the Brand of Excellence

XL Food Systems Ltd.

Annual Report 1986

100 YEARS

1986 was a keystone year for XL Food Systems

As our 100th anniversary, 1986 marked a time to celebrate our rich heritage and reflect on the strengths and expertise that built your Corporation into the largest Alberta-based producer of beef and beef products.

1986 was also a year of change

It represented the beginning of a new chapter in the history of the Corporation, and a time of charting a strategic new course for the future. We changed our name from L. K. Resources Ltd. to XL Food Systems Ltd., signifying the transition from a diversified conglomerate into a major Canadian food production and marketing company.

Finally, 1986 was a year of growth and achievement

Implementation of new long-range financing, extension of a successful Joint Venture with Centennial Packers Ltd., and the innovative and aggressive efforts of your management team have resulted in visible progress.

It is with pride, anticipation, and justified optimism that XL Food Systems Ltd. looks to another 100 years of growth and success.

REPORT TO SHAREHOLDERS

With your approval last year, XL Food Systems Ltd. became our new corporate name; a change symbolic of our renewed commitment to specialization and excellence in the food industry.

Key developments during 1986 enabled your Corporation to make significant inroads toward building its position in the marketplace as a leading Canadian food company with a strong international presence.

A new financing package was arranged late in 1986 with the Province of Alberta Treasury Branches. The Treasury Branches have a long history of strong financial support to viable western Canadian enterprises, and have knowledge and expertise in agricultural matters.

The new arrangement eliminates $8.5 million in long-term corporate debt as well as $3 million in anticipated interest payments and gives the Corporation financial certainty – not present since the Canadian Commercial Bank was put into liquidation. XL Food now has the ability to strengthen its position in the food business through possible investment in and development of profitable food-related ventures.

Your Corporation improved operating results from a loss of $1.6 million in 1985 (34 cents per share), to a loss of $305,000 (6 cents per share) in 1986. Fixed assets increased by $1.2 million in 1986, reflecting a continued commitment to preserve our reputation of high product quality. Net loss after extraordinary items was $1.5 million in 1986, following a writedown

associated with the Corporation's re-direction into foods. Progress in operating results was significant, for a year of excessive costs associated with the refinancing, however, further improvements are needed and expected in 1987.

The Joint Venture, initiated in 1985 with Centennial Packers Ltd., was expanded in March of 1986, and has had a positive impact on Corporation operations. As forecast at the 1985 Annual Meeting, cost savings incurred by pooling resources contributed to an improvement of approximately $1 million in net operating revenues this year.

During 1986, your Corporation was able to increase its market share of Alberta beef through innovative marketing techniques, in spite of the general decline of beef demand in recent years. Industry organizations continue to counteract public misinformation about the nutritive content of beef which contributed to this decline in demand.

This year, XL Food was presented with an Export Achievement Award from Alberta Economic Development and Trade, and Alberta Agriculture, acknowledging our 1985 export performance in international marketing. We continued to expand exports during 1986, with an increase of sales to the United States and Pacific Rim countries, in conjunction with our Joint Venture partner.

Also in 1986, a senior executive of XL Food was appointed as Western Chairman of the Canadian Meat Council. This has provided a voice for Alberta in the development of national meat policy in an industry where national and international considerations are having a greater effect than ever before.

Significant progress in labour relations was achieved during 1986 – a year which will be remembered in Alberta for its unstable labour environment. Labour contracts were established with the XL Beef and Montagne Meats Associations without any work stoppage, enabling your Corporation to maintain a high level of productivity. We remain committed to building communication and co-operation to ensure responsible working relationships with our employees.

Much of the progress of your Corporation in 1986 is attributed to the innovative and aggressive efforts of our management team. We take this opportunity to pay special tribute to the contribution made by members of your Board of Directors, and thank the many loyal employees whose support is fundamental to the success of the Corporation.

On behalf of the Board of Directors,

G.E. Kaumeyer

Gerald E. Kaumeyer
Chairman of the Board

Gorham W. Hussey

Gorham W. Hussey
President and Chief Executive Officer


HP

BEEF OPERATIONS

With the beef industry in North America continuing through a period of rationalization, the challenge to productivity and profitability among beef producers remains one of achieving optimum efficiency in operations, and employing innovative and aggressive marketing strategies.

The Joint Venture with Centennial Packers Ltd. has proved to be a practical way to achieve both these objectives; producing a greater volume of product at increased efficiency, and improving our marketing performance.

XL Food has assigned valuable employees to key positions on the new Joint Venture marketing-oriented beef management team. Significant contributions were also made by your Corporation's sales, procurement and accounting personnel to ensure the on-going success of the Joint Venture.

Joint Venture Operations

The first stage of the Joint Venture with Centennial, initiated in 1985, involved the slaughtering operations and removed duplication of effort in cattle buying, slaughtering and sales. Joint Venture operations represent a significant percentage of total Canadian cattle slaughter.

The second stage of the Joint Venture, initiated in 1986, combined the boxed beef processing and marketing operations of both companies, and has captured, for the Joint Venture, a larger share of the boxed beef market in Canada.

Productivity was enhanced in 1986 through the acquisition of new equipment for our beef processing facilities. A vacuum packaging system implemented at XL Food's boxed beef plant was the first of its type to be installed in Canada, and the latest technology available to North America. New equipment designed to improve carton quality has also been purchased. These improvements are indicative of a commitment to provide the latest technology available to ensure product excellence, increase by-product recovery, and continue to strengthen our competitiveness in world markets.

How the Joint Venture Operates

The Joint Venture management team operates five modern boxed beef, boning and slaughter plants located in Calgary, Alberta. Three of these plants are owned by XL Food.

Cattle obtained from Alberta producers and XL Food's feedlots are slaughtered at the two Joint Venture slaughtering plants. Some carcasses are sold directly to customers in Canada, but the majority undergo further processing at other Joint Venture plants. The slaughtering plants also produce edible and inedible beef by-products and hides.

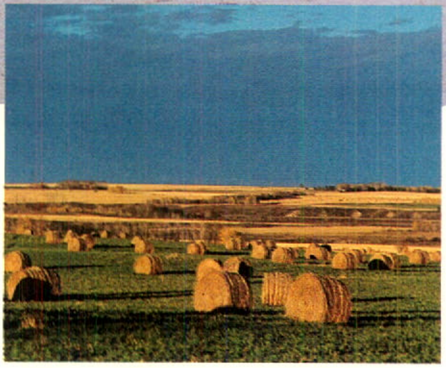
Edible beef by-products such as livers and tongues are sold to retail outlets across Canada and abroad. Inedible beef by-products are sold to renderers, while hides are sold worldwide for the production of leather products.

The Joint Venture boxed beef plants process beef carcasses into vacuum packaged primals and sub-primals for sale to retailers and the hotel, restaurant and institutional trade (HRI). Boxed beef has the advantages of increasing shelf life, reducing transportation costs, and significantly reducing labour costs to the customer.

A key strength of the Joint Venture is that the marketing operations of Centennial and XL Food were very complementary prior to being combined. XL Food brought a large sales and distribution base among the wholesale and retail trade to the Joint Venture, while Centennial Packers contributed an excellent sales and distribution base with the HRI trade.

The increased marketing strength of the Joint Venture is evident in its ability to implement innovative customized boxed beef programs for major Canadian retailers.

AGRICULTURAL OPERATIONS



XL Food's agricultural operations are a vital link in the Corporation's beef production chain. The expertise and experience developed over a 100 year history have made the Corporation a leader in animal husbandry, and has given the XL brand of beef a reputation for leanness and quality.

The Corporation's agricultural operations, located near Bassano, Alberta, include L.K. Ranches, XL Custom Feeding, and XL Feeds Ltd. L.K. Ranches, one of the largest ranching operations in Alberta, is located on 77,000 acres of deeded and crown-leased lands. Dryland farming produces wheat and barley, while approximately 2,000 acres of irrigated land produce forage for the Corporation's calf backgrounding lot. XL Custom Feeding operations are capable of feeding up to 25,000 head of cattle at any one time. XL Feeds operates a feed mill with a single shift production capacity of 1000 tons/week.

The Corporation has introduced advanced technology to supplement proven successful farming, ranching and cattle feeding methods. The use of computers in monitoring performance has provided valuable management information for these operations. This knowledge, along with expertise in the breeding of cattle, has given XL Food's agricultural operations the ability to customize feeding programs, and test new methods and techniques to ensure high performance, high yielding, lean beef.

XL Food is able to execute precise quality control of every aspect of beef production. From the dryland operations providing high quality feed, through cattle feeding, and to final processing and marketing, these fully integrated operations provide the Corporation with a unique edge on the marketplace.

For these reasons, XL Food's agricultural operations are a major asset to be utilized in the continued growth and success of the Corporation.

NEW PRODUCT DEVELOPMENT

XL Food is committed to value-added beef products, and is taking an innovative, aggressive approach to developing and diversifying its product line.

Innovation was the focus of product development strategy in 1986. The focus for 1987 will be on continued development of customer-oriented products and programs to meet specific customer needs. As such, your Corporation is defining potential consumer trends and taking an active role in developing beef products that are responsive to customer needs.

In addition to producing nutritious beef products for a health-conscious market, XL Food is also addressing growing consumer demand for convenience. Frozen beef patties are already part of the Corporation's product line, and new items currently being researched include consumer convenience foods such as microwavable beef products and retail-ready branded beef items.

The integrated nature of XL Food's agricultural and beef processing operations provides the Corporation with unique opportunities to control product quality and respond to the consumer market.

Export Opportunities

The Corporation's efforts to expand markets in the international arena in 1985 and 1986 have already shown substantial progress, and XL Food will continue to direct efforts to building new export business with our Joint Venture partner.

To take advantage of export opportunities for international marketing, activities must be planned and executed in conjunction with various trade and government agencies. XL Food has co-operated with both federal and provincial governments in developing new export markets for Alberta beef. In 1986, XL Food received an Export Achievement Award from the Alberta government for the Corporation's 1985 export performance.

XL Food's efforts in the export area are indicative of the Corporation's commitment to innovation, service and quality to meet the specific needs of customers and consumers – whether they are in Toronto or Tokyo.

Conclusion

XL Food Systems Ltd. has the broad charter and now the ability to become a leading Canadian food company specializing in food production and marketing. Your management team continues to chart a course to achieve this goal.

In 1986, management restructured long-term debt, established new banking facilities, developed additional marketing and export opportunities, streamlined operations, and concentrated all efforts towards building your Corporation as a food production and marketing company.

XL Food is now 100 years into the future and looking forward to the next century with pride, anticipation and continued optimism for growth and success.

1986 FINANCIAL REVIEW

Non-Recurring Costs Incurred Due to Previous Banking Arrangements

In September 1985 the Corporation's principal banker, the Canadian Commercial Bank, ("CCB"), was ordered into liquidation. An excessive amount of management time and many extra costs were incurred throughout fiscal 1986 in arranging alternative banking facilities. Your management believes that as a result of the downfall of the CCB, the Corporation incurred in excess of $1 million in non-recurring expenses. These non-recurring expenses were primarily comprised of professional fees, including legal and accounting costs, along with redundant interest costs and lost opportunities.

The lack of proper banking facilities throughout 1986 concerned both our customers and suppliers and created a lack of confidence in the Corporation causing lower volumes of throughput in our feedlot operations. Notwithstanding this negative environment, improved meat operations and controlled capital projects allowed the Corporation to report significant improvements in profitability.

Arrangement of New Banking Facilities

In September 1986 the Corporation negotiated a restructuring of its principal long-term debt with the CCB-In Liquidation, and obtained new banking lines of credit with the Province of Alberta Treasury Branches. These arrangements also permitted the Corporation to reduce its long-term debt by $8.5 million and increase its shareholders' equity by $6.5 million. Operating lines were increased by $4.5 million and term facilities were increased by $1.4 million. The Corporation is currently utilizing only $13.9 million of its $18.5 million revolving line of credit.

In support of these new lines of credit, the Government of the Province of Alberta has entered into an Interest Deficiency Guarantee Agreement with the Province of Alberta Treasury Branches. The agreement provides that the Government guarantee interest deficiencies "as defined" for a five (5) year period commencing January 1, 1987. The guarantee is non-cumulative with the Government's maximum liability aggregating $1.5 million per annum. Based upon the Corporation's long-term debt reduction record of the past two years, and forecasts of earnings for the future, management believes the Government would not be required to honour their guarantee.

Under the terms of the restructuring agreement the CCB-In Liquidation, has converted its income debenture into 65,453 First Preferred shares, Series "C" of the Corporation, and a $4,078,000 non-interest bearing term loan due January 1, 1990. Further details of this transaction are contained in Note 5 of the Notes to the Consolidated Financial Statements.

This loan is specifically secured by certain non-essential assets which the Corporation will be disposing of in the near future. The proceeds from such sales are dedicated to the reduction of this non-interest bearing term loan. No other assets of the Corporation are pledged to the CCB as security for this loan. With these arrangements in place the Corporation can enter fiscal 1987 with confidence and financial strength that had not been present throughout 1986.

First Preferred Shares, Series "A" and Series "B" Shareholders

In conjunction with the refinancing and restructuring of its long-term debt, the Corporation was also able to achieve a settlement with the shareholders of First Preferred shares, Series "A" and Series "B". These outstanding First Preferred shares with a principal balance of $1,641,000 were redeemable on October 1, 1986. In addition, Preferred share dividends due from April 1, 1983 to October 1, 1986 aggregating approximately $700,000 were outstanding. The net settlement arrangement with these First Preferred shareholders resulted in a $1.4 million cash payment along with the issuance of 250,000 Common shares of the Corporation. Further details of this transaction are contained in Notes 5 and 6 of the Notes to the Consolidated Financial Statements.

Expansion of Joint Venture

In March 1986 the Corporation expanded its Joint Venture operations with Centennial Packers Ltd. by including its boxed beef processing and marketing facilities. This rationalization of facilities has resulted in lower unit costs of production, improved productivity, a larger share of the market, and has been instrumental in assisting the Corporation to improve its overall profitability.

Equity Interest in Line Resource Information Inc.

In 1984, the Corporation sold its geophysical operations to Line Resource Information Inc., ("LRI") retaining a 40% equity interest in LRI. The Corporation secured its Note Receivable from LRI by way of a fixed charge debenture.

LRI reported successful results from operations over the 1985-1986 winter, but their financial condition began to deteriorate through the fall and early winter of 1986. This situation was primarily caused by the rapid decline of the western Canadian energy sector which had been severely impacted by low oil prices. In early December 1986, management of your Corporation in conjunction with LRI's principal banker made the decision to place LRI under a court-appointed receiver.

After assessment of the situation, management determined the carrying value of the Corporation's investment in LRI should be written down by approximately $1.8 million. Events which have occurred after the decision by management include a low level of western Canadian oil activity, and discontinuance of federal and provincial government incentives. Management believes future recoveries from the disposal of LRI assets will be more than sufficient to cover the revised carrying value of the Corporation's investment in LRI.

Operating Results

Fiscal 1986 saw consolidated sales increase to $248 million, up $6.2 million from the previous year. Gross margins after direct expenses increased slightly but were hampered by lower than usual volumes of throughput in the cattle feeding operation. General and administrative expenses increased slightly, primarily due to professional fees and other costs associated with the banking situation. Overall interest costs decreased by $1.2 million or 26% principally due to the financial restructuring arrangements with the CCB-In Liquidation.

Operating results have improved significantly, however, compared to fiscal 1985. Loss for fiscal 1986 before extraordinary items amounted to $305,000 (6 cents per share) compared to $1.6 million (34 cents per share) in 1985. Net loss after extraordinary items amounted to $1.5 million compared to net income after extraordinary items of $2.7 million in fiscal 1985. Working capital provided from operations amounted to $1.3 million for fiscal 1986 compared to $16,000 for the same period of the prior year. Additions to fixed assets amounted to $1.2 million for fiscal 1986 compared to $.9 million for fiscal 1985. Working capital amounted to $3.7 million at September 30, 1986, a decrease of $.8 million from fiscal 1985.

Financial Summary

Important steps were taken this year which will assist the Corporation to return to profitability. The financial strength of XL Food was significantly improved in 1986 by reducing and restructuring long-term debt amounting to $8.5 million and increasing its shareholders' equity by $6.5 million.

The establishment of new banking facilities concludes a year filled with uncertainty and non-recurring costs the Corporation incurred unnecessarily by the decision to liquidate the Canadian Commercial Bank. Despite this very difficult and costly situation, your Corporation was successful in achieving the objectives noted in the 1985 Financial Review.

With problems and costs associated with the lack of permanent banking facilities now concluded, the beef slaughtering and processing operations are more efficient and profitable than ever before. The trend in profitability has continued for the first quarter of fiscal 1987, and your Corporation looks to the future with renewed vigor in becoming a leading Canadian food company.

XL FOOD SYSTEMS LTD.
(formerly L.K. Resources Ltd.)

Consolidated Balance Sheet
September 30, 1986

Assets

	1986	1985
Current assets:		
Cash	$ 115,000	—
Accounts receivable	16,019,000	15,853,000
Inventories, at lower of cost and net realizable value	7,734,000	6,602,000
Prepaid expenses	89,000	117,000
Total current assets	23,957,000	22,572,000
Assets held for disposal (Notes 2 and 5)	3,474,000	6,012,000
Fixed assets, less accumulated depreciation and amortization (Note 3)	27,327,000	27,726,000
Other assets (Note 4)	6,570,000	7,002,000
	$61,328,000	63,312,000

On behalf of the Board:

, Director

Graham W. Hussey, Director

See accompanying notes.

Liabilities

	1986	1985
Current liabilities:		
Due to bank (Note 5):		
Bank overdraft	$ —	1,328,000
Bank loans	13,927,000	12,342,000
Accounts payable and accrued liabilities	5,459,000	3,425,000
Current portion of long-term debt	830,000	912,000
Total current liabilities	20,216,000	18,007,000
Income debenture (Note 5)	—	12,800,000
Long-term debt, net of current portion (Note 5)	13,808,000	13,432,000
Non-interest bearing term loan (Note 5)	4,078,000	—
Deferred income taxes	722,000	1,633,000
Minority interest – cumulative, retractable, redeemable preferred shares of subsidiary	221,000	221,000
Shareholders' equity:		
Share capital (Note 6)	12,089,000	5,543,000
Contributed surplus	352,000	352,000
Appraisal surplus	11,525,000	11,541,000
Retained earnings (deficit)	(1,221,000)	245,000
	22,745,000	17,681,000
Less: Shares held for employee stock purchase plan	(462,000)	(462,000)
	22,283,000	17,219,000
Contingent liability (Note 9)		
	$61,328,000	63,312,000

Auditors' Report to the Shareholders

We have examined the consolidated balance sheet of XL Food Systems Ltd. as at September 30, 1986 and the consolidated statements of income and deficit and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the Corporation as at September 30, 1986 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Calgary, Canada
December 19, 1986

Peat, Marwick, Mitchell & Co.
Chartered Accountants

XL FOOD SYSTEMS LTD.

(formerly L.K. Resources Ltd.)

Consolidated Statement of Income and Deficit

Year ended September 30, 1986

	1986	1985
Sales	$ 248,007,000	241,883,000
Expenses:		
Direct	241,854,000	235,867,000
General and administrative	1,588,000	1,527,000
Interest – long-term	1,798,000	1,795,000
– other	1,588,000	1,501,000
Depreciation and amortization	1,784,000	1,775,000
	248,612,000	242,465,000
Loss before income taxes, income debenture interest and extraordinary items	(605,000)	(582,000)
Income taxes (Note 7):		
Current (recovered)	(47,000)	—
Deferred (recovered)	(253,000)	(255,000)
	(300,000)	(255,000)
Loss before income debenture interest and extraordinary items	(305,000)	(327,000)
Income debenture interest	—	(1,269,000)
Loss before extraordinary items	(305,000)	(1,596,000)
Extraordinary items (Note 8)	(1,177,000)	4,289,000
Net income (loss)	(1,482,000)	2,693,000
Retained earnings (deficit), beginning of year	245,000	(2,448,000)
Realized gain on appraised lands	16,000	—
Retained earnings (deficit), end of year	$ (1,221,000)	245,000
Income (loss) per share:		
Before extraordinary items	$(.06)	(.34)
Extraordinary items	(.24)	.86
	$(.30)	.52

See accompanying notes.

XL FOOD SYSTEMS LTD.

(formerly L.K. Resources Ltd.)

Consolidated Statement of Changes in Financial Position

Year ended September 30, 1986

	1986	1985
Funds provided from (used for) operations:		
Loss before extraordinary items	$ (305,000)	(1,596,000)
Add:		
Non-fund items	1,594,000	1,612,000
Working capital provided from operations	1,289,000	16,000
Decrease in non-cash working capital balances	764,000	293,000
Net funds provided from operations	2,053,000	309,000
Investing activities:		
Additions to fixed assets	(1,244,000)	(872,000)
Decrease (increase) in other assets	160,000	(562,000)
Special project expenditures	—	(228,000)
	(1,084,000)	(1,662,000)
Proceeds on sale of fixed assets	771,000	70,000
Proceeds on sale of oil and gas properties	—	9,164,000
	(313,000)	7,572,000
Financing activities:		
Issue of long-term debt	119,000	94,000
Issue of common shares	241,000	—
Conversion of First Preferred shares, Series "B" to Common shares	(241,000)	—
Issue of First Preferred shares, Series "C"	6,546,000	—
Redemption of Preferred shares of subsidiary	—	(75,000)
Reduction of long-term debt	(8,547,000)	(8,124,000)
Increase in assets held for disposal	—	(750,000)
	(1,882,000)	(8,855,000)
Net increase in short-term bank indebtedness	(142,000)	(974,000)
Short-term indebtedness, beginning of year	(13,670,000)	(12,696,000)
Short-term indebtedness, end of year	$(13,812,000)	(13,670,000)
(Increase) decrease in non-cash working capital balances:		
Accounts receivable	$ (166,000)	616,000
Inventories	(1,132,000)	467,000
Prepaid expenses	28,000	96,000
Income taxes payable	—	(53,000)
Accounts payable and accrued liabilities	2,034,000	(833,000)
	$ 764,000	293,000

See accompanying notes.

Notes to the Consolidated Financial Statements

September 30, 1986

1. Significant accounting policies:

(a) Principles of consolidation

At the Special and Annual General Meeting of Shareholders held on March 18, 1986 it was resolved as a special resolution that the Articles of the Corporation be amended to change the name of the Corporation from L.K. Resources Ltd. to XL Food Systems Ltd. The consolidated financial statements include the accounts of XL Food Systems Ltd. and its subsidiaries.

(b) Joint Venture Accounting

The Corporation operates principally in the agribusiness beef production field which is comprised of an integrated operation of raising, feeding, slaughtering and processing of cattle, along with feed and grain production. All of the Corporation's slaughtering and processing operations are conducted jointly with another party. The joint venture accounts consist only of current assets, current liabilities, other than bank operating loans, and revenues and expenses arising from day-to-day operations. Ownership of the fixed assets and other non-current assets of these operations remain with the joint venture participants. Each joint venture participant is responsible for its own current liabilities and maintains separate banking arrangements and provides separate security to its own lenders on the assets of its own facilities. Accordingly, the consolidated financial statements reflect only the Corporation's proportionate interest in the current assets, current liabilities, revenues and expenses of the joint venture.

(c) Depreciation and amortization

Depreciation is provided on the straight-line method using the following rates which are designed to depreciate or amortize the assets over their estimated useful lives:

Assets	Rate
Buildings	2½ - 10%
Vehicles and moveable equipment	10 - 30%
Machinery, equipment, furniture and fixtures	10 - 20%
Fences, wells and dugouts	5 - 10%

Financing costs are being amortized on the straight-line method over a five-year period.

(d) Foreign exchange

Accounts of the United States subsidiary have been translated to Canadian funds under the temporal method on the following basis:

Monetary assets and liabilities at the exchange rate on September 30, 1986.

Non-monetary assets and liabilities at the rate of exchange prevailing when acquired or incurred.

Revenue and expenses (excluding depreciation and amortization which are translated at the same rate as the related assets) at the average rate of exchange for the year. Gains and losses arising from foreign currency translation of current items are included in the determination of net income for the year, while those of non-current items are amortized over their remaining lives.

(e) Goodwill

Goodwill is being amortized on a straight-line basis over thirty years.

(f) Appraisal surplus

In 1979, a predecessor company obtained mortgage financing secured by lands. Certain of the lands securing this mortgage had an appraised value of $17,634,000. Accordingly, the Board of Directors approved the recording of the excess of the appraisal value over the previous carrying value which amounted to $16,575,000 on which a provision for income taxes of $3,900,000 has been provided and credited to deferred income taxes. The appraisal value of the lands was determined by Floen Appraisals Ltd., as of March 5, 1979; all other lands are carried at cost. Certain of these lands have been sold resulting in $1,150,000 of the appraisal surplus being realized.

(g) Comparative figures

Certain comparative figures for 1985 have been reclassified to conform with 1986 presentation.

(h) Net income (loss) per share

Net income (loss) per common share is based on the monthly weighted average number of common shares outstanding.

2. Assets held for disposal under the Restructuring Agreement (at estimated realizable value):

	1986	1985
Accounts receivable	$ 749,000	749,000
Notes receivable	1,500,000	3,844,000
Investments	500,000	80,000
Land	268,000	433,000
Buildings	327,000	648,000
Other	130,000	258,000
	$ 3,474,000	6,012,000

3. Fixed assets, at cost, except land:

Land	$17,190,000	17,210,000
Buildings	8,704,000	8,630,000
Vehicles	972,000	942,000
Machinery and equipment	9,321,000	8,574,000
Furniture and fixtures	468,000	446,000
Land improvements	465,000	426,000
Fences, wells and dugouts	744,000	742,000
	37,864,000	36,970,000
Accumulated depreciation and amortization	(10,537,000)	(9,244,000)
	$27,327,000	27,726,000

4. Other assets:

Notes receivable, net of current portion	$ 119,000	224,000
Goodwill, at cost less accumulated amortization of $1,443,000 (1985 - $1,196,000)	6,009,000	6,256,000
Financing costs, less accumulated amortization of $983,000 (1985 - $877,000)	259,000	340,000
Other, at cost	183,000	182,000
	$ 6,570,000	7,002,000

5. Long-term debt:

10¾% (1985 - 13½%) first mortgage, payable in monthly installments including interest of $79,000 (1985 - $92,000), secured by certain lands and premises situated in Alberta, due June 25, 1988	$ 6,700,000	6,948,000
Term bank loan, interest at prime plus 1½%, payable in monthly installments including interest of $83,500, secured by mortgage on certain lands, buildings and equipment	5,974,000	6,483,000
Term bank loan, interest at prime plus 1¾%, payable in monthly installments, including interest of $16,000, secured by mortgage on certain lands, buildings and equipment	1,400,000	—
Obligations under capital leases	213,000	235,000
Other	351,000	678,000
	14,638,000	14,344,000
Deduct current portion	(830,000)	(912,000)
	$13,808,000	13,432,000

Restructuring Agreement:

In September 1986 the Corporation negotiated a restructuring of its principal long-term debt with the Canadian Commercial Bank – In Liquidation, and obtained new banking lines of credit with Province of Alberta Treasury Branches. Although the closing date of these transactions occurred subsequent to September 30, 1986, the accompanying consolidated financial statements give effect to this restructuring arrangement.

Under the terms of a Restructuring Agreement the Canadian Commericial Bank – In Liquidation, ("CCB"), has converted its income debenture aggregating $10,624,000 into 65,453 First Preferred shares, Series "C" of the Corporation having an ascribed value of $6,546,000, and a $4,078,000 non-interest bearing term loan due January 1, 1990.

The non-interest bearing term loan aggregating $4,078,000 is secured by a fixed and specific charge on certain assets of the Corporation, which have been classified as "Assets held for disposal" in the accompanying consolidated balance sheet.

Proceeds from the disposition of these assets are dedicated to the reduction of the non-interest bearing term loan and to the extent the proceeds exceed the balance of the term loan outstanding, the Corporation shall apply such excess towards the redemption of the First Preferred shares, Series "C". To the extent that the proceeds on the disposition of the "Assets held for disposal" are less than $4,078,000 and in excess of $3,500,000, the Corporation will, on January 1, 1990, issue additional First Preferred shares, Series "C" for such deficiency on the basis of one First Preferred share, Series "C" for each $100 of deficiency.

In addition, the Corporation borrowed $1,400,000 under its new banking arrangements and applied such funds towards the reduction of the indebtedness to CCB. CCB then purchased 14,000 First Preferred shares, Series "B" from the existing Preferred shareholders. The 14,000 First Preferred shares, Series "B" held by the CCB have been converted to 14,000 First Preferred shares, Series "C".

Principal repayments of the Corporation's long-term debt in each of the next five years, are as follows:

1987	$830,000
1988	789,000
1989	812,000
1990	822,000
1991	907,000

All bank indebtedness is secured by general assignments of accounts receivable and a pledge of inventories. In addition, a first, fixed and floating charge debenture, aggregating $35,000,000 has been issued as additional security with specific charges against certain lands, buildings and equipment, subject to permitted encumbrances. The Corporation's present revolving lines of credit aggregate $18,500,000.

6. Share capital:

	1986	1985
First Preferred Shares without nominal or par value.		
Authorized 200,000 shares; issued:		
Nil, (1985 - 16,414) 8¾% Cumulative Redeemable Preferred shares, Series "A"	$ —	—
Nil, (1985 - 20,000) 7% Cumulative Redeemable Convertible First Preferred shares, Series "B"	—	1,641,000
79,453, (1985 - Nil) 7½% Non-cumulative Redeemable First Preferred shares, Series "C"	7,946,000	—
78,000, (1985 - Nil) 7% Non-cumulative Redeemable Convertible First Preferred shares, Series "D"	—	—
Common shares without nominal or par value. Unlimited authorized number of shares; Issued 5,263,844 shares (1985 - 5,013,844 shares)	4,143,000	3,902,000
	$12,089,000	5,543,000

At the Special and Annual General Meeting of Shareholders held on March 18, 1986, it was resolved as a Special Resolution that the Articles of the Corporation be amended to change the designation of the Class "A" Special shares and Class "B" Non-voting shares to Common Shares, and to change the number of authorized Common Shares to an unlimited number.

As outlined in Note 5 under the terms of a restructuring agreement, the Corporation has issued 65,453 First Preferred shares, Series "C" and converted 14,000 First Preferred shares, Series "B" to 14,000 First Preferred shares, Series "C".

The First Preferred shares, Series "C" are designated as 7½% non-cumulative, non-voting, redeemable preferred shares, without nominal or par value. The Corporation may redeem, at stated value, at any time, the whole or any part of the outstanding First Preferred shares, Series "C". No dividend or redemption of these shares, is required prior to December 31, 1989. Dividends shall be payable annually on the first day of January in each year and shall accrue from January 1, 1990. The Corporation shall apply 30% of its net cash flow (as defined), to payment of the dividend amount in cash. To the extent that 30% of net cash flow exceeds the dividend amount, the excess shall be applied towards a redemption of the First Preferred shares, Series "C". To the extent that 30% of net cash flow is less than the dividend amount, the Corporation shall issue additional First Preferred shares, Series "C" to Series "C" shareholders on the basis of one First Preferred share, Series "C" for each $100 deficiency.

First Preferred shares, Series "C" may also be redeemed from proceeds on the disposition of "Assets held for disposal" as outlined in Note 5.

In addition, the Corporation has exchanged 250,000 Common shares in the capital of the Corporation for the remaining outstanding 2,414 First Preferred shares, Series "B" held by the existing Preferred shareholders.

The restructuring agreement also provides for the granting of an option, by the Corporation to the Canadian Commercial Bank – In Liquidation, to acquire 1,002,769 Common shares of the Corporation at $0.75 per share. The option may be exercised at any time during the option period, January 1, 1990 to December 31, 1991. However, if prior to December 31, 1989, the Corporation has repaid the non-interest bearing term loan, redeemed all of the First Preferred shares, Series "C" and paid a fee of $750,000 to the optionee, the option agreement shall be terminated.

As part of the refinancing, the Government of the Province of Alberta has entered into an Interest Deficiency Guarantee Agreement with the Province of Alberta Treasury Branches. The Government has guaranteed all "interest deficiencies" as defined for a five year period commencing January 1, 1987. The guarantee is non-cumulative and the Government's maximum guarantee to the Province of Alberta Treasury Branches is $1,500,000 per annum.

In consideration of the Government entering into the Guarantee Agreement, the Corporation has issued, to an escrow agent, 75,000 First Preferred shares, Series "D", having an issue and redemption price of $100 per share, along with an additional 3,000 First Preferred shares, Series "D" to cover dividends potentially payable pursuant to such Preferred shares.

At such time as Treasury Branches makes a demand for monies under the Guarantee Agreement, the escrow agent will transfer such number of First Preferred shares, Series "D" to the Government of the Province of Alberta, equal in face value to the amount of funds provided by the Government. First Preferred shares, Series "D" not required to be released from escrow in any fiscal year, under the terms and conditions of the Guarantee Agreement, shall be cancelled.

The First Preferred shares, Series "D" are designated as 7% non-cumulative, non-voting, redeemable, convertible preferred shares without nominal or par value. The Corporation may redeem at any time, the whole or any part of the outstanding First Preferred shares, Series "D". Dividends shall be payable by issuance of like Preferred shares. The holder shall be entitled, at the holder's option, to convert the First Preferred shares, Series "D" to Common shares of the Corporation at a price equal to eighty percent (80%) of an averaged price as listed on the Toronto Stock Exchange during the period prior to the time of conversion to Common shares.

Notwithstanding anything else contained in the conditions attached to the First Preferred shares, Series "D", the Preferred shares shall not be convertible to the extent that, by virtue of any such conversion together with any previous conversion, the holder of such Preferred shares would become the holder in the aggregate of 10% or more of the Common shares of the Corporation issued and outstanding at any one time.

The Corporation has further agreed, subject to Treasury Branches concurrence, and subsequent to the total redemption of the First Preferred shares, Series "C", that the First Preferred shares, Series "D" shall be redeemed on the same basis as the redemption formula for First Preferred shares, Series "C".

Under the Employee Stock Purchase Plan the Corporation has authorized and issued 157,000 Common shares at September 30, 1986.

Under the Employee Stock Option Plan the Corporation has authorized 343,000 Common shares. During 1986 options aggregating 121,000 Common shares were granted at a price of $0.52 per share. Options aggregating 68,000 Common shares were cancelled during the year. The Options are exercisable at 20% per year on a cumulative basis and are for a term of six years. Total shares reserved under the option plan aggregate 322,750 Common shares at September 30, 1986.

7. Income taxes:

Income tax recovery differs from the amount that would have been expected if the reported pre-tax loss was subject to the combined Federal and Provincial tax rates for the year. The principal reasons for the difference between such "expected" income tax recovery and the amount actually recovered are as follows:

	1986	1985
Computed "expected" income tax recovery	$ 295,000	276,000
Add (deduct):		
Amortization of goodwill	(124,000)	(140,000)
Inventory allowance	21,000	43,000
Manufacturing and processing credit	(19,000)	10,000
Drawdown of deferred income taxes accumulated at different rates	38,000	59,000
Income subject to United States taxes at lower effective rates	5,000	35,000
Unrecognized tax benefit of losses carried forward of subsidiaries	—	(4,000)
Non-deductible losses of equity investment	—	(108,000)
Non-taxable portion of capital gain	40,000	—
Other	44,000	84,000
	$ 300,000	255,000

8. Extraordinary items:

	1986	1985
Provision for write down of assets held for disposal (net of deferred income tax of $585,000; 1985 - $128,000)	$ (1,250,000)	(268,000)
Gain on sale of oil and gas properties (net of deferred income tax of $805,000)	—	4,499,000
Costs of abandonment of special project (net of deferred income tax of $61,000)	—	(167,000)
Reduction of income taxes arising from application of losses carried forward	73,000	225,000
	$ (1,177,000)	4,289,000

9. Contingent liability:

A statement of claim has been filed against the Corporation by a former employee for wrongful dismissal in the amount of approximately $250,000. The Corporation does not believe the claim has any substance and accordingly has not provided for any liability in its accounts.

XL FOOD SYSTEMS LTD.

Corporate Information

Officers

Gerald E. Kaumeyer
Chairman of the Board

Gorham W. Hussey
President and Chief Executive Officer

T. Peter Luzi
Senior Vice-President

G. David Michaels
Secretary/Treasurer

Directors

Ralph B. Bunje Jr.
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Partner of Bunje Buss & Lloyd

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Balzac, Alberta
Farmer

Donald J. Douglas
Calgary, Alberta
Vice-President and General Manager
United Management Ltd.

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Associate Professor
Faculty of Management
University of Calgary

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President and Chief Executive Officer
XL Food Systems Ltd.

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Chairman of the Board
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T. Peter Luzi
Calgary, Alberta
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Printed in Canada