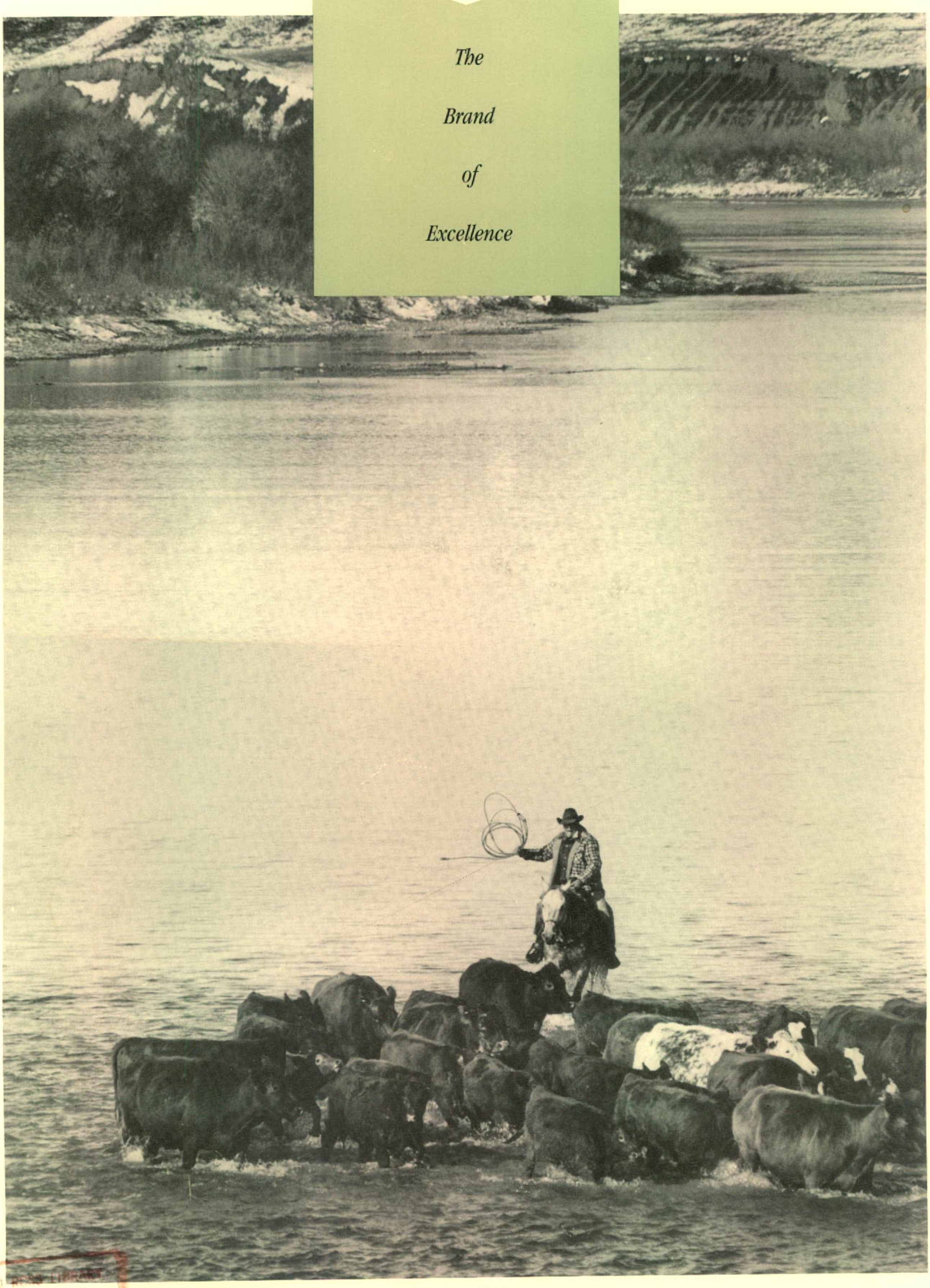
XL FOOD SYSTEMS LTD.

The

Brand

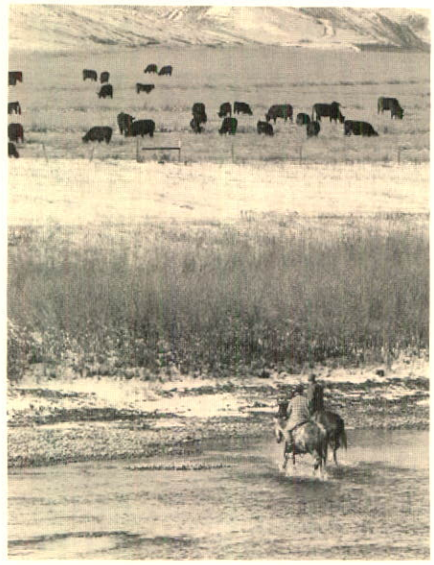
of

Excellence



1987 Annual Report

CORPORATE PROFILE



XL Food Systems Ltd., a Canadian corporation, is the largest Alberta-based producer of beef and beef products. The Corporation is the only fully integrated beef operation in Canada with profit centres involved in every phase of beef production — from the raising of calves to providing large retailers and wholesalers premium quality cuts of beef.

Operations of the Corporation are divided into two areas of activity. The Agricultural Division provides a vital link in the food production chain. The operations include LK Ranches, XL Custom Feeding and XL Feeds Ltd. The expertise and experience developed during the Company's 100-year ranching history has positioned XL as a leader in animal husbandry and made the XL brand of beef synonomous with quality.

Under its Beef Processing Division, XL and its joint venture partner operate five beef processing plants and a nation-wide food distribution system. The Calgary-based facilities consist of two slaughter plants where fed cattle are processed for the wholesale carcass market; two boxed beef plants where carcasses are further converted into vacuum-packed sub-primals for the retail and hotel, restaurant and institutional (HRI) food trades; and lastly, a boning plant which produces boneless beef and other value-added products for the retail market.

The 1987 fiscal year was highlighted by substantial success. The joint venture between XL Food Systems and another major industry beef processor achieved significant new efficiencies and inroads into the marketplace. The management team was strengthened in 1987 and our new natural beef program was implemented. We expect these factors, combined with the identification and marketing of new products for niche markets will continue to enhance XL's financial and operating growth in 1988.

XL Food Systems Ltd. (formerly L.K. Resources Ltd.) became a public company in October 1979. The Company trades on both the Alberta and Toronto Stock Exchanges under the symbol XLF.

FINANCIAL HIGHLIGHTS

	1987	1986	1985	1984	1983
(Thousands of dollars except per share amounts)					
Gross revenue	235,998	228,362	241,883	229,538	153,498
Total assets	64,931	61,312	63,312	69,084	68,027
Net income (loss)	(94)	(1,482)	2,693	480	(5,094)
Net income (loss) per share	(.02)	(.30)	.52	.06	(1.08)
Working capital provided (used) from operations	1,819	1,289	16	4,541	(4,518)
Working capital (deficiency) at year end	3,483	3,741	4,565	3,808	(3,286)
Capital expenditures net of proceeds	1,178	673	802	(4,881)	373
Common shareholders' equity	14,278	14,337	15,578	12,885	12,405
Common shareholders' equity per share*	2.69	2.72	3.10	2.57	2.47

*Including Class A Special and Class B Non-Voting shares

REPORT TO SHAREHOLDERS

For XL Food Systems Ltd., 1987 was, without question, one of the most positive years the Company has experienced since 1982. Over this five year period we have encountered a variety of harsh circumstances including a nation-wide recession, severe drought, a collapse in beef and crop prices, and a severe rationalization of the beef industry. But through this, XL adapted and responded in a positive manner.

The operating environment in 1987 continued to present new challenges. At the forefront once again was industry rationalization — a condition which is expected to continue to the end of this decade. We are certain that this process will result in further closures of inefficient and uncompetitive beef processing plants. Since 1975 for instance, 15 federally inspected beef slaughter plants across Canada have shut down. Declining beef consumption along with competition for a reduced number of slaughter cattle are the two primary factors influencing the rationalization trend in North America.

Beef consumption peaked in 1976 at approximately 113 pounds per capita, has since fallen to 86 pounds per capita and is expected to level out at 75 pounds per capita by 1990. The reduction in slaughter cattle supplies which has occurred over the past decade was exaggerated in 1987 with large shipments of live, high-grade slaughter cattle going to the United States. Adding to this problem was the fact that the United States was allowed to export its ungraded or "no-roll" beef into Canada. For the most part this product was of lower grade and price. The net effect is that Canadian producers like XL were faced with a reduced supply of slaughter cattle, increased cattle prices, increased competition for market share and reduced gross margins.

XL's response was to identify and pursue strategies that would allow the Company to maximize the profit margins available in this environment. Specifically, the Company entered into a joint venture with Centennial Packers Ltd. in an effort to become more efficient and cost effective. Initiated two years ago, 1987 was the first full year of operation with a complete blending of the joint venture's beef processing and distribution operations. The joint venture enabled XL to streamline activities by eliminating processing duplications, reduce operating costs through bulk buying and segregate specialized operations.

Overall, the joint venture, the strengthening of the management team and the introduction of our new Natural Beef Program have had a very favorable impact on XL's operating and financial performance. Though we must still report an operating loss before income taxes of \$29,000, this represents a significant improvement over a similar loss of \$1,024,000 in 1986. We were particularly pleased by the fact that our working capital from operations increased by 38 per cent from \$1.3 million in 1986 to \$1.8 million in 1987. Similarly, sales increased in 1987 to \$236 million from \$228 million in 1986. For XL, the positive financial trend signals a return to profitability and financial strength. In addition, it reinforces the viability of the joint venture and its impact on efficiency and cost reductions.

Today, XL finds itself firmly positioned in the beef industry. Together with our joint venture partner, we command a major share of both the Alberta slaughter market and the Canadian and Alberta boxed beef market. However, with Cargill Ltd., a major United States meat packer, setting up a plant in southern Alberta in 1989, XL must continue to look at imaginative and workable solutions to maintain our position in the industry. In the following year XL will continue to review a feasibility study currently under way to consolidate the five beef processing facilities. This would in turn enable the Company to achieve maximum efficiency and cost savings. To achieve such a goal XL is also reviewing the possibility of a formal combination with our joint venture partner along with financing alternatives. Such arrangements would enhance XL's position in the beef industry and allow us to remain a competitive, viable entity.

A factor which is sure to have a significant impact on XL in the years to come and an event which we eagerly await is the final signing and implementation of a free trade agreement with the United States. Although the beef industry already operates in a relatively open market, a free trade agreement is looked upon as a positive step in eliminating the tariffs and non-tariff trade barriers which do exist. Such action would provide Canadian producers access to U.S. feeder cattle supplies as well as open up new U.S. markets for beef products. The fact that the Canadian beef grading system is more strict and places a higher value on quality lean beef than does the American grading system could give XL a marketing advantage in targeting these U.S. markets.

XL is very proud of the achievements and progress realized in 1987. There is no doubt that much of this success must be attributed to our employees and the innovative efforts of the joint venture management team. We are confident that these groups, together with the Board of Directors, will see XL continue to grow, compete and succeed in the future.

On behalf of the Board of Directors,

Gerald E. Kaumeyer
Chairman of the Board,
President and Chief Executive Officer

The following are members of XL's joint venture management team. Back row, left to right: Tony Ruffo, Plant Manager, Montagne-Foothills; Norman Duclos, Plant Manager, Montagne-Bonnybrook; Bill Watkin, General Manager, Slaughter and Fabrication; Wayne Proceviat, Plant Manager, XL Beef. Front row: Fred Free, Plant Manager, Montagne-Foothills; Bill McGill, Plant Manager, Centennial Plant; Larry Roble, Plant Manager, Dearborn Plant; Barry Reimer, General Manager, Food Services.

OPERATIONS REVIEW

In 1987, the management team was strengthened and the Company achieved greater efficiency and significant inroads into the marketplace in Canada and internationally.

JOINT VENTURE

Background

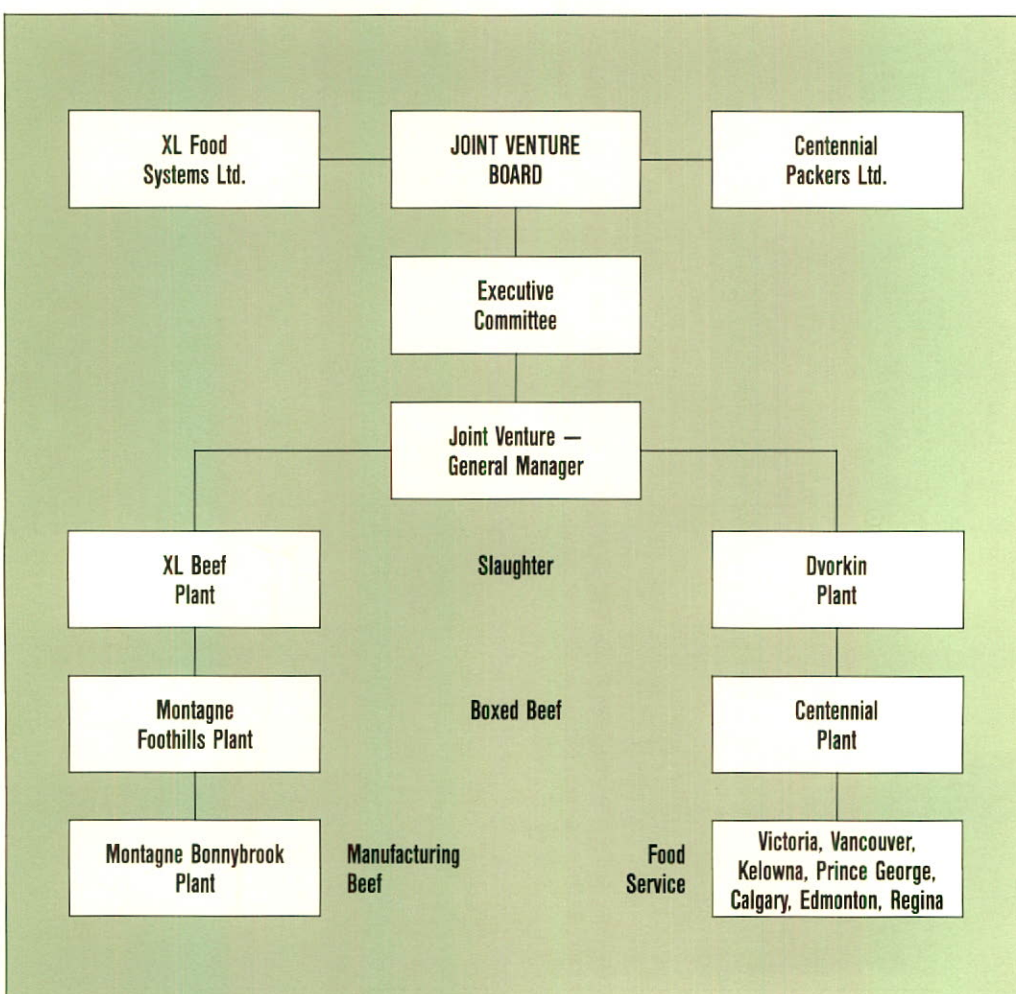
The joint venture between XL Food Systems Ltd. and Centennial Packers Ltd. was initiated in 1985 when the two slaughter operations combined to remove duplication of effort in slaughtering, cattle buying and sales. This first step proved very successful. Both companies recognized that further benefits could be achieved if the beef processing facilities were fully integrated. Therefore, in April 1986 the second stage of the joint venture was implemented, bringing together both companies' boxed beef facilities and food distribution systems. The positive impact of the alliance is clear — after the first full year of operation the joint venture has captured the major share of the Canadian boxed beef market.

Environment

The joint venture is a very positive response to an uncertain environment. The beef industry in North America has been characterized by reduced cattle supply and ongoing rationalization for several years. During 1987 the number of processing plants was further reduced and we experienced an industry-wide consolidation of operations. Another factor affecting the beef industry was increased competition for slaughter cattle because of large numbers of live Alberta cattle moving south of the border to U.S. slaughter facilities.

A final but prominent factor influencing the operating environment for the joint venture and the beef industry as a whole, is the steady decline of per capita beef consumption in North America. The decline

Joint Venture Structure



which began in 1976 is expected to level out by 1990. Influencing this decline in consumption is a reduced cattle supply, competition from pork, poultry and other non-meat protein alternatives as well as misinformation regarding cholesterol and calorie levels of lean Alberta beef. To address this last point, the industry sponsored a promotional and educational campaign to communicate the nutritional facts of beef to consumers and retailers. This campaign appears to be having a positive impact on consumers' attitudes toward beef.

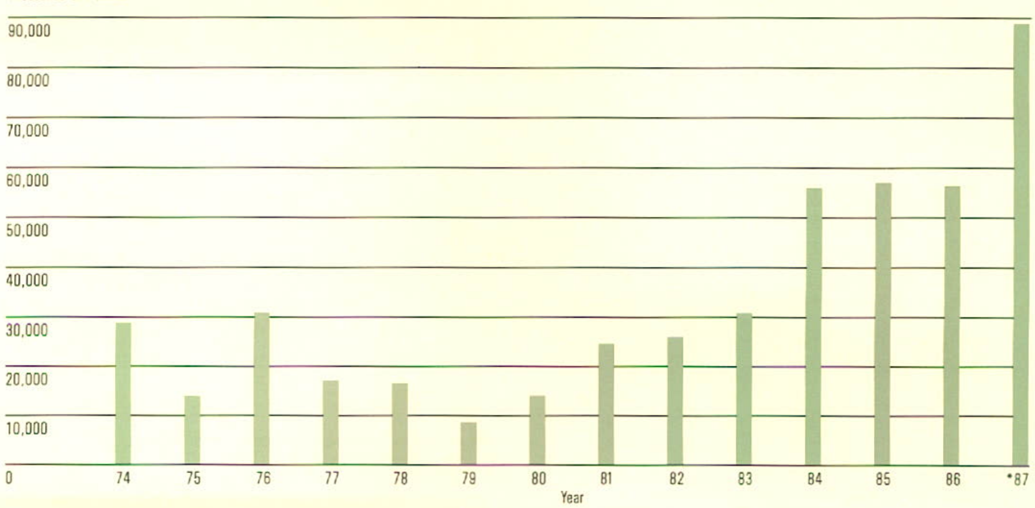
Achievements

Despite this uncertain operating environment, XL realized substantial achievements in 1987. First and foremost, the combined forces of the joint venture launched the two companies from a position of follower to that of leader in the beef industry. Today, the joint venture enjoys the largest share of both the Alberta cattle slaughter market and the boxed beef market.

Another positive result of the joint venture has been the complementary integration of the two companies' marketing and distribution networks which target the entire wholesale and retail market as well as the hotel, restaurant and institutional trade. Our enhanced marketing capability was highlighted recently when we received, for the second consecutive year, the Export Achievement Award from Alberta Economic Development and Trade, acknowledging our 1986 export performance in international marketing. During 1987 our exports continued to expand, with an increase in sales to the United States and Pacific Rim countries. This past year, the joint venture was also successful in penetrating the Hong Kong market for the first time by negotiating Canada's first major sale of beef into this market.

Beef Imports from the United States

Thousands of Pounds



Source: Statistics Canada

*Estimate

To meet growing competition at home and from the United States, XL and its joint venture partner are pursuing the enhancement of by-product recovery systems and further development of value-added products.

AGRICULTURAL OPERATIONS

Vital Link

XL Food's agricultural operations command a leading role in Alberta's beef industry. This distinction is a consequence of two factors — a successful 100-year operating history and the ability to incorporate into XL's operations, efficient, technologically advanced farming, ranching and cattle feeding methods. Today, these operations represent a vital link in the Corporation's vertically integrated beef production chain.

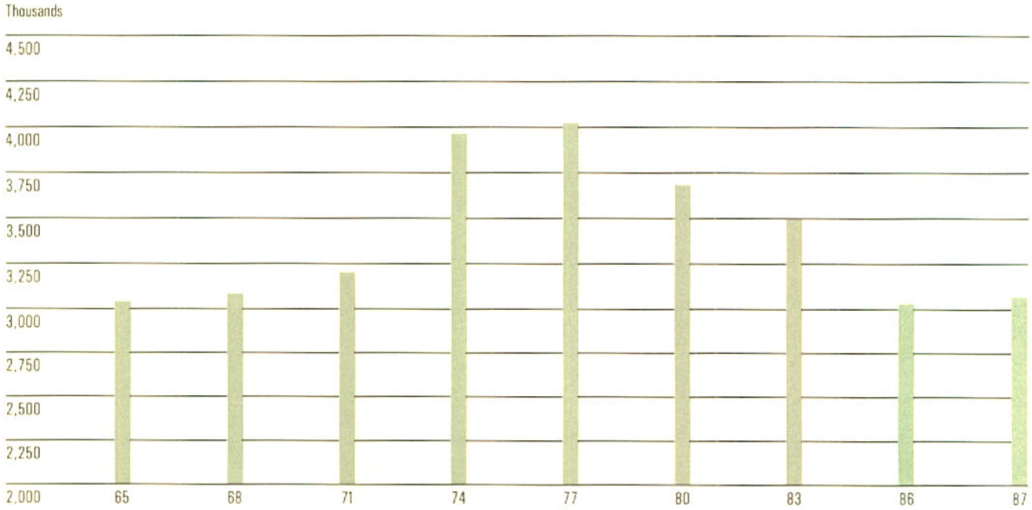
The Agricultural Division consists of extensive farm and ranching operations located near Bassano, Alberta. This division encompasses LK Ranches which is one of the largest ranching operations in Alberta, consisting of 77,000 acres of deeded and Crown-leased lands. Included in this area is approximately 12,000 acres of dryland farming, some of which has been converted back to pasture this year to complement our feeding operations and minimize grain farming expenses. A second component is XL Custom Feeding, a cattle backgrounding and fattening operation which is capable of feeding up to 25,000 head of cattle at any one time. Lastly, there is XL Feeds Ltd., which supplies a complete range of rations and feed supplements for the Company's feedlot operations and local customers. In 1987, XL's ranching and feeding operations saw an increase in both gross margins and production volumes. This increase was due primarily to the introduction of the Natural Beef Program, a unique new program with distinct marketing advantages which enhances the function of the agricultural division, creates added value and further justifies the role of the integrated operations.

Agricultural Profitability

Cattle numbers traditionally follow cyclical patterns brought about by the growth or depletion of cow herds. In the past several years the industry has experienced a depletion or liquidation of cow herds resulting in a reduced supply of slaughter cattle accompanied by higher prices. However, the liquidation trend appeared to have reversed itself in 1987 with Alberta being the first province to show evidence of cow herd expansion. Although we are moving out of the trough of this cycle, a further three years will be required before there will be any appreciable increase in the availability of slaughter cattle. It is anticipated that during this period we should enjoy high cattle prices which, combined with the Natural Beef Program, will continue to be contributing factors to the profitability of XL's agricultural operations.

XL's agricultural operations are a significant asset, allowing the Company to execute precise cost and quality control over every aspect of beef production. From the ranching and feedlot operations to final processing and marketing, these fully integrated operations provide the Corporation with the ability to compete effectively while maintaining superior product quality.

Alberta Cattle Inventories



Source: Canada Agriculture/Alberta Agriculture January 1 Surveys

In 1987, cow herds showed evidence of expansion in Alberta for the first time since 1977.

BEEF PROCESSING OPERATIONS

Primary Function

Another primary function of XL's integrated corporate structure is the beef slaughter and processing operations. These comprise a slaughter plant which is currently the largest single shift slaughter capacity plant in Canada, a boxed beef plant equipped with the most up to date carcass breaking and packaging equipment, and a cow boning plant which is one of the few free-standing efficient cow and rough cut boning operations in western Canada.

Extensive Expertise

As with XL's ranching operations, the Company has gained extensive expertise in the beef processing industry and a reputation for producing the highest-quality, lean beef. Despite this attractive position, the significant rationalization of the beef industry prompted XL to pursue the joint venture with Alberta-based Centennial Packers Ltd. Given that the joint venture operations are now so totally blended, a complete discussion of XL's beef processing operations for 1987 must address the combined facilities in order to give a true operating picture.

Together XL and its joint venture partner operate five Calgary-based beef processing plants and have an extensive sales and distribution network with branches in Victoria, Vancouver, Kelowna, Prince George, Calgary, Edmonton and Regina. The companies also have sales offices in Montreal, Moncton and recently in St. John's, Newfoundland.

Increased Benefits

The joint venture beef processing operations experienced an improved performance in 1987 compared to previous years. This was achieved by minimizing shrink loss and, most importantly, increasing utilization of beef by-products. These benefits were, however, offset to some degree by the continued shortage of slaughter cattle in Alberta. This situation was further aggravated by large shipments of live cattle during the year to the United States. Both factors resulted in limited slaughter supply in Alberta and higher cattle costs which, in turn, reduced the Company's gross margins on beef processing activities.

Another major factor affecting the joint venture and the industry's operating viability is increased competition from "no-roll" boxed beef imports from the United States. These ungraded beef products have been allowed Canada-wide distribution while at the same time Canadian beef products must first be graded before being allowed interprovincial access. The potential impact of this ungraded U.S. product will be to erode the reputation for quality that Canadian beef has established. This is certain to have a negative effect on an already depressed demand for beef products.

Competition Solutions

To meet the growing competition both at home and abroad, XL and its joint venture partner have been examining various operating and product alternatives. One of the considerations includes the feasibility of consolidating the five manufacturing facilities into one world scale plant. Such a plant would duplicate existing plant capacities and market share. However, it would result in significant increases in operating efficiency, increased productivity and further cost savings. An additional competitive advantage currently being pursued is maximizing our by-product recovery systems and further developing value-added products. We believe there are numerous opportunities for the introduction of new value-added beef products with the potential to generate increased profit. Extensive involvement with our retail customers in new product development, a broad exposure to the food service industry and access to international markets gives us a real advantage in introducing new products to new markets.

One major concern in anticipating U.S. competition under free trade is the relative imbalance in labor costs. U.S. plants, in addition to enjoying the economies of scale, have the advantage of substantially lower labor rates than Canada. While productivity in XL's plants is at a level which matches industry standards, the labor cost imbalance remains a factor to be examined. However, with major improvements in the beef processing operations in 1987 and a keen eye focused on the future, XL will continue to operate as an aggressive, competitive and viable corporation.

NEW PRODUCT DEVELOPMENT

Comprehensive Marketing Program

XL, together with our joint venture partner, has developed a comprehensive marketing program which researches, tests and develops a myriad of new product and packaging ideas in the marketplace. In addition, through cooperative alliances with some of our retail customers, the joint venture has been able to assist other companies in the development of products for specific markets. Such arrangements can prove very profitable for both parties.

XL is committed to increasing the availability of value-added beef products and is aggressively pursuing the development and diversification of our product lines. In addition to producing high quality, nutritional beef products for the health conscious market, XL is also addressing growing consumer demand for convenience and single portion food products for the increasing number of one- and two-person households. Included in the Corporation's product line are now the "natural beef" cuts and, under consideration are microwaveable products and retail branded beef items. In addition, XL is also targeting new beef products to be used exclusively for the restaurant or food service industry. This is a growing market which could offer unique opportunities.

Concept to Reality

This year XL was very pleased to see one aspect of its new product development program advance from the concept stage to initial test marketing. In March 1987, XL Foods, in cooperation with the Toronto-based Loblaws Supermarkets Limited, launched the Natural Beef Program — a beef marketing program unique in Canada.

The Natural Beef Program was conceived in the fall of 1986. Loblaws had identified the development of a new consumer trend — expressed by the increasing demand for natural products of all types. The food chain's next step was to identify a company capable of producing a completely natural beef product. Their search led to XL Foods. XL, the only company in Canada with totally integrated beef operations including ranching, feeding and processing, proved to be the logical choice to coordinate and operate a program which required the highest degree of control from calf to consumer.

With the definition of "natural" beef comes several parameters for quality control. The process begins with a careful selection of calves. The calves are then raised in a "natural" environment, and at no time are any artificial additives, preservatives, chemicals, growth accelerators or antibiotics used. The production methods are closely supervised by the management of LK Ranches with all the cattle being fed in XL Custom Feeding facilities.

"Natural" Quality Ensured

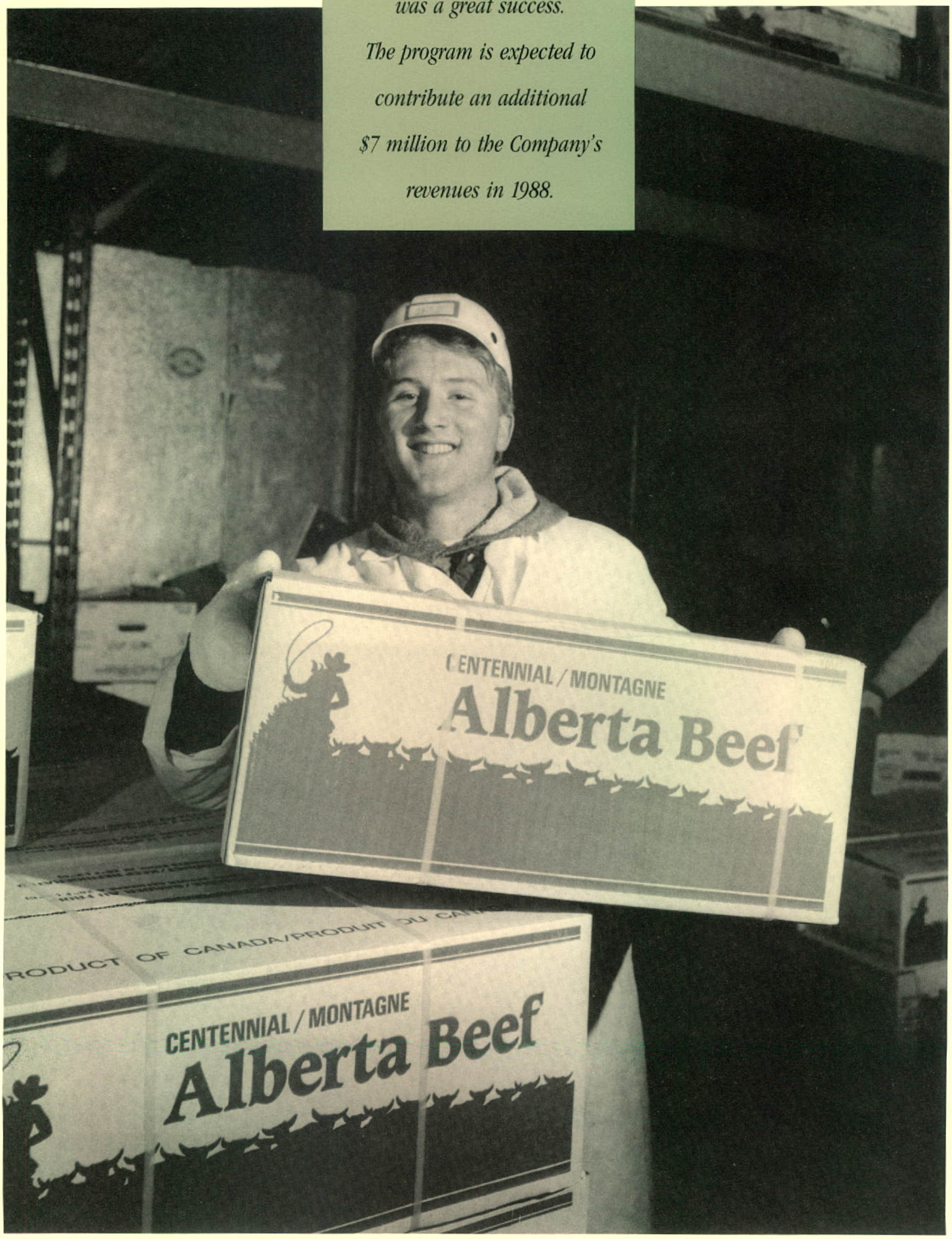
Controls are enforced from the time a calf is born through to the time the beef is processed, packaged and distributed. This ensures that all the requirements and standards for health and quality meet the "natural" criteria. If at any time a calf fails to meet the Natural Beef health requirements, it is removed from the program, thereby ensuring that the distributor and the consumer receive the product they expect.

In 1987, XL commenced delivery of Natural Beef to Loblaws for distribution to their Ontario outlets. The product was marketed under Loblaws' brand name Natural Choice™. The fact that a segment of consumers are demanding more natural food products and are willing to pay a reasonable premium is evident from the overwhelming response to initial Natural Choice sales. Due to the success of the test marketing phase, Loblaws has requested an increased supply of natural beef during 1988. With this increase, the Natural Beef Program will continue to have a positive influence on XL's operating and financial position.

Programs such as Natural Beef emphasize the advantage of integrated operations. We are confident that integration will continue to provide XL with an avenue to unique marketing opportunities. This feature, combined with an aggressive, creative marketing and product development team, will allow XL to remain competitive and to focus on the changing needs and demands of various consumer markets, both large and small. This last point also reinforces the fact that the Natural Beef Program does just that — fills a consumer niche which demands specific characteristics. Such programs add a new dimension to XL's other high-quality beef products.

Boxed beef from XL's Montagne Meats plant is loaded for shipment to retail outlets in Montreal, Quebec.

Test marketing of XL's new Natural Beef Program was a great success. The program is expected to contribute an additional $7 million to the Company's revenues in 1988.



1987 FINANCIAL REVIEW

Although operating results for fiscal 1987 report a net loss, it is a dramatic improvement over the losses recorded in the two previous years. This upward trend lends credence to the viability of the joint venture with Centennial Packers Ltd. and the positive impact it will continue to exert on XL's operating and financial performance.

To a large degree XL Food's financial figures for the fiscal year reflect the negative impact experienced in the fourth quarter of high slaughter prices and a reduced cattle supply. This situation, in conjunction with lower commodity prices and lower throughput in our feeding operations, affected the performance of our agricultural operations. Because new operating bank lines of credit were not finalized until December 1986, XL was also unable to buy significantly into the 1986 fall calf crop and therefore did not have the normal quota of calves going through our feeding facilities.

This situation was offset to some degree by the successful negotiation and commencement of the Natural Beef Program. The benefits of this program will be long-term. Currently, 12,000 animals are on hand or have been identified for the program in 1988 and 1989 with appropriate financing in place. The Natural Beef Program will greatly improve ranching and feedmill operations and provide additional throughput which had not been previously available. It is expected the program will contribute an additional $7 million to XL's 1988 revenue.

Consolidated sales for 1987 increased to $236 million, up $8 million from the previous year. Gross margins which should have shown a corresponding increase remained constant from 1986. This was due primarily to reduced margins in the last quarter as a result of high beef prices and reduced demand. The pinch in gross margins was offset to some degree by a decline in both general and administrative and long-term interest expenses. The G & A expenses declined from $1.6 million in 1986 to $1.1 million in 1987. Long-term interest expenses were also reduced by 18 per cent from $1.8 million in 1986 to $1.5 million in 1987.

The loss reported in 1987 is a significant improvement over 1986 and 1985. We attribute this positive trend to the increased efficiencies associated with the joint venture. For fiscal 1987, the operating loss before income taxes amounted to $129,000 compared to a loss of $605,000 in 1986. In fiscal 1987 the net loss after extraordinary items was $94,000 ($.02 per share) as opposed to a loss of $1,482,000 ($.30 per share) in 1986. Improved operating results positively influenced our cash flow position which increased by $.5 million from $1.3 million in 1986 to $1.8 million in 1987.

Capital expenditures for the year were $1.2 million. Of this amount, $750,000 was financed by long-term debt with the remainder funded through cash flow. Working capital decreased $.2 million from $3.7 million in 1986 to $3.5 million in 1987, however the Company ended the year with an improved debt to equity position of .6:1.

XL continued to take steps in fiscal 1987 to improve its financial position. The Company met with a great deal of success in reducing our non-strategic assets, a process which began in 1985. In 1986 XL realized proceeds on the sale of certain seismic equipment at an amount substantially greater than was anticipated. The disposal of other non-strategic assets included the real estate from its former Cee-Der Log Buildings operations and its investment in shares of Triweb Resources, which were sold without loss. As a result, the Company reduced its non-interest bearing note from $4 million to $2.4 million in 1987. This note has been further reduced by $.5 million in the first quarter of 1988 through additional realization of these assets. XL expects to realize on the remainder of its non-strategic assets in 1988.

Throughout 1987, XL Foods in association with our joint venture completed an extensive study to examine the feasibility of consolidating the joint venture's five meat processing facilities. The study provides the necessary strategy for increasing productivity and efficiency needed to compete in the next decade. Phase One of the plan which has now been approved in principle will increase efficiencies and maintain XL as a low-cost producer.

In keeping with the feasibility study and ongoing review of the joint venture, XL in conjunction with Centennial Packers Ltd. have also solicited the services of an independent financial advisor to assist in merger negotiations and to examine the financial needs of a merged company. This study is due for completion by March 31, 1988. A merger between the two joint venture companies would of course be subject to shareholder approval.

In 1988 and beyond, XL will continue to focus on new and innovative means to achieve increased cost efficiencies, profitability and productivity. The steps just outlined will greatly enhance XL's efforts in meeting these goals. XL is also looking forward to a return in 1988 to a stability of cattle supply which will help maintain reasonable costs for cattle throughput and in turn improve the profitability of the ranching operations. Lastly, XL will continue to concentrate on seeking out profitable market niches and increasing the number of value-added beef products to its marketing line.

CONSOLIDATED BALANCE SHEET

September 30, 1987

Assets	1987	1986
Current assets:		
Cash	$ —	115,000
Accounts receivable	19,097,000	16,019,000
Inventories, at lower of cost and net realizable value	9,636,000	7,734,000
Prepaid expenses	198,000	89,000
Total current assets	28,931,000	23,957,000
Assets held for disposal (Notes 2 and 6)	2,175,000	3,474,000
Fixed assets, less accumulated depreciation and amortization (Note 3)	27,037,000	27,327,000
Other assets (Note 4)	6,788,000	6,570,000
	$64,931,000	61,328,000

Liabilities		
Current liabilities:		
Demand bank loans (Note 5)	$15,859,000	13,927,000
Outstanding cheques less cash on hand	4,724,000	—
Accounts payable and accrued liabilities	4,151,000	5,459,000
Current portion of long-term debt	714,000	830,000
Total current liabilities	25,448,000	20,216,000
Long-term debt, net of current portion (Note 5)	13,842,000	13,808,000
Non-interest bearing term loan (Note 6)	2,392,000	4,078,000
Deferred income taxes	954,000	722,000
Minority interest — cumulative, retractable, redeemable preferred shares of subsidiary	71,000	221,000
Shareholders' equity:		
Share capital (Note 7)	12,124,000	12,089,000
Contributed surplus	352,000	352,000
Appraisal surplus	11,525,000	11,525,000
Deficit	(1,315,000)	(1,221,000)
	22,686,000	22,745,000
Less: Shares held for employee stock purchase plan	(462,000)	(462,000)
	22,224,000	22,283,000
Contingency (Note 11)		
	$64,931,000	61,328,000

On behalf of the Board:

Director

Director

See accompanying notes.

CONSOLIDATED STATEMENT OF INCOME AND DEFICIT

Year ended September 30, 1987

	1987	1986
Sales	$235,998,000	228,362,000
Expenses:		
Direct	229,978,000	222,628,000
General and administrative	1,065,000	1,588,000
Interest — long-term	1,475,000	1,798,000
— other	1,638,000	1,588,000
Depreciation and amortization	1,871,000	1,784,000
	236,027,000	229,386,000
	(29,000)	(1,024,000)
Other (Note 8)	(100,000)	419,000
Loss before income taxes and extraordinary items	(129,000)	(605,000)
Income taxes (Note 9):		
Current (recovered)	—	(47,000)
Deferred (recovered)	166,000	(253,000)
	166,000	(300,000)
Loss before extraordinary items	(295,000)	(305,000)
Extraordinary items (Note 10)	201,000	(1,177,000)
Net loss	(94,000)	(1,482,000)
Retained earnings (deficit), beginning of year	(1,221,000)	245,000
Realized gain on appraised lands	—	16,000
Deficit, end of year	$ (1,315,000)	(1,221,000)
Income (loss) per share:		
Basic:		
Before extraordinary items	$(.06)	(.06)
Extraordinary items	.04	(.24)
	$(.02)	(.30)

See accompanying notes.

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

Year ended September 30, 1987

	1987	1986
Operating activities:		
Loss before extraordinary items	$ (295,000)	(305,000)
Add:		
Non-fund items	2,114,000	1,594,000
Working capital provided from operations	1,819,000	1,289,000
Increase in working capital balances	(1,558,000)	(679,000)
	261,000	610,000
Investing activities:		
Additions to fixed assets	(1,197,000)	(1,244,000)
Decrease (increase) in other assets	(370,000)	185,000
Proceeds on sale of fixed assets	19,000	771,000
	(1,548,000)	(288,000)
Financing activities:		
Proceeds on sale of assets held for disposal, net of disposition costs of $56,000	1,630,000	—
Reduction of non-interest bearing loan	(1,686,000)	—
Reduction of long-term debt	(833,000)	(8,547,000)
Issue of long-term debt	751,000	119,000
Cost of issuing long-term debt	(291,000)	(25,000)
Issue of common shares	35,000	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	(150,000)	—
Increase in assets held for disposal	(101,000)	—
	(645,000)	(1,907,000)
Net increase in demand bank loans	(1,932,000)	(1,585,000)
Demand bank loans, beginning of year	(13,927,000)	(12,342,000)
Demand bank loans, end of year	$(15,859,000)	(13,927,000)
(Increase) decrease in working capital balances:		
Accounts receivable	$ (3,078,000)	(166,000)
Inventories	(1,902,000)	(1,132,000)
Prepaid expenses	(109,000)	28,000
Outstanding cheques less cash on hand	4,839,000	(1,443,000)
Accounts payable and accrued liabilities	(1,308,000)	2,034,000
	$ (1,558,000)	(679,000)

See accompanying notes.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

September 30, 1987

1. Significant Accounting Policies

(a) Principles of Consolidation

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 comprises 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 of their estimated useful lives:

Assets	Rate
Buildings	2½ - 10%
Vehicles and movable 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) Goodwill

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

(e) 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 $15,074,000. Accordingly, the Board of Directors approved the recording of the excess of the appraisal value over the previous carrying value. The appraisal value of the lands was determined by Floen Appraisals Ltd., as of March 5, 1979; all other lands are carried at cost.

(f) Comparative Figures

Certain comparative figures for 1986 have been reclassified to conform with 1987 presentation.

(g) 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 (at estimated realizable value)

	1987	1986
Accounts receivable	$ 850,000	749,000
Notes receivable	1,325,000	1,500,000
Other	—	1,225,000
	$ 2,175,000	3,474,000

3. Fixed Assets, at cost, except land

	1987	1986
Land	$17,190,000	17,190,000
Buildings	8,898,000	8,704,000
Vehicles	963,000	972,000
Machinery and equipment	9,794,000	9,321,000
Furniture and fixtures	544,000	468,000
Land improvements	465,000	465,000
Fences, wells and dugouts	749,000	744,000
	38,603,000	37,864,000
Accumulated depreciation and amortization	(11,566,000)	(10,537,000)
	$27,037,000	27,327,000

4. Other Assets

	1987	1986
Notes receivable, net of current portion	$ 254,000	119,000
Goodwill, at cost less accumulated amortization of $1,689,000 (1986 - $1,443,000)	5,763,000	6,009,000
Financing costs, less accumulated amortization of $1,127,000 (1986 - $983,000)	406,000	259,000
Other, at cost	365,000	183,000
	$ 6,788,000	6,570,000

5. Long-Term Debt

	1987	1986
10¾% first mortgage, payable in monthly installments including interest of $79,000 (1986 - $92,000), secured by certain lands and premises situated in Alberta, due June 25, 1988	$ 6,413,000	6,700,000
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	5,902,000	5,974,000
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	1,913,000	1,400,000
Obligations under capital leases	146,000	213,000
Other	182,000	351,000
	14,556,000	14,638,000
Deduct current portion	(714,000)	(830,000)
	$13,842,000	13,808,000

The Corporation anticipates that the first mortgage due in 1988 will be refinanced with long-term debt in the usual course of business.

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

1988	$714,000
1989	829,000
1990	757,000
1991	812,000
1992	874,000

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. Non-Interest Bearing Term Loan

The non-interest bearing term loan aggregating $2,392,000 (1986 - $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.

7. Share Capital

	1987	1986
First Preferred shares without nominal or par value. Authorized 200,000 shares; issued 79,453, 7½% Non-cumulative Redeemable First Preferred Shares, Series "C"	$ 7,946,000	7,946,000
Common shares without nominal or par value. Unlimited authorized number of shares; issued; 5,303,744 shares (1986 - 5,263,844 shares)	4,178,000	4,143,000
	$12,124,000	12,089,000

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 First Preferred shares, Series "C" 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 6.

In conjunction with a restructuring agreement carried out in 1986, the Company has granted an option to its former bankers 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 arrangements with the Company's bankers, the Government of the Province of Alberta has entered into an Interest Deficiency Guarantee Agreement with the Province of Alberta Treasury Branch. 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 Branch is $1,500,000 per annum.

In consideration of the Government entering into the Guarantee Agreement, the Corporation has issued, to an escrow agent, 60,000 First Preferred shares, Series "D", having an issue and redemption price of $100 per share, along with an additional 2,400 First Preferred shares, Series "D" to cover dividends potentially payable pursuant to such Preferred shares.

At such time as Treasury Branch 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 average 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 Branch 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, 1987.

Under the Employee Stock Option Plan the Corporation has authorized for issue 343,000 Common shares at prices ranging from $0.52 to $1.00. Options aggregating 104,000 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 178,500 Common shares at September 30, 1987. During 1987, options for 39,900 common shares were exercised for $35,000.

8. Other

	1987	1986
Settlement of management contract	$(275,000)	—
Income arising from assets held for disposal — discontinued operations	175,000	419,000
	$(100,000)	419,000

9. Income Taxes

Income tax expense (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 expensed (recovered) are as follows:

	1987	1986
Computed "expected" income taxes (recovery)	$ (64,000)	(295,000)
Add (deduct):		
Amortization of goodwill	126,000	124,000
Inventory allowance	—	(21,000)
Manufacturing and processing credit	15,000	19,000
Drawdown of deferred income taxes accumulated at different rates	(81,000)	(38,000)
Non deductible (taxable) portion of capital loss (gain)	24,000	(40,000)
Unrecognized tax benefit of losses of subsidiaries	36,000	—
Other	110,000	(49,000)
	$ 166,000	(300,000)

10. Extraordinary Items

	1987	1986
Recovery of (provision for) writedown of assets held for disposal, net of deferred income taxes of $66,000 (1986 - $585,000)	$ 201,000	(1,250,000)
Reduction of income taxes arising from application of losses carried forward	—	73,000
	$ 201,000	(1,177,000)

11. Contingency

A statement of claim was filed against the Corporation on May 6, 1985, 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.

AUDITORS' REPORT

Auditors' Report to the Shareholders

We have examined the consolidated balance sheet of XL Food Systems Ltd. as at September 30, 1987 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, 1987 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 11, 1987

Peat Marwick
Chartered Accountants

CORPORATE INFORMATION

Officers

Gerald E. Kaumeyer
Chairman of the Board, President and Chief Executive Officer

T. Peter Luzi
Senior Vice-President

Joan Connally
Assistant Secretary Treasurer

Directors

John K. Church
Balzac, Alberta
Farmer

Donald J. Douglas
Calgary, Alberta
President
United Management Ltd.

Matthew Gaasenbeek
Toronto, Ontario
President
Camreco Inc.

Dr. James B. Graham
Cochrane, Alberta
Associate Professor
Faculty of Management
University of Calgary

Gerald E. Kaumeyer
Nanton, Alberta
Chairman of the Board, President and Chief Executive Officer
XL Food Systems Ltd.

T. Peter Luzi
Calgary, Alberta
Senior Vice-President
XL Food Systems Ltd.

Neil A. McKinnon
Bassano, Alberta
Rancher

Fred H. Peacock
Calgary, Alberta
President
Peacock Holding Company Ltd.

Auditors

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Solicitors

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Calgary, Alberta
T2P 2M2

Bank

Province of Alberta Treasury Branches
420 - 2nd Street S.W.
Calgary, Alberta
T2P 3K4

Registrars and Transfer Agents

The Canada Trust Company
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Calgary, Alberta
T2P 3K4

The Canada Trust Company
110 Yonge Street
Toronto, Ontario
M5C 1T4

Stock Exchanges

Alberta Stock Exchange
Calgary, Alberta
Trading Symbol: XLF

Toronto Stock Exchange
Toronto, Ontario
Trading Symbol: XLF

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