAP, the Company provided a valuation allowance of \$2,874,840 against the total future tax asset. The Company continues to evaluate its taxable position quarterly and considers factors such as estimated taxable income, the history of losses for tax purposes and the growth of the Company, among others.

## **Net Earnings**

Consolidated net earnings for the quarter ended February 28, 2003 were \$248,248, or 7.0% of revenue, compared to \$267,852 for the same quarter of 2001, or 8.2% of revenue.

## **Liquidity and Capital Resources**

The Company's balance sheet continued to strengthen in the quarter ended February 28, 2003. At February 28, 2003, the Company has current assets of \$10,027,113, current liabilities of \$2,795,161 and a cash position of \$6,154,779. Working capital increased \$2,782,460 to \$7,231,952 at February 28, 2003 from \$4,449,492 at November 30, 2002 primarily through an increase in cash and a decrease in billings in excess of revenues.

The Company has credit facilities consisting of an operating line, standby letters of credit and forward exchange contract facilities. The credit facilities permit the Company to borrow funds directly for general corporate purposes (including acquisitions) at floating rates. No borrowings against the operating line were outstanding as at February 28, 2003. The Company has issued standby letters of credit totalling US\$859,900. The company has utilized the standby letters of credit to back certain performance obligations to our customers. The Company has entered forward exchange contracts in the amount of US\$864,000. The Company utilizes its forward exchange contract facility to reduce the level of exposure to exchange rate movements between the U.S. dollar and Canadian dollar.

Operating cash flow for the three months ended February 28, 2003, before changes in non-cash working capital items, was \$352,863, compared with \$266,306 for the three months ended February 28, 2002, an increase of \$86,557. Changes in non-cash working capital items were a usage of cash of \$114,878 for the three months ended February 28, 2003 compared to usage of cash of \$1,107,130 for the same period in 2002. Changes occurred in most non-cash working capital items between these two periods - all within the normal business activities of the Company. The three largest changes in non-cash working capital were to Accounts receivable, Accounts payable and accrued liabilities and Billings in excess of revenues. These changes reflect the increased business activities of the Company.

Net cash provided by financing activities for the three months ended February 28, 2003 amounted to \$2,702,500 compared \$150,422 for the same period in 2002. The issuance of preferred and common shares provided funds of \$2,719,093 for the three months ended February 28, 2003 compared to \$150,422 for the same period in 2002.

Cash used in investing activities totalled \$29,754 for the three months ended February 28, 2003, compared with \$97,828 for the same period in 2002. The decrease is reflective of the decrease in property, plant and equipment acquisitions.

The net increase in cash and cash equivalents amounted to \$2,910,731 for the three months ended February 28, 2003 compared to a decrease of \$788,230 for the three months ended February 28, 2002.

The Company's current ratio increased to 3.6:1 at February 28, 2003 compared to 2.0:1 at November 30, 2002.

## **Backlog**

Backlog consists of firm, fixed, signed orders issued to the Company and executable by the Company subsequent to the balance sheet date. Order backlog as at February 28, 2003 was at \$2.3 million compared to \$3.7 million at November 30, 2002 and \$7.6 million at February 28, 2002. The high backlog balance at February 28, 2002 was the result of two substantially incomplete major contracts, one with the Royal Danish Navy and the other with the Canadian Department of National Defence awarded to the Company in

the last half of FY2001. Because governments approve budget expenditures on an annual basis, multi-year contracts with government agencies have a termination-for-convenience clause that allows the contract to be terminated should future budget funding not be approved. The Company has included the full value of these contracts in backlog as no evidence exists that the contracts would be terminated.

### **Recent Corporate Developments**

In January 2003, the Company proceeded with a Normal Course Issuer Bid whereby it will purchase its own shares out of the market through the facilities of the TSX. All shares repurchased by the Company will be cancelled. The bid will commence on January 16, 2003 and terminate January 15, 2004.

In February 2003, the Company announced that it has completed a private placement of US\$2,000,000 (CDN\$3,100,000) with four New York based institutional funds.

Again in February 2003, the Company announced the launch of COP-IDS®, a client server application that allows customers to integrate OSI's mapping and imagery display technology into existing Command and Control systems rapidly and cost effectively. COP-IDS stands for Common Operational Picture – Image Display Server. and it is designed to meet the emerging requirements for our customers' international fleets to be able to operate from and share common tactical data in the field. COP-IDS allows our customers to share data across Command and Control systems, regardless of the systems in use.

In March 2003, the Company through its wholly-owned subsidiary, OSI Geomatics Ltd., announced that it has won a contract with the City of Ottawa to produce land mapping data critical to the planning and management of city infrastructure in the Nation's capital.

Again, in March 2003 the Company confirmed that OSI and its teaming partners have been short-listed as potential contractors to supply its ECPINS® navigation display system to two international customers in the military defence industry. The award of formal contracts is subject to further technical evaluation and preparation of formal agreements.

In April 2003, the Company received a contract from the Canadian Navy to develop submarine navigation systems for deployment on the Canadian Navy's Victoria Class Navy submarines.

### **Change in Accounting Policy**

Effective December 1, 2002, the Company adopted the new recommendations of the Canadian Institute of Chartered Accountants with respect to accounting for stock-based compensation and other stock-based payments. The new recommendations are applied prospectively to all stock-based payments to non-employees, and to employee awards that are direct awards of stock, call for settlement in cash or other assets, or are stock appreciation rights that call for settlement by the issuance of equity instruments, granted on or after December 1, 2002.

### **Risks and Uncertainties**

Past performance is not a guarantee of future performance. Certain statements made in this report by the Company constitute forward looking statements, and are subject to risks and uncertainties the may cause future results to differ materially from those expected. Factors that may cause such difference include, but not limited to, the factors discussed in the 2002 year end Management Discussion and Analysis of Financial Condition and Results of Operations and the additional factor discussed below. If any of these events actually occur, they could materially adversely affect the Company, its financial condition or results of operations.

**We depend on offshore sub-contract labour in our geomatics operations to maintain a competitive position in the geomatics marketplace.**

Our geomatics operations are highly dependent upon labour resources located outside North America. While we enter into sub-contract agreements with these suppliers, we can not be sure that the labour resources will be available when we require them and at the levels we require them. Accordingly, maintaining our competitiveness will depend on a number of factors, including:

- . the geopolitical uncertainties specific to the home country of each sub-contractor;
- . the cultural compatibility between Canada and the home country of each sub-contractor;
- . the English language proficiency of the labour resources made available to us;
- . labour pool characteristics such as work ethic, education, skill level and attrition;
- . the infrastructure of both the sub-contractor's home country and the sub-contractor.

While the presence of these factors and the impact of these factors are difficult to predict, any one or more of them could adversely affect our geomatics operations in the future.