



# Offshore Systems International Ltd.

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

For the three months ended February 29, 2004

## **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 three months ended February 29, 2004 in comparison with those for the three months ended February 28, 2003. This discussion should be read in conjunction with the Company's unaudited financial statements for the three months ending February 29, 2004, its 2003 Audited Financial Statements and the 2003 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® line of electronic chart navigation systems for commercial and military customers. ECPINS® 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® systems deployed with the Canadian and United States Coast Guards, the Canadian Navy, the New Zealand Royal Navy, the Royal Danish Navy and the United States Navy. In 2004, the Company will be deploying systems with the Royal Navy and the Royal Australian Navy.

In 2002, the Company expanded the business scope of its wholly owned subsidiary Offshore Charts Ltd. beyond production of electronic navigation charts to include production of land-based mapping products. The Offshore Charts Ltd. subsidiary was also renamed OSI Geomatics Ltd. to better reflect its business expansion. The Company's U.S. subsidiary – Offshore Systems International Inc. was reactivated and renamed to OSI Geomatics Inc. to enter the U.S. mapping

market. Collectively, the two subsidiaries form the Company's new business unit – OSI Geomatics.

In February 2003, the Company announced the launch of a new product, Common Operational Picture - Image Display Server ("COP-IDS<sup>®</sup>"), a client server application that allows customers to integrate the Company's mapping and imagery display technology into existing Command and Control ("C2") systems rapidly and cost effectively. COP-IDS<sup>®</sup> facilitates the integration of information from multiple geo-spatial sources – such as land maps, nautical charts, aerial and space photo imagery and special military information – into a single fused display. COP-IDS<sup>®</sup> is designed to meet the emerging requirements of international fleets to be able to operate from and share common tactical data in the field. COP-IDS<sup>®</sup>; allows the Company's customers to share data across C2 systems, regardless of which C2 applications systems are in use. COP-IDS<sup>®</sup> is a C2 product that addresses the needs of not only Navy applications but also Army, Air Force, Special Forces and joint forces applications.

Starting in the Company's 2004 fiscal year, it added a new line of business – OSI Applications, which will develop software applications and tools for situational awareness. OSI Applications is a division of the Company's subsidiary Offshore Systems Ltd. The Applications business unit provides products and services to military forces, government agencies and systems integrators to enable improved situational awareness. The business unit's initial product is Common Operational Picture – Integrated Display Server (COP-IDS<sup>®</sup>).

## **Overall Performance**

### **Earnings**

For the three months ended February 29, 2004, the Company had earnings of \$551,791 or \$0.02 per share on a basic and diluted basis.

The Company's results for the three months ended February 29, 2004 were largely driven by the Company's successful selection for the major fleet contract with the Royal Navy, as part of a successful teaming arrangement with Lockheed Martin UK and Kelvin Hughes Ltd.

### **Backlog**

Total backlog as at February 29, 2004 is \$18.0 million compared to \$3.3 million at November 30, 2003. Total backlog is the total of the firm and option backlogs. Firm backlog consists of firm, fixed, signed orders issued to the Company and executable by the Company subsequent to the balance sheet date. Firm backlog as at February 29, 2004 was at \$7.0 million compared to \$0.9 million at November 30, 2003 and \$2.3 million at February 28, 2003. Option backlog consists of unexercised contract options at the balance sheet date and indefinite-quantity contracts executable by the Company subsequent to the balance sheet date. Option backlog as at February 29, 2004 was at \$11.0 million compared to \$2.4 million at November 30, 2003. Should our customers elect to exercise contract options or place orders against indefinite-quantity contracts, the option backlog converts to firm backlog.

The timing of the awarding of major contracts to the Company can significantly impact the Company's total backlog position. Historically, major contracts that have been awarded to the Company have taken up to three years to finalize with the contracting process involving lengthy discussions and negotiations with several groups of people within the prospective customer's organization. The Company has continually pursued and will continue to pursue major contracts and as a result there could be large variations in its total backlog position from one fiscal quarter to another. The high firm backlog and option balances at February 29, 2004 were the result of the Company and its partners winning the Royal Navy tender.

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 by the contracting government agency should future budget funding not be approved. The Company has included the full value of these contracts in total backlog as no evidence exists that the contracts would be terminated.

## **Risks and Uncertainties**

Certain statements made in this report by the Company constitute forward-looking statements, and are subject to risks and uncertainties that may cause future results to differ materially from those expected. Factors that may cause such differences include, but are not limited to, the factors discussed below. If any of these events actually occur, they could have a materially adverse effect on the Company, its financial condition or results of operations.

**We depend heavily on our government contracts, which are only partially funded, subject to termination, heavily regulated and audited. The termination of one or more of these contracts could have a negative impact on our operations. The contract termination clauses are generally in favour of the Government Agencies. Typically the termination clause for convenience is 30 days or less with the condition that all costs to that date are paid by the Government Agencies.**

The termination of funding for a government program would result in a loss of anticipated future revenues attributable to that program. That could have a negative impact on our operations. Also, we can give no assurance that we would be able to procure new government contracts to offset the revenues lost as a result of any termination of our contracts. As our revenues are dependent on our procurement, performance and payment under our contracts, the loss of one or more critical contracts could have a negative impact on our financial condition.

In addition, sales to the governments we work with may be affected by:

- changes in procurement policies;
- budget considerations;
- changing concepts of national defence; and
- political developments abroad.

The influence of any of these factors, which are largely beyond our control, could also negatively impact our financial condition.

**We derive a significant amount of revenue from only a few customers. We depend on the international governments for a significant portion of our sales, and the loss of any of these relationships or a shift in any of these governments' funding could have severe consequences on our financial condition.**

Approximately 83% of our revenue in the three months ended February 29, 2004 was from the U.S. Coast Guard, Royal Navy and Royal Australian Navy. Therefore, any significant disruption or deterioration of any of our relationships with these entities' governments would significantly reduce our revenues. These governments may choose to use other competing corporations for their navigational equipment. In addition, a shift in government spending to other programs in which we are not involved could have severe consequences for our results of operations.

**Our product lines are not broadly diversified.**

We derive and expect to derive a substantial majority of our revenue from navigational equipment sales. If customers do not purchase our products as a result of competition, technological

change, budget constraints or other factors, we do not have other product categories that we could rely on to make up any shortfall in sales. As a result, our revenue could decrease and our business and operating results would be adversely affected.

**We derive a significant portion of our revenues from international sales and are subject to the risks of doing business in foreign countries.**

In the three months ended February 29, 2004, approximately 97% of our revenues were from international customers, including governmental customers: 22% from the United States and 75% from other international countries. We expect that international sales will continue to account for a significant portion of our revenues for the foreseeable future. As a result, we are subject to risks of doing business internationally, including those risks related to:

- changes in regulatory requirements;
- domestic and foreign government policies, including requirements to expend a portion of program funds locally and governmental industrial co-operation requirements;
- fluctuations in foreign currency exchange rates;
- the complexity and necessity of using foreign representatives and consultants;
- imposition of tariffs or embargoes, export controls and other trade restrictions; and
- compliance with a variety of foreign laws.

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 operations in the future.

**We have established teaming relationships and strategic partnerships with international corporations to pursue major international government procurements, and our reputation and results of operations could be adversely affected by our inability to control their operations.**

We rely on agreements with international corporations to assist us in pursuing contracts for major government procurements. We do not have assurance that these third parties will:

- remain in business,
- maintain the financial stability required to fulfill the requirements of these international procurements and
- continue to consider the Company's products in their business priorities.

There can be no assurance that we would be able to pursue and secure major international government procurements without these third parties.

**Competition within our markets may reduce our procurement of future contracts and our sales.**

The defence industry in which we operate is highly competitive. Our competitors range from smaller companies, which are primarily targeting the pleasure boat market, to large diversified corporations in the radar/marine equipment segment of the industry. Some of our competitors may have more extensive or more specialized engineering, manufacturing and marketing capabilities than we have. There can be no assurance that we can continue to compete effectively with these companies.

**Our future success will depend on our ability to develop new technologies that achieve market acceptance.**

The defence market is characterized by rapidly changing technologies and evolving industry standards. Accordingly, our future performance depends on a number of factors, including our ability to

- identify emerging technological trends in our market;

- develop and maintain competitive products;
- enhance our products by adding innovative features that differentiate our products from those of our competitors; and
- manufacture and bring products to market quickly at cost-effective prices.

We believe that, in order to remain competitive in the future, we will need to continue to develop new products, which will require the investment of significant financial resources in new product development. In addition, there can be no assurance that the market for our products will develop or continue to expand as we currently anticipate. The failure of our technology to gain market acceptance could significantly reduce our revenues and harm our business. Furthermore, we cannot be sure that our competitors will not develop competing technology, which gains market acceptance in advance of our products. The possibility that our competitors might develop new technology or products might cause our existing technology and products to become obsolete. If we fail in our new product development efforts or our products fail to achieve market acceptance more rapidly than our competitors, our revenues will decline and our business, financial condition and results of operations will be negatively affected.

**We depend on the recruitment and retention of qualified personnel, and our failure to attract and retain such personnel could seriously harm our business.**

Due to the specialized nature of our business, our future performance is highly dependent upon the continued services of our key engineering personnel and executive officers. Our prospects depend upon our ability to attract and retain qualified engineering, manufacturing, marketing, sales and management personnel for our operations. Competition for personnel is intense, and we may not be successful in attracting or retaining qualified personnel. Our failure to compete for these personnel could seriously harm our business, results of operations and financial condition.

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

Our geomatics and systems operations are highly dependent upon labour resources located outside North America. While we enter into sub-contract agreements with these suppliers, we cannot 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 and
- 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 and systems operations in the future.

**We may be unable to adequately protect our intellectual property rights, which could affect our ability to compete.**

Protecting our intellectual property rights is critical to our ability to compete and succeed as a company. We have trademark and copyright registrations, which are necessary and contribute significantly to the preservation of our competitive position in the market. There can be no assurance that any of these patents and other intellectual property will not be challenged, invalidated or circumvented by third parties. In the future, we may not be able to obtain necessary licenses on commercially reasonable terms. We enter into confidentiality and invention assignment agreements with our employees, and enter into nondisclosure agreements with our

suppliers and customers, as appropriate, so as to limit access to and disclosure of our proprietary information. These measures may not suffice to deter misappropriation or independent third party development of similar technologies.

**We depend on component availability and our key suppliers to manufacture and deliver our products and services.**

Our operations are highly dependent on the timely delivery of materials by outside suppliers. While we enter into purchase agreements with a few of our suppliers, we cannot be sure that materials, components, and subsystems will be available in the quantities we require, if at all. If any of the suppliers fail to meet our needs, we may not have readily available alternatives. Our inability to fill our supply needs would jeopardize our ability to satisfactorily complete our obligations under our contracts on a timely basis. This might result in reduced sales, contractually imposed penalties for delay in delivery, termination of one or more of these contracts or damage to our reputation and relationships with our customers. All of these events could have a negative effect on our financial condition.

**The unpredictability of our results may harm or contribute to the volatility of the trading price of our securities.**

Our operating results may vary significantly over time for a variety of reasons, many of which are outside our control and any of which may harm our business. The value of our securities may fluctuate as a result of considerations that are difficult to forecast, such as:

- the volume and timing of product orders received and delivered;
- levels of product demand;
- government spending patterns;
- the timing of contract receipt and funding;
- our ability and the ability of our key suppliers to respond to changes in customer orders;
- the timing of our new product introductions and our competitors' new product introductions;
- the cost and availability of components and subsystems;
- price erosion;
- the adoption of new technologies and industry standards;
- competitive factors, including pricing, availability and demand for competing products;
- fluctuations in foreign currency exchange rates; and
- regulatory developments.

**We may pursue strategic relationships, investments and acquisitions. We may not be able to successfully manage our operations if we fail to successfully integrate the acquired technologies and/or businesses.**

As part of our business strategy, we may expand our product offerings to include application software products that are complementary to our existing products. This strategy may involve technology licensing agreements, joint development agreements, investments or acquisitions of other businesses that offer complementary products. The risks that the Company may encounter in acquiring or licensing technology from third parties include the following:

- difficulty in integrating the third party product with our products,
- undiscovered software errors in the third party product,
- difficulties in selling the third party product,
- difficulties in providing satisfactory support for the third party product,
- potential infringement claims from the use of the third party product and
- discontinuation of third party product lines.

The risks commonly encountered in the investment in or acquisition of businesses would accompany any future investments or acquisitions by us. Such risks may include the following:

- issues related to product transition (such as development, distribution and customer support),

- the substantial management time devoted to such activities,
- the potential disruption of our ongoing business,
- undisclosed liabilities,
- failure to realize anticipated benefits (such as synergies and cost savings) and
- the difficulty of integrating previously distinct businesses into one business unit.

**We may require additional capital, in which case we may need to raise additional funds from lenders and equity markets in the future.**

If our expenses exceed our revenues, we may choose to raise additional financing. In addition, we may choose to raise additional financing in order to capitalize on potential opportunities in the marketplace that may accelerate our growth objectives. Our ability to arrange such financing in the future will depend in part on the prevailing capital market conditions as well as on our business performance. There can be no assurance that we will be successful in our efforts to arrange additional financing, if needed, on terms satisfactory to us. If additional financing is raised by the issuance of shares, shareholders may experience dilution to their equity interest in us.

**Our business could be adversely affected if we fail to manage our growth effectively.**

If we fail to manage our growth effectively, our business and operating results could be adversely affected, which could cause the market price of our stock to fall. We expect to continue to grow our operations domestically and internationally, and to hire additional employees. The growth in our operations and staff has placed, and will continue to place, a significant strain on our management systems and resources. If we fail to manage our future anticipated growth, we may experience higher operating expenses, and we may be unable to meet the expectations of investors with respect to future operating results. To manage this growth we must, among other things, continue to:

- improve our financial and management controls, reporting systems and procedures;
- add and integrate new senior management personnel;
- improve our licensing models and procedures;
- hire, train and retain qualified employees;
- control expenses;
- diversify channel sales strategies; and
- invest in our internal networking infrastructure and facilities.

We have committed funds to obtaining additional systems and facilities to accommodate our current and future anticipated growth. To the extent that this anticipated growth does not occur or occurs more slowly than we anticipate, we may not be able to reduce expenses to the same degree. If we incur operating expenses out of proportion to revenue in any given quarter, our operating results may be adversely impacted.

**Third parties may claim that we infringe their proprietary rights.**

We potentially may receive claims that we have infringed the intellectual property rights of others. As the number of products in the software industry increases and the functionality of these products further overlap, we may become increasingly subject to infringement claims, including patent, trademark and copyright infringement claims. In addition, former employers of our former, current or future employees may assert claims that such employees have improperly disclosed to us the confidential or proprietary information of these former employers. Any such claim, with or without merit, could be time-consuming to defend, result in costly litigation, divert management's attention from our core business, require us to stop selling or delay shipping, or cause the redesign of our product. In addition, we may be required to pay monetary amounts as damages, for royalty or licensing arrangements, or to satisfy indemnification obligations that we have with some of our customers.

We license and use software from third parties in our business. These third party software licenses may not continue to be available to us on acceptable terms. Also, these third parties may from time to time receive claims that they have infringed the intellectual property rights of others, including patent and copyright infringement claims, which may affect our ability to continue licensing this software. Our inability to use any of this third party software could result in shipment delays or other disruptions in our business, which could materially and adversely affect our operating results.

**We may not be able to protect our proprietary information.**

We rely on a combination of copyright, trademark and trade secret laws, confidentiality procedures, contractual provisions and other measures to protect our proprietary information. All of these measures afford only limited protection. These measures may be invalidated, circumvented or challenged, and others may develop technologies or processes that are similar or superior to our technology. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy our products or to obtain or use information that we regard as proprietary.

**Our products may contain significant defects, which may result in liability and/or decreased sales.**

Software products frequently contain errors or failures, especially when first introduced or when new versions are released. Despite our efforts to test our products, we might experience significant errors or failures in our products, or they might not work with other hardware or software as expected. This could delay the development or release of new products or new versions of products, or could adversely affect market acceptance of our products. End-user customers use our products for applications that are critical to their businesses, and they have a greater sensitivity to product defects than the market for other software products generally. Our customers may claim that we are responsible for damages to the extent they are harmed by the failure of any of our products. If we were to experience significant delays in the release of new products or new versions of products, or if customers were dissatisfied with product functionality or performance, we could lose revenue or be subject to liability for service or warranty costs. Should this occur, our business and operating results could be adversely affected.

**Our products rely on third party software products and our reputation and results of operations could be adversely affected by our inability to control their operations.**

Our products incorporate and use software products developed by other entities. We do not have assurance that such third parties will:

- remain in business,
- support our product lines,
- maintain viable product lines and
- make their product lines available to us on commercially acceptable terms.

Any significant interruption in the supply of such third-party technology could have a materially adverse effect on our business, results of operation, cash flows and financial condition.

## Selected Information

Statement of Earnings Information	(Unaudited)		(Audited)		
	For the three months ended		For the years ended November 30		
	February 29, 2004 \$	February 28, 2003 \$	2003 \$	2002 \$	2001 \$
Revenue	4,029,760	3,563,175	11,520,793	13,868,779	7,919,632
Gross profit	2,568,773	1,860,487	6,361,725	6,771,387	4,585,372
Gross profit percentage	63.7%	52.2%	55.2%	48.8%	57.9%
Earnings for the period	551,791	248,248	385,369	1,635,031	496,409
Basic earnings per share	0.02	0.01	0.01	0.06	0.02
Diluted earnings per share	0.02	0.01	0.01	0.06	0.02
Balance Sheet Information	(Unaudited)		(Audited)		
	As at		As at November 30		
	February 29, 2004 \$	February 28, 2003 \$	2003 \$	2002 \$	2001 \$
Cash and cash equivalents	1,716,195	6,154,779	3,837,555	3,244,048	2,037,625
Working capital	8,292,690	7,231,951	8,071,926	4,449,492	2,848,151
Current assets	10,538,062	10,027,113	10,377,836	8,810,568	6,022,312
Total assets	12,131,976	11,930,172	11,728,257	10,766,438	7,375,007
Current liabilities	2,245,372	2,795,162	2,305,910	4,361,076	3,174,161
Long term debt	140,539	129,568	187,384	372,717	371,484
Total liabilities	2,385,911	2,924,730	2,493,294	4,733,793	3,545,645
Shareholders' equity	9,746,065	9,005,442	9,234,963	6,032,645	3,829,362

The Company's annual and quarterly results are primarily affected by the level, timing and duration of customer orders and customer product delivery requirements. The Company depends heavily on government contracts and derives a significant amount of revenue from a few customers, which may result in varying revenue, gross profit and earnings.

The fluctuations in revenue year over year were largely attributable to the substantial completion in fiscal year 2002 of the Canadian Department of National Defence contract awarded to the Company in fiscal year 2001, the Marinette Marine Corp. contracts to provide ECDIS systems for the U.S. Coast Guard Juniper class buoy tenders, and the substantial completion of the Danish Navy contract during FY2003.

The fluctuations in gross profit year over year were largely attributable to projects that include a large proportion of third-party systems or labour at low gross profit margins.

## Results of Operations

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

	<u>Three months ended</u>	
	<u>February 29, 2004</u>	<u>February 28, 2003</u>
Revenue		
Software	74.3%	5.8%
Geomatics	17.8%	19.4%
Systems and system components	4.6%	72.5%
Other	3.2%	2.3%
	<u>100.0%</u>	<u>100.0%</u>
Cost of sales	<u>36.3%</u>	<u>47.8%</u>
Gross profit	63.7%	52.2%
Expenses		
General and administrative	18.1%	19.5%
Research and development	11.5%	13.6%
Sales and marketing	19.7%	14.1%
Amortization	1.3%	1.5%
Interest	0.0%	0.0%
Foreign exchange loss	(0.6%)	3.8%
Technology Partnerships Canada royalty	1.2%	1.1%
Technology Partnerships Canada contribution	0.0%	(8.4%)
	<u>51.2%</u>	<u>45.2%</u>
Earnings from operations	12.5%	7.0%
Income tax recovery	<u>1.1%</u>	<u>0.0%</u>
Earnings for the period	<u><u>13.7%</u></u>	<u><u>7.0%</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®"), delivers the majority of the revenue.

The Company recognizes revenue from each source when earned in compliance with CDN GAAP. Certain revenues 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. When it has been determined that a project or a project segment will generate a loss, the Company estimates that loss and books a reserve for the total expected loss on the project or project segment. 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.

Consolidated revenue for the three months ended February 29, 2004 was \$4,029,760, compared with \$3,563,175 for the three months ended February 28, 2003, an increase of 13%. The Company's revenues are primarily affected by the level, timing and duration of customer orders and customer product delivery requirements. The Company depends heavily on government contracts and derives a significant amount of revenue from a few customers, which may result in varying revenue and margins. During fiscal year 2003 ("FY2003"), the Company continued and expanded its business development initiatives with prospective and existing customers. Some of the activities did not result in closing orders during FY2003 but may yield orders in subsequent fiscal years. The selection of the Company for the fleet-wide contract with the Royal Navy as part of a teaming arrangement with Lockheed Martin UK and Kelvin Hughes Ltd. is one example of this situation. The main customers for the Company's products and services were the Royal Navy through Lockheed-Martin UK, the U.S. Coast Guard and the Royal Australian Navy through Nautronix Ltd. Revenue from these customers accounted for 83% of the consolidated revenue for the three months ended February 29, 2004.

A significant change in the Company's revenue mix occurred in the three months ended February 29, 2004. Revenues during this period shifted to Software from Systems and system components. The revenue shift is the result of a change in the nature of contracts the Company entered into during the last fiscal quarter of 2003 and the first fiscal quarter of 2004. These contracts require the Company to deliver off-the-shelf or customized versions of its ECPINS® software. Historically, the Company's contracts focused on the delivery of ECPINS® electronic chart navigation systems. Should this trend continue, the Company's major revenue source will become ECPINS® software.

### **Segment Results**

Revenue from the Navigation Systems business unit for the three months ended February 29, 2004 was \$3,280,098, compared to \$2,868,956 for the same period last year, an increase of \$411,142 or 14%. This increase is the net of two factors - a decrease attributable to the substantial completion of two contracts, the Canadian Department of National Defence contract awarded to the Company in fiscal year 2001 and the Marinette Marine Corp. contracts to provide ECDIS systems for the U.S. Coast Guard Juniper class buoy tenders, and an increase attributable to the new Royal Navy contract.

Revenue from the Geomatics business unit for the three months ended February 29, 2004 was \$721,344 compared to \$694,219 for the same period last year, an increase of \$27,125 or 4%. The business unit maintained revenue levels in the current fiscal year with that of the previous fiscal year. The first three to four months of the calendar year are generally the slowest period in the business cycle for the geomatics business unit.

The Company's new business unit – Applications generated \$28,318 in revenue for the three months ended February 29, 2004.

In all three business units, the Company continues to invest significant corporate, sales and marketing resources in identifying and pursuing new opportunities and contracts, both in its existing customer base and with new prospective customers.

### **Gross Profit**

The Company's gross profit increased \$708,286 to \$2,568,773 for the three months ended February 29, 2004 from \$1,860,487 for the same period last year. Gross profit percentage increased to 63.7% from 52.2% period over period. The increase was attributable to the significant software-only revenue by the Navigation System business unit for the three months ended February 29, 2004. The increase is the result of the shift to delivering off-the-shelf or customized versions of its ECPINS® software from the delivery of ECPINS® electronic chart navigation systems. Should this change in revenue mix continue, the Company will continue to report gross margin percentages that are higher than those reported historically.

### **Segment Results**

Gross profit from the Navigation Systems business unit for the three months ended February 29, 2004 was \$2,396,046, compared to \$1,609,411 for the same period last year, an increase of \$786,635 or 49%. Gross profit percentage increased to 73.0% from 56.2% period over period. The increase was attributable to the significant software revenue for the three months ended February 29, 2004.

Gross profit from the Geomatics business unit for the three months ended February 29, 2004 was \$153,759 compared to \$251,076 for the same period last year, a decrease of \$97,317 or 39%. Gross profit percentage decreased to 21.3% from 35.9% period over period. The decrease is the result of competitive nature of the geomatics market where customers are very price sensitive.

### **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, net of interest and other income. G&A increased \$35,629 for the three months ended February 29, 2004 to \$730,073 from \$694,444 in same period last year. The increase is primarily the result of increased public company costs in investor relations and directors and officers insurance. As a percentage of revenue, G&A decreased to 18.1% from 19.5% period over period. The Company continues to protect its Intellectual Property and its ability to conduct its businesses in an unrestricted manner through the appropriate avenues. These activities may result in increased G&A expenses in future periods.

### **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 expenses research and development costs in the period incurred unless, in the opinion of management, certain development costs meet the deferral criteria under

Canadian GAAP, in which case development expenditures are capitalized and amortized over the estimated life of the related products. To date, the Company has not capitalized any development costs.

The Company continued to invest in new product development in 2003. The Company believes that in order to maintain its technological capabilities, it must continue to develop existing products and introduce new high quality products that challenge and redefine the industry standards. R&D costs decreased \$19,871 to \$463,224 or 11.5% of revenue for the three months ended February 29, 2004, compared to \$483,095 or 13.6% of revenue in the same period last year. The apparent decrease is the result of approximately \$214,000 of R&D costs charged to direct costs to support the software customization required to meet the needs of specific customers. The actual increase in spending is the result of additional salaries and benefits for new staff to support the additional R&D activities related to the development of the recently released COP-IDS® product and the continuing development of the ECPINS® product.

In November of 1999, the Company announced an agreement with Technology Partnerships Canada ("TPC") whereby TPC granted financial assistance to the Company to fund research and development activities. The maximum eligible repayable contribution is \$4,000,177 over the period to March 31, 2003. As at November 30, 2003, the Company has claimed the full amount eligible under the TPC program. Also, under the terms of the agreement, the Company is required to pay TPC a royalty based on the revenue of its subsidiary Offshore Systems Ltd. To November 30, 2003, the Company has accrued for future payment or paid royalties of \$1,189,265. Royalty payments will continue until the cumulative royalties paid or payable to November 30, 2008 are at least \$7,810,230 or until November 30, 2014.

### **Sales and Marketing Expenses**

Sales and marketing ("S&M") expenses consist 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 \$291,626, or 58%, for the three months ended February 29, 2004 to \$793,277 (19.7% of revenue) from \$501,651 (14.1% of revenue) for the same period last year. The increase in expenses was the result of the Company's increased level of business development activity relating to its expansion efforts into American, European and Asia-Pacific markets. These expansion efforts required the Company to hire additional S&M staff to pursue specific opportunities in these regions. 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 through the establishment of marketing agreements with companies local to the targeted regions. Some of these activities may not result in closing orders during the current year but may yield orders in subsequent fiscal years.

### **Amortization**

Total amortization decreased slightly to \$52,066 from \$54,614 for the three months ended February 28, 2003. The decrease reflects the dollar value and mix of fixed assets in the Company at February 29, 2004.

### **Interest**

Interest expense increased to \$268 from \$250 for the three months ended February 28, 2003. The Company did not utilize its credit facility during the three months ended February 29, 2004.

### **Income Taxes**

Based on the information available at the time of the issue of the unaudited financial statements for the three months ended February 29, 2004, the Company estimated that it will have sufficient

taxable earnings in future years to utilize a portion of the Company's \$4,502,648 Canadian and \$451,030 U.S. non-capital losses carried forward. As a result of this assessment, the Company recognized a future tax asset of \$278,903 for the three months ended February 29, 2004. In accordance with Canadian GAAP, the Company provided a valuation allowance of \$3,456,714 against the total future tax asset as it is not considered more likely than not that the remaining future tax asset will be recovered. 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 three months ended February 29, 2004 were \$551,791, or 13.7% of revenue, compared to \$248,248 for the three months ended February 28, 2003, or 7.0% of revenue.

### Summary of Quarterly Results

<b>For the three months ended</b>	<b>Revenue</b> \$	<b>Gross Profit</b> \$	<b>Earnings</b> \$	<b>Basic Earnings per Share</b> \$	<b>Diluted Earnings per Share</b> \$
February 29, 2004	4,029,760	2,568,773	551,791	0.02	0.02
November 30, 2003	2,724,438	1,630,781	323,756	0.01	0.01
August 31, 2003	2,275,153	1,176,211	(338,797)	(0.01)	(0.01)
May 31, 2003	2,958,027	1,694,246	152,162	0.00	0.00
February 28, 2003	3,563,175	1,860,487	248,248	0.01	0.01
November 30, 2002	4,058,028	1,882,968	519,179	0.02	0.02
August 31, 2002	2,697,781	1,552,578	536,535	0.02	0.02
May 31, 2002	3,827,452	1,694,925	311,465	0.01	0.01
February 28, 2002	3,285,518	1,640,916	267,852	0.01	0.01

For a discussion on the factors that affect the quarterly results, please refer to the section **Selected Information**.

### Liquidity and Capital Resources

The Company strives to maintain cash-contributing profitable operations that provide an adequate liquidity and capital resource base for growth. Every business endeavour the Company develops or acquires targets a positive cash flow from the outset.

The Company believes that cash flow from operating activities, together with cash on hand and borrowings available under its revolving credit facilities, will be sufficient to fund currently

anticipated working capital, planned capital spending and debt service requirements for the next 12 months. There can be no assurance that these resources will be adequate or that additional financing will be available to the Company.

At February 29, 2004, the Company had current assets of \$10,538,062, current liabilities of \$2,245,372 and a cash position of \$1,716,195. Working capital increased \$220,764 to \$8,292,690 at February 29, 2004 from \$8,071,926 at November 30, 2003 primarily through a combination of an increase in accounts receivable and a decrease in cash.

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 29, 2004. The Company has issued standby letters of credit totalling US\$127,000. 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\$1,186,836. The Company utilizes its forward exchange contract facility to reduce its exposure to exchange rate movements.

Operating cash flow for the three months ended February 29, 2004, before changes in non-cash working capital items, was \$583,725, compared with \$352,863 for the three months ended February 28, 2003, a increase of \$230,862. The Company's higher earnings for the three months ended February 29, 2004 was the significant contributor to this increase.

Changes in non-cash working capital items for the three months ended February 29, 2004 were a usage of cash of \$2,621,762 compared to usage of cash of \$114,878 for the same period in 2003. Changes occurred in most non-cash working capital items between these two periods - all within the normal business activities of the Company. The largest change was to Accounts receivable which is the result of extended milestone terms that exist in certain contracts.

Net cash used by financing activities for the three months ended February 29, 2004 amounted to \$40,689 compared a net cash provided of \$2,702,500 for the same period in 2003. The issuance of preferred and common shares provided funds of \$2,832,118 for the three months ended February 28, 2003 compared to \$24,729 for the same period in 2004.

Cash used in investing activities totalled \$42,634 for the three months ended February 29, 2004, compared with \$29,754 for the same period in 2003. The increases are reflective of the increase in property, plant and equipment acquisitions.

As a result of the above mentioned changes, the net decrease in cash and cash equivalents amounted to \$2,121,360 for the three months ended February 29, 2004 compared to an increase of \$2,910,731 for the three months ended February 28, 2003.

The Company's current ratio increased to 4.7:1 at February 29, 2004 compared to 4.5:1 at November 30, 2003.

## **Off-Balance Sheet Arrangements**

### **Derivatives**

The Company uses foreign exchange contracts to hedge transactions denominated in United States dollars. The fair value of these derivative instruments at February 29, 2004 is a liability of \$41,237. For a discussion on these contracts, please see Note 9 of the Company's non-audited financial statements for three months ended February 29, 2004.

## **Transactions with Related Parties**

During the last three years, the Company did not enter into any transactions with its management, members of its Board of Directors or major shareholders.

## **Proposed Transactions**

The Company has not proposed any asset or business acquisition or disposition.

## **Critical Accounting Policies**

The Company prepares its consolidated financial statements in accordance with accounting principles generally accepted in Canada, and makes estimates and assumptions that affect its reported amounts of assets, liabilities, revenue and expenses, and the related disclosure of contingent liabilities. The Company bases its estimates on historical experience and other assumptions that it believes are reasonable in the circumstances. Actual results may differ from these estimates.

The following critical accounting policies affect the Company's more significant estimates and assumptions used in preparing its consolidated financial statements:

### **Revenue**

The Company is required to estimate the costs to complete certain systems and geomatics services contracts. Revenues from these contracts are recognized on the percentage-of-completion method measured by the percentage of costs incurred to total estimated costs to complete for each contract. When it has been determined that a contract will generate a loss for the Company, the Company estimates that loss and books a reserve for the total expected loss on the contract. In the event that actual results differ from these estimates, or the Company adjusts these estimates in future periods, the Company may need to adjust the revenues for these projects.

### **Future Income Taxes**

The Company is required to estimate its income taxes in each of the jurisdictions in which it operates. This process involves estimating the Company's actual current tax exposure, together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in future tax assets and liabilities that may be included on the Company's consolidated balance sheet. The Company recognizes future income taxes to the extent that their realizations are considered more likely than not and provides a valuation allowance against any remaining balance. The valuation allowance is based on the Company's estimates of taxable income by jurisdiction in which it operates and the period over which its future tax assets will be recoverable. In the event that actual results differ from these estimates, or the Company adjusts these estimates in future periods, the Company may need to adjust the valuation allowance.

### **Stock-based Compensation**

The company has established three stock option plans under which options to purchase common shares may be granted to directors, officers and employees of the company and to any other person or company permitted by the applicable regulatory authorities to purchase unissued common shares. The Company does not recognize a compensation expense when stock options are granted under stock option plans to employees and directors with no cash settlement features. However, direct awards of stock to employees, stock option and stock awards granted

