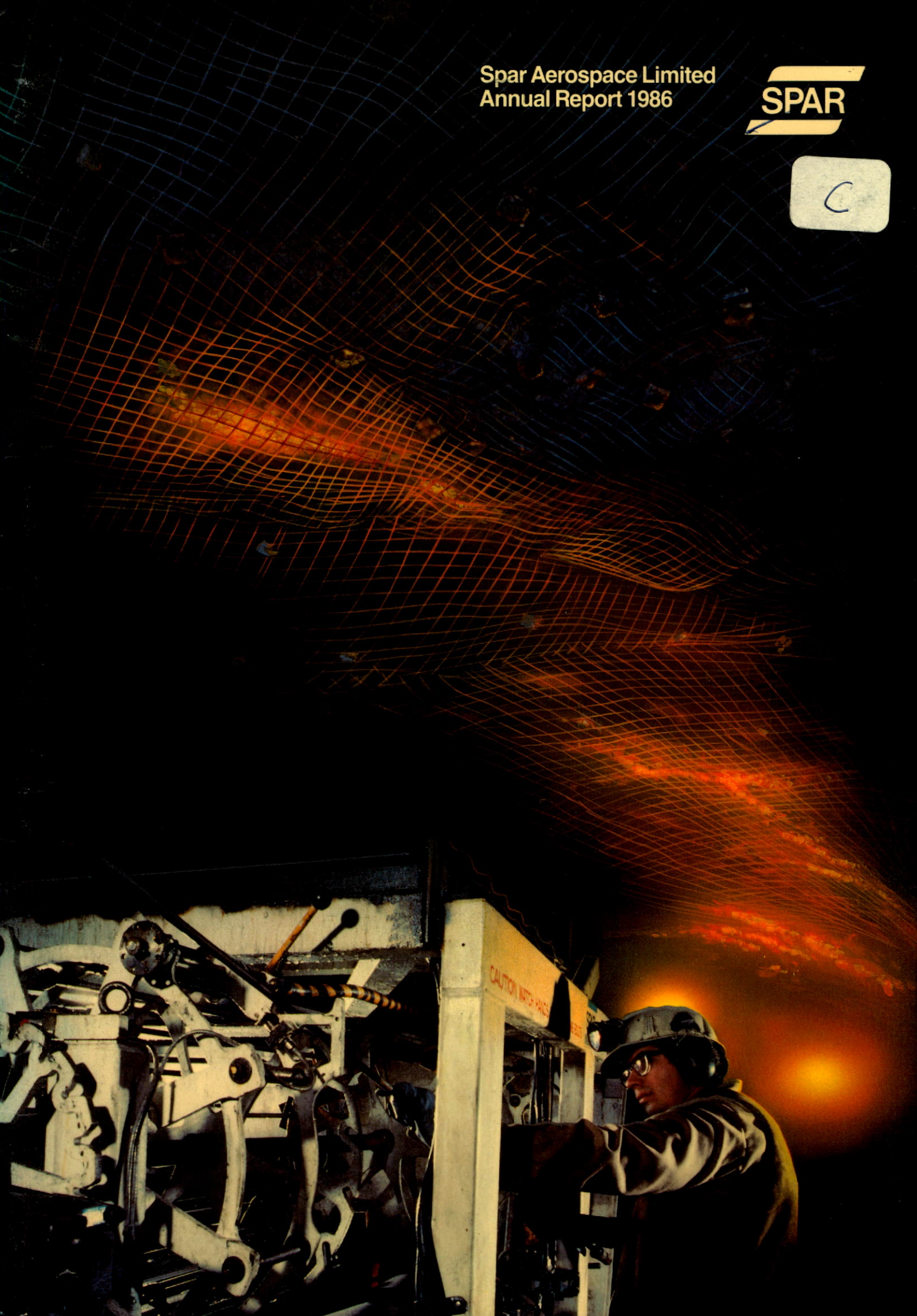


Spar Aerospace Limited
Annual Report 1986



CORPORATE PROFILE

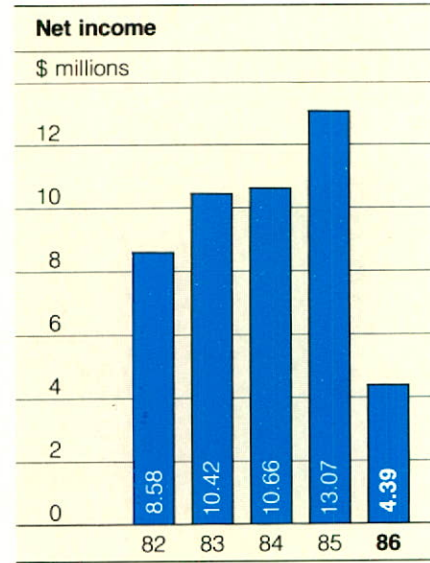
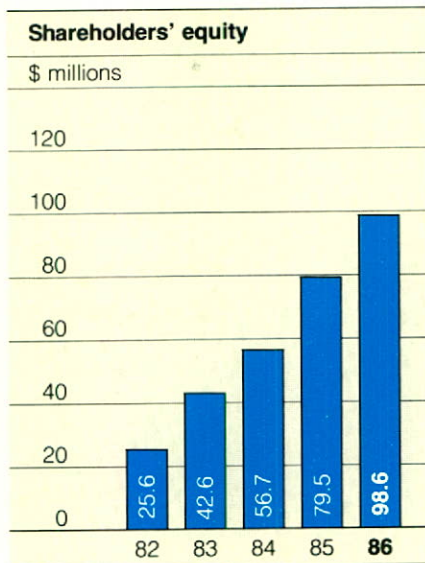
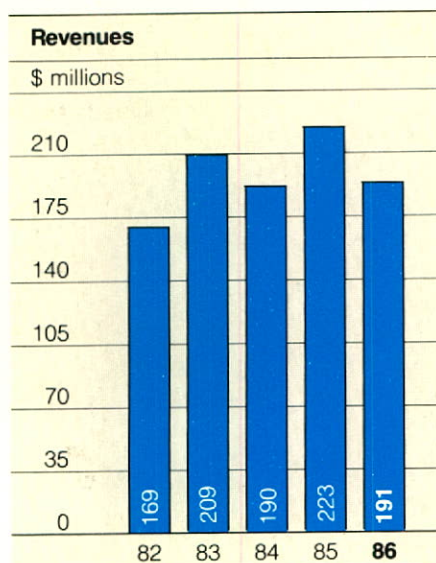
Spar Aerospace Limited is a Canadian, shareholder-owned company with products and services in the space, remote manipulation, communications, defence and aviation markets.

The company employs over 2,000 people, including about 600 engineers and technicians – one of the largest technological groups in the private sector in Canada.

In 19 years Spar has gained international recognition as a diversified technology company. More than half of Spar's sales are in international markets. Spar devotes 20% of its time to research and development, including cooperative programs with several Canadian universities.

FINANCIAL HIGHLIGHTS

	1986	1985
(\$000s)		
Revenues	\$191,018	\$223,278
Net income for the year	4,394	13,070
Working capital	54,030	58,561
Long term debt	1,384	2,388
Convertible subordinated debentures	–	14,987
Cash dividends on subordinate voting shares	4,845	4,342
Shareholders' equity	98,582	79,521
(in dollars)		
Basic earnings per subordinate voting share	\$0.42	\$1.41
Fully diluted earnings per subordinate voting share	\$0.42	\$1.33
Shareholders' equity per subordinate voting share outstanding at year end	\$9.16	\$8.16



Cover:

A miner adjusts Spar's remote manipulator built for Inco to screen and bolt ceilings in deep earth, hard rock mines. It is currently undergoing tests and is an application of space-age technology to make safer and more productive a basic Canadian resource industry.

REPORT TO SHAREHOLDERS

RESULTS

For the year ended December 31, 1986 Spar Aerospace Limited had revenues of \$191 million compared to \$223 million in 1985, while net income was \$4.4 million (\$.42 per share) compared to \$13.1 million (\$1.41 per share) the previous year.

The lower revenues and consequent pressure on profits were attributable to a number of factors, including losses in the Communications Group resulting from continuing heavy investment in new product and market development, a strike by members of the Canadian Auto Workers union at Spar's Toronto plants which lasted from October 10, 1986 to February 5, 1987 and delays in the receipt of authorization from customers to commence work on a number of new programs.

Nonetheless, the company maintained a sound financial position with working capital at year-end of \$54.0 million, debt of \$1.4 million, and shareholders' equity of \$98.6 million (\$9.16 per share). Effective May 9, 1986 Spar called for conversion of the 8% convertible subordinated debentures due May 1, 1988, increasing shareholders' equity by \$14.4 million.

Spar's investment in research and development was \$6.0 million in 1986. Including sponsored research and development, total expenditures for the year were \$21.6 million, a gain of 77% over 1985, which represents 11.3% of revenues.

STRATEGY

Over the past 19 years Spar has concentrated on a strategy of building the capability of its advanced technology businesses, particularly in terms of people skills and market acceptance, to take advantage of opportunities in domestic and international markets. The formation in the third quarter of 1986 of the new Communications Group combining the Communications Systems Division with COMTEL, and the more recent formation of the Structures and Mechanisms Group which combines the Remote Manipulator Systems Division with Astro Aerospace, are part of the continuing process of adapting to change in order to improve Spar's operating and marketing effectiveness.

Today, based on its achievements in space robotics, in defence electro-optics and in satellite-based communications, Spar has attained broad credibility as a major participant in these large and growing markets.

Advanced technology is a dynamic, fast-growing business with great profit potential for Spar. However, the sheer size of many of its projects, coupled with the long lead times needed to move from initial proposal to receipt of contracts, means that growth comes in measured strides. A period of increased revenues and profitability, such as in the early eighties, must inevitably be followed by one of consolidation, as occurred in 1985 and 1986. Expansion will follow as new projects are reflected in the revenue base.

Over the next five years Spar will concentrate on expanding its Canadian, United States and international markets in robotics, electro-optics and satellite-based communications. It will enhance its technological skills through a growing

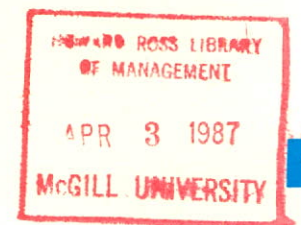
program of research and development, both internally and in conjunction with universities across Canada. The Company will continue to promote the development of its supplier base across Canada to ensure that major systems activities can be expanded within each of its principal markets. It will continue to seek out and enter into joint ventures and license agreements with other world class companies in its selected areas of expertise, both to broaden its technological base and to enhance its market penetration.

Concurrently, Spar will direct its attention to gaining the maximum return on its investments in its aircraft engine and helicopter transmission and aircraft equipment servicing activities. Traditionally these have provided a stable base for its advanced technology businesses.

GOVERNMENT AFFAIRS

We are encouraged by the agreement of March 1986, between the Prime Minister of Canada and the President of the United States, concerning Canada's participation in the forthcoming Space Station project. A Canadian industrial team, led by Spar, is under contract to define the Mobile Servicing Centre (MSC) which we expect will be used to construct and service the Space Station. The MSC is a project that could lead to major technological advances in robotics and artificial intelligence with broad application to resource and manufacturing industries across Canada.

Canada's position as a leading world trader is increasingly being threatened within the international marketplace. Continuing improvement to our productivity is the only answer to this challenge.



REVIEW OF OPERATIONS

This will require increasing investment in research and development and capital facilities and equipment. The necessary long-term commitment to these programs of investment requires support from both the private and the public sectors. In this regard government support to research and development is crucial. An illustration of the benefits that flow from government investment in space research is the cross Canada program of university research into artificial intelligence and the special purpose industrial robots being developed within Canada based on the Canadarm technology.

OUTLOOK

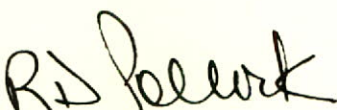
In 1987 management anticipates higher revenues based on an increased order backlog. Reduced development expenses within our Communications Group and a return to normal operations by those Toronto-based components affected by the Canadian Auto Workers union strike will remove a serious drain on profits.

Looking to the longer term future we remain confident that our continuing concentration on advanced robotics, satellite-based communications and electro-optical defence systems will lead to significant growth in revenues and earnings over the next five years.

We would like to take this opportunity on behalf of the Board to thank all Spar employees for their efforts and our shareholders for their valued support.



Larry D. Clarke
Chairman and
Chief Executive Officer



R. Donald Pollock
President and
Chief Operating Officer

March 5, 1987

SPACE

Satellites

The company is the principal supplier in Canada and a major international manufacturer of satellites and satellite subsystems for communications and surveillance markets.



Testing a satellite antenna

Spar and its predecessor companies have contributed to the design and manufacture of 50 satellites and subsystems, including the fabrication of structures and payloads for the following Canadian and international satellites: Alouette I and II, ISIS I and II, the CTS (Hermes), SBS, Palapa B, Westar IV, G-Star, Satcom, TDRSS, and the Anik A, B and C series, as well as the prime contract for the Anik D1 and D2 satellites.

In 1986, Spar successfully completed a \$160 million prime contract to provide two satellites and a related ground control system for EMBRATEL, the Brazilian government-owned telecommunications company. *Brasilsat* is similar to Anik D, the communications satellite currently serving Canada's needs, and has the capability to carry 16,000 two-way voice communications or 24 television channels. It is the first domestic communications satellite system in Latin America.

In 1986 the company signed a \$200 million contract with Telesat Canada to supply two dual band (24 C-band channels and 20 KU-band channels) Anik E communications satellites, launch support services and associated equipment.

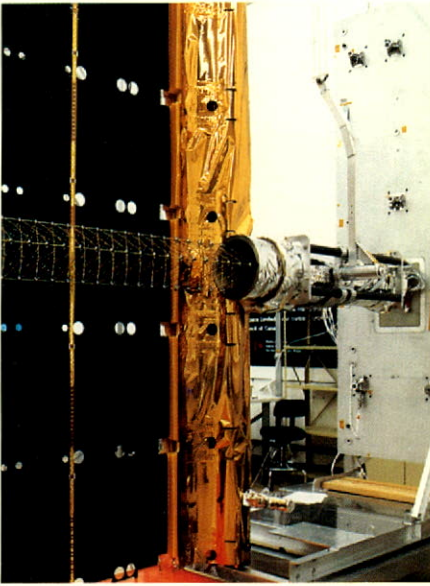
This next generation of Canadian-built satellites will represent the most powerful in commercial service over North America when launched in 1990. The Anik E provides extended capacity and great versatility to meet the burgeoning demand of an increasingly deregulated telecommunications market.

Surveillance technology, on earth and in space, is emerging as an important new market. In 1984, Spar received a \$14.4 million contract to design and develop radar sensing technology for the new Radarsat satellite for the Department of Energy, Mines and Resources. This expertise will enable the company to penetrate markets in the 1990s for commercial and scientific surveillance systems capable of detecting and monitoring natural resources, shipping activities and environmental data.

In another major project, Spar completed a \$33 million contract from Hughes Aircraft Company of California to supply subsystems for five Intelsat VI satellites with options for 11 more, and has completed the initial phase of a \$14 million design and development contract from the Federal Government for a mobile communications satellite (MSAT) to improve voice and data transmission from vehicles, aircraft and ships in remote parts of Canada. In addition, Spar was awarded, in early 1987, a \$10 million contract by the Department of National Defence, to build transponders for the Search and Rescue Satellite-Allied Tracking (SARSAT) system.

Deployable Space Structures

Spar completed the development, integration and testing of the first set of solar arrays for the European Space Agency's powerful Olympus satellite in 1986. This \$50 million program expanded the company's technical capability in large deployable space structures – a technology that will be needed for advanced space projects such as the U.S. Space Station.



Testing a solar array

Astro Aerospace Corporation, Spar's California-based subsidiary, is building the longest man-made structure ever to be erected in space – a 60-meter deployable, retractable tower which will be used aboard the shuttle to study the effects of vibrations and other stresses on large structures in orbit.

REMOTE MANIPULATION

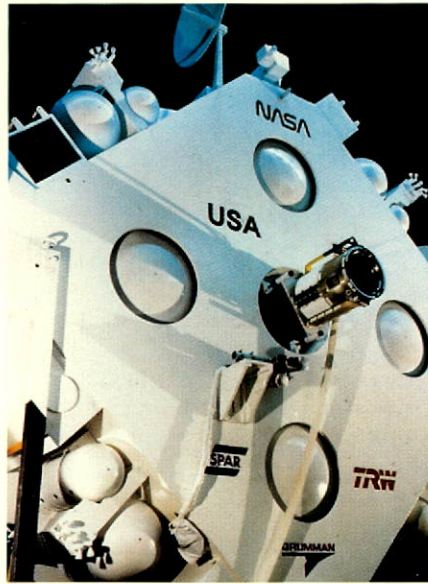
Teleoperator Systems in Space

Spar is a world leader in the design, development and manufacture of teleoperator systems of which the Remote Manipulator System (RMS) for NASA's space shuttle is the leading example.

In early 1987, Spar was awarded contracts worth \$19 million by the U.S. National Aeronautics and Space Administration (NASA) for

additional work on the Remote Manipulator System, or Canadarm. Four end effectors will be redesigned and refurbished and a fifth will be built to the same specifications. The end effector is the "hand" of the Canadarm, a snare mechanism at the end of the 15-meter manipulator that grasps payloads in space. Spar's Montreal facility will redesign and build five manipulator control interface units, which link the Canadarm to the astronauts' controls aboard the shuttle.

The next major step in Canadian participation in manned space flight is the planned commitment by the Government of Canada of some \$800 million over the next 15 years to the U.S. Space Station, a permanent operational centre some 400 kilometers above the earth.



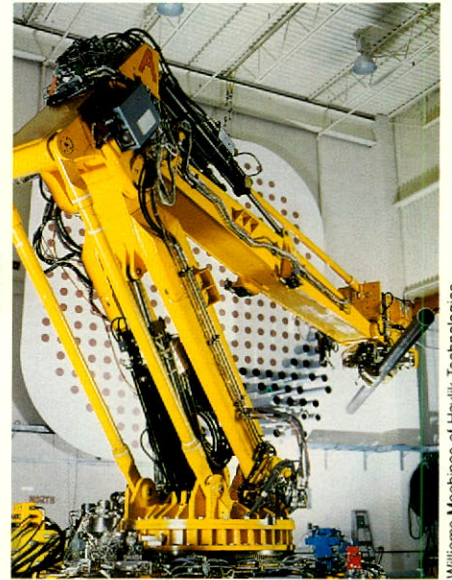
Orbital Maneuvering Vehicle

Spar has been designated the prime contractor for the Canadian government's contribution, called the Mobile Servicing Centre (MSC), which will be used to construct and service the space station and attached payloads. The MSC design and definition work to date totals \$18 million and expands Spar's capabilities in robotics and artificial intelligence.

In June 1986, NASA selected a team including Spar to negotiate a contract leading to the construction of the Orbital Maneuvering Vehicle (OMV). The OMV is an unmanned, remotely operated propulsion vehicle that extends the range of the space shuttle in positioning spacecraft. It can also be adapted to support the Space Station project.

Teleoperator Systems on Earth

To date, the primary industrial applications of this unique form of robotics have been in the nuclear power and mining industries. Spar has recently finished a \$45 million contract from Ontario Hydro to produce a remote manipulation and control system to replace fuel tubes in Candu nuclear reactors. In March 1985, Spar and Inco Limited signed a memorandum of understanding to develop remotely controlled mining equipment to enhance the safety and productivity of Inco's hardrock mining operations. The first prototype system valued at \$600,000 was delivered in September 1986, and is currently being tested underground in Sudbury.



Teleoperator to re-tube Candu reactors

Williams Machines of Havlik Technologies

Based on Spar's experience in producing the RMS, the company has moved into the design and development of advanced manufacturing systems. A small but significant current contract involves the design and manufacture of the production facility for Moli Energy Limited, a British Columbia-based producer of high energy rechargeable lithium cells.

In addition, in late 1987 Spar will complete for Decoustics Ltd. of Rexdale, Ontario an advanced robotic system for cutting various sizes of fibreglass acoustical panels. This contract is evidence of Spar's growing commitment to the design and development of industrial teleoperator systems.

COMMUNICATIONS

Spar has completed more than 25 projects worldwide for satellite earth stations, subsystems and components.



Spar earth station in Tibet

Since 1984, the company has undertaken contracts valued at more than \$35 million to provide earth stations and unassembled kits to the People's Republic of China for two major domestic satellite

systems. These projects involve the training of Chinese engineers and technicians by Spar and the transfer of technology. Through these contracts Spar has become the leading supplier to the Chinese satellite communications industry.

During 1986, additional international contracts were awarded to build ground-based satellite communications equipment in Zambia, Mozambique and Bangladesh. Spar's U.S. subsidiary, COMTEL, completed shipment of two Time Division Multiple Access (TDMA) systems to Indonesia and India. TDMA is a digital switching technology that improves the efficiency of private satellite networks by permitting several earth stations to share a common satellite channel. Data and voice signals are digitally separated within pre-determined time slots.

Early this year Spar began work on a \$23.8 million project to build a new Intelsat A station for Liberia, one of the most modern of its kind in the world. Completion is scheduled for late 1988.

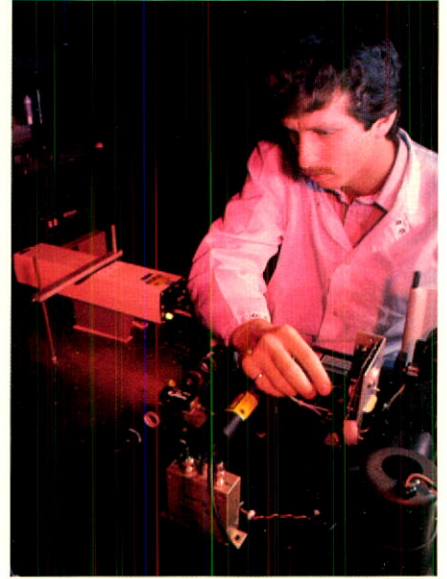
DEFENCE

Spar's Defence Systems Division is located in Toronto and Kanata. It is engaged in the field of tactical infrared surveillance from product development through manufacture to life cycle support for the Canadian and U.S. Armed Forces.

The Division develops and manufactures electro-optical products and provides its defence customers with comprehensive engineering and life cycle support.

In March 1986, the Division moved into a custom-built electro-optical facility in Weston, Ontario. There it

develops, assembles, tests and supports military electro-optical systems, primarily the Infrared Search and Target Designation system, which is under development for the U.S. and Canadian navies. The \$90 million project is the largest defence-development sharing contract to be awarded between Canada and the U.S.



Optical component testing

An infrared system for battlefield surveillance is under development in the company's Kanata facility. This system will meet requirements of both the Canadian and U.S. Armed Forces.

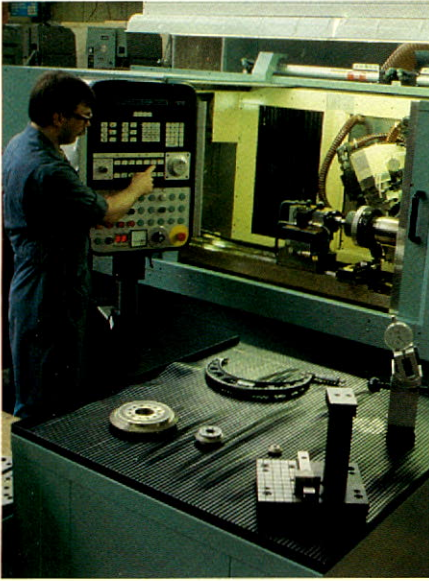
The tactical infrared surveillance family of products will be further broadened by the manufacture, under licence from Martin Marietta, of the Forward Looking Infrared (FLIR) system for the Air Defence Anti-Tank System (ADATS). This is an element of a major contract to supply Low Level Air Defence (LLAD) systems to the Canadian Forces.

Other FLIR systems currently under development by Spar are undergoing flight trials on a Canadian Forces CP140 Maritime Patrol Aircraft and in a ground-based application by the U.S. Army.

AVIATION

Gear and Transmission Manufacturing

During the year, the Gears and Transmissions Division shipped more than 100 transmission kits to Sikorsky for its Blackhawk helicopters. The production problems that affected the early stages of this contract are largely overcome and improved performance is being achieved.



Precision gear grinding

In 1986, General Electric Company awarded Spar contracts valued at \$28 million for follow-on production of accessory gearboxes and other components for engines that power turboshaft helicopters and turbo-prop and turbojet aircraft.

This work will continue for the next three years and, if options are exercised, carry through to the mid-1990s.

Services

In 1986, Aviation Services Division began a new program worth up to \$1 million annually for the repair and overhaul of a number of components for the NATO E3A AWACS, an aircraft that carries out long-range radar surveillance. The initial contract is for a period of five years and is expected to continue for up to 20 years.



CF 18 generator overhaul

The division is also developing new business in Thailand and Singapore for overhaul of components on fixed-wing aircraft and helicopters, thus adding to the division's international outreach. Repair work also has begun on the CF18 variable speed constant frequency generator, a capability in new technology that holds significant long-term potential for future business in both military and commercial markets.

RESEARCH AND DEVELOPMENT

Research and development (R & D) plays an increasingly important part in Spar's growth.

In February 1986, Spar and the Federal Government signed a Memorandum of Understanding under which the Government will invest some \$130 million and Spar \$170 million over the next five years on research and development projects aimed at "strengthening exports and internal economic growth." This agreement will assist Spar in undertaking long-range R & D essential to enhancing its technology for international markets.

Support for basic research is important to the success of an advanced technology company. Spar's major effort is an advanced research program in artificial intelligence and robotics, undertaken in 1984 with an initial three-year grant of \$750,000 to the Canadian Institute for Advanced Research, to sponsor research at three Canadian universities. The company continues to assist the Institute on projects of mutual interest.



Artificial intelligence research with a Cincinnati Milacron robot.

Spar works closely with the academic community on projects ranging from co-sponsorship of an antenna engineering professorship at McMaster University to academic program support at the undergraduate level at the University of Montreal's École Polytechnique – the nation's largest engineering school.

For the past five years the company has awarded a substantial bursary to an engineering student at each of 14 Canadian Universities. The award honors the late John H. Chapman and is designated by the faculty on the basis of academic performance and high professional promise.

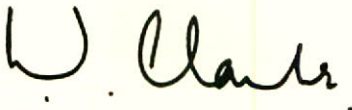
CONSOLIDATED BALANCE SHEET

(\$000s) December 31, 1986

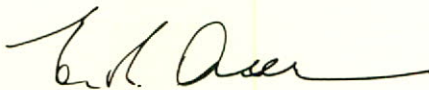
	1986	1985
Assets		
Current assets:		
Marketable securities (note 2)	\$ 74,488	\$ 18,246
Accounts receivable (note 12)	74,850	49,046
Income tax recoverable	5,015	4,298
Inventories (note 3)	27,641	48,090
Prepaid expenses and other	9,937	6,704
Total current assets	191,931	126,384
Accrued incentive revenue	8,556	4,348
Fixed assets (notes 4, 9 and 12)	30,541	27,553
Loans receivable	2,096	2,064
Long term investment (note 5)	3,278	2,600
Deferred costs (note 9)	6,476	2,802
Goodwill	3,905	3,835
Total assets	\$246,783	\$169,586

(See accompanying notes to consolidated financial statements)

On behalf of the Board:



Director



Director

Spar Aerospace Limited
amalgamated under the Canada Business Corporations Act.

(\$000s) December 31, 1986

	1986	1985
Liabilities and Shareholders' Equity		
Current liabilities:		
Bank indebtedness	\$ 68,503	\$ 14,322
Accounts payable and accrued charges	40,642	32,651
Payroll and other taxes payable	5,157	3,640
Current deferred income taxes	1,610	5,402
Dividend payable	1,074	1,167
Current portion of long term debt (note 6)	1,034	5,411
Customer advance payments (note 3)	19,881	5,230
Total current liabilities	137,901	67,823
Long term debt (note 6)	1,384	2,388
Deferred income taxes	8,916	4,867
Convertible subordinated debentures (note 7)	-	14,987
Shareholders' equity:		
Share capital (notes 7 and 8)	64,020	44,508
Retained earnings	34,562	35,013
Total shareholders' equity	98,582	79,521
Total liabilities and shareholders' equity	\$246,783	\$169,586

Auditors' Report

To the Shareholders of Spar Aerospace Limited:

We have examined the consolidated balance sheet of Spar Aerospace Limited as at December 31, 1986 and the consolidated statements of income and retained earnings 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 company as at December 31, 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.

Toronto, Canada
February 20, 1987

C. Clarkson Gordon
Chartered Accountants

CONSOLIDATED STATEMENT OF INCOME

(\$000s) for the year ended December 31, 1986

	1986	1985
Revenues	\$191,018	\$223,278
Cost of sales including all expenses except items shown below (note 9)	139,868	153,429
Administrative and selling expenses	29,691	28,806
Research and development costs (notes 9 and 12)	6,007	9,261
Depreciation and amortization	6,612	5,650
Interest on long term debt	982	3,043
Other income (net)	(721)	(2,407)
Amortization of goodwill	485	426
	182,924	198,208
Income before income taxes	8,094	25,070
Income tax expense (note 9)	3,700	12,000
Net income for the year	\$ 4,394	\$ 13,070
Earnings per subordinate voting share (in dollars)		
Basic	\$ 0.42	\$ 1.41
Fully diluted	\$ 0.42	\$ 1.33

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

(\$000s) for the year ended December 31, 1986

	1986	1985
Retained earnings, beginning of year	\$ 35,013	\$ 26,285
Net income for the year	4,394	13,070
Dividends on subordinate voting shares	(4,845)	(4,342)
Retained earnings, end of year	\$ 34,562	\$ 35,013

(See accompanying notes to consolidated financial statements)

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

(\$000s) for the year ended December 31, 1986

	1986	1985
Operating activities		
Net income from operations	\$ 4,394	\$13,070
Items not affecting cash (note 13)	3,146	7,613
	7,540	20,683
Net increase (decrease) in cash invested in working capital related to operations (note 13)	14,761	(29,369)
Other	193	747
Net cash from (used in) operating activities	22,494	(7,939)
Financing activities		
Issue of subordinate voting shares	19,512	14,078
Conversion of subordinated debentures to share capital	(14,987)	(7,838)
Employee share purchase plan term loans	(32)	(119)
Long term debt repayments and provision for current instalments	(5,381)	(1,493)
Increase in long term debt	-	736
Dividends	(4,845)	(4,342)
Net cash from (used in) financing activities	(5,733)	1,022
Investment activities		
Additions to fixed assets	(9,397)	(8,660)
Long term investment	(678)	(2,600)
Deferred costs	(4,070)	(1,349)
Purchase of technology	(555)	(300)
Net cash used in investment activities	(14,700)	(12,909)
Increase (decrease) in cash	2,061	(19,826)
Cash, beginning of year	3,924	23,750
Cash, end of year	\$ 5,985	\$ 3,924

"Cash" consists of marketable securities less bank indebtedness.

(See accompanying notes to consolidated financial statements)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(tabular amounts are in thousands of dollars)

December 31, 1986

1. Summary of accounting policies

The accompanying financial statements consolidate the accounts of the company and its subsidiaries and have been prepared by management in accordance with generally accepted accounting principles consistently applied.

Because a precise determination of many assets and liabilities depends on future events, the preparation of financial statements for a period necessarily involves the use of estimates and approximations. The financial statements have, in management's opinion, been properly prepared within reasonable limits of materiality and within the framework of the accounting policies summarized below.

(a) Revenue recognition

Revenue is accrued under the percentage of completion method as the work is performed and provision is made for any anticipated losses when the estimate of total costs on a contract indicates a loss. As some contracts extend over one or more years, any revisions in cost and profit estimates made during the course of the work are reflected in the accounting period in which the facts indicating a need for the revision become known. Some contracts contain incentive and/or penalty provisions based on performance relative to established targets. Such awards or penalties are included in revenue or cost estimates when such amounts can reasonably be determined.

(b) Research and development costs

The company expenses all research and development expenditures, after deducting investment tax credits and government assistance, as incurred with the exception of certain development costs incurred prior to commencement of or during initial commercial production of new products which are deferred and amortized on a straight-line basis over a five-year period commencing in the year of initial commercial production. Should the company determine that no future benefit will accrue on a program, the unamortized deferred cost will be totally written off at that time.

(c) Inventories

Inventories of raw materials and finished goods are valued at the lower of cost, determined on a moving average basis, and market value, determined as the lesser of replacement cost or net realizable value. Contracts in process are valued at estimated sales value calculated on the percentage of completion basis.

(d) Fixed assets

Additions to fixed assets are recorded at cost after deducting investment tax credits and government assistance. Depreciation and amortization are provided on the straight-line method on a basis estimated to amortize the cost of the assets over their useful lives as follows:

Machinery and equipment	10% to 33⅓%
Buildings	5%
Leasehold improvements	Term of the lease plus renewal option if applicable

Fixed assets include those lease obligations which transfer substantially all of the benefits and risks associated with ownership.

(e) Goodwill

Goodwill represents the unamortized price of purchased technology and is amortized on the basis of management's estimate of the useful lives of the technologies. Additional payments for purchased technologies are recorded in the year of determination and amortized on a straight-line basis over the remaining term of the original goodwill.

(f) Foreign exchange

Transactions in foreign currencies are translated into Canadian dollars at the approximate rate prevailing at the time of the transactions. Assets and liabilities in foreign currencies are translated at rates prevailing at the year end. Foreign exchange gains and losses are included in income for the year, except those which relate to long term monetary items which are deferred and amortized over the term of the debt.

(g) Accrued incentive revenue

Accrued incentive revenue relates to satellite contracts and represents the non-current portion of the present value of cash payments, net of allowances for performance failures, that the company estimates it will receive.

(h) Income taxes

The corporation and its subsidiary companies follow the practice of providing for income taxes based on income included in the financial statements regardless of when such income is subject to payment of taxes under the tax laws.

2. Marketable securities

The company's marketable securities portfolio is carried at cost and consists of the following:

	1986		1985	
	Cost	Market	Cost	Market
Retractable preferred shares	\$ 6,046	\$ 6,015	\$ 7,362	\$ 7,494
Canadian government bonds	54,559	55,000	4,706	4,967
Corporate bonds and other	13,883	13,906	6,178	6,253
	\$74,488	\$74,921	\$18,246	\$18,714

(\$000s)

1985

1986

Cost

Market

Market

\$ 7,362

\$ 7,494

4,706

4,967

6,178

6,253

\$18,246

\$18,714

3. Inventories

Inventories consist of the following:

	(\$000s)	
	1986	1985
Contract costs and estimated earnings recognized to date	\$380,633	\$393,822
Less customer advance payments	360,751	351,731
	19,882	42,091
Raw materials, parts and supplies	6,921	5,522
Finished goods	838	477
	\$ 27,641	\$ 48,090

Customer advance payments in excess of contract costs and estimated earnings of \$19,881,000 (1985 – \$5,230,000) are included in current liabilities.

4. Fixed assets

Fixed assets consist of the following:

	(\$000s)	
	1986	1985
Cost:		
Land	\$ 400	\$ 400
Buildings and leasehold improvements	7,638	7,122
Machinery and equipment	49,606	41,254
Machinery and equipment under capital leases	2,757	2,757
	60,401	51,533
Less: accumulated depreciation and amortization	29,860	23,980
	\$ 30,541	\$ 27,553

5. Long term investment

Investment in MacDonald, Dettwiler and Associates Ltd. is carried at cost and consists of the following:

	(\$000s)	
	1986	1985
9.75% convertible, redeemable debentures, maturing in 1988	\$ 2,600	\$ 2,600
Common shares	678	
	\$ 3,278	\$ 2,600

6. Long term debt

The company's long term debt consists of the following:

	(\$000s)	
	1986	1985
Bank term loan of \$3,000,000 (U.S. funds) bearing interest at 15.9%, repaid April 30, 1986	\$ –	\$ 4,193
Bank term loan bearing interest at 17.7% repayable in semi-annual instalments of \$175,000 (U.S. funds) to January 31, 1987	242	734
Capital lease obligations expiring from 1987 to 1989 bearing interest at 12.0% to 14.5%	1,484	2,046
Other	692	826
	2,418	7,799
Less: amount included in current liabilities	(1,034)	(5,411)
	\$ 1,384	\$ 2,388

Long term debt is repayable as follows:	(\$000s)
1987	\$1,034
1988	1,001
1989	160
1990	176
1991 and beyond	47
	\$2,418

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(tabular amounts are in thousands of dollars)

December 31, 1986

7. Convertible subordinated debentures

In April 1986 the company called its 8% convertible subordinated debentures, all of which were converted into subordinate voting shares.

8. Share capital

A summary of changes to issued share capital for the year ended December 31, 1986 is as follows:

(\$000s)	Subordinate voting		Special		Total
	Shares	\$	Shares	\$	\$
Issued and outstanding, December 31, 1985	9,731,358	44,356	1,078,512	152	44,508
a) Conversion of subordinated debentures to subordinate voting shares	788,781	14,987			14,987
b) Issue of subordinate voting shares for cash under employee share purchase plan	189,966	4,209			4,209
c) Exercise of options for cash	34,000	316			316
d) Conversion of Special Shares to subordinate voting shares	27	1	(1,379)	(1)	
Issued and outstanding, December 31, 1986	10,744,132	63,869	1,077,133	151	64,020
Authorized, December 31, 1986	Unlimited		12,000,000		

Preferred Shares and Junior Preferred Shares

Such classes of shares may be issued in one or more series with such designations, preferences, rights, privileges, restrictions and conditions attached as may be determined by the directors.

Authorized—10,000,000 Preferred Shares and 20,000,000 Junior Preferred Shares;

Issued and outstanding—none

Special Shares

The articles of the company provide that, subject to the Canada Business Corporations Act, Special Shares are:

- (i) not transferable except in certain limited circumstances;
- (ii) ranked, as to payment of dividends and repayment of capital, junior to all other existing shares of the company;
- (iii) limited as to repayment of capital to the amount paid up thereon;
- (iv) not entitled to dividends except in a year in which dividends of at least \$0.375 have been paid on the subordinate voting shares and then payable subject to prescribed limits;
- (v) entitled to 10 votes per share at a meeting of shareholders;
- (vi) only redeemable on or after June 30, 1991 at the redemption price of \$0.075 per share;
- (vii) purchasable by the company at any time;
- (viii) convertible by the holder into subordinate voting shares at any time on the basis of one subordinate voting share for 50 Special Shares.

The Special Shares carry a preemptive right entitling the holders to receive newly issued Special Shares in proportion to such shareholders' holdings of Special Shares.

On the issue of additional subordinate voting shares (except in certain circumstances) or on the issue of any security convertible into subordinate voting shares, the company is required to offer to the Special shareholders, at a specified price, sufficient additional Special Shares in proportion to their holdings of Special Shares to bring the number of Special Shares, to be outstanding thereafter, up to 10% of the number of subordinate voting shares outstanding on a fully diluted basis. Neither Special Shares nor subordinate voting shares are to be subdivided or consolidated without the other being subdivided or consolidated on the same basis.

Subordinate voting shares

Each subordinate voting share entitles the holder to:

- (i) one vote per share;
- (ii) receive dividends when declared;
- (iii) receive, on dissolution of the company, subject to the prior rights of the holders of Preferred and Junior Preferred Shares but in priority to the rights of the holders of Special Shares, the amount paid up thereon together with any declared and unpaid dividends and, after payment to the holders of Special Shares of the amount paid up on such Special Shares, to receive any declared and unpaid dividends thereon together with the remaining property of the company.

Employee stock option

At December 31, 1986, 454,500 subordinate voting shares were reserved for issuance upon the exercise of options granted to full-time employees, including 428,500 to officers of the company, at prices ranging from \$3.205 to \$24.75 per share. These options may be exercised at various periods to 1996.

In 1986, 34,000 options were exercised and options on 15,000 subordinate voting shares were forfeited on termination of employment.

Employee share purchase plan

In each of 1984, 1985 and 1986, the company introduced a share purchase plan to qualified employees. Under each plan a qualified employee may purchase subordinate voting shares of the company having an aggregate cost to the employee of 7½% of the employee's annualized base earnings. The company provides an interest-free loan to the full amount of the employee's commitment, repayable over three years and secured by the subordinate voting shares purchased under the plan. At the end of each of these three years, the company will pay a bonus to each participant equal to 13½% of the employee's commitment to be used to purchase additional subordinate voting shares.

Employees have purchased or are committed to purchase a total of 641,200 subordinate voting shares under the 1984, 1985 and 1986 plans at \$18.73, \$24.19 and \$22.37 per share, respectively. At December 31, 1986, outstanding loans amounted to \$3,313,000 (1985 – \$3,165,000), of which \$1,397,000 (1985 – \$1,359,000) is included in loans receivable and \$1,916,000 (1985 – \$1,806,000) in accounts receivable.

Shares required for future issue

At December 31, 1986, a total of 585,013 subordinate voting shares may be required for future issue as follows: 21,543 for conversion of the Special Shares, 454,500 for exercise of stock options and approximately 108,970 for participants in the 1984, 1985 and 1986 employee share purchase plans.

9. Income taxes

Investment tax credits

Investment tax credits earned in the current year on scientific research and capital expenditures have been applied to reduce the cost of the related expenditures and assets as follows:

	(\$000s)	
	1986	1985
Fixed assets	\$ 300	\$ 500
Deferred costs	200	—
Cost of sales	3,350	8,800
Research and development costs	850	1,200
	\$ 4,700	\$10,500

Effective income tax rate

The company's income tax provision consists of the following:

	(\$000s)	
	1986	1985
Combined basic Canadian Federal and Provincial income tax rate	50.0%	48.4%
Income tax expense prior to the following (reductions) increases	\$ 4,047	\$12,134
– Manufacturing and processing deduction	(526)	(1,604)
– Losses of foreign subsidiaries (not recognized)	—	2,102
– All other items (net)	179	(632)
Income tax expense	\$ 3,700	\$12,000

Loss carry forwards

The company has not recognized the tax benefit of losses of prior years in the amount of \$5,800,000 in respect of foreign subsidiaries.

	Year of expiry	(\$000s) Annual rental
10. Commitments		
Facility		
Toronto – Caledonia Road	1989	\$ 341
– 1700 Ormont Drive	1988	388
– 1235 Ormont Drive	2001	433
Ottawa – Kanata	1988	523
Other	1987-1992	783
		\$ 2,468

At December 31, 1986, the company is committed to sell \$18,300,000 U.S. dollars under forward exchange contracts at an average conversion rate of \$1.4368 Canadian. These contracts mature on various dates throughout 1987.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(tabular amounts are in thousands of dollars)

December 31, 1986

11. Pension and retirement plans

Pension contributions by employees together with those made by the company are deposited with trustees according to the terms of the plans. Pensions at retirement are related to various factors including remuneration, years of service and, in the case of certain officers, the market value of the company's subordinate voting shares.

Actuarial valuations as of December 31, 1985 indicated an excess of fund assets over the actuarially computed current service obligations. The company's policy is to amortize such surplus over three years and has included one-third of this surplus in income in 1986, which, after certain offsets and income taxes, increased net income in the year by approximately \$2,025,000 (1985 - \$1,435,000).

Based on actuarial valuation of the company's pension plans at December 31, 1985, the estimated past service liability unfunded and unrecorded in the accounts at December 31, 1986 is \$140,000 (1985 - \$590,000).

The liability related to certain retirement plans for certain officers is estimated to be \$1,667,000 at December 31, 1986 (1985 - \$1,634,000). This amount is unfunded and not recorded in the accounts, and will be amortized over the estimated number of years to normal retirement.

The amount charged (credited) to earnings in respect of all pension and retirement plans was (\$580,000) (1985 - \$742,000).

12. Government assistance

On February 14, 1986 the Federal Government executed a Memorandum of Understanding (M.O.U.) under which the Government will share the costs of research and development and capital expenditures with the company over the period 1986 to 1991 to a maximum of \$130 million or 43.6% of the total investment by the company.

Government assistance received and receivable from the Federal Government related to research and development activities and capital expenditures in the year totalled \$15,573,000 (1985-\$2,950,000). This assistance normally takes the form of grants which may be repayable in the form of royalties based on future sales levels related to the projects funded, or the company's ability to meet certain investment targets as specified in the agreements. At December 31, 1986 no provision for repayment has been recorded with respect to contributions received and receivable. Amounts, if any that may be repayable will be accounted for in the period in which conditions arise that will cause repayment.

Government assistance received in the current year has been applied to reduce the cost of the related expenditures and assets as follows:

	(\$000s)	
	1986	1985
Fixed assets	\$ 2,175	\$ 1,436
Research and development costs	13,398	1,514
	\$15,573	\$ 2,950

13. Statement of changes in financial position

Items not affecting cash

The components of net income which did not affect cash consist of the following:

	(\$000s)	
	1986	1985
Depreciation and amortization	\$ 6,612	\$ 5,650
Deferred income taxes	257	4,072
Amortization of goodwill	485	426
Accrued incentive revenue	(4,208)	(2,535)
	\$ 3,146	\$ 7,613

Net increase (decrease) in cash invested in working capital related to operations

The net increase in cash invested in working capital related to operations results from the following increases (decreases) in working capital components:

	(\$000s)	
	1986	1985
Accounts receivable	\$25,804	\$ 9,753
Income tax recoverable	717	4,298
Inventories	(20,449)	16,166
Prepaid expenses and other	3,233	2,851
Accounts payable and accrued charges	(7,991)	(4,073)
Payroll and other taxes payable	(1,517)	(1,255)
Dividend payable	93	(291)
Customer advance payments	(14,651)	1,920
Net increase (decrease) in working capital related to operations	\$(14,761)	\$29,369

14. Comparative figures

The comparative financial statements have been reclassified from the statements previously presented to conform to the presentation of the 1986 financial statements.

15. Industry segment information

The company's operating divisions have been grouped into two industry segments.

It is the company's policy to price internal sales or transfer values for services, generally on an equivalent basis as that used for pricing externally.

(\$000s)	Gears and transmissions, aviation and other services		Satellites, communications and advanced systems		Eliminations		Consolidated	
	1986	1985	1986	1985	1986	1985	1986	1985
External revenues	\$44,139	\$51,785	\$146,879	\$171,493			\$191,018	\$223,278
Intersegment revenues	975	1,971			\$ (975)	\$(1,971)		
Total revenue	\$45,114	\$53,756	\$146,879	\$171,493	\$ (975)	\$(1,971)	\$191,018	\$223,278
Segment operating profit	\$ 1,322	\$ 9,056	\$ 14,194	\$ 25,393	\$ (189)	\$ (417)	\$ 15,327	\$ 34,032
General corporate expenses							(6,934)	(7,955)
Interest on long term debt							(982)	(3,043)
Other interest income (net)							683	2,036
Income taxes							(3,700)	(12,000)
Net income							\$ 4,394	\$ 13,070
Identifiable assets	\$36,083	\$47,369	\$163,886	\$ 82,713			\$199,969	\$130,082
Corporate assets							46,814	39,504
Total assets							\$246,783	\$169,586
Capital expenditures	\$ 1,411	\$ 2,322	\$ 7,737	\$ 5,807				
Depreciation and amortization	\$ 1,426	\$ 1,179	\$ 4,034	\$ 3,138				

- The company operates principally in Canada.
- The company's revenues from export markets were approximately \$108,500,000 in 1986 (1985 – \$124,300,000).
- A significant portion of the company's business is with various branches and agencies of the Canadian government and crown corporations as well as with foreign government agencies.

Gears and transmissions, aviation and other services includes: (i) gears and transmission systems and equipment

for gas turbine engines, fixed and rotary wing aircraft and robotic applications; (ii) repair and overhaul of a wide range of commercial and military aircraft instrumentation and mechanical components and helicopter maintenance.

Satellites, communications and advanced systems includes: (i) satellite systems and subsystems and ground-based satellite communications systems; (ii) remote manipulator systems for space and terrestrial applications; and (iii) defence systems.

TEN-YEAR REVIEW

(dollars in thousands, except per share figures)

	1986	1985	1984	1983	1982	1981	1980	1979	1978	1977
Earnings (loss) per share										
Basic										
– income (loss) from continuing operations	\$0.42	\$1.41	\$1.88	\$1.73	\$1.34	\$0.44	(\$0.17)	\$0.31	\$0.53	\$0.41
– net income (loss)	\$0.42	1.41	1.26	1.42	1.43	0.37	(0.28)	0.31	0.53	0.41
Fully diluted										
– income from continuing operations	\$0.42	1.33	1.65	1.43	1.06	0.40*	**	0.28	0.40	0.36
– net income	\$0.42	1.33	1.15	1.20	1.12	0.34*	**	0.28	0.40	0.36
Cash dividends paid per										
Subordinate voting share	\$0.46	0.46	0.40	0.35	0.20		0.15	0.15	0.11	0.07
Preferred Share					0.54	1.08	1.08	1.08	1.06	
Deferred Share								0.05	0.03	
Shareholders' equity per subordinate voting share outstanding at year end	\$9.16	8.16	6.45	5.33	3.85	2.58	2.20	2.28	2.40	1.98
Revenues (1)	\$191,018	223,278	190,031	209,321	169,121	113,101	120,986	108,813	91,869	70,089
Income (loss) from continuing operations	\$ 4,394	13,070	15,916	12,709	8,049	2,554	(375)	1,605	2,184	1,311
Net income (loss)	\$ 4,394	13,070	10,661	10,423	8,580	2,167	(877)	1,605	2,184	1,311
Capital expenditures (net of government grants and tax credits) (2)	\$ 9,397	8,660	13,738	4,788	2,525	1,678	4,155	4,567	2,851	4,000
Long term debt (including current portion) (2)	\$ 2,418	22,786	31,381	29,796	8,256	12,198	7,000	945	710	1,272
Shareholders' equity	\$ 98,582	79,521	56,715	42,567	25,635	17,463	15,645	14,730	13,854	12,441
Working capital (2)	\$ 54,030	58,561	54,662	54,835	17,096	11,758	3,227	6,089	7,979	7,621
Ratio of current assets to current liabilities (2)	1.4	1.9	2.1	2.1	1.2	1.3	1.1	1.2	1.4	1.6
Number of employees (2)	2,089	2,221	2,172	2,041	1,902	1,895	2,100	1,900	1,670	1,400
Number of shareholders										
Subordinate voting	4,459	4,590	4,452	3,489	2,800	2,930	2,970	2,690	2,150	2,060
Preferred and Special	39	40	42	57	64	620	675	780	744	

* Does not include exercise of warrants which would be anti-dilutive.

** Fully diluted not shown as effect would decrease loss per share.

(1) Amounts reported are for continuing operations only. Years prior to 1984 have been restated to exclude discontinued operations.

(2) Amounts reported for 1984 and prior years have not been restated; such years include historical amounts for discontinued operations.

DIRECTORS

David R. Beatty

President
Weston Foods
George Weston Limited
(Elected director 1983)

Larry D. Clarke*

Chairman of the Board and
Chief Executive Officer
Spar Aerospace Limited
(Elected director 1967)

Camille A. Dagenais†

Chairman of the Board
The SNC Group
(Elected director 1980)

John D. Houlding†

President and
Chief Executive Officer
Polar Gas Project
(Elected director 1977)

Philip A. Lapp*

President
Philip A. Lapp Limited
(Elected director 1967)

Earl H. Orser*†

President and
Chief Executive Officer
London Life Insurance Company
(Elected director 1978)

R. Don Pollock

President and
Chief Operating Officer
Spar Aerospace Limited
(Elected director 1984)

Jeffery A. Skelton

Vice President
Government Affairs
Aluminum Company of Canada, Ltd.
(Elected director 1986)

David A. B. Steel*

Businessman
(Elected director 1967)

Barbara L. Steele†

Company Director
(Elected director 1980)

Ihor Suchoversky

President
Alcan International Limited and
Vice President Research and
Technology
Alcan Aluminium Limited
(Elected director 1986)

†Member of the Audit Committee

*Member of the Executive Committee

DIRECTORS EMERITUS

David S. Beatty

(Elected director 1969)
(Appointed Director Emeritus 1985)

William H. Jackson

(Elected director 1967)
(Appointed Director Emeritus 1985)

Roland B. Dodwell

(Elected director 1967)
(Appointed Director Emeritus 1986)

OFFICERS

Larry D. Clarke

Chairman of the Board and
Chief Executive Officer

Earl H. Orser

Vice Chairman of the Board

R. Don Pollock

President and
Chief Operating Officer

Anthony L. Anderson

Senior Vice President,
Finance and Administration

E. Peter Birch

Vice President, Administration

Gil A. Branchflower

Vice President and General Manager
Satellite and Aerospace Systems
Division

David C. Cleland

Vice President
and Corporate Controller

George D. Dill

Vice President

Eric R. Grimshaw

Vice President and General Manager
Structures and Mechanisms Group

John E. Lockyer

Vice President and
Assistant to the President

John D. MacNaughton

Senior Vice President,
Marketing and Technology

Thomas G. Mathers

Vice President, Human Resources

J. Ron McCullough

Vice President, Technology

John Neville

Vice President, Planning and
Corporate Development

Ken J. Perry

Vice President and General Manager
Gears and Transmissions Division

Sheldon Polansky

Legal Advisor and Secretary

Christopher G. Trump

Vice President and Executive
Assistant to the Chairman

Auditors

Clarkson Gordon

Transfer Agents

The Canada Trust Company

Listed

Toronto Stock Exchange
Montreal Stock Exchange
(Trading Symbol: SPZ)

CORPORATE INFORMATION

Executive Offices

Royal Bank Plaza, South Tower
P.O. Box 83, Suite 3690
Toronto, Canada M5J 2J2
Telephone: (416) 865-0480

Corporate Office

6303 Airport Road, Suite 403
Mississauga, Ontario L4V 1R8
Telephone: (416) 678-9750

Government Relations Offices

77 Metcalfe Street, Suite 200
Ottawa, Ontario K1P 5L6
Telephone: (613) 563-0230

1745 Jefferson Davis Highway
Crystal Square #4, Suite 608
Arlington, Virginia 22202
Telephone: (703) 920-9322

Aviation Services Division

825 Caledonia Road
Toronto, Ontario M6B 3X8

1190 McTavish Road N.E.
Calgary, Alberta T2E 7G6

Communications Group

21025 Trans Canada Highway
Ste-Anne-de-Bellevue
Quebec H9X 3R2

Commercial Telecommunications
Corporation (COMTEL)
Santa Maria, California

Defence Systems Division

P.O. Box 13050
Kanata, Ontario K2K 1X3

1235 Ormont Drive
Weston, Ontario M9L 2W6

Gears and Transmissions Division

825 Caledonia Road
Toronto, Ontario M6B 3X8

Structures and Mechanisms Group

1700 Ormont Drive
Weston, Ontario M9L 2W7

Astro Aerospace Corporation
Carpinteria, California

Satellite and Aerospace Systems Division

21025 Trans Canada Highway
Ste-Anne-de-Bellevue
Quebec H9X 3R2

Wholly-owned subsidiaries

Astro Aerospace Corporation

6384 Via Real
Carpinteria, California 93013-2993
U.S.A.

Commercial Telecommunications Corporation (COMTEL)

2811 Airpark Drive
Santa Maria, California 93455
U.S.A.

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