



## **Offshore Systems International Ltd.**

Consolidated Financial Statements  
(Prepared in accordance with Canadian Generally  
Accepted Accounting Principles)

**November 30, 2004 and 2003**  
(expressed in Canadian dollars)

## AUDITORS' REPORT

To the Shareholders of  
**Offshore Systems International Ltd.**

We have audited the consolidated balance sheets of **Offshore Systems International Ltd.** as at November 30, 2004 and 2003 and the consolidated statements of earnings and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at November 30, 2004 and 2003 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Vancouver, Canada,  
January 24, 2005.

*Ernst + Young LLP*

Chartered Accountants

# Offshore Systems International Ltd.

Canadian GAAP

(Incorporated under the laws of the Province of British Columbia, Canada)

## Consolidated Balance Sheets

As at November 30, 2004 and 2003

(expressed in Canadian dollars)

	2004 \$	2003 \$
<b>Assets</b>		
<b>Current assets</b>		
Cash	251,037	3,837,555
Accounts receivable (note 4)	9,140,478	4,621,836
Inventory (note 5)	649,427	665,503
Prepaid expenses and deposits	142,752	430,419
Future tax assets (note 12)	780,331	822,523
	<hr/> 10,964,025	<hr/> 10,377,836
<b>Property, plant, and equipment</b> (note 6)	1,346,713	1,350,421
	<hr/> 12,310,738	<hr/> 11,728,257
<b>Liabilities and Shareholders' Equity</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities (note 7)	2,596,362	2,126,061
Billing in excess of revenues	79,865	45,907
Rent payable	-	133,942
	<hr/> 2,676,227	<hr/> 2,305,910
<b>Accrued long term royalties</b>	-	187,384
	<hr/> 2,676,227	<hr/> 2,493,294
<b>Commitments and contingencies</b> (notes 10 and 11)		
<b>Capital stock</b>		
Authorized		
100,000,000 Class A preference shares with no par value, issuable in series, of which 10,000,000 shares are designated Series A voting non-cumulative retractable convertible at a ratio of 1:1, 1% preference shares		
100,000,000 Class B preference shares with a par value of \$50 each, issuable in series of which 10,000,000 are designated Series 1 voting cumulative convertible shares at a ratio of 1:45.5, 6% preference shares		
100,000,000 common shares without par value		
Issued and outstanding		
30,262 Class A preference shares – Series A (2003 – 30,262) (note 9(b))	-	-
57,711 Class B preference shares – Series 1 (2003 – 61,244) (note 9(c))	1,926,157	2,065,420
27,488,074 Common shares (2003 - 26,807,475) (note 9(a))	19,026,125	18,508,498
	<hr/> 20,952,282	<hr/> 20,573,918
<b>Warrants</b> (note 9(c))	661,575	661,575
<b>Additional Paid in Capital</b>	214,492	43,050
<b>Deficit</b>	<hr/> (12,193,838)	<hr/> (12,043,580)
	<hr/> 9,634,511	<hr/> 9,234,963
	<hr/> 12,310,738	<hr/> 11,728,257

Approved by the Board of Directors

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signed Director

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signed Director

See accompanying notes to consolidated financial statements

# Offshore Systems International Ltd.

Canadian GAAP

## Consolidated Statement of Earnings and Deficit For the years ended November 30, 2004 and 2003 (expressed in Canadian dollars)

	2004 \$	2003 \$
<b>Revenue</b>		
Software	5,576,540	1,036,417
Systems and system components	4,328,740	6,208,464
Geomatics	2,979,728	3,560,440
Other	566,295	715,472
	<hr/> 13,451,303	<hr/> 11,520,793
<b>Cost of sales</b>	<hr/> 5,669,324	<hr/> 5,159,068
<b>Gross profit</b>	<hr/> 7,781,979	<hr/> 6,361,725
<b>Expenses</b>		
General and administrative	3,435,688	2,498,021
Research and development	2,104,806	1,548,523
Sales and marketing	3,160,359	2,000,238
Amortization	231,033	241,295
Interest	2,045	2,824
Foreign exchange loss	38,338	151,961
Technology Partnerships Canada royalty (note 10)	124,425	50,473
Technology Partnerships Canada contribution (note 10)	(1,471,414)	(376,880)
	<hr/> 7,625,280	<hr/> 6,116,455
<b>Earnings before income taxes</b>	156,699	245,270
<b>Income tax expense (recovery) (note 12)</b>		
Future income tax recovery	(479,446)	(363,484)
Current income tax expense	521,404	223,385
	<hr/> 41,958	<hr/> (140,099)
<b>Earnings for the year</b>	114,741	385,369
<b>Deficit – Beginning of year</b>	(12,043,580)	(12,188,284)
<b>Class B preference share dividends</b>	(264,999)	(53,484)
<b>Premium on purchase and cancellation of common shares (note 9(f))</b>	-	(187,181)
<b>Deficit – End of year</b>	<hr/> (12,193,838)	<hr/> (12,043,580)
<b>Basic earnings per share (note 9(e))</b>	0.00	0.01
<b>Diluted earnings per share (note 9(e))</b>	0.00	0.01
<b>Weighted average number of common shares outstanding – basic (note 9(e))</b>	27,230,561	25,977,123
<b>Weighted average number of common shares outstanding – diluted (note 9(e))</b>	27,230,561	27,142,492

See accompanying notes to consolidated financial statements

# Offshore Systems International Ltd.

Canadian GAAP

## Consolidated Statements of Cash Flows

For the years ended November 30, 2004 and 2003

(expressed in Canadian dollars)

	2004	2003
	\$	\$
<b>Cash flows used in operating activities</b>		
Earnings for the year	114,741	385,369
Items not affecting cash		
Amortization	362,564	359,979
Stock based compensation	171,442	43,050
Future tax assets	42,192	(168,807)
	<hr/> 690,939	<hr/> 619,591
Changes in non-cash working capital items		
Accounts receivable	(4,518,642)	(653,197)
Inventory	16,076	601,303
Prepaid expenses and deposits	287,667	(198,204)
Accounts payable and accrued liabilities	383,735	(458,348)
Billings in excess of revenues	33,958	(1,596,818)
Rent payable	(133,942)	-
Long term royalties	(187,384)	(185,333)
	<hr/> (4,118,532)	<hr/> (2,490,597)
	<hr/> (3,427,593)	<hr/> (1,871,006)
<b>Cash flows used in investing activities</b>		
Additions to property, plant, and equipment	<hr/> (358,856)	<hr/> (309,386)
<b>Cash flows from financing activities</b>		
Issue of Common shares	398,479	606,069
Issue of Class B preference shares - Series 1 and warrants	-	3,004,200
Class B preference share issue costs	(20,115)	(277,205)
Class B preference shares dividends paid	(178,433)	(53,484)
Share repurchases	-	(505,681)
	<hr/> 199,931	<hr/> 2,773,899
<b>Increase (decrease) in cash</b>	(3,586,518)	593,507
<b>Cash – Beginning of year</b>	<hr/> 3,837,555	<hr/> 3,244,048
<b>Cash – End of year</b>	<hr/> <hr/> 251,037	<hr/> <hr/> 3,837,555

See accompanying notes to consolidated financial statements

## 1 Nature of operations

Offshore Systems International Ltd. (OSIL) develops and provides display systems and data for defense, government and commercial customers. Collectively, OSIL and its subsidiaries are referred to as the Company. OSIL conducts its operations through three business units. The Company's Navigation Systems business unit develops and produces moving geographic information display systems and software. The Company's Applications business unit develops situational awareness products for command and control systems. The Company's Geomatics business unit provides digital land map and electronic nautical chart production services, and produces and distributes electronic nautical chart data.

## 2 Summary of significant accounting policies

### Principles of consolidation

These consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All material intercompany transactions and balances have been eliminated on consolidation.

### Foreign currency translation

The operations of the Company's U.S. based subsidiary are considered integrated (financially and operationally dependent on OSIL) and are translated to Canadian dollars using current rates of exchange for monetary assets and liabilities. Historical rates of exchange are used for non-monetary assets and liabilities and average rates for the period are used for revenues and expenses except for amortization, which is translated at exchange rates used in the translation of the related asset accounts. Gains or losses resulting from these translation adjustments are included in income.

Transactions completed in foreign currencies are recorded in Canadian dollars at the rates prevailing at the time of the transactions. Monetary assets and liabilities denominated in foreign currencies are recorded in the consolidated financial statements in equivalent Canadian dollars at the rate of exchange prevailing at the balance sheet date.

The Company purchases foreign exchange forward contracts to hedge sales to customers denominated in U.S. dollars, Australian dollars and Euros (€) and the related accounts receivable. Foreign exchange translation gains and losses on foreign currency denominated derivative financial instruments used to hedge anticipated U.S. dollar, Australian dollar, and Euro denominated sales are recognized as an adjustment of the revenues when the sale is recorded. The Company does not utilize derivative financial instruments for trading or speculative purposes.

### Use of estimates

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

### Cash and cash equivalents

Cash and cash equivalents consist of cash and deposit instruments with an initial maturity of three months or less.

### Accounts Receivable

The Company maintains an allowance for doubtful accounts against its accounts receivable for estimated losses that may arise if any of its customers are unable to make required payments. Management specifically analyzes the age of outstanding customer balances, historical bad debts, customer credit-worthiness and changes in customer payment terms when making estimates of the uncollectability of the Company's accounts receivable. If the Company determines that the financial condition of any of its customers deteriorates, increases in the allowance may be made.

**Inventory**

Materials and components are stated at the lower of cost and replacement value as determined by the first-in first-out method. Work-in-process and manufactured parts are stated at the cost of materials and direct labour applied to the product and the applicable share of overhead. Finished goods are stated at the lower of cost and net realizable value. The Company assesses the need for inventory write-downs based on its assessment of estimated net realizable value using assumptions about future demand and market conditions. If market conditions differ from those originally estimated by the Company, an additional inventory write-down may be required

**Property plant and equipment**

Property plant and equipment are recorded at cost. Amortization is provided using the declining balance method based on the assets' estimated useful lives as follows:

	%
Equipment	20 – 25
Computer software	33
Furniture and fixtures	20
Leasehold improvements	20
Licenses and patents	10

An impairment loss is recognized when the undiscounted cash flows expected from use and eventual disposition of the asset are less than the carrying amount of the asset. An impairment charge is recorded to reduce the carrying value of the asset to its fair value.

**Income taxes**

The Company accounts for income taxes using the liability method of tax allocation. Under the liability method, future income tax assets and liabilities are determined based on differences between their financial reporting and tax bases and are measured using substantively enacted tax rates and laws expected to be in effect when the differences are expected to reverse. The Company provides a valuation allowance against future tax assets to the extent that the Company does not consider them to be more likely than not of being realized.

**Revenue recognition**

Revenue from certain projects for Navigation Systems, Applications, and Geomatics is 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. Costs include all direct costs including material, labour and subcontracting costs and certain indirect costs related to contracts. A provision is made for the entire amount of future estimated losses, if any, on contracts in progress.

Certain other Systems and system components revenue and Navigation Systems and Applications Software revenue is 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 or determinable, collection is probable, and there are no ongoing obligations of the Company to provide future services with the exception of warranties and maintenance.

Navigation Systems revenue under bill-and-hold arrangements, whereby revenue has been recognized but the goods have not been shipped, is recognized when risks of ownership have been passed on to the customer, there is a signed contract with the customer, the customer has a substantial business purpose for ordering the goods on a bill-and-hold basis, a fixed delivery schedule has been established with the customer and the Company does not retain any specific performance

obligations such that the earnings process is not complete. Goods held under such arrangements are segregated, ready for shipment and not subject to being used to fill other orders. The customers are charged additional fees for storage and other associated costs until shipment occurs.

Certain revenue from the sale of Geomatics services is recognized as the services are provided. Revenue from the sale of Geomatics products is recorded at the time of delivery. Revenue from systems components and other revenues are recorded at the time of delivery or as the services are provided.

Revenue from contracts with multiple deliverables is recognized based on the division of the multiple deliverables into separate units of accounting and arrangement consideration is allocated among separate units based on their relative fair values. Revenue from each unit is recognized in accordance with the applicable policies as described above.

Maintenance and technical support revenues are recognized rateably based on the terms of their respective contract agreements, generally one to four years.

### **Unbilled revenue**

Unbilled revenue is revenue that has been recognized using the percentage of completion method of accounting less amounts billed to the customer in accordance with the milestone terms of the contract. Unbilled revenue is reduced when customers are invoiced and the respective accounts receivable is recorded.

### **Billing in excess of revenues**

Billings in excess of revenue are amounts that have been billed to the customer but have not been recognized in revenue.

### **Research and development**

Research costs are expensed in the period incurred. Development costs are expensed in the period incurred unless, in the opinion of management, the deferral criteria are satisfied in all material respects, in which case development expenditures are capitalized and amortized over the estimated life of the related products.

### **Government assistance**

Government assistance is recorded when there is reasonable assurance that the Company has complied with, and will continue to comply with, all conditions necessary to obtain the government assistance. Government assistance towards current research expenditures is recorded as a reduction of expenses in the consolidated statement of earnings. The liability to repay government assistance is recognised as an expense in the period in which conditions arise that cause the government assistance to be repayable.

### **Earnings per share**

Basic earnings per share are computed using the weighted average number of common shares outstanding during the year. The treasury stock method is used for the calculation of diluted earnings per share. Under the treasury stock method, the weighted average number of common shares outstanding for the calculation of diluted earnings per share assumes that the proceeds to be received on the exercise of dilutive stock options and warrants are applied to repurchase common shares at the average market price for the period. Stock options and warrants are dilutive when the average market price of the common shares during the period exceeds the exercise price of the options and warrants.

**Guarantees**

The Company warrants that its software and hardware products will operate substantially in conformity with product documentation and that the physical media will be free from defect. The specific terms and conditions of the warranties are generally one year but may vary depending on the country in which the products are sold. The Company accrues for known warranty issues if a loss is probable and can be reasonably estimated, and accrues for estimated incurred but unidentified warranty issues based on historical activity. To date, the Company has had no material warranty claims.

**Derivative Financial Instruments**

Derivative financial instruments are utilized by the Company in the management of its foreign currency exposure to reduce its exposure to fluctuations in foreign exchange on certain committed and anticipated transactions. The Company formally documents the relationships between derivative financial instruments and hedged items, as well as the risk management objective and strategy. The Company assesses, on an ongoing basis, whether the derivative financial instruments continue to be effective in offsetting changes in fair values or cash flows of the hedged transactions.

Foreign exchange translation gains and losses on foreign currency denominated derivative financial instruments used to hedge anticipated or committed foreign currency exposures are recognized as an adjustment to the related operating costs, revenue or capital expenditures when the hedged transaction is recorded. Derivatives that are not subject to hedge accounting are recorded on the balance sheet with the changes in fair value being recorded in the statement of earnings each period. For the fiscal year 2004, all derivative financial instruments met the criteria for hedge accounting.

**3 Change in accounting policy**

Effective December 1, 2003, the Company adopted the new recommendations of the Canadian Institute of Chartered Accountants (“CICA”) Handbook Section 3870 – Stock-Based Compensation and Other Stock-Based Payments (“CICA 3870”) requiring the use of the fair value method of accounting for stock-based compensation transactions. The new recommendations have been adopted prospectively. Prior to the adoption of this standard, the settlement method was used whereby any consideration received on the exercise of stock options or the purchase of stock was credited to share capital. As required by the new recommendations, the Company discloses the pro forma effects of awards granted, modified or settled prior to December 1, 2003 to the income for the period as if the fair value method had been in use at the date of grant.

**4 Accounts receivable**

	<b>2004</b>	<b>2003</b>
	\$	\$
Trade	4,655,150	1,691,685
Unbilled revenue	4,116,828	2,854,942
Technology Partnerships Canada contribution (note 10)	257,266	-
Other	111,234	75,209
	<hr/>	<hr/>
	9,140,478	4,621,836
	<hr/>	<hr/>

# Offshore Systems International Ltd.

Canadian GAAP

Notes to the Consolidated Financial Statements

November 30, 2004 and 2003

(expressed in Canadian dollars)

## 5 Inventory

	2004	2003
	\$	\$
Materials and components	638,127	620,429
Finished goods	11,300	45,074
	<u>649,427</u>	<u>665,503</u>

## 6 Property, plant, and equipment

	2004		
	Cost	Accumulated Amortization	Net
	\$	\$	\$
Equipment	3,910,980	3,038,921	872,059
Computer software	936,591	546,190	390,401
Furniture and fixtures	131,095	94,705	36,390
Leasehold improvements	222,737	193,084	29,653
Licenses and patents	57,267	39,057	18,210
	<u>5,258,670</u>	<u>3,911,957</u>	<u>1,346,713</u>
	2003		
	Cost	Accumulated Amortization	Net
	\$	\$	\$
Equipment	3,772,026	2,838,400	933,626
Computer software	721,250	401,909	319,341
Furniture and fixtures	126,534	86,378	40,156
Leasehold improvements	222,737	185,673	37,064
Licenses and patents	57,267	37,033	20,234
	<u>4,899,814</u>	<u>3,549,393</u>	<u>1,350,421</u>

## 7 Accounts payable and accrued liabilities

	2004	2003
	\$	\$
Trade	1,343,129	1,171,353
Accrued employee costs	572,589	408,592
Accrued royalties (note 10)	311,851	183,435
Accrued liabilities	282,227	362,681
Class B preference shares dividends declared and unpaid (note 9(c))	86,566	-
	<u>2,596,362</u>	<u>2,126,061</u>

## 8 Credit facilities

In June 2004, the Company renewed certain credit facilities with a Canadian chartered bank, which consist of an operating line, a foreign exchange forward contract facility and standby letters of credit. The operating line bears interest at the chartered bank's prime lending rate plus 0.5% with interest payable monthly. The prime lending rate at November 30, 2004 was 4.25% (2003 – 4.50%). The standby letters of credit are denominated in U.S. dollars and bear interest at rates between 1% and 2% per annum. Funds drawn on the operating line and the standby letters of credit are repayable on demand. As of November 30, 2004, letters of credit, relating principally to customer contracts, amounting to U.S. \$127,000 (2003 – U.S. \$127,000) and Australian \$283,886 (2003 – nil) have been issued. The Company utilizes letters of credit to back certain performance obligations with its customers.

The maximum amount(s) available to the Company under the operating line is \$1,000,000 and under the foreign exchange forward contract facility are U.S. \$2,000,000 and Australian \$3,678,061. The credit facilities are collateralized by a general assignment of book debts, a general security agreement and general security agreements, from each of Offshore Systems Ltd., OSI Geomatics Ltd and OSI Geomatics Inc. In addition, the Company is required to meet certain covenants as outlined in the credit facilities agreement. As at November 30, 2004, the Company had drawn on its foreign exchange contract facility in the amount of U.S. \$851,196 (2003 – U.S. \$1,343,705), Australian \$3,678,061 (2003 – nil), and €383,310 (2003 – nil). The Company has not drawn on the operating line facility during the fiscal years ended November 30, 2004 and 2003.

## 9 Capital Stock

### (a) Issued and outstanding Common shares

	2004		2003	
	Number of Common shares	Amount \$	Number of Common shares	Amount \$
<b>Balance – Beginning of year</b>	26,807,475	18,508,498	26,043,243	18,220,929
<b>Issued during the year:</b>				
Exercise of stock options	519,847	398,479	1,208,198	606,069
Class A preference shares converted	-	-	11,034	-
Class B preference shares converted	160,752	119,148	-	-
Common shares purchased and cancelled (note 9(f))	-	-	(455,000)	(318,500)
<b>Balance – End of year</b>	<b>27,488,074</b>	<b>19,026,125</b>	<b>26,807,475</b>	<b>18,508,498</b>

### (b) Class A preference shares

The Company has 30,262 (November 30, 2003 - 30,262) Class A preference shares outstanding that have a nominal value for financial statement purposes. These Class A preference shares are being held in escrow but are no longer subject to any escrow restrictions and may be converted at any time into common shares of the Company, by notice in writing from the holders.

# Offshore Systems International Ltd.

Canadian GAAP

Notes to the Consolidated Financial Statements

November 30, 2004 and 2003

(expressed in Canadian dollars)

## (c) Class B preference shares

	2004		2003	
	Number of Class B preference shares	Amount \$	Number of Class B preference shares	Amount \$
<b>Balance – Beginning of year</b>	61,244	2,065,420	-	-
<b>Issued during the year:</b>				
Class B preference shares issued	-	-	61,244	2,342,625
Share issue costs	-	(20,115)	-	(277,205)
Class B preference shares converted	(3,533)	(119,148)	-	-
<b>Balance – End of year</b>	<b>57,711</b>	<b>1,926,157</b>	<b>61,244</b>	<b>2,065,420</b>

The Company completed a private placement on February 13, 2003 consisting of 61,244 units for total gross proceeds of \$3,004,200. Each unit consists of one Class B Series 1 preference share and 22.75 common share purchase warrants exercisable at \$1.10. The preference shares are voting convertible shares at a ratio of 1:45.5 and have a cumulative dividend of 6% per annum. Declared unpaid cumulative dividends to November 30, 2004 amount to \$86,566. The Company has the right to redeem the preference shares after five years. The share purchase warrants are convertible to common shares at a ratio of 1:1 and expire five years after issue. The private placement incurred share issue costs of \$297,320. The gross proceeds of \$3,004,200 were allocated between the preference shares and warrants based on their relative fair value at the date of issuance. The \$2,342,625 fair value of the preference shares has been estimated based on the fair value of the underlying common shares. The \$661,575 fair value of the warrants has been estimated using the Black-Scholes option pricing model. Assumptions used in the pricing model included: (i) risk free interest rate of 2.7%, (ii) expected volatility of 66%, (iii) an estimated life of 5 years and (iv) an expected dividend rate of 0%.

## (d) Stock option plans

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 number of common shares authorized for grant under the Company's stock option plans is 10,930,732, of which 4,375,494 are available for granting. The exercise price of options granted pursuant to the plans may not be less than the market price of the common shares at the time of grant. The plans provide that options may be granted with vesting periods and expiry dates at the discretion of the board of directors. Options granted to directors and executives vest over periods ranging from immediately to three years and options granted to employees vest one year after the date granted.

# Offshore Systems International Ltd.

Canadian GAAP

Notes to the Consolidated Financial Statements

November 30, 2004 and 2003

(expressed in Canadian dollars)

A summary of the status of the Company's stock option plans at November 30 is as follows:

	2004		2003	
	Number of shares	Weighted average exercise price \$	Number of shares	Weighted average exercise price \$
Outstanding - Beginning of year	2,890,046	1.02	3,130,047	0.83
Granted	496,750	1.12	1,290,601	1.07
Exercised	(519,847)	0.42	(1,208,198)	0.50
Forfeited	(22,725)	0.74	(122,404)	0.96
Expired	(590,177)	1.06	(200,000)	1.50
Outstanding - End of year	<u>2,254,047</u>	1.11	<u>2,890,046</u>	1.02

A summary of the Company's stock options outstanding and exercisable at November 30, 2004 is as follows:

	Options outstanding			Options exercisable		
Range of exercise prices \$	Number outstanding at November 30, 2004	Weighted average remaining contractual life (years)	Weighted average exercise price \$	Number exercisable at November 30, 2004	Weighted average exercise price \$	
1.01 - 1.35	2,194,047	1.11	1.10	1,992,047	1.09	
1.36 - 1.41	60,000	0.55	1.41	60,000	1.41	
1.01 - 1.41	<u>2,254,047</u>	<u>1.10</u>	<u>1.11</u>	<u>2,052,047</u>	<u>1.11</u>	

A summary of the Company's stock options outstanding and exercisable at November 30, 2003 is as follows:

	Options outstanding			Options exercisable		
Range of exercise prices \$	Number outstanding at November 30, 2003	Weighted average remaining contractual life (years)	Weighted average exercise price \$	Number exercisable at November 30, 2003	Weighted average exercise price \$	
0.42 - 0.60	140,862	0.32	0.48	140,862	0.48	
0.61 - 0.90	485,000	0.73	0.76	485,000	0.76	
0.91 - 1.35	2,093,934	1.57	1.07	1,623,688	1.08	
1.36 - 2.00	170,250	0.84	1.62	70,250	1.42	
0.42 - 2.00	<u>2,890,046</u>	<u>1.32</u>	<u>1.02</u>	<u>2,319,800</u>	<u>0.99</u>	

## Stock-based compensation

For the year ended November 30, 2004, the Company incurred non-cash stock-based compensation expense of \$171,442 related to stock options granted to employees and consultants (2003 expense of \$43,050 related to stock options granted to consultants). The expense was included in General and administrative costs and was recorded in additional paid-in capital. The fair value of the stock options was estimated using the Black-Scholes option pricing model, using the

following assumptions: dividend yield of 0% (2003 – 0%); a volatility rate between 54% and 58% (2003 – 26% and 114%); risk-free interest rate between 2.2% and 2.6% (2003 – 2.6% and 2.9%); and an expected average life of 1 to 3 years (2003 – 1 to 4 years).

The weighted average fair value of the options granted during the year ended November 30, 2004 was \$0.46 per option (November 30, 2003 - \$0.45)

#### Pro forma disclosure

The following pro forma financial information presents the income for the year had the Company recognized stock-based compensation using a fair value method for all stock awards granted, modified or settled prior to December 1, 2003:

	<b>2004</b>	<b>2003</b>
	\$	\$
Earnings as reported	114,741	385,369
Add: Stock-based compensation cost	171,442	43,050
Less: Pro forma stock-based compensation cost	(196,642)	(560,941)
Pro forma income (loss)	<u>89,541</u>	<u>(132,522)</u>
Pro forma basic and diluted earnings (loss) per share	<u>0.00</u>	<u>(0.01)</u>

The fair value of the stock options was estimated using the the Black-Scholes option pricing model, using the following assumptions: dividend yield of 0% (2003 – 0%); a volatility rate between 54% and 103% (2003 – 26% and 114%); risk-free interest rate between 2.2% and 2.6% (2003 – 2.6% and 2.9%); and an expected average life of 1 to 3 years (2003 – 1 to 4 years).

#### Shareholder Rights Plan

On April 18, 2001, the Board of Directors of the Company adopted a shareholder rights plan (the Rights Plan). The Rights Plan was approved by the Toronto Stock Exchange in accordance with its policies. On March 12, 2004, the Board of Directors carried a resolution regarding the continued existence of the Rights Plan, subject to receipt of shareholder approval, for an additional three year period. The continued existence of the Rights Plan was approved by the shareholders of the Company by ordinary resolution at the annual general meeting of the Company held on April 22, 2004.

The objectives of the Rights Plan are to ensure, to the extent possible, that all shareholders of the Company are treated equally and fairly in connection with any take-over offer for the Company. Take-over offers may not always result in shareholders receiving equal or fair treatment or full value for their investment. In addition, current Canadian securities legislation only requires a take-over offer to remain open for 21 days. The board believes that this period may be insufficient for the shareholders to evaluate a bid, or for the board to pursue alternatives that could maximize shareholder value and to make informed recommendations to shareholders.

The Rights Plan is designed to discourage discriminatory or unfair take-over offers for the Company and gives the board time, if appropriate, to pursue alternatives to maximize shareholder value in the event of an unsolicited take-over bid for the Company. The Rights Plan will encourage an offeror to proceed by way of a permitted bid or to approach the Board of Directors with a view to negotiation by creating the potential for substantial dilution of the offeror's position. The permitted bid provisions of the Rights Plan are designed to ensure that, in any take-over bid, all shareholders are treated equally, receive the maximum value for their investment and are given adequate time to properly assess the take-over bid on a fully informed basis.

**(e) Earnings per share**

<b>Basic earnings per share</b>	<b>2004</b>	<b>2003</b>
Earnings for the year	\$ 114,741	\$ 385,369
Less: Class B preferred share dividends	173,133	145,350
Earnings (loss) available to common shareholders	<u>\$ (58,392)</u>	<u>\$ 240,019</u>
Weighted average number of common shares outstanding	27,230,561	25,977,123
Basic earnings per share	<u>\$ 0.00</u>	<u>\$ 0.01</u>
<b>Diluted earnings per share</b>		
Earnings for the year	\$ 114,741	\$ 385,369
Less: Class B preferred share dividends	173,133	145,350
Earnings (loss) available to common shareholders	<u>\$ (58,392)</u>	<u>\$ 240,019</u>
Weighted average number of common shares outstanding	27,230,561	25,977,123
Dilutive effect of Class A preference shares – Series A (*1)	-	30,262
Dilutive effect of Class B preference shares – Series 1 (*1)	-	-
Dilutive effect of stock options (*1)	-	1,135,107
Adjusted weighted average number of common shares outstanding	<u>27,230,561</u>	<u>27,142,492</u>
Diluted earnings (loss) per share	<u>\$ 0.00</u>	<u>\$ 0.01</u>

The outstanding 1,393,301 warrants were not in the money and therefore were not included in the diluted earnings per share calculation.

(\*1) The Class B preference shares – Series 1 were anti-dilutive for the purposes of calculating diluted earnings per share for fiscal 2004 and 2003. The stock options and the Class A preference shares – Series A were anti-dilutive for fiscal 2004.

**(f) Normal course issuer bid**

In January 2003, the Company received approval for a normal course issuer bid that entitles the Company to repurchase up to 1,300,000 common shares for cancellation between January 16, 2003 and January 15, 2004. The purchases are made on the open market. During the period January 16, 2003 to November 30, 2003 the Company purchased 455,000 of its common shares on the open market under the normal course issuer bid at an average cost of \$1.11 per share for an aggregate consideration of \$505,681. The premium on the purchase and cancellation of the common shares under the normal course issuer bid was \$187,181 and was charged to the deficit. No common shares were purchased under the normal course issuer bid during the period December 1, 2003 to January 15, 2004.

**10 Technology Partnerships Canada**

On April 26, 2004, the Company entered into an agreement with Technology Partnerships Canada (TPC) whereby TPC granted financial assistance to the Company for the purpose of funding research and development activities to be completed on or before March 31, 2007. The maximum eligible contribution by TPC is \$3,768,391. As at November 30, 2004, the Company has claimed for \$1,471,414 of assistance under the agreement. Accounts receivable at November 30, 2004 includes \$257,266 of amounts receivable from TPC in connection with these claims (2003 – nil).

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In addition, the Company is required to pay a royalty of 1.4% on annual gross Navigation Systems and Applications revenue for the period January 1, 2006 to December 31, 2008 and a royalty of 2.5% on annual gross Navigation Systems and Applications revenue for the period January 1, 2009 to December 31, 2013. Royalty payments will continue until the cumulative royalties paid or payable to December 31, 2013 are at least \$6,079,176 or until December 31, 2017. No amounts for royalty payments in connection with this agreement have been recorded in the financial statements.

On November 15, 1999, the Company entered into an agreement with TPC whereby TPC granted financial assistance to the Company for the purpose of funding research and development activities to be completed on or before March 31, 2003. Under the agreement with TPC, the Company was eligible to receive contributions to a maximum of \$4,000,177 over the period from December 23, 1998 to March 31, 2003. As of March 31, 2003, the Company has received the maximum allowed under the agreement. There are no amounts recorded in accounts receivable with respect to these claims (2003 – nil).

In addition, the Company is required to pay a royalty of 3% on annual gross Navigation Systems and Applications revenue for the period December 1, 1999 to November 30, 2008. The Company has paid royalties of \$929,303 to date (2003 – \$745,911) and has accrued royalties of \$311,851 at November 30, 2004 (November 30, 2003 - \$370,819). 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.

Although the Company believes that its submissions for TPC funding meet the terms and conditions of the TPC agreements, the final determination may be subject to audit by government authorities in the ordinary course of business.

During the year ended November 30, 2004, the Company was subject to an audit by government authorities. The results of the audit have not been communicated to the Company. The Company has no reason to believe that the audit will have a material impact on the Company's financial results.

TPC royalties paid and accrued are as follows:

	2004 \$	2003 \$
Royalties paid	183,392	391,752
Accrued royalties		
Short term	311,851	183,435
Long term	-	187,384
	311,851	370,819

If the Company causes an event of default, as defined in the agreement, TPC can suspend or terminate any obligation to contribute to the costs of the project or require the Company to repay all or part of the contributions made, together with interest, from the date of demand.

**11 Commitments and contingencies**

The Company has entered into operating leases for its office premises in Canada and for certain equipment. Minimum lease payments required under the remaining terms of the leases are as follows:

Years ending November 30	\$
2005	276,041
2006	265,501
2007	179,933
2008	3,665
2009	-
	<hr/>
	725,140
	<hr/>

For the fiscal year ended November 30, 2004, the Company paid basic rent of \$256,705 (2003 - \$256,705). In addition to basic rent, the Company is required to pay a portion of certain costs and property taxes for the above commitments. In 2004, the Company paid \$90,229 (2003 - \$77,719) for these costs.

In July 2002, two of the Company's subsidiaries, Offshore Systems Ltd. and OSI Geomatics Ltd., and four employees became subject to a lawsuit for an undisclosed amount by Triathlon Ltd., a subsidiary of MacDonald, Dettwiler and Associates Ltd., related to use of confidential information and breach of fiduciary duty. No amount has been accrued at November 30, 2004 in respect of these claims because the potential liability for the claims and the amount of damages, if any, cannot be reasonably estimated.

**12 Income taxes**

The Company is subject to Canadian federal and British Columbia provincial taxes in Canada. The Company is also subject to federal income taxes in the U.S.

Earnings before income taxes consisted of the following:

	<b>2004</b>	<b>2003</b>
	\$	\$
Canadian income (loss)	10,709	(5,992)
U.S. income	145,990	251,262
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	156,699	245,270
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# Offshore Systems International Ltd.

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The Company has non-capital losses for Canadian income tax purposes of approximately \$3,079,232, which are available for carry forward to reduce future years' taxable income. These income tax losses expire as follows:

	<b>2004</b>
	\$
Year ending November 30	
2005	89,418
2006	2,345,461
2007	-
2008	-
2009	169,005
2010	-
2011	475,348

The Company has net operating losses for U.S. income tax purposes of approximately \$315,342, which are available for carry forward to reduce future years' taxable income of the U.S. company. These income tax losses expire as follows:

	<b>2004</b>
	\$
Year ending November 30	
2018	32,506
2019	-
2020	253,625
2021	29,211

The Company also has investment tax credits for Canadian income tax purposes of approximately \$977,499, which can be used to offset future income taxes otherwise payable and expire as follows:

	<b>2004</b>
	\$
Year ending November 30	
2005	117,678
2006	130,114
2007	-
2008	-
2009	-
2010	-
2011	146,453
2012	191,931
2013	199,522
2014	191,801

The Company has capital losses for Canadian income tax purposes of approximately \$354,466, which are available for carry forward to reduce future years' income from capital gains. These capital losses carry forward indefinitely.

The Company has undeducted scientific research and experimental development expenses for Canadian income tax purposes of approximately \$4,775,417, which are available for carry forward to reduce future years' income for tax purposes. These expenses carry forward indefinitely.

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The future tax asset consists of the following:

	2004	2003
	\$	\$
<b>Future tax assets</b>		
Non-capital loss carry-forwards and net operating losses	1,191,426	1,742,868
Net capital loss carry-forwards	63,130	63,130
Scientific research and experimental development costs	1,701,004	1,543,916
Investment tax credits	680,793	569,579
Property, plant and equipment	895,457	555,339
Other	91,420	105,763
	<hr/>	<hr/>
	4,623,230	4,580,595
Valuation allowance	(3,842,899)	(3,758,072)
	<hr/>	<hr/>
<b>Future tax asset</b>	780,331	822,523

The Company increased its valuation allowance against future income tax assets to reflect the amount of the future tax benefit that was more likely than not to be realized. A valuation allowance continues to be provided against future income tax assets for which the more likely than not criteria of future realization has not been met. During the year, the future income tax expense related to the increase of the valuation allowance was \$42,192 (2003 – a recovery of \$168,807). Although the Company believes that its tax estimates are reasonable, the ultimate tax determination involves significant judgment that could become subject to audit by tax authorities in the ordinary course of business.

A reconciliation of the combined Canadian federal and provincial income tax rate with the Company's effective income tax rate is as follows:

	2004	2003
	\$	\$
Expected statutory rate	35.79%	37.79%
	<hr/>	<hr/>
Expected provision for income taxes	56,083	92,688
Change in tax rates applied in valuation allowance	1,199	25,235
Change in valuation allowance	84,827	772,232
Foreign tax differentials	(8,453)	9,135
Temporary differences arising during the year	(189,402)	(1,052,335)
Non-deductible expenses and other	97,704	12,946
	<hr/>	<hr/>
Income tax expense (recovery)	41,958	(140,099)

**13 Segmented information**

The Company's reportable segments are as outlined below. Accounting policies used by these segments are the same as those described in the significant accounting policies as disclosed in note 2. The Company defines reportable segments as components of the Company about which separate financial information is available and which is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance.

	<b>2004</b>			
	<b>Navigation Systems</b>	<b>Applications</b>	<b>Geomatics</b>	<b>Total</b>
	\$	\$	\$	\$
Revenue	10,232,671	191,279	3,027,353	13,451,303
Gross profit	6,561,870	171,518	1,048,591	7,781,979
Technology Partnerships Canada - net	(1,184,932)	(162,057)	-	(1,346,989)
Interest expense	1,902	-	143	2,045
Income tax expense	22,760	-	19,198	41,958
Net earnings (loss)	1,105,793	(972,476)	(18,576)	114,741
Property, plant and equipment expenditures	137,470	20,135	201,251	358,856
Amortization	233,128	2,778	126,658	362,564
				<b>2003</b>
	<b>Navigation Systems</b>	<b>Applications</b>	<b>Geomatics</b>	<b>Total</b>
	\$	\$	\$	\$
Revenue	7,927,166	-	3,593,627	11,520,793
Gross profit	4,797,613	-	1,564,112	6,361,725
Technology Partnerships Canada - net	(326,407)	-	-	(326,407)
Interest expense	624	-	2,200	2,824
Income tax expense (recovery)	(2,917)	-	(137,182)	(140,099)
Net earnings	124,594	-	260,775	385,369
Property, plant and equipment expenditures	201,540	-	107,846	309,386
Amortization	255,462	-	104,517	359,979
<b>Total assets employed</b>	<b>Navigation Systems</b>	<b>Applications</b>	<b>Geomatics</b>	<b>Total</b>
	\$	\$	\$	\$
As at November 30,				
2004	10,562,064	17,357	1,731,317	12,310,738
2003	10,103,117	-	1,625,140	11,728,257

The Applications business unit began operations effective fiscal year 2004.

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Geographically, revenues reported are based on the location of the Company's customers.

	2004	2003
	\$	\$
Australia/New Zealand	4,818,763	1,021,844
Europe	4,332,392	2,094,063
United States	2,872,860	5,103,062
Canada	1,427,288	3,296,257
Other	-	5,567
Total	<u>13,451,303</u>	<u>11,520,793</u>

Approximately 58% of revenue for the year ended November 30, 2004 (2003 - 65%) is derived from the three largest ultimate customers at 26%, 24% and 8%, respectively (2003 - 27%, 20%, 18%).

The three largest customers for 2004 were the Royal Australian Navy, the Royal Navy of the United Kingdom and the U.S. Coast Guard. The three largest customers for 2003 were the U.S. Coast Guard, the Canadian Navy and the Royal Danish Navy.

Geographically, property, plant and equipment are reported based on location. At November 30, 2004 and 2003, all of the Company's property, plant and equipment was located in Canada.

## 14 Financial instruments

### Fluctuations in foreign currency exchange rates

The Company enters into transactions denominated in U.S. dollars, Australian dollars and Euros and as such its revenue, expenses, monetary assets and liabilities will be affected by fluctuations in the various currencies relative to its functional currency, the Canadian dollar.

The Company uses foreign exchange forward contracts to hedge transactions denominated in U.S. dollars, Australian dollars and Euros. The purpose of the Company's hedging activities is to reduce the level of exposure to exchange rate movements. At November 30, 2004, the Company had foreign exchange forward contracts maturing in the following year to sell U.S. \$851,196 (2003 - U.S. \$1,343,705), Australian \$3,678,061 (2003 - nil), and €383,310 (2003 - nil). The exchange rates set in the forward exchange contracts ranged between 1.1870 to 1.1942 for U.S. \$1.00, 0.9005 to 0.9576 for Australian \$1.00, and 1.5777 for €1.00. The contracts mature between December and May 2005.

The fair value of derivative instruments generally reflects the estimated amounts that the Company would receive or pay to settle the contracts at November 30, 2004. The fair value of the above derivative financial instruments was an unrecorded liability of \$42,303 at November 30, 2004 (2003 - \$82,907).

## 15 Supplemental cash flow information

	2004	2003
	\$	\$
Cash paid during the year for interest	<u>2,045</u>	<u>2,824</u>
Cash paid during the year for income taxes	<u>12,916</u>	<u>-</u>