

# **Offshore Systems International Ltd.**

Interim Consolidated Financial Statements (Unaudited)

Three and Six Months Ended May 31, 2005 and 2004

(expressed in Canadian dollars)

(Prepared in accordance with United States Generally Accepted Accounting Principles)

# Offshore Systems International Ltd.

U.S. GAAP

## Consolidated Balance Sheets (unaudited)

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

(expressed in Canadian dollars)

|  | As at           |                      |
|--|-----------------|----------------------|
|  | May 31,<br>2005 | November 30,<br>2004 |
|  | \$              | \$                   |
| <b>Assets (note 10)</b>  |                 |                      |
| <b>Current assets</b>  |                 |                      |
| Cash   | 13,580,479      | 251,037              |
| Restricted cash (note 4)   | 220,000         | -                    |
| Accounts receivable (note 5)   | 7,306,453       | 9,140,478            |
| Inventory (note 6)   | 893,754         | 649,427              |
| Prepaid expenses and deposits  | 325,229         | 142,752              |
| Deferred income taxes  | 844,141         | 780,331              |
|  | <hr/>           | <hr/>                |
|  | 23,170,056      | 10,964,025           |
| <b>Deferred income taxes</b>   | 31,366          | -                    |
| <b>Plant and equipment</b> (note 7)  | 989,952         | 938,102              |
| <b>Intangible and other assets</b> (note 8)                                | 876,098         | 408,611              |
| <b>Goodwill</b> (note 3)   | 397,139         | -                    |
|  | <hr/>           | <hr/>                |
|  | 25,464,611      | 12,310,738           |
| <b>Liabilities</b>   |                 |                      |
| <b>Current liabilities</b>   |                 |                      |
| Bank indebtedness  | 193,301         | -                    |
| Accounts payable and accrued liabilities (note 9)                          | 3,139,283       | 2,596,362            |
| Income taxes payable   | 209,650         | -                    |
| Unearned revenue   | 98,088          | 79,865               |
| Deferred income taxes  | 43,767          | -                    |
|  | <hr/>           | <hr/>                |
|  | 3,684,089       | 2,676,227            |
| <b>Deferred income taxes</b>   | 77,887          | -                    |
|  | <hr/>           | <hr/>                |
|  | 3,761,976       | 2,676,227            |
| <b>Stockholders' Equity</b>  |                 |                      |
| <b>Capital stock</b>   |                 |                      |
| Authorized (note 11(a))  |                 |                      |
| Issued and outstanding   |                 |                      |
| 30,262 Class A preference shares – Series A (2004 – 30,262) (note 11(b))   | 30,262          | 30,262               |
| 390,000 Class B preference shares – Series 2 (2004 – nil) (note 11(c)(ii)) | 12,649,066      | -                    |
| nil Class B preference shares – Series 1 (2004 – 57,711) (note 11(c)(i))   | -               | 2,163,621            |
| 27,488,074 common shares (2004 - 27,488,074)                               | 20,047,731      | 20,047,731           |
|  | <hr/>           | <hr/>                |
|  | 32,727,059      | 22,241,614           |
| <b>Warrants</b> (note 11(c))   | 5,206,844       | 661,575              |
| <b>Additional Paid in Capital</b>  | 5,071,694       | 928,169              |
| <b>Accumulated deficit</b>   | (21,330,012)    | (14,196,847)         |
| <b>Accumulated other comprehensive income</b>                              | 27,050          | -                    |
|  | <hr/>           | <hr/>                |
|  | 21,702,635      | 9,634,511            |
|  | <hr/>           | <hr/>                |
|  | 25,464,611      | 12,310,738           |
| <b>Contingencies</b> (note 14)   |                 |                      |

The accompanying notes are an integral part of these unaudited interim consolidated financial statements.

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## Consolidated Statement of Earnings (unaudited) (expressed in Canadian dollars)

|   | <b>Three Months Ended May 31,</b> |             | <b>Six Months Ended May 31,</b> |             |
|---|-----------------------------------|-------------|---------------------------------|-------------|
|   | <b>2005</b>                       | <b>2004</b> | <b>2005</b>                     | <b>2004</b> |
|   | \$                                | \$          | \$                              | \$          |
| <b>Revenue</b>  |                                   |             |                                 |             |
| Software  | 281,521                           | 1,397,516   | 1,772,689                       | 4,390,779   |
| Geomatics   | 906,015                           | 998,970     | 1,213,596                       | 1,717,703   |
| Systems and system components   | 555,079                           | 227,344     | 960,808                         | 414,238     |
| Other   | 139,070                           | 150,005     | 194,449                         | 280,875     |
|   | <hr/>                             | <hr/>       | <hr/>                           | <hr/>       |
|   | 1,881,685                         | 2,773,835   | 4,141,542                       | 6,803,595   |
| <b>Cost of sales</b>  | <hr/>                             | <hr/>       | <hr/>                           | <hr/>       |
|   | 1,511,334                         | 998,832     | 2,539,082                       | 2,459,819   |
| <b>Gross profit</b>   | <hr/>                             | <hr/>       | <hr/>                           | <hr/>       |
|   | 370,351                           | 1,775,003   | 1,602,460                       | 4,343,776   |
| <b>Expenses</b>   |                                   |             |                                 |             |
| General and administrative  | 999,877                           | 925,044     | 2,035,961                       | 1,655,117   |
| Research and development  | 461,925                           | 583,351     | 781,158                         | 1,046,575   |
| Sales and marketing   | 674,562                           | 735,541     | 1,226,818                       | 1,528,818   |
| Depreciation and amortization   | 78,971                            | 55,978      | 132,717                         | 108,044     |
| Interest  | 8,687                             | 103         | 21,403                          | 371         |
| Foreign exchange loss (gain)  | 50,912                            | 8,101       | (22,232)                        | (16,640)    |
| Technology Partnerships Canada royalty (note 12)                            | 37,867                            | 7,708       | 92,558                          | 56,634      |
| Technology Partnerships Canada contribution (note 12)                       | (470,628)                         | (851,542)   | (736,145)                       | (851,542)   |
|   | <hr/>                             | <hr/>       | <hr/>                           | <hr/>       |
|   | 1,842,173                         | 1,464,284   | 3,532,238                       | 3,527,377   |
| <b>Net earnings (loss) before income taxes</b>                              | <hr/>                             | <hr/>       | <hr/>                           | <hr/>       |
|   | (1,471,822)                       | 310,719     | (1,929,778)                     | 816,399     |
| <b>Income tax expense (recovery) (note 15)</b>                              |                                   |             |                                 |             |
| Deferred income tax expense (recovery)                                      | 143,189                           | (217,363)   | (95,176)                        | (496,266)   |
| Current income tax expense  | 82,756                            | 147,994     | 82,756                          | 380,786     |
|   | <hr/>                             | <hr/>       | <hr/>                           | <hr/>       |
|   | 225,945                           | (69,369)    | (12,420)                        | (115,480)   |
| <b>Net earnings (loss)</b>  | <hr/>                             | <hr/>       | <hr/>                           | <hr/>       |
|   | (1,697,767)                       | 380,088     | (1,917,358)                     | 931,879     |
| Foreign currency translation adjustment                                     | 27,050                            | -           | 27,050                          | -           |
| <b>Comprehensive income (loss)</b>  | <hr/>                             | <hr/>       | <hr/>                           | <hr/>       |
|   | (1,670,717)                       | 380,088     | (1,890,308)                     | 931,879     |
| <b>Net earnings (loss) available to common shareholders</b><br>(note 11(e)) | <hr/>                             | <hr/>       | <hr/>                           | <hr/>       |
|   | (6,880,135)                       | 303,366     | (7,133,165)                     | 778,435     |
| <b>Earnings per share</b> (note 11(e))                                      |                                   |             |                                 |             |
| Basic earnings per share  | (0.25)                            | 0.01        | (0.26)                          | 0.03        |
| Diluted earnings per share  | (0.25)                            | (0.01)      | (0.26)                          | 0.01        |
| <b>Weighted average number of common shares outstanding</b> (note 11(e))    |                                   |             |                                 |             |
| Basic   | 27,488,074                        | 27,145,769  | 27,488,074                      | 26,964,789  |
| Diluted   | 27,488,074                        | 29,771,620  | 27,488,074                      | 32,525,826  |

The accompanying notes are an integral part of these unaudited interim consolidated financial statements.

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## Consolidated Statements of Stockholders' Equity and Accumulated Deficit (unaudited)

For the six months ended May 31, 2005

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

(expressed in Canadian dollars)

|  | Class A Preference Shares |           | Class B Preference Shares |             | Common Shares |            | Warrants   |           | Additional Paid In Capital | Accumulated Deficit | Accumulated Other Comprehensive Income | Total Stockholders' Equity |
|--|---------------------------|-----------|---------------------------|-------------|---------------|------------|------------|-----------|----------------------------|---------------------|--|----------------------------|
|  | Number                    | Amount \$ | Number                    | Amount \$   | Number        | Amount \$  | Number     | Amount \$ |                            |                     |  |                            |
| <b>Balance - November 30, 2004</b>   | 30,262                    | 30,262    | 57,711                    | 2,163,621   | 27,488,074    | 20,047,731 | 1,393,301  | 661,575   | 928,169                    | (14,196,847)        | -                                      | 9,634,511                  |
| Accretion of discount on Class B preference shares Series 1                      | -                         | -         | -                         | 33,439      | -             | -          | -          | -         | -                          | (33,439)            | -                                      | -                          |
| Stock-based compensation   | -                         | -         | -                         | -           | -             | -          | -          | -         | 2,524                      | -                   | -                                      | 2,524                      |
|  | 30,262                    | 30,262    | 57,711                    | 2,197,060   | 27,488,074    | 20,047,731 | 1,393,301  | 661,575   | 930,693                    | (14,230,286)        | -                                      | 9,637,035                  |
| Net loss for the period  | -                         | -         | -                         | -           | -             | -          | -          | -         | -                          | (219,591)           | -                                      | (219,591)                  |
| <b>Balance - February 28, 2005</b>   | 30,262                    | 30,262    | 57,711                    | 2,197,060   | 27,488,074    | 20,047,731 | 1,393,301  | 661,575   | 930,693                    | (14,449,877)        | -                                      | 9,417,444                  |
| Accretion of discount on Class B preference shares Series 1                      | -                         | -         | -                         | 390,672     | -             | -          | -          | -         | -                          | (390,672)           | -                                      | -                          |
| Repurchase of Class B preference shares Series 1                                 | -                         | -         | (57,711)                  | (2,587,732) | -             | -          | -          | -         | (668,785)                  | 370,967             | -                                      | (2,885,550)                |
| Issue of Class B preference shares Series 2 and warrants, net of issue costs     | -                         | -         | 390,000                   | 12,536,563  | -             | -          | 12,395,064 | 4,545,269 | -                          | -                   | -                                      | 17,081,832                 |
| Beneficial conversion feature on Class B preference shares Series 2              | -                         | -         | -                         | (4,796,649) | -             | -          | -          | -         | 4,796,649                  | -                   | -                                      | -                          |
| Accretion of discount on Class B preference shares Series 2                      | -                         | -         | -                         | 112,503     | -             | -          | -          | -         | -                          | (112,503)           | -                                      | -                          |
| Accretion of beneficial conversion feature on Class B preference shares Series 2 | -                         | -         | -                         | 4,796,649   | -             | -          | -          | -         | -                          | (4,796,649)         | -                                      | -                          |
| Foreign currency translation adjustment  | -                         | -         | -                         | -           | -             | -          | -          | -         | -                          | -                   | 27,050                                 | 27,050                     |
| Dividends on Class B preference shares series 1                                  | -                         | -         | -                         | -           | -             | -          | -          | -         | -                          | (62,785)            | -                                      | (72,785)                   |
| Dividends on Class B preference shares series 2                                  | -                         | -         | -                         | -           | -             | -          | -          | -         | -                          | (190,726)           | -                                      | (180,726)                  |
| Stock-based compensation   | -                         | -         | -                         | -           | -             | -          | -          | -         | 13,137                     | -                   | -                                      | 13,137                     |
|  | 30,262                    | 30,262    | 390,000                   | 12,649,066  | 27,488,074    | 20,047,731 | 13,788,365 | 5,206,844 | 5,071,694                  | (19,632,245)        | 27,050                                 | 23,400,402                 |
| Net loss for the period  | -                         | -         | -                         | -           | -             | -          | -          | -         | -                          | (1,697,767)         | -                                      | (1,697,767)                |
| <b>Balance - May 31, 2005</b>  | 30,262                    | 30,262    | 390,000                   | 12,649,066  | 27,488,074    | 20,047,731 | 13,788,365 | 5,206,844 | 5,071,694                  | (21,330,012)        | 27,050                                 | 21,702,635                 |

# Offshore Systems International Ltd.

U.S. GAAP

Consolidated Statement of Cash Flows (unaudited)

Three and Six Months Ended May 31, 2005 and 2004

(expressed in Canadian dollars)

|   | Three Months Ended<br>May 31 |             | Six Months Ended<br>May 31 |             |
|---|------------------------------|-------------|----------------------------|-------------|
|   | 2005<br>\$                   | 2004<br>\$  | 2005<br>\$                 | 2004<br>\$  |
| <b>Cash flows from (used in) operating activities</b>                             |                              |             |                            |             |
| Net earnings (loss) for the period  | (1,697,767)                  | 380,088     | (1,917,358)                | 931,879     |
| Items not affecting cash  |                              |             |                            |             |
| Depreciation and amortization   | 118,184                      | 83,802      | 202,854                    | 161,849     |
| Stock based compensation  | 13,137                       | 33,006      | 15,661                     | 33,006      |
| Deferred income taxes   | 143,189                      | (64,470)    | (95,176)                   | (115,480)   |
| Other   | 4,420                        | -           | 4,420                      | -           |
|   | (1,418,837)                  | 432,426     | (1,789,599)                | 1,011,254   |
| Changes in non-cash working capital items   |                              |             |                            |             |
| Accounts receivable   | 1,403,092                    | (1,359,153) | 2,383,378                  | (3,983,827) |
| Inventory   | (31,200)                     | (81,880)    | (244,327)                  | (51,644)    |
| Prepaid expenses and deposits   | 114,844                      | 91,029      | (182,477)                  | 175,987     |
| Accounts payable and accrued liabilities  | 1,258,425                    | 312,017     | 493,011                    | 253,801     |
| Income taxes payable  | 87,366                       | -           | 87,366                     | -           |
| Unearned revenue  | (2,228)                      | 43,993      | (7,748)                    | 42,471      |
| Rent payable  | -                            | (133,942)   | -                          | (133,942)   |
| Accrued long term royalties   | -                            | (46,845)    | -                          | (93,690)    |
|   | 2,830,299                    | (1,174,781) | 2,529,203                  | (3,790,844) |
|   | 1,411,462                    | (742,355)   | 739,604                    | (2,779,590) |
| <b>Cash flows from (used in) financing activities</b>                             |                              |             |                            |             |
| Issue of Common shares  | -                            | 264,239     | -                          | 315,416     |
| Share issue cost – Class B preference shares – Series 1                           | -                            | (20,115)    | -                          | (20,115)    |
| Issue of Class B preference shares – Series 2 and warrants, net<br>of issue costs | 17,081,832                   | -           | 17,081,832                 | -           |
| Repurchase of Class B preference shares – Series 1                                | (2,885,550)                  | -           | (2,885,550)                | -           |
| Class B preference share dividends declared and paid                              | (166,945)                    | -           | (253,511)                  | (91,866)    |
|   | 14,029,337                   | 244,124     | 13,942,771                 | 203,435     |
| <b>Cash flows from (used in) investing activities</b>                             |                              |             |                            |             |
| Purchase of Mapcon Mapping Consultants Inc, net of cash<br>acquired (note 3)      | (1,176,241)                  | -           | (1,176,241)                | -           |
| Advances from (payment to) operating line of credit                               | (355,093)                    | -           | 193,301                    | -           |
| Increase in restricted cash   | (220,000)                    | -           | (220,000)                  | -           |
| Additions to plant and equipment  | (77,955)                     | (35,666)    | (105,379)                  | (65,364)    |
| Additions to intangibles  | (58,081)                     | (166,093)   | (71,664)                   | (179,031)   |
|   | (1,887,370)                  | (201,759)   | (1,379,983)                | (244,395)   |
| <b>Translation adjustment</b>   | 27,050                       | -           | 27,050                     | -           |
| <b>Increase (decrease) in cash</b>  | 13,580,479                   | (699,190)   | 13,329,442                 | (2,820,550) |
| <b>Cash – Beginning of period</b>   | -                            | 1,716,195   | 251,037                    | 3,837,555   |
| <b>Cash – End of period</b>   | 13,580,479                   | 1,017,005   | 13,580,479                 | 1,017,005   |

# Offshore Systems International Ltd.

U.S. GAAP

Notes to the Consolidated Financial Statements (unaudited)

Three and Six Months Ended May 31, 2005 and 2004

(expressed in Canadian dollars)

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## 1 Basis of presentation

These unaudited interim consolidated financial statements have been prepared by management and include the accounts of Offshore Systems International Ltd. and its subsidiaries, collectively referred to as the Company. These unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP") and all amounts herein have been expressed in Canadian dollars unless otherwise noted. These unaudited interim consolidated financial statements do not include all the information and footnote disclosures required for compliance with U.S. GAAP for annual financial statements applied on a consistent basis. These unaudited interim consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements and notes thereto. These unaudited interim consolidated financial statements conform in all material respects with Canadian generally accepted accounting principles ("Canadian GAAP"), except as disclosed in notes 19 and 20.

The preparation of these unaudited interim consolidated financial statements and the accompanying notes requires management to make estimates and assumptions that affect the amounts reported. In the opinion of management, these unaudited interim consolidated financial statements reflect all adjustments (which include only normal recurring adjustments) necessary to state fairly the results for the periods presented. Actual results could vary from these estimates and the operating results for the interim period presented are not necessarily indicative of the results expected for the full year.

## 2 Accounting changes

### a) Changes in accounting policies relating to the adoption of U.S. GAAP

Effective December 1, 2004, the Company elected to report its consolidated financial statements in conformity with U.S. GAAP. The Company continues to report all amounts in Canadian dollars. All accounting policies are the same as described in note 2 to the Company's audited financial statements for the year ended November 30, 2004, which were prepared in accordance with Canadian GAAP filed with the appropriate securities commissions except for the following which have been retroactively adopted to comply with U.S. GAAP:

#### *Stock Based Compensation*

The Company grants stock options to employees, officers, directors, and persons providing management or consulting services to the Company pursuant to the stock option plans described in note 11(d). As allowed by Statement of Financial Accounting Standard 123 Accounting for Stock Based Compensation, ("SFAS 123") as amended by Statement of Financial Accounting Standard 148, the Company followed the Accounting Principles Board Opinion 25, Accounting for Stock Issued to Employees, ("APB 25") and presented pro forma information that is required by SFAS 123. APB 25 requires compensation cost for stock-based employee compensation plans to be recognized over the vesting period based on the difference, if any, between the quoted market price of the Company's stock as of the grant date and the amount an employee must pay to acquire the stock.

For stock options granted to non-employees, the Company follows the requirements of SFAS 123 and related interpretations. Costs are measured at the estimated fair value of the consideration received or the estimated fair value of the options issued, whichever is more reliably measurable. The value of the options issued for consideration other than employee services is determined on the earlier of a performance commitment or completion of performance by the provider of goods or services.

#### *Beneficial conversion feature and accretion of discount on preference shares issued with attached warrants*

For U.S. GAAP purposes, during the fiscal year 2003 and the three months ended May 31, 2005 the Company recorded beneficial conversion features of \$668,785 and \$4,796,649 on the issuance of Class B preference shares Series 1 and 2, respectively, as a reduction to the net earnings available to common shareholders calculated on the effective conversion price of the preference shares to common shares based on the proceeds allocated to the preference shares. In both cases, the conversion feature of the preference shares vested immediately and the Company recorded the accretion of the full amount of

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Notes to the Consolidated Financial Statements (unaudited)

Three and Six Months Ended May 31, 2005 and 2004

(expressed in Canadian dollars)

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the beneficial conversion feature. For both the Series 1 and Series 2 Class B preference shares, the discount on these shares that resulted from the allocation of the gross proceeds to the Class B preference shares and to the attached warrants is accreted over the five-year life of the warrants. This resulted in an accretion of \$503,175 and \$536,614 to Deficit for the three and six months ended May 31, 2005 respectively (\$33,439 and \$66,878 for the three and six months ended May 31, 2004 respectively).

Under Canadian GAAP, there is not a requirement to record the beneficial conversion feature and accretion of discount when preference shares are issued with attached warrants.

## *Derivative Financial Instruments*

Under Canadian GAAP, there is a requirement for derivatives outside of hedging relationships to be recognized on the balance sheet at fair market value; however for derivatives in hedging relationships, Canadian GAAP does not specify how such derivatives should be recorded. As a result, under Canadian GAAP, in some instances derivatives may not be recorded on the balance sheet. Under U.S. GAAP it is required that all derivatives be recorded as assets or liabilities, measured at fair value. Derivatives that are not hedges are adjusted to fair value through income. If the derivative is a hedge, depending upon the nature of the hedge, changes in the fair value of the derivative are either offset against the fair value of assets, liabilities or firm commitments through income, or recognized in other comprehensive income until the hedged item is recognized in income. The ineffective portion of a derivative's change in fair value is immediately recognized into income.

## **b) Recent pronouncements**

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard 123R, Share-Based Payment, ("SFAS 123R") a revision to SFAS 123. SFAS 123R requires all share-based payments to be recognized in the financial statements based on their values using either a modified-prospective or modified-retrospective transition method. The standard no longer permits pro-forma disclosure or prospective recognition. Accordingly, from the date of adoption, December 1, 2005, of the revised standard, the Company will be required to recognize compensation expense for all share-based payments based on grant-date fair value, including those granted, modified or settled prior to September 1, 2005, that were previously disclosed on a pro-forma basis. The Company is currently evaluating the impact of SFAS 123R on its consolidated financial statements.

In December 2004, the FASB issued SFAS No. 153, "Exchange of Nonmonetary Assets, an amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions" ("SFAS No. 153"). The amendments made by SFAS No. 153 are based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. Further, the amendments eliminate the narrow exception for nonmonetary exchanges of similar productive assets and replace it with a broader exception for exchanges of nonmonetary assets that do not have commercial substance. SFAS No. 153 is to be applied prospectively and is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The Company is currently evaluating the impact of SFAS No. 153 on its consolidated financial statements.

## **3 Acquisition**

On April 8, 2005, the Company acquired all of the issued and outstanding shares of Mapcon Mapping Consultants Inc. ("Mapcon") of Salt Lake City, Utah for \$1,347,382 (USD\$1,113,907). The acquisition was effective April 1, 2005. Mapcon is a privately held land mapping company in the U.S. geomatics (digital and electronic chart data production) market. The results of Mapcon's operations have been included in the consolidated financial statements commencing April 1, 2005.

The following table summarizes the fair value of the assets acquired and liabilities assumed by the Company at April 1, 2005, the date of acquisition. The acquisition was accounted for using the purchase method whereby assets acquired and liabilities assumed were recorded at their fair values at April 1, 2005. The excess of the purchase price over the fair market value was recorded as goodwill. The allocation of the purchase price is preliminary and the final allocation may be subject to refinement in the next 12 months. The purchase price is subject to certain adjustments related to working capital and the achievement of a minimum level of sales bookings against a specific contract.

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Notes to the Consolidated Financial Statements (unaudited)  
Three and Six Months Ended May 31, 2005 and 2004  
(expressed in Canadian dollars)

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|  | \$               |
|--|------------------|
| <b>Assets</b>  |                  |
| Current assets   | 819,568          |
| Equipment  | 208,791          |
| Intangible assets  | 350,784          |
| Goodwill   | 382,712          |
| <b>Total assets acquired</b>                               | <u>1,761,855</u> |
| <b>Liabilities</b>   |                  |
| Current liabilities not including deferred tax liabilities | 198,165          |
| Deferred tax liabilities – current                         | 42,177           |
| Deferred tax liabilities – long term                       | 75,058           |
| <b>Total liabilities assumed</b>                           | <u>315,400</u>   |
| Net assets acquired (cash consideration)                   | 1,347,382        |
| Direct acquisition costs incurred by the Company           | 99,073           |
| Cash of acquired operations                                | 270,214          |

The following table presents details of the purchased intangible assets:

|                        | Estimated useful life | Amount<br>\$ |
|------------------------|-----------------------|--------------|
| Customer contract      | 16 months             | 157,248      |
| Customer relationships | 4 to 10 years         | 193,536      |

The pro forma Offshore Systems International Ltd. consolidated operating results assuming the acquisition of Mapcon had occurred as of December 1, 2004, are as follows:

|                                     | 3 Months Ended May 31, |           | 6 Months Ended May 31, |           |
|-------------------------------------|------------------------|-----------|------------------------|-----------|
|                                     | 2005                   | 2004      | 2005                   | 2004      |
|                                     | \$                     | \$        | \$                     | \$        |
| Revenue                             | 2,024,702              | 3,049,028 | 4,660,036              | 7,353,981 |
| Earnings (loss)                     | (1,651,780)            | 417,492   | (1,767,503)            | 1,006,686 |
| Earnings (loss) per share – basic   | (0.25)                 | 0.01      | (0.25)                 | 0.03      |
| Earnings (loss) per share – diluted | (0.25)                 | 0.00      | (0.25)                 | 0.01      |

## 4 Restricted cash

Restricted cash consists of cash pledged with a bank as collateral for bid bonds.

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## 5 Accounts receivable

|   | May 31,<br>2005  | November 30,<br>2004 |
|---|------------------|----------------------|
|   | \$               | \$                   |
| Trade   | 2,125,855        | 4,679,207            |
| Unbilled revenue                                      | 4,636,448        | 4,116,828            |
| Technology Partnerships Canada contribution (note 12) | 470,628          | 257,266              |
| Other   | 109,884          | 111,234              |
| Allowance for doubtful accounts                       | (36,362)         | (24,057)             |
|   | <u>7,306,453</u> | <u>9,140,478</u>     |

The Company has collateralized its accounts receivable as security against its operating line facility.

## 6 Inventory

|                          | May 31,<br>2005 | November 30,<br>2004 |
|--------------------------|-----------------|----------------------|
|                          | \$              | \$                   |
| Materials and components | 714,429         | 638,127              |
| Finished goods           | 165,451         | 11,300               |
| Work in process          | 13,874          | -                    |
|                          | <u>893,754</u>  | <u>649,427</u>       |

## 7 Plant and equipment

|                        | <u>May 31, 2005</u>      |                             |                |
|------------------------|--------------------------|-----------------------------|----------------|
|                        | Cost                     | Accumulated<br>Depreciation | Net            |
|                        | \$                       | \$                          | \$             |
| Equipment              | 4,044,913                | 3,126,015                   | 918,898        |
| Furniture and fixtures | 138,283                  | 103,088                     | 35,195         |
| Leasehold improvements | 234,175                  | 198,316                     | 35,859         |
|                        | <u>4,417,371</u>         | <u>3,427,419</u>            | <u>989,952</u> |
|                        | <u>November 30, 2004</u> |                             |                |
|                        | Cost                     | Accumulated<br>Depreciation | Net            |
|                        | \$                       | \$                          | \$             |
| Equipment              | 3,910,980                | 3,038,921                   | 872,059        |
| Furniture and fixtures | 131,095                  | 94,705                      | 36,390         |
| Leasehold improvements | 222,737                  | 193,084                     | 29,653         |
|                        | <u>4,264,812</u>         | <u>3,326,710</u>            | <u>938,102</u> |

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## 8 Intangible and other assets

|                        | May 31, 2005     |                                   |                |
|------------------------|------------------|-----------------------------------|----------------|
|                        | Cost<br>\$       | Accumulated<br>Amortization<br>\$ | Net<br>\$      |
| Computer software      | 1,141,984        | 621,752                           | 520,232        |
| Customer contract      | 163,176          | 20,397                            | 142,779        |
| Customer relationships | 200,832          | 5,029                             | 195,803        |
| Licenses and patents   | 57,267           | 39,983                            | 17,284         |
|                        | <u>1,563,259</u> | <u>687,161</u>                    | <u>876,098</u> |

  

|                      | November 30, 2004 |                                   |                   |
|----------------------|-------------------|-----------------------------------|-------------------|
|                      | Cost<br>\$        | Accumulated<br>Amortization<br>\$ | Net<br>\$         |
| Computer software    | \$ 936,591        | \$ 546,190                        | \$ 390,401        |
| Licenses and patents | 57,267            | 39,057                            | 18,210            |
|                      | <u>\$ 993,858</u> | <u>\$ 585,247</u>                 | <u>\$ 408,611</u> |

## 9 Accounts payable and accrued liabilities

|  | May 31,<br>2005<br>\$ | November 30,<br>2004<br>\$ |
|--|-----------------------|----------------------------|
| Trade  | 1,285,005             | \$ 1,343,129               |
| Accrued employee costs   | 637,425               | 572,589                    |
| Accrued liabilities  | 1,125,162             | 282,227                    |
| Accrued royalties (note 12)                                      | 91,691                | 311,851                    |
| Class B preference shares Series 1 dividends declared and unpaid | -                     | 86,566                     |
|  | <u>3,139,283</u>      | <u>\$ 2,596,362</u>        |

## 10 Credit facilities

In February 2005, 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 May 31, 2005 was 4.25% (2004 – 4.25%). The standby letters of credit are denominated in U.S. dollars and bear interest at the rate of 1.25% per annum. Funds drawn on the operating line and the standby letters of credit are repayable on demand. As of May 31, 2005, letters of credit, relating principally to customer contracts, amounting to U.S. \$nil (2004 – U.S. \$818,398) and Australian

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\$1,605,038 (2004 – Australian \$2,750,000) 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 \$2,000,000 and under the foreign exchange forward contract facility are U.S. \$2,000,000 and Australian \$2,500,000. The credit facilities are collateralized by an assignment of accounts receivable, a general security agreement from the Company and its subsidiaries 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 May 31, 2005, the Company had drawn on its foreign exchange contract facility in the amount of U.S. \$nil (2004 – U.S. \$818,398) and Australian \$1,605,038 (2004 – \$2,750,000).

## 11 Capital Stock

### (a) 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 share are designated Series 1 voting, cumulative, convertible shares at a ratio of 1:45.5, 6% preference shares, and

10,000,000 are designated Series 2 voting, cumulative, convertible shares at a ratio of 1:58.82, 7% preference shares

Unlimited Class C preference shares without par value, issuable in series

Unlimited common shares without par value

### (b) Class A preference shares

The Company has 30,262 (November 30, 2004 - 30,262) Class A preference shares outstanding that have a carrying value of \$30,262 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.

### (c) Class B preference shares

#### (i) Series 1

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. 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%. During the fiscal year 2003, the Company has recorded a beneficial conversion feature of \$668,785 in dividends calculated on the effective conversion price of the preference shares to common shares based on the proceeds allocated to the preference shares. The conversion feature of the preference shares vested immediately and the Company recorded the accretion of the full amount of the beneficial conversion feature. The preference share discount that resulted from the allocation of the gross proceeds is accreted over the five-year life of the warrants. This resulted in an accretion of \$390,672 and \$33,439

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to accumulated deficit for the three and six months ended May 31, 2005 respectively (\$33,439 and \$66,878 for the three and six months ended May 31, 2004 respectively). During fiscal 2004 3,533 Class B Series 1 preference shares were converted into common shares.

On April 11, 2005, 57,711 Class B Series 1 preference shares were repurchased by the Company at their par value of \$50 per share for aggregate cash consideration of \$2,885,550. The unamortized discount in the amount of \$390,672 as of the repurchase date was amortized and accreted to the Class B series 1 preference shares and the beneficial conversion feature of \$668,785 was deducted from additional paid in capital. The repurchase resulted in a decrease of \$370,967 to deficit.

## (ii) Series 2

On April 11, 2005, the Company completed a private placement consisting of 19,500 units for total gross proceeds of \$19,500,195. The issue price was \$1,000.01 per unit. Each unit consist of 20 voting Class B preference shares Series 2 ("Preference Shares") and 588 share purchase warrants ("Warrants"). The Preference Shares entitle the holders to receive a fixed preferential cumulative 7% dividend payable semi-annually. Each Preference Share is convertible at the option of the holder at any time into 58.82 of the Company's common shares, calculated by dividing the issue price of \$50.00 for each Preference Share by the conversion price of \$0.85. Each Warrant entitles the holder to purchase one of the Company's common shares at the exercise price of \$0.85 for a period of five years. Fees for advisory, investment banking and legal and other professional services in connection with this private placement were paid in the amount of \$2,418,363 and 929,064 warrants were issued to an investment bank and related party (note 13) in connection with the private placement. The fair value of the finder's fee warrants was estimated to be \$0.47 per warrant, using the Black-Scholes option pricing model, and has been recognized as a share issue cost.

The gross proceeds of \$19,500,195 were allocated between the Preference Shares and Warrants based on their relative fair value at the date of issuance. The \$20,188,235 fair value of the preference shares has been estimated based on the fair value of the underlying common shares. The \$5,389,020 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 2.88%, (ii) expected volatility of 59%, (iii) an estimated life of 5 years and (iv) an expected dividend rate of 0%. The Company has recorded a beneficial conversion feature of \$4,796,649 as a reduction to the net earnings available to common shareholders calculated on the effective conversion price of the preference shares to common shares based on the proceeds allocated to the Preference Shares. The conversion feature of the Preference Shares vested immediately and the Company recorded the accretion of the full amount of the beneficial conversion feature. The Preference Share discount that resulted from the allocation of the gross proceeds is accreted over the five-year life of the Warrants. This resulted in an accretion of \$112,503 to accumulated deficit for the three and six months ended May 31, 2005.

Each Class B Series 2 Preference Share entitles the holder to one vote either in person or by proxy at any general meeting of the shareholders of the Company. The Company has the right to require the shareholders of the Preference Shares to convert each such share into 58.82 Common Shares if (i) at any time after 13 months following the issuance of the Preference Shares, the closing trade price of the Company's common shares exceeds \$2.13 for at least 20 consecutive trading days, or (ii) at any time, the Company completes a firm public underwritten offering of its common shares for more than \$40,000,000 at a price per common share greater than \$1.70. The Preference Shares are redeemable at the option of the Company at any time after the third anniversary of the issuance date for an amount equal to the original issuance price plus a premium of 20% of the original issue price. The Preference Shares are not subject to any right of redemption at the option of the holder.

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## (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.

A summary of the Company's stock options outstanding and exercisable at May 31, 2005 is as follows:

| Range of exercise prices<br>\$ | Number outstanding at<br>May 31, 2005 | Options outstanding                                 |                                       | Options exercisable                   |                                       |
|--------------------------------|---------------------------------------|---|---------------------------------------|---------------------------------------|---------------------------------------|
|                                |                                       | Weighted average remaining contractual life (years) | Weighted average exercise price<br>\$ | Number exercisable at<br>May 31, 2005 | Weighted average exercise price<br>\$ |
| 0.75 – 1.00                    | 768,000                               | 3.94  | 0.85                                  | 618,000                               | 0.87                                  |
| 1.01 – 1.35                    | 1,620,947                             | 1.00  | 1.06                                  | 1,474,947                             | 1.06                                  |
| 1.36 – 1.41                    | 60,000                                | 0.05  | 1.41                                  | 60,000                                | 1.41                                  |
| 0.75 – 1.41                    | 2,448,947                             | 1.90  | 1.00                                  | 2,252,947                             | 1.01                                  |

## Stock-based compensation

For the three and six months ended May 31, 2005, the Company incurred non-cash stock-based compensation expense of \$13,137 and \$15,661 respectively, related to stock options granted to third parties (three and six month period ended May 31, 2004 - \$33,006). The expense was included in general and administrative costs and was recorded in additional paid-in capital.

The fair value of stock options was estimated using the Black-Scholes option pricing model using the following weighted average assumptions by grant year:

|                                | 3 Months Ended May 31, |            | 6 Months Ended May 31, |            |
|--------------------------------|------------------------|------------|------------------------|------------|
|                                | 2005                   | 2004       | 2005                   | 2004       |
| Risk-free interest rate        | 2.78%                  | 2.21%      | 2.78%                  | 2.20%      |
| Volatility                     | 41%                    | 58%        | 41%                    | 83%        |
| Estimated average option lives | 1.38 years             | 3.00 years | 1.38 years             | 1.10 years |
| Dividend yield                 | 0.00%                  | 0.00%      | 0.00%                  | 0.00%      |

## Pro forma disclosure

The Company applies the intrinsic value method for employee stock options granted as prescribed in APB 25. Had compensation cost been determined using the fair value approach set forth in SFAS 123, the Company's earnings for the three and six months ended May 31, 2005 and 2004 and earnings (loss) per share would have been in accordance with the pro forma amounts indicated below:

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|  | For the three months ended |                       | For the six months ended |                       |
|--|----------------------------|-----------------------|--------------------------|-----------------------|
|  | May 31,<br>2005<br>\$      | May 31,<br>2004<br>\$ | May 31,<br>2005<br>\$    | May 31,<br>2004<br>\$ |
| Earnings (loss) as reported                                    | (1,697,767)                | 380,088               | (1,917,358)              | 931,879               |
| Add: Stock-based compensation cost                             | 13,137                     | 33,006                | 15,661                   | 33,006                |
| Less: Pro forma stock-based compensation cost                  | (220,582)                  | (120,724)             | (253,051)                | (127,024)             |
| Pro forma income (loss)  | (1,905,212)                | 292,370               | (2,154,748)              | 837,861               |
| Pro forma basic earnings (loss) per share                      | (0.26)                     | 0.01                  | (0.27)                   | 0.03                  |
| Pro forma diluted earnings (loss) per share                    | (0.26)                     | (0.01)                | (0.27)                   | 0.01                  |
| Weighted average number of common shares outstanding – basic   | 27,488,074                 | 27,145,769            | 27,488,074               | 26,964,789            |
| Weighted average number of common shares outstanding – diluted | 27,488,074                 | 29,771,620            | 27,488,074               | 32,525,826            |

The fair value of stock options was estimated using the Black-Scholes option pricing model using the following weighted average assumptions by grant year:

|                                | 3 Months Ended May 31, |            | 6 Months Ended May 31, |            |
|--------------------------------|------------------------|------------|------------------------|------------|
|                                | 2005                   | 2004       | 2005                   | 2004       |
| Risk-free interest rate        | 2.85%                  | 2.21%      | 2.85%                  | 2.21%      |
| Volatility                     | 54%                    | 58%        | 54%                    | 58%        |
| Estimated average option lives | 4.06 years             | 3.00 years | 4.06 years             | 3.00 years |
| Dividend yield                 | 0.00%                  | 0.00%      | 0.00%                  | 0.00%      |

## (e) Earnings per share

|   | Three Months Ended<br>May 31 |            | Six Months Ended<br>May 31 |            |
|---|------------------------------|------------|----------------------------|------------|
|   | 2005<br>\$                   | 2004<br>\$ | 2005<br>\$                 | 2004<br>\$ |
| <b>Basic earnings (loss) per share</b>  |                              |            |                            |            |
| Net earnings (loss)   | (1,697,767)                  | 380,088    | (1,917,358)                | 931,879    |
| Less: Accretion of discount on Class B preference shares Series 1   | (390,672)                    | (33,439)   | (424,111)                  | (66,878)   |
| Accretion of beneficial conversion feature on Class B preference shares Series 2  | (4,796,649)                  | -          | (4,796,649)                | -          |
| Accretion of discount on Class B preference shares Series 2   | (112,503)                    | -          | (112,503)                  | -          |
| Class B preference share dividends Series 1   | (62,785)                     | (43,283)   | (62,785)                   | (86,566)   |
| Class B preference share dividends Series 2   | (190,726)                    | -          | (190,726)                  | -          |
| Add: Excess of carrying value of Class B preference shares series 1 and beneficial conversion feature over repurchase consideration paid. | 370,967                      | -          | 370,967                    | -          |
| Net earnings (loss) available to common shareholders  | (6,880,135)                  | 303,366    | (7,133,165)                | 778,435    |
| Weighted average number of common shares outstanding  | 27,488,074                   | 27,145,769 | 27,488,074                 | 26,964,789 |
| Basic earnings (loss) per share   | (0.25)                       | 0.01       | (0.26)                     | 0.03       |

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|   | Three Months Ended May<br>31 |                   | Six Months Ended<br>May 31 |                   |
|---|------------------------------|-------------------|----------------------------|-------------------|
|   | 2005                         | 2004              | 2005                       | 2004              |
| Diluted earnings (loss) per share   | \$                           | \$                | \$                         | \$                |
| Net earnings  | (1,697,767)                  | 380,088           | (1,917,358)                | 931,879           |
| Less: Accretion of discount on Class B preference shares Series 1   | (390,672)                    | (531,638)         | (424,111)                  | (565,078)         |
| Accretion of beneficial conversion feature on Class B preference shares Series 2  | (4,796,649)                  | -                 | (4,796,649)                | -                 |
| Accretion of discount on Class B preference shares Series 2   | (112,503)                    | -                 | (112,503)                  | -                 |
| Class B preference share dividends Series 1   | (62,785)                     | -                 | (62,785)                   | -                 |
| Class B preference share dividends Series 2   | (190,726)                    | -                 | (190,726)                  | -                 |
| Add: Excess of carrying value of Class B preference shares series 1 and beneficial conversion feature over repurchase consideration paid. | 370,966                      | -                 | 370,967                    | -                 |
| Net earnings (loss) available to common shareholders  | <u>(6,880,135)</u>           | <u>(151,550)</u>  | <u>(7,133,165)</u>         | <u>366,801</u>    |
| Weighted average number of common shares outstanding  | 27,488,074                   | 27,145,769        | 27,488,074                 | 26,964,789        |
| Dilutive effect of Class A preference shares – Series A (*1)  | -                            | -                 | -                          | 30,262            |
| Dilutive effect of Class B preference shares – Series 1   | -                            | 2,625,851         | -                          | 2,625,851         |
| Dilutive effect of Class B preference shares – Series 2 (*2)  | -                            | -                 | -                          | -                 |
| Dilutive effect of warrants (*3)  | -                            | -                 | -                          | 1,393,301         |
| Dilutive effect of stock options (*1)   | -                            | -                 | -                          | 1,511,623         |
| Adjusted weighted average number of common shares outstanding   | <u>27,488,074</u>            | <u>29,771,620</u> | <u>27,488,074</u>          | <u>32,525,826</u> |
| Diluted earnings (loss) per share   | <u>(0.25)</u>                | <u>(0.01)</u>     | <u>(0.26)</u>              | <u>0.01</u>       |

(\*1) The Class A preference shares – Series A and stock options were anti-dilutive for the purposes of calculating diluted earnings per share for the three and six months ended May 31, 2005 and for the three months ended May 31, 2004.

(\*2) The Class B preference shares – Series 2 were anti-dilutive for the purposes of calculating diluted earnings per share for the three and six months ended May 31, 2005.

(\*3) For the three and six months ended May 31, 2005, the outstanding 13,788,365 warrants were not included in the diluted earnings per share calculation as they were anti-dilutive. For the three months ended May 31, 2004, the outstanding 1,393,301 warrants were not included in the diluted earnings per share calculation as they were anti-dilutive.

## 12 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 May 31, 2005, the Company has claimed \$2,207,559 of assistance under the agreement. Accounts receivable at May 31, 2005 includes \$470,628 of amounts receivable from TPC in connection with these claims (November 30, 2004 – \$257,266).

In addition, under the April 26, 2004 agreement, 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

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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 had received the maximum allowed under the agreement. There are no amounts recorded in accounts receivable with respect to these claims.

In addition, under the November 15, 1999 agreement, the Company is required to pay a royalty of 3% on annual gross Navigation Systems and Applications business unit revenue for the period December 1, 1999 to November 30, 2008. The Company has paid royalties of \$1,242,022 to date (November 30, 2004 – \$929,303) and has accrued royalties of \$91,691 at May 31, 2005 (November 30, 2004 - \$311,851). 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 fiscal year 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 outcome of the audit will have a material impact on the Company's financial results.

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.

## 13 Related party transactions

On April 11, 2005, Mr. E. Brinton Coxe, a director of the Company, assisted the Company in structuring and arranging the private placement financing (note 11(c)(ii)). In consideration for his services, the Company paid him compensation of \$815,908 and 350,000 common share purchase warrants. The cash compensation of \$815,908 paid to Mr. Coxe included an adjustment in the amount of \$15,908 to reflect exchange rate changes between the U.S. dollar and Canadian Dollar. Mr. Coxe has also participated in the financing by purchasing 100 units personally.

On April 8, 2005, Gerald J. Shields was elected to the Company's Board of Directors and became a related party as he provides legal services to the Company through a law firm in which he has an interest.

## 14 Contingencies

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 May 31, 2005 in respect of these claims because the potential liability for the claims and the amount of damages, if any, cannot be reasonably estimated. Management believe that the claims are without merit.

## 15 Income taxes

The Company is subject to income taxes in Canada and the United States and the use of estimates is required in determining the Company's provision for income taxes. Although the Company believes its tax estimates are reasonable, the ultimate tax determination involves significant judgement that could become subject to audit by tax authorities in the ordinary course of business. The effective rate used to record income tax expense for the three and six months ended May 31, 2005 differed

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from the Canadian federal and provincial combined statutory tax rate primarily due to the change in valuation allowance to reflect those future tax benefits that were more likely than not to be realized, future income tax payments that will result from the payment of Class B preference share dividends and, also, items not deductible for income tax purposes. The change in effective tax rate from 2004 to 2005 was due primarily to the effect of the change in valuation allowance.

At May 31, 2005, the Company adjusted its valuation allowance against deferred 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 those deferred tax assets for which there is uncertainty of future realization.

|  | For the three months ended |                 | For the six months ended |                  |
|--|----------------------------|-----------------|--------------------------|------------------|
|  | May 31,<br>2005            | May 31,<br>2004 | May 31,<br>2005          | May 31,<br>2004  |
|  | \$                         | \$              | \$                       | \$               |
| Deferred income tax expense (recovery) | 143,189                    | (217,363)       | (95,176)                 | (496,266)        |
| Current income tax expense             | 82,756                     | 147,994         | 82,756                   | 380,786          |
| Income tax expense (recovery)          | <u>225,945</u>             | <u>(69,369)</u> | <u>(12,420)</u>          | <u>(115,480)</u> |
| Effective tax rate                     | (15%)                      | (22%)           | (1%)                     | (14%)            |

## 16 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 of the Company's audited consolidated annual financial statements for the year ended November 30, 2004 prepared in accordance with U.S. GAAP. 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.

|  | Three Months Ended May 31, 2005 |              |           |             |
|--|---------------------------------|--------------|-----------|-------------|
|  | Navigation<br>Systems           | Applications | Geomatics | Total       |
|  | \$                              | \$           | \$        | \$          |
| Revenue                                    | 956,378                         | 19,412       | 905,895   | 1,881,685   |
| Gross profit                               | 105,823                         | 17,446       | 247,082   | 370,351     |
| Technology Partnerships Canada - net       | (432,761)                       | -            | -         | (432,761)   |
| Interest expense                           | 8,596                           | -            | 91        | 8,687       |
| Income tax expense (recovery)              | 118,934                         | -            | 107,011   | 225,945     |
| Net earnings (loss)                        | (999,747)                       | (211,722)    | (486,298) | (1,697,767) |
| Property, plant and equipment expenditures | 64,969                          | -            | 12,986    | 77,955      |
| Intangible expenditures                    | 5,519                           | -            | 52,562    | 58,081      |
| Depreciation and amortization              | 52,003                          | 1,074        | 65,107    | 118,184     |

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(expressed in Canadian dollars)

|  | <b>Six Months Ended May 31, 2005</b> |                     |                  |              |
|--|--------------------------------------|---------------------|------------------|--------------|
|  | <b>Navigation<br/>Systems</b>        | <b>Applications</b> | <b>Geomatics</b> | <b>Total</b> |
|  | \$                                   | \$                  | \$               | \$           |
| Revenue                                    | 2,897,155                            | 30,912              | 1,213,475        | 4,141,542    |
| Gross profit                               | 1,303,913                            | 27,457              | 271,090          | 1,602,460    |
| Technology Partnerships Canada - net       | (643,587)                            | -                   | -                | (643,587)    |
| Interest expense                           | 19,827                               | -                   | 1,576            | 21,403       |
| Income tax expense (recovery)              | (95,176)                             | -                   | 82,756           | (12,420)     |
| Net earnings (loss)                        | (810,017)                            | (384,548)           | (722,793)        | (1,917,358)  |
| Property, plant and equipment expenditures | 92,393                               | -                   | 12,986           | 105,379      |
| Intangible expenditures                    | 15,867                               | 1,213               | 54,584           | 71,664       |
| Depreciation and amortization              | 104,896                              | 2,149               | 95,809           | 202,854      |

|  | <b>Three Months Ended May 31, 2004</b> |                     |                  |              |
|--|--|---------------------|------------------|--------------|
|  | <b>Navigation<br/>Systems</b>          | <b>Applications</b> | <b>Geomatics</b> | <b>Total</b> |
|  | \$                                     | \$                  | \$               | \$           |
| Revenue                                    | 1,691,056                              | 39,986              | 1,042,793        | 2,773,835    |
| Gross profit                               | 1,252,341                              | 29,699              | 492,963          | 1,775,003    |
| Technology Partnerships Canada - net       | (782,654)                              | (61,180)            | -                | (843,834)    |
| Interest expense                           | 37                                     | -                   | 66               | 103          |
| Income tax recovery                        | (69,369)                               | -                   | -                | (69,369)     |
| Net earnings (loss)                        | 446,985                                | (214,047)           | 147,150          | 380,088      |
| Property, plant and equipment expenditures | 23,737                                 | 11,929              | -                | 35,666       |
| Intangible expenditures                    | 10,269                                 | -                   | 155,824          | 166,093      |
| Depreciation and amortization              | 55,811                                 | 538                 | 27,453           | 83,802       |

|  | <b>Six Months Ended May 31, 2004</b> |                     |                  |              |
|--|--------------------------------------|---------------------|------------------|--------------|
|  | <b>Navigation<br/>Systems</b>        | <b>Applications</b> | <b>Geomatics</b> | <b>Total</b> |
|  | \$                                   | \$                  | \$               | \$           |
| Revenue                                    | 4,971,154                            | 68,304              | 1,764,137        | 6,803,595    |
| Gross profit                               | 3,648,387                            | 48,667              | 646,722          | 4,343,776    |
| Technology Partnerships Canada - net       | (733,728)                            | (61,180)            | -                | (794,908)    |
| Interest expense                           | 228                                  | -                   | 143              | 371          |
| Income tax recovery                        | (115,480)                            | -                   | -                | (115,480)    |
| Net earnings (loss)                        | 1,417,635                            | (525,346)           | 39,590           | 931,879      |
| Property, plant and equipment expenditures | 50,955                               | 14,409              | -                | 65,364       |
| Intangible expenditures                    | 20,062                               | -                   | 158,969          | 179,031      |
| Depreciation and amortization              | 110,614                              | 615                 | 50,620           | 161,849      |

| <b>Total assets employed</b> | <b>Navigation<br/>Systems</b> | <b>Applications</b> | <b>Geomatics</b> | <b>Total</b> |
|------------------------------|-------------------------------|---------------------|------------------|--------------|
|                              | \$                            | \$                  | \$               | \$           |
| As at May 31, 2005           | 22,491,606                    | 16,421              | 2,956,584        | 25,464,611   |
| As at November 30, 2004      | 10,562,064                    | 17,357              | 1,731,317        | 12,310,738   |

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

|                       | For the three months ended |                  | For the six months ended |                  |
|-----------------------|----------------------------|------------------|--------------------------|------------------|
|                       | May 31,<br>2005            | May 31,<br>2004  | May 31,<br>2005          | May 31,<br>2004  |
|                       | \$                         | \$               | \$                       | \$               |
| Europe                | 293,678                    | 415,953          | 1,920,679                | 2,480,974        |
| Australia/New Zealand | 477,049                    | 1,019,610        | 788,936                  | 1,967,873        |
| United States         | 631,572                    | 832,518          | 832,285                  | 1,728,111        |
| Canada                | 479,386                    | 505,754          | 599,642                  | 626,637          |
| Total                 | <u>1,881,685</u>           | <u>2,773,835</u> | <u>4,141,542</u>         | <u>6,803,595</u> |

Geographically, plant and equipment and intangible and other assets are reported based on location. At May 31, 2005 and November 30, 2004, all of the Company's plant and equipment and intangible and other assets were located in Canada and the U.S. as follows:

|                             | Canada           |                      | United States   |                      |
|-----------------------------|------------------|----------------------|-----------------|----------------------|
|                             | May 31,<br>2005  | November 30,<br>2004 | May 31,<br>2005 | November 30,<br>2004 |
|                             | \$               | \$                   | \$              | \$                   |
| Plant and equipment         | 932,741          | 938,102              | 57,212          | -                    |
| Intangible and other assets | 359,599          | 408,611              | 913,636         | -                    |
| Total                       | <u>1,292,340</u> | <u>1,346,713</u>     | <u>970,848</u>  | <u>-</u>             |

## 17 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 May 31, 2005, the Company had foreign exchange forward contracts maturing in the following periods to sell Australian \$1,605,038 (May 31, 2004 – \$2,750,000). As at May 31, 2005, the Company had drawn on its foreign exchange contract facility in the amount of U.S. \$nil (2004 – U.S. \$818,398) and Australian \$1,605,038 (2004 – \$2,750,000). The exchange rates set in the forward exchange contracts ranged between 0.9486 to 0.9578 for Australian \$1.00. The contracts mature between June and July 2005.

## 18 Financial guarantees

The Company utilizes letters of credit to back certain performance obligations with its customers. The standby letters of credit are repayable on demand after certain conditions have been met. As of May 31, 2005, one letter of credit, relating principally to a customer contract, had been issued for Australian \$283,886 (November 30, 2004 – Australian \$283,886).

**19 Reconciliation of generally accepted accounting principles**

The Company prepares its unaudited interim consolidated financial statements in accordance with U.S. generally accepted accounting principles which, as applied in these unaudited interim consolidated financial statements, conform in all material respects to Canadian GAAP, except for the differences below as follows:

(a) Under Canadian GAAP, for stock option awards granted by the Company after December 1, 2003, the Company is required to recognize compensation when stock options are granted to employees and directors under stock option plans with no cash settlement feature based on the fair value method. As permitted by the standard, the Company had applied this change prospectively for new awards granted on or after December 1, 2003. Under U.S. GAAP, the Company accounts for stock based compensation to employees and directors in accordance with the intrinsic value method of the Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees".

(b) Under Canadian GAAP, there is not a requirement to record the beneficial conversion feature and accretion of discount when preference shares are issued with attached warrants. For U.S. GAAP purposes, during the fiscal year 2003 and the three and six months ended May 31, 2005 the Company recorded beneficial conversion features of \$668,785 and \$4,796,649 on the issuance of Class B preference shares Series 1 and 2, respectively as a reduction to the net earnings available to common shareholders calculated on the effective conversion price of the preference shares to common shares based on the proceeds allocated to the preference shares. In both cases, the conversion feature of the preference shares vested immediately and the Company recorded the accretion of the full amount of the beneficial conversion feature. For both the Series 1 and Series 2 Class B preference shares, the discount on these shares that resulted from the allocation of the gross proceeds to the Class B preference shares and to the attached warrants is accreted over the five-year life of the warrants. This resulted in an accretion of \$503,175 and 536,614 to deficit for the three and six months ended May 31, 2005, respectively (\$33,439 and \$66,878 for the three and six months ended May 31, 2004, respectively).

(c) Under Canadian GAAP, there is a requirement for derivatives outside of hedging relationships to be recognized on the balance sheet at fair market value, however for derivatives in hedging relationships, Canadian GAAP does not specify how such derivatives should be recorded. As a result, under Canadian GAAP in some instances derivatives may not be recorded on the balance sheet. Under U.S. GAAP it is required that all derivatives be recorded as assets or liabilities, measured at fair value. Derivatives that are not hedges are adjusted to fair value through income. If the derivative is a hedge, depending upon the nature of the hedge, changes in the fair value of the derivative are either offset against the fair value of assets, liabilities or firm commitments through income, or recognized in other comprehensive income until the hedged item is recognized in income. The ineffective portion of a derivative's change in fair value is immediately recognized into income. With respect to the ineffective portion of derivative's changes in fair value, the Company has recorded a foreign exchange loss amount of \$7,748 for the three and six months ended May 31, 2005 under U.S. GAAP which has not been recorded under Canadian GAAP.

(d) Under Canadian GAAP, the Company was not required to record stock based compensation for options granted to third parties prior to December 1, 2001. Under U.S. GAAP, the Company is required to record stock based compensation for options granted to third parties based on the fair value method as required by SFAS 123 retroactive for all prior periods. As a result, these stock based compensation transactions, result in differences when compared to the same balances as previously reported under Canadian GAAP.

(e) For Canadian GAAP financial statement purposes, the Company's 30,262 (November 30, 2004 - 30,262) Class A preference shares have been presented at a nominal value. For U.S. GAAP financial statement purposes, these shares have been presented at a value of \$30,362.

(f) For Canadian GAAP financial statement purposes, the Company has recorded a cumulative translation adjustment of \$23,091 which is a separate component of shareholders' equity. For U.S. GAAP purposes changes in the cumulative translation adjustment are included as a component of accumulated other comprehensive income.

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(g) If Canadian GAAP were followed:

i) the effect on the Consolidated Statements of Earnings would be:

|   | For the three months ended |                       | For the six months ended |                       |
|---|----------------------------|-----------------------|--------------------------|-----------------------|
|   | May 31,<br>2005<br>\$      | May 31,<br>2004<br>\$ | May 31,<br>2005<br>\$    | May 31,<br>2004<br>\$ |
| Earnings (loss) for the period, U.S. GAAP                         | (1,697,767)                | 380,088               | (1,917,358)              | 931,879               |
| Adjustment for stock based compensation (a),(d)                   | (201,145)                  | (81,418)              | (224,790)                | (81,418)              |
| Adjustment for loss on derivative (c)                             | 7,748                      | -                     | 7,748                    | -                     |
| Earnings (loss) for the period, Canadian GAAP                     | (1,891,164)                | 298,670               | (2,134,400)              | 850,461               |
| Basic earnings (loss) per common share, Canadian GAAP             | (0.08)                     | 0.01                  | (0.09)                   | 0.03                  |
| Diluted earnings (loss) per common share, Canadian GAAP           | (0.08)                     | 0.01                  | (0.09)                   | 0.03                  |
| Weighted average number of common shares - basic, Canadian GAAP   | 27,488,074                 | 27,023,112            | 27,488,074               | 27,023,112            |
| Weighted average number of common shares - diluted, Canadian GAAP | 27,488,074                 | 27,802,463            | 27,488,074               | 27,802,463            |

ii) Balance Sheet items which would differ under Canadian GAAP are as follows:

|  | May 31,<br>2005<br>\$ | November 30,<br>2004<br>\$ |
|--|-----------------------|----------------------------|
| Common shares (d)                        | 19,026,125            | 19,026,125                 |
| Class A preference shares – Series A (e) | -                     | -                          |
| Class B preference shares – Series 1 (b) | -                     | 1,926,157                  |
| Class B preference shares – Series 2 (b) | 17,081,637            | -                          |
| Warrants (b)                             | 661,770               | 661,575                    |
| Additional paid in capital (a), (d)      | 454,943               | 214,492                    |
| Accumulated Deficit (a), (b), (c), (d)   | (12,495,870)          | (12,193,838)               |
| Cumulative translation adjustment (f)    | 27,050                | -                          |

(h) Pro forma information – Stock based compensation

The following pro forma financial information as required by The Canadian Institute of Chartered Accountants (“CICA”) Handbook section 3870, Stock-Based Compensation and Other Stock – based Payments, presents the earnings 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:

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 (expressed in Canadian dollars)

|  | For the three months ended |                 | For the six months ended |                 |
|--|----------------------------|-----------------|--------------------------|-----------------|
|  | May 31,<br>2005            | May 31,<br>2004 | May 31,<br>2005          | May 31,<br>2004 |
|  | \$                         | \$              | \$                       | \$              |
| Earnings (loss) for the period, Canadian GAAP      | (1,891,164)                | 298,670         | (2,134,400)              | 850,461         |
| Add: Stock-based compensation cost                 | 214,282                    | 114,424         | 240,451                  | 114,424         |
| Less: Pro forma stock-based compensation cost      | (220,582)                  | (120,724)       | (253,051)                | (127,024)       |
| Pro forma income (loss)                            | (1,897,464)                | 292,370         | (2,147,000)              | 837,861         |
| Pro forma basic earnings (loss) per share          | (0.08)                     | 0.01            | (0.09)                   | 0.03            |
| Pro forma diluted earnings (loss) per share        | (0.08)                     | 0.01            | (0.09)                   | 0.03            |
| Weighted average number of common shares – basic   | 27,488,074                 | 27,023,112      | 27,488,074               | 27,023,112      |
| Weighted average number of common shares – diluted | 27,488,074                 | 27,802,463      | 27,488,074               | 27,802,463      |

The fair value of the stock options was estimated using the Black-Scholes option pricing model using the following weighted average assumptions by grant year:

|                                | 3 Months Ended May 31, |            | 6 Months Ended May 31, |            |
|--------------------------------|------------------------|------------|------------------------|------------|
|                                | 2005                   | 2004       | 2005                   | 2004       |
| Risk-free interest rate        | 2.85%                  | 2.21%      | 2.85%                  | 2.21%      |
| Volatility                     | 54%                    | 58%        | 54%                    | 58%        |
| Estimated average option lives | 4.06 years             | 3.00 years | 4.06 years             | 3.00 years |
| Dividend yield                 | 0.00%                  | 0.00%      | 0.00%                  | 0.00%      |

## 20 Other Information

The following presents the conversion of the Company's comparative financial information from Canadian GAAP to U.S. GAAP and presents a comparison for amounts which differ between Canadian GAAP and U.S. GAAP:

(a) Balance sheet at November 30, 2004:

|   | As previously<br>reported under<br>Canadian GAAP | As currently<br>reported under<br>U.S. GAAP |
|---|--|---|
|   | \$   | \$  |
| <b>Shareholders' Equity</b>                 |  |   |
| <b>Capital stock</b>                        |  |   |
| Issued and outstanding                      |  |   |
| 30,262 Class A preference shares – Series A | -  | 30,262                                      |
| 57,711 Class B preference shares – Series I | 1,926,157  | 2,163,621                                   |
| 27,488,074 common shares                    | 19,026,125                                       | 20,047,731                                  |
|   | 20,952,282                                       | 22,241,614                                  |
| <b>Additional Paid in Capital</b>           | 214,492  | 928,169                                     |
| <b>Accumulated Deficit</b>                  | (12,193,838)                                     | (14,196,847)                                |

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(expressed in Canadian dollars)

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(b) Statement of Earnings and Accumulated Deficit for the three months and six months ended May 31, 2004

|   | As previously reported under<br>Canadian GAAP       |   | As currently reported under U.S.<br>GAAP            |   |
|---|---|---|---|---|
|   | For the three<br>months ended<br>May 31, 2004<br>\$ | For the six<br>months ended<br>May 31, 2004<br>\$ | For the three<br>months ended<br>May 31, 2004<br>\$ | For the six<br>months ended<br>May 31, 2004<br>\$ |
| <b>Accumulated Deficit – Beginning of period</b>  | (11,583,655)  | (12,043,580)                                      | (13,619,622)  | (14,046,108)                                      |
| <b>Class B preference share dividend paid</b>     | 86,567  | 178,433   | 86,567  | 178,433   |
| <b>Class B preference share dividend accreted</b> | -   | -   | 33,439  | 66,878  |
| <b>Accumulated Deficit – End of period</b>        | (11,371,552)  | (11,371,552)                                      | (12,933,054)  | (12,933,054)                                      |

## 21 Subsequent event

On July 11, 2005, the Company announced that it has signed a non-binding letter of intent to acquire a United States defence contracting company. The acquisition is expected to approximately double the Company's revenue and employee base. The target company, with multiple offices in the United States, is a supplier of technology and services to the U.S. Department of Defence and key defence prime contractors.