Varity Corporation

Annual Report
1986

VARITY

Services

Perkins Engines

Products
Diesel engines
Parts

Plants
France
Germany
United Kingdom [3]
United States

Associate Companies
Brazil (see M-F)
Diesel engines
Mexico (19%)
Diesel engines
Peru (24%)
Diesel engines

Licensees
Argentina
Bulgaria
Greece
India
Iran
Pakistan
Poland
South Africa
Spain
Turkey
Uruguay
Yugoslavia

Building Supplies

Wolverine Brass

Products
Faucets
Other plumbing products

Plant
South Carolina

Glynn-Johnson

Products
Door and window hardware

Plant
Illinois

Newell

Products
Builder's hardware
Automotive stampings

Plant
Michigan

H. B. Sherman/ Handy Things

Products
Lawn care products
Christmas tree stands

Plant
Missouri

Marvel

Products
Refrigeration equipment

Plant
Indiana

Varity Development

Varity Development

Varity Enterprises
Venture capital investments

Varity Properties
Commercial real estate development

Central Electronics Group
Electronic products and services

Polygon Reinsurance Company Limited
Reinsurance

Panagri Trading Corporation
Trade and barter

Agricredit Acceptance Corporation
Retail finance

Barclays Bank Agricultural Finance Corporation
Retail finance (30%)

Other

Massey-Ferguson AgriWorld
Agribusiness development

Varity World Trade Limited
Business development in developing world

Rhinanthus Leasing Limited
Equipment leasing

Meglitha Limited
Equipment leasing

St. Dunstan's Hill Leasing Limited
Equipment leasing

[ ] = No. of plants
( ) = % owned

Varity in Profile

Varity Corporation is a diversified industrial holding company, based in Canada, whose operating businesses design, manufacture and distribute farm machinery, industrial machinery, diesel engines, automotive and hydraulic components, and building products on an international scale.

The Company also engages in retail finance and reinsurance, commercial and industrial real estate development, countertrade on world markets, venture capital investments in smaller, high-growth businesses, and large-scale agribusiness development projects, primarily in the developing world. A new business unit of Varity designs, produces and markets a range of highly specialized electronic sensors for various types of mobile machinery.

Varity, whose origin dates to 1847, is the Western World's largest producer of tractors through its Massey-Ferguson Group, and a leading supplier of diesel power through its Perkins Engines Group. The MF Industrial business supplies approximately 10 per cent of the world's light and medium-duty backhoe loaders and other off-highway industrial machinery. Another business, Pacoma fluid power products, is a significant international producer of hydraulic components. The Company's newest branded-product business, Dayton Walther, is a major North American supplier to the automotive and building supply industries.

The Company's products are made by subsidiaries, Associates and licensees in 33 countries and sold in 190 countries through a network of more than 10,000 distributors and dealers.

Equipment

Compon

Massey-Ferguson

Products
Agricultural tractors
Implements
Parts

Plants
France
Italy [2]
United Kingdom [2]

Associate Companies
Brazil (37%)
Agricultural tractors
Combines
Implements
Iron Castings
India (49%)
Tractors
Implements
Libya (33-1/3%)
Tractors
Canada (45%)
Combine harvesters
Large 4-wheel drive tractors
Morocco (24%)
Tractors
Saudi Arabia (20%)
Tractors
South Africa(18.95%)
Tractors
Harvesting machinery
Implements

Licensees
Argentina
Guyana
Indonesia
Iran
Japan
Kenya
Pakistan
Poland
Spain
Turkey
Uruguay
Zimbabwe

MF Industrial

Products
Industrial tractors
Tractor loaders
Backhoe loaders
Forklifts
Telescopic loaders

Plant
United Kingdom

Associate Companies
Brazil (see M-F)
Industrial tractors
Backhoes

Massey-Ferguson Australia

Products
Tractors
Harvesting equipment
Implements

Pacoma

Products
Hydraulic cylinders
Valves

Plant
Germany

Dayton-Walther

Products
Auto & truck wheels
Wheel assemblies
Hubs
Brake components
Trailer couplers
Jacks
Trailer landing gear
Fifth wheels
Suspension systems

Plants
United States [11]
Canada [3]
United Kingdom

Associate Companies
Mexico [2] (40%)

Licensees
Ireland
Spain
Venezuela

MASSEY-FERGUSON

MF Industrial

Perkins
Engines

Pacoma

DAYTON WALTHER

Financial and Operating Highlights

Varity Corporation
(Millions of U.S. dollars except per share amounts)

Years ended January 31,	**1987**	1986	1985
Operating Summary			
Net sales			
Continuing operations	**$ 1,359.3**	$ 1,288.4	$ 1,293.6
Discontinued operations		121.3	175.0
Total net sales	**$1,359.3**	$1,409.7	$1,468.6
Income (loss)*			
Income (loss) from continuing operations before income taxes	**$ (23.7)**	$ 36.6	$ 55.6
Income tax (provision) recovery	**0.4**	(12.7)	(17.8)
	$ (23.3)	$ 23.9	$ 37.8
Loss from discontinued operations (after recovery of income taxes of $15.4 million and $22.8 million for the years ended January 31, 1986 and 1985, respectively)		$ (20.0)	$ (30.6)
Net income (loss)	**$ (23.3)**	$ 3.9	$ 7.2
Cash provided by operations	**$ 52.0**	$ 44.3	$ 86.9
Per Common Share (after Preferred Share dividend entitlements)			
Net loss	**$ (0.21)**	$ (0.16)	$ (0.12)
Financial Status (at year end)			
Total assets	**$ 1,504.1**	$ 1,249.8	$ 1,449.2
Shareholders' equity	**$ 342.1**	$ 362.1	$ 310.4

*The Company believes that tax on any future income from continuing operations will be sheltered by the substantial tax loss carry-forwards available in all principal operating subsidiaries.

Contents

10-K Report

A copy of the Company's 10-K report for the year ended January 31, 1987 is available to shareholders upon request to the Company Secretary.

Le rapport en français

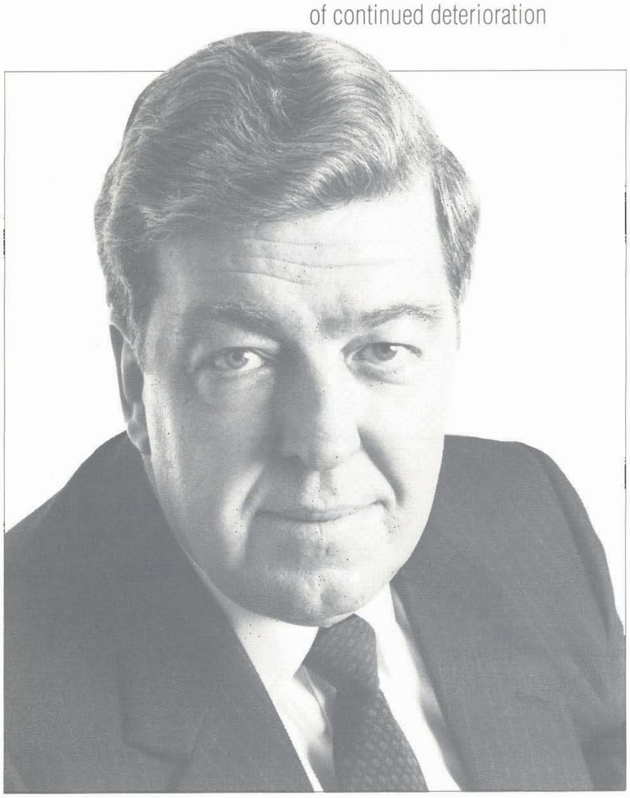
Le rapport du conseil aux actionnaires et certains extraits du rapport annuel en francais peuvent être obtenus sur demande en s'adressant au Secrétaire de la Compagnie.

Annual Meeting

The meeting will be held in the Commonwealth Ballroom of the Holiday Inn Downtown, Toronto, Canada, at 2:00 p.m. on Wednesday, June 10, 1987.

To our Shareholders

Capsule review of fiscal 1986: no other single year in the recent history of the Company witnessed so many developments of major importance. The period was marked by progress in our program of strategic initiatives and corporate redevelopment. From a near-term perspective, 1986 was disappointing, with financial performance falling short of projections, largely the result of continued deterioration



in farm machinery markets and erratic behavior of international currency values.

Briefly reviewing the accomplishments of 1986:

- We completed our first major acquisition since 1974 with the purchase of Dayton Walther Corporation, a long-established and successful supplier to the North American automotive industry.
- Our two largest businesses, Massey-Ferguson tractors and farm equipment and Perkins diesel engines, introduced highly innovative core products, including the world's most highly computer-automated tractors for agriculture and the first high-speed direct injection diesel engines exclusively designed for passenger cars.
- We negotiated a comprehensive restructuring and recapitalization program.
- For the third year in a row, we increased our share of the world market for agricultural tractors. We also improved our penetration in the global market for light and medium industrial machinery.
- We enhanced the competitive dynamics of the Perkins diesel engine business by acquiring a well-known diesel producer in the United Kingdom, L. Gardner and Sons, with a strong position in the European coach and bus market.
- We made significant early progress in developing a corporate portfolio of investments in growth-oriented business opportunities, finishing the year with modest to substantial equity positions in five smaller, fast-rising enterprises.
- Our operations in Australia underwent financial and operational restructuring that resulted in substantial debt retirement and extension of remaining debt maturities. These actions improved the balance sheet and reduced debt service costs. The Australia business is operating profitably despite continuing distress in the nation's agricultural economy.
- We adopted a new corporate identity compatible with our diversification into business sectors unrelated to farm machinery, safeguarding our prominent branded-product identities with their established customer acceptance and marketing values.
- We installed the corporate organizational framework in which to operate effectively as a diversified industrial management holding company on a global scale.

Operating Results

Varity recorded a loss of U.S. \$23.3 million on sales of \$1,359 million in the year ended January 31, 1987. These results compared with year-earlier net income of \$3.9 million on sales of \$1,288 million. Adjusted for fluctuations in international currency values, year-to-year sales actually declined almost seven per cent, primarily due to a further decline in global industry demand for agricultural tractors. For the fifth consecutive year, our operations were cash-generative, with cash flow from operations gaining by some 18 per cent to approximately \$52 million; this is a consequence of our continuing concentration on tight management of assets.

Our financial performance reflects severe persisting problems in our operating environment. The capital goods industries in which we participate remain flat or depressed; key market leaders have registered major losses. In fact, we are not aware of any publicly held company dependent primarily on sales of farm machinery that was profitable in 1986.

At the same time, Varity's two biggest businesses completely reshaped and modernized their central product lines. Costs associated with these decisive product development programs have largely been absorbed. Competition must spend to catch up or face the prospect of reduced market share. The cost of introducing an unprecedented number of new products in a short span of time was greater than expected. In spite of careful planning, we encountered difficulties in adapting our manufacturing processes to the radically changed technologies associated with our new products. This caused temporary delays in restocking the inventory pipeline.

We cannot be satisfied with the financial results of 1986. We can do better in 1987—even given the likelihood that operating circumstances will remain arduous. On balance, we emerged from the past year stronger than we entered it. We reduced our dependence on farm machinery, achieved greater geographic balance in the deployment of assets, and continued the systematic process of trimming costs and improving efficiency.

Dayton Walther

At the end of December 1986, Varity acquired the assets of Dayton Walther Corporation, of Dayton, Ohio. The new subsidiary is a major supplier of wheels, brake components, and other engineered metal products to North American manufacturers of cars, trucks and trailers. It has also developed a substantial business in the manufacture and distribution of products for the building supply industry, as well as a range of specialized consumer goods.

Dayton Walther represents a key step in our diversification. We were attracted to this opportunity for several reasons. It is counter-cyclical to our farm machinery interests. It is heavily engaged in the original equipment, or OEM, marketplace, where we are already active through the Perkins and Pacoma divisions. Dayton Walther has a reputation for superior quality products and outstanding engineering; no less than six of its plants have earned the highest quality designation that its customers bestow on suppliers. Like Varity, Dayton Walther is market-sensitive, placing a high premium on assured customer satisfaction. Unlike Varity, it has little business abroad, thereby presenting an attractive growth opportunity for the parent company and possibly for some of our licensees, Associates and distributors throughout the world.

Equity Financing

As part of the 1986 restructuring agreement, certain lending institutions that received Class I Series A preferred shares intend to offer these shares to the public.

The offering is now expected to take place in the summer of 1987. Under terms of the 1986 restructuring, Varity is obligated to participate in this offering with treasury shares. The scope of our participation and the precise terms of the offering remain to be determined.

Tractor Operations Reorganized

In response to 1986 operating losses, the Massey-Ferguson tractors business has been completely reorganized. We have established separate distribution companies in France, Germany, North America and the United Kingdom; two tractor manufacturing companies, in France and the U.K.; a world-wide parts business; and an integrated manufacturing and distribution company in Italy. Each operating unit has its own management team, and each is responsible for profitability.

The driving purpose of these measures is improved profitability. To achieve this goal in hostile markets, we are encouraging a more entrepreneurial approach that requires closer links between operational managements and the customers they serve. We expect every unit of the Massey-Ferguson Group to act as a small business—by renewed focus on maximised profitability, cost control, and fast, effective response to the changing demands of their markets.

Business Outlook

We foresee little likelihood of major improvement in demand for farm machinery; Massey-Ferguson markets will remain difficult. For Perkins, many markets will continue to be highly competitive due to surplus capacity in the industry.

Demand for Dayton Walther automotive products is likely to continue at a reasonably buoyant level, although vehicle sales in North America may suffer marginal slippage. We expect sales of MF Industrial's backhoe loaders and other workhorse products to advance somewhat, as the pace of commercial and residential construction in North America and Europe continues to benefit from relatively low interest rates. Pacoma's aggressive sales program is likely to achieve further penetration of the international market for hydraulic systems.

Varity's roster of operating businesses has expanded with the launch of the Central Electronics Group as a stand-alone business offering its advanced-technology products and services in the commercial marketplace. The feasibility of this venture was confirmed by CEG's contributions to the electronic technology incorporated into Massey-Ferguson's new 3000 Series of computerized tractors whose "Autotronic" control features were awarded a Gold Medal at Europe's leading agricultural exposition.

Three Directors Retire, One Elected

Two members of the Board of Directors intend to retire in 1987 after long and valuable service. A. M. Runciman has been a member of the Board since 1975, while J. Page R. Wadsworth joined in 1977. Each has provided thoughtful and perceptive counsel throughout the stressful years of retrenchment and rebuilding.

Early in 1987, Alastair Morton, a member of the Board since I981, resigned to devote his energies to his new post as Britain's co-chairman of the Eurotunnel consortium. We wish him every success in his challenging assignment.

We welcome Thomas N. Davidson to the Board. Mr. Davidson is chairman of the board of PCL Industries Limited, of Toronto, a holding company with diversified manufacturing operations. He is also chairman of Sterling Trust Corporation and the Metro Toronto Convention Centre, and a director of several other Canadian and U.S. companies.

Management Appointments

As an industrial holding company, Varity has evolved by strategic design into an operating structure that divides our interests into three major areas—wholegoods for end-use customers in retail markets; component products for original equipment markets; and diverse services for specialized markets.

To meet our need for headquarters senior management skills in the latter sector, several changes of executive assignments were carried out in 1986. James M. Felker was appointed senior vice president responsible for Varity Development, a new headquarters business unit that incorporates most of the Company's service-related activities, including commercial real estate development, trade and barter, insurance and retail finance, the newly formed electronics business, and Varity Enterprises' venture capital portfolio; he is also responsible for the orderly consolidation of Dayton Walther into Varity.

Mr. Felker has been succeeded as president of Massey-Ferguson by John D. Sword, who was a senior manager at Massey-Ferguson before becoming president of MF Industrial in 1983. Mr. Sword has been replaced at the industrial machinery business by Richard E. Robson, who had been vice president in charge of Varity International Services. John Towers, who had been a senior manager at Perkins, has succeeded Mr. Robson at Varity International Services.

In other senior management changes, Bob M. Brown became president and chief executive officer of Dayton Walther; he was formerly senior vice president and senior business advisor of Varity. Mr. Brown was replaced by James Vance, formerly vice chairman of the board and chief financial officer of Dayton Walther. J. R. Nowling was named vice president responsible for communications and external affairs.

One year ago, on this page, we noted that the Company was experiencing "a hard-won corporate renewal." We have now moved beyond that stage. In a measured way, we are becoming a global enterprise composed of autonomously managed businesses, each a real or potential market leader, each a reliable source of utilitarian products or services, and each intent on making regular contributions to profit and growth.

The fact that our goal drew perceptibly nearer in 1986, despite setbacks, is a tribute to the energy, skill and commitment of our employees at every level of the organization. To them, and to our shareholders, customers, distributors, dealers, and suppliers, the Board extends grateful thanks.

On behalf of the Board,

Victor Rice
Chairman and Chief
Executive Officer
Toronto, April 27, 1987

Blueprint for Profitable Growth

Vincent D. Laurenzo
President
Varity Corporation

Varity Corporation is intent on achieving profitable growth in the coming years through careful execution of our strategic program to diversify. By entering new businesses that reduce our vulnerability to agricultural markets, the Company expects to develop its industrial/commercial portfolio in ways that improve its capacity to generate value for shareholders.

In the context of total corporate revenues, we intend to manage our business so as to decrease the contribution from farm machinery-related operations to 50 per cent or less by 1990.

We expect to reach this goal by:

• Building our existing businesses; for example, our acquisition of L. Gardner and Sons in 1986 and the diesel operations of Rolls Royce in 1984 have significantly increased the product spectrum and marketing opportunities for Perkins;

• Participating in joint ventures, with particular emphasis on projects that assist in the rationalization of the farm machinery and diesel engine industries, both of which are suffering severe over-capacity;

• Undertaking major acquisitions in non-agricultural business sectors; Varity's purchase in 1986 of Dayton Walther, a major supplier to the North American automotive and building supply industries, has already reduced our dependence on agriculture to less than 55 per cent of corporate revenues;

• Developing a corporate portfolio of investments in smaller, high-growth companies with the expectation that some will grow and prosper to the point that Varity would wish to acquire additional equity interests or divest at a substantial profit;

• Locating and becoming part of turnaround prospects in the local, national or international business community, as witnessed by our investment in 1986 in Ontario Bus Industries, a company with superior products, new management, and an urgent requirement for additional capital to fulfill the opportunities coming its way.

This is, admittedly, an ambitious scenario for future growth and profitability. At the same time, it is what the Company has been working towards since 1979 and it is completely within reach.

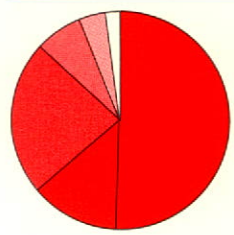
The 1986 restructuring plan improved financial stability of the Company notwithstanding the ongoing depressed agricultural machinery markets. Completion of the plan provides the framework under which Varity is embarking upon a profitable future.

By 1990, Varity will have shifted from its historical position as a farm machinery producer with related operations, to an international, diversified holding company with greatly reduced dependence on the cyclical uncertainties of the agricultural industry.

Our long-term intent is to manage a number of related businesses, each of which operates autonomously with the sole requirement that it meets a consistently acceptable return on assets to be retained in Varity's portfolio.

To that end, Varity has embraced the condition of change as a fixed element in the character of our company. This continuing flexibility allows us to reduce exposure, improve operating efficiencies, seek diversification, maintain competitiveness and take advantage of any market share opportunities. As these operational benefits accumulate, the Company's ability to create shareholder value will be substantially enhanced.

Sale of Varity Products by Major End Use 1986*



Farm Machinery
Transportation
Diesel Engines
Industrial Machinery
Building Products
Hydraulic Products

***including pro forma consolidation of Dayton Walther 12-month sales.**

Massey-Ferguson Group

The Massey-Ferguson Group consists of four distribution companies in France, Germany, North America and the United Kingdom; a parts business selling to distributors worldwide; two tractor manufacturing companies in France and the United Kingdom; and a manufacturing and distribution company in Italy. In addition, the axle manufacturing operation based at Como, Italy, is being developed as a stand-alone business.

Massey-Ferguson's tractors, ranging from 15 to 150 horsepower, are supplemented by harvesting products and farm implements sourced from contract suppliers. The tractors are marketed under the Massey-Ferguson and Landini brands.

Massey-Ferguson responded to an extremely difficult market environment in the worldwide tractor industry, which saw retail sales slide by more than 60,000 units in 1986, by introducing 17 new tractor models. Massey-Ferguson believes this was the largest single model changeover ever undertaken in the agricultural machinery industry—equivalent to a major car maker changing its entire product line in one stroke. This bold step sent a clear signal of uncompromising commitment to the marketplace despite the low commodity prices and crop surpluses that continue to afflict agricultural economies everywhere.

Notwithstanding the persisting problems of our customers, Massey-Ferguson improved market share for the third year in a row. Although the farm machinery market is expected to remain sluggish in 1987, our near-term outlook is buoyed by our new products, including the pace-setting 3000 Series, and the competitive benefits of a tractor range characterized by top quality, advanced specifications, and strategic concentration in the most popular power ratings.

North America

In a major marketing thrust, Massey-Ferguson undertook the development of new niche market segments to reduce dependency on a lagging farm economy.

An intensive demonstration program resulted in sales to several major airlines which are employing our smaller tractors to tow baggage carts and handle other ground support operations. Massey-Ferguson tow tractors are now used at 57 U.S. airports.

Our field sales staff and dealers also launched a campaign to develop demand in such markets as public parks, golf courses and other facilities requiring versatile, lower-powered tractors and accessories for large-scale groundskeeping.

Highlight of the year was the well-received introduction of our new products, staged at sites throughout the continent for dealers and their staffs. For the entire dealer network, these events underscored the fact that Massey-Ferguson products offered dramatic technological leadership across the medium horsepower range.

Europe

Entry of Spain and Portugal into the European Economic Community promises to be beneficial to Massey-Ferguson. A strong distributor raised our 1986 sales in Portugal; in Spain, a reorganization of our distribution

John D. Sword
President
Massey-Ferguson

Financial summary for fiscal 1986:

Revenue	**$805.7 million**
Trading loss	**$27.0 million**
Total assets	**$616.3 million**
Employees	**6,523**

Massey-Ferguson's new 3000 Series tractors offer unique computer-controlled operating features.

system will enable us to capitalize on improved sales opportunities.

In the United Kingdom, the total tractor market shrank by more than 20 per cent. Massey-Ferguson suffered a modest loss of market share during the year but expects to rebound in 1987 with the debut of our new products. We maintained market position in the reduced markets of France, Italy and Germany, and enthusiasm for our new tractors was starting to reflect in sales at year-end.

Massey-Ferguson's share of the market for harvesting equipment in Sweden, Norway and Finland advanced to nearly 19 per cent in 1986, almost three points better than 1985.

Our programs for dealer-distributor development resulted in a significant strengthening of our network in key sales areas.

Middle East, Asia and Africa

Throughout 1986, farm machinery sales remained inhibited by the continuing shortage of foreign exchange in many countries and low oil revenues in others. Nevertheless, Massey-Ferguson increased its market share to 15 per cent.

This success resulted from our ongoing practice, in partnership with distributors, of providing complete packages of tractors, implements, harvesting equipment and support services for effective mechanization of Third World agriculture. For example, considerable savings in the cost of hauling sugar cane are being achieved using our latest tractors specially developed for haulage operations.

In the Middle East, sales of French-sourced M-F 2005 Series tractors reached record levels in a reduced market. Since their introduction in 1982, these tractors have established an excellent reputation on large farms and agribusiness projects. In 1986, the M-F 2725 was the best selling over-100 horsepower tractor to the major wheat projects in Saudi Arabia—some buying their first Massey-Ferguson products in a market sector previously dominated by competitors.

In China, we repeated earlier sales successes with further contracts awarded in 1986.

Licensee operations continued to make encouraging progress. Especially noteworthy was a gain of 19 per cent of market share in Turkey, resulting in the selection of Tarma as "World Export Operations Dealer of the Year."

Latin America

Following drastic measures in Brazil to curb inflation and interest rates, demand for farm equipment improved and Massey-Ferguson and Perkins increased their shares of market.

Other markets, notably Venezuela, Peru and Chile, recovered to pre-depression levels, as governments assigned high priority to agricultural development. Both Massey-Ferguson and Landini branded products are sold in these countries, giving us nearly 30 per cent of the market.

Peru produced our "World Export Distributor of the Year," Enrique Ferreyros, whose energetic efforts helped us achieve a near-50 per cent market share.

Venezuela was a major market for Landini, importing more than 800 tractors in the over-100 horsepower range.

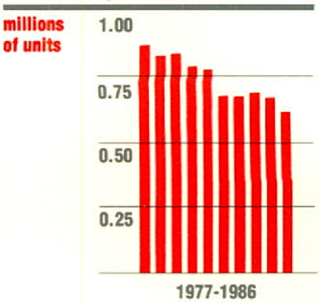
Massey-Ferguson Australia

Adri Verhagen
President
Massey-Ferguson Australia

Financial summary for fiscal 1986:

Revenue	$24.7 million
Trading profit	$8.0 million
Total assets	$49.9 million
Employees	294

Tractors
World Industry Retail Sales



The Australian business manufactures and markets combine harvesters and also markets Massey-Ferguson tractors and harvesting equipment. Massey-Ferguson Australia is the only divisional business based on geography rather than products.

Operating results were adversely affected in 1986 as the market for agricultural equipment in Australia slumped to the lowest levels on record. The tractor market declined 40 per cent while the market for combine harvesters slumped by 55 per cent compared with 1985. Contributing to the depressed machinery market in Australia were high levels of world-wide cereal stocks which depressed commodity prices, together with discounting by the European Economic Community and the United States in traditional Australian export markets. Higher operating costs and rising interest rates also adversely affected farmers' terms of trade.

While the Division's market share remained stable, profit margins suffered due to excessive competitor inventory levels. During the year, a major financial restructuring program significantly improved our debt-to-equity position and balance sheet. As a result of the reorganization of the operational and financial structure of the Australian business, we expect significant improvements in operating performance during 1987.

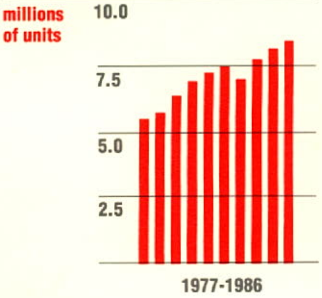
Perkins Engines

John F. Devaney
President
Perkins Engines Divison

Financial summary for fiscal 1986:

Revenue	$450.1 million
Trading profit	$24.1 million
Total assets	$328.2 million
Employees	5,928

Diesel Engines
World Industry Production



Perkins Engines manufactures and markets diesel engines in the 30 to 1,200 horsepower range. Perkins products are specified by more than 500 manufacturers of powered equipment and marketed by a global network of 4,000 distributors, dealers, and parts and service outlets. Main plants, located in the United Kingdom, have an annual capacity of 250,000 units. When combined with Associates and licensees, Perkins has a total annual capacity of 620,000 units.

Perkins' reputation for world leadership in diesel engine research and development was reinforced during 1986 when many new products were unveiled.

The flagship of our new technology is Prima, a high-speed diesel engine for cars and vans. At the heart of this revolutionary new engine is its combustion system which features direct injection—the first time this technology has been achieved at engine speeds of 4,500 revolutions per minute for passenger cars. The result is unrivalled fuel economy (40 per cent more efficient than gasoline), low cost of ownership, and excellent driveability. Developed at a cost of $35 million, the new engine is now in full-scale production at Perkins' main assembly plant in Peterborough, England, and is being supplied to customers such as Austin Rover and Freight Rover.

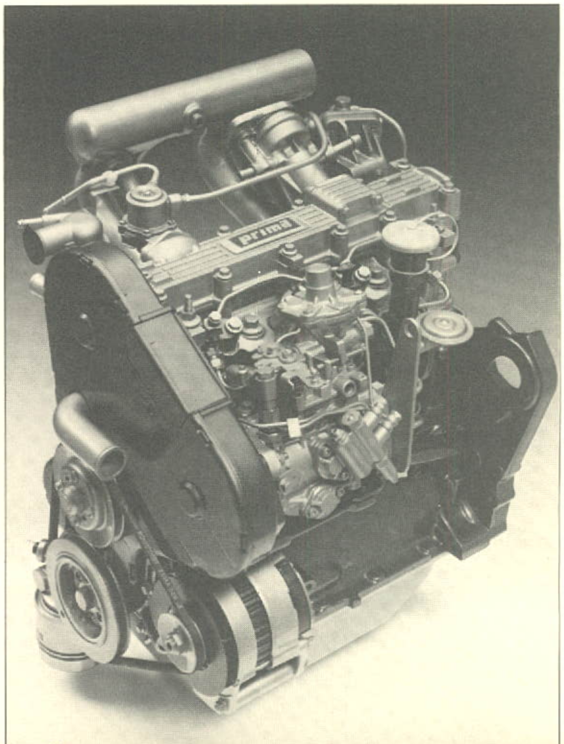
The Perkins Phaser engine, with a new combustion system called Quadram, has also garnered sales successes with the British-based Seddon Atkinson Company. As the power unit in a range of 16 tonne trucks, Phaser is gaining widespread popularity among operators requiring more power and torque yet with minimised noise and emission levels. The Phaser engine received a special "Engine Excellence" award from the United Kingdom's Institute of Transport Managers which cited Phaser's advances in power output and economy.

In a year that saw a Perkins-powered vehicle win the European Truck Racing Championship, the Shrewsbury Operation (formerly Rolls-Royce Diesels International) also unveiled a new Eagle 800 Series commercial vehicle engine range with improved fuel consumption and a typical 500,000-mile operating life. Several important new marine engine ranges were also introduced. The fuel-thrifty 536 horsepower CV8 marine unit is now available, along with a revitalised series of heavy-duty commercial marine diesel units. Marketed as Perkins Heavy Duty Power, this range was designed to meet a wide variety of needs for workboats, including tugs, barges, ferries and offshore supply vessels.

Three marine versions of the widely-acclaimed Prima car engine were also unveiled. These units were designed to offer high-level performance and economy in a package that is both smaller and lighter than any comparable marine range in the world.

In the vitally important off-highway sector, three new ranges of industrial engines—the 500, 1000 and 2000—were launched. Developed specifically for industrial and construction applications, the units comprise engines in a power band from 40 to 400 horsepower.
Resulting from engineering research programs run separately but in parallel, the units represent the widest range of diesels ever launched simultaneously by a single diesel engine manufacturer. The

The new turbocharged Prima 80T vehicle diesel engine, offering a 40 per cent fuel advantage over comparable gasoline engines.



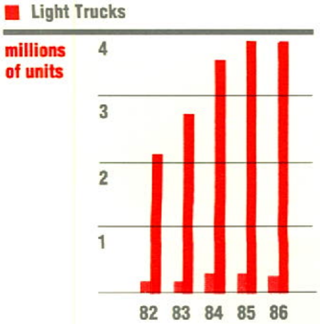
Bob M. Brown
President
Dayton Walther

Financial summary for fiscal 1986*:

Revenue	**$25.1 million**
Trading profit	**$1.2 million**
Total assets	**$224.8 million**
Employees	**2,820**

*Consolidated operating results for the Company include Dayton Walther operating results for the month ended January 31, 1987.

North American Factory Sales
Heavy/Medium Trucks
Light Trucks



decision to develop the new engines, incorporating the most advanced diesel engine technology available, followed the most extensive market research carried out for the diesel industry. It involved 400 end users and 60 manufacturers throughout the world.

In December 1986, the British Army ordered more than 2,000 Perkins diesel engines for a new type of vehicle used to transport ammunition on the battlefield. Deliveries of the Perkins Eagle MX engine will begin in 1988 and continue for seven years.

In addition to its vast product development activities, Perkins won important new business. Caterpillar, one of the world's foremost manufacturers of construction equipment, chose Perkins power for a new backhoe loader, and Renault Agriculture selected the same four cylinder 4.236 model as the power unit for a new tractor.

Dayton Walther

Dayton Walther, acquired by Varity Corporation in December 1986, serves the automotive and building supply industries. The Transportation Group is a full-service (design, prototype, test, and manufacture) supplier of components for automobile, truck and trailer manufacturers. The Building Products Group makes plumbing products, door and window hardware, and a range of consumer products, including lawn care equipment and specialized refrigeration equipment.

Products

Dayton Walther produces four classes of high-quality, engineered transportation products:

- Dayton Walther is the U.S. market leader in wheel end components, which includes spoke wheel assemblies and hub assemblies, using either brake drum or disc brake rotors for class 6, 7 and 8 trucks and trailers.
- Disc brake products, consisting primarily of hydraulic disc brake components such as rotors, spindles, calipers, steering knuckles, and caliper supports.
- Mobile home and recreational vehicle products, including couplers (used to connect a trailer to another vehicle) and jacks (used to raise or lower the trailer in relationship to the coupler and to provide a pivot wheel for maneuvering the vehicle in restricted spaces).
- Other transportation products, including trailer landing gear supports, fifth wheel couplers, and truck and trailer suspension systems. Dayton Walther also produces castings and machined products for the automotive industry to customer specifications, such as castings for the F-series Ford truck, the single largest selling vehicle in the automotive field.

Dayton Walther supplies replacement parts for all its products through distribution networks that account for approximately 15% of Transportation Products Group sales.

The firm also produces and sells building products componentry. These are:

- Plumbing products, which are marketed primarily under the Wolverine Brass brand name, known for quality plumbing products since 1896. Products include kitchen, bath and laboratory faucets, valves, and a broad line of speciality items.
- Builders' hardware products, which are marketed under the Glynn-Johnson brand name. These include overhead door holders, door latches, door catches, bumpers and special builders' hardware items. A high degree of Glynn-Johnson's sales are through architectural specifications.
- Consumer hardware products, including a variety of hose

Dayton Walther executive offices and engineering centre in Dayton, Ohio.

nozzles as well as lawn and garden sprinkling accessories, are sold under the H. B. Sherman brand. Other products include hose couplings and connectors sold to hose manufacturers and consumers and a variety of industrial job items such as air hose nozzles and hose clamps. This business also sells a broad line of high-quality Christmas tree stands under the Handy Things brand.

- The Newell Division sells an engineered proprietary line of extruded vinyl products for window manufacturers and stampings for the automotive industry. The vinyl products line has experienced excellent growth with continuing good prospects.
- Under the Marvel brand name, the business designs, fabricates, assembles and markets built-in under-the-counter and free-standing compact refrigerators, freezers, icemakers, and beverage dispensers. It also produces solar-powered refrigerators for special applications.

These five businesses operate independently in the Building Products Group.

Facilities

Dayton Walther's executive offices and development laboratory are located in Dayton, Ohio. The business, its subsidiaries and affiliates operate 25 facilities, including 19 in the United States, three in Canada, and one in the United Kingdom. The firm carries a minority equity position in two Associate companies in Mexico.

History

Dayton Walther was founded by George Walther, Sr. as the Dayton Steel Foundry early in the century. Following the firm's incorporation in 1909, the founder patented a cast steel truck wheel which quickly replaced the wooden spoke wheel as the industry standard.

Over the years, Dayton Walther has developed many products which have contributed to its growth. It has expanded its engineering product offering for light trucks and automobiles, increasing penetration of the transportation equipment market. The latest new product offering was the disc brake for medium trucks. In fiscal 1986, transportation products accounted for approximately 75 percent of consolidated sales.

Through acquisitions in 1980, Dayton Walther extended its business beyond the transportation industry and formed the Buildings Products Group, which is actively seeking increased business and has several unusual possibilities under consideration.

Dayton Walther has attained the reputation of a "can-do" company in its markets, and its products are widely recognized for value, durability, reliability, superior engineering and quality control.

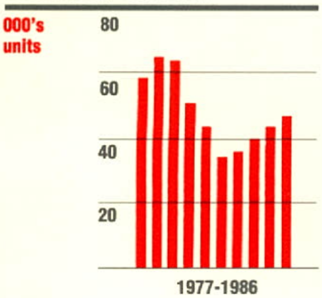
MF Industrial

Richard E. Robson
President
MF Industrial

Financial summary for fiscal 1986:

Revenue	$119.6 million
Trading profit	$3.1 million
Total assets	$56.5 million
Employees	881

Industrial Machinery
World Industry Retail Sales



MF Industrial designs, manufactures and distributes industrial, material handling, and light construction machinery in the 45-100 horsepower range from its headquarters in Manchester, England. It also markets complete driveline assemblies (engines, transmissions and axles) under the "Powerskid" label.

Sales in 1986 increased by $15 million to $121 million. Eighty per cent of production was exported, of which 33 per cent went to North America.

In the latter part of 1986, MF Industrial introduced product families specifically designed and equipped for targetmarket sectors in North America and the United Kingdom.

For North America's highly competitive municipality and

MF Industrial's high-performance backhoe loaders continue to capture a larger share of the world market.

landscaping markets, a range of nine machines—consisting of utility tractors and landscaper tractor loaders—was unveiled. These machines, spanning 45 to 70 horsepower, included the first turbo-powered model bearing the MF Industrial nameplate. In the U.K, a new line of five industrial tractors was offered to the market composed of local governmental authorities, where MF Industrial already ranks as the market leader.

In 1986, the reputation of the "Powershuttle" transmission continued to grow in stature in international markets. This advanced transmission system became standard equipment in MF Industrial's mainstream range of backhoe loaders; it is also fitted in the new utility and landscaper machines introduced in North America.

Earlier in the year, the addition of the MF50EX farm handler tractor to the materials handling product range contributed importantly to increased sales. Together with the MF24 telescopic handler and the MF14H/16H rough-terrain forklift trucks, MF Industrial now supplies a comprehensive lineup of materials handling equipment to meet customer requirements.

Sales Performance

MF Industrial maintained world market share despite persisting economic uncertainties in several key sales areas.

In North America, demand weakened for tractor loaders and industrial tractors. Nevertheless, MF Industrial improved market penetration to 21 per cent, reflecting a high degree of product acceptance in important market segments. The MF50H/HX Elite backhoe loaders continued to win favour with repeat orders from major fleet users, including the municipal fleet in Dallas, Texas. In addition, the top-rated 80 horsepower MF60H backhoe loader is also making significant market inroads.

In Europe, industry market demand rose by 21 per cent, and MF Industrial improved market share to 15.6 per cent. Our sales of backhoe loaders in France climbed 58 per cent, largely as a result of aggressive marketing activities. In Germany, MF Industrial continued as market leader in backhoe loader sales and in Italy the volume shipped rose by 75 per cent following an adjustment in distribution methods. Sales in the U.K. were level.

With Spain's admission to the European Economic Community and subsequent reduction of tariff barriers, MF Industrial established a distribution network of seven dealers serving mainland Spain and the Canary Islands. As a result, sales expanded throughout the year. Economic activity in Portugal gained substantially, increasing MF Industrial shipments to the Iberian markets to over 200 units. In Australia, MF Industrial assigned exclusive import rights from February 1987 to Domino Industries, which replaces Massey-Ferguson Australia. This permits single-tier distribution that promises to be more responsive to customer needs in a troubled marketplace.

With low commodity prices and lack of foreign exchange characterising most other overseas markets, machinery manufacturers must engage in creative marketing to achieve incremental sales. For example, MF Industrial financed sales to Tunisia through an innovative barter transaction, taking wine and phosphates in exchange for backhoe loaders.

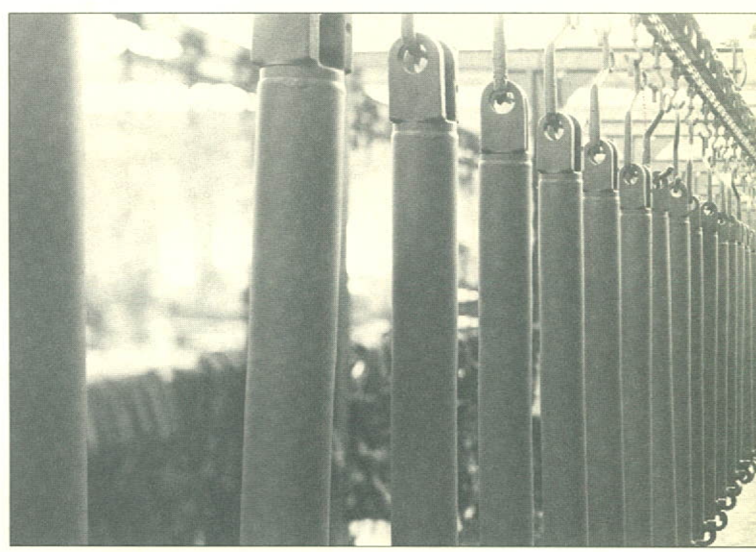
Horst Braxmaier
President
Pacoma Components

Financial summary for fiscal 1986:

Revenue	$44.0 million
Trading profit	$0.5 million
Total assets	$27.7 million
Employees	797

Pacoma Components

The Pacoma Components business manufactures and markets hydraulic cylinders, valves and allied equipment to producers of agricultural,



Pacoma hydraulic cylinders enjoyed significant sales growth in 1986.

industrial and construction machinery. The Pacoma factory, located in West Germany, has annual capacity of 400,000 cylinders, 300,000 valves and 20,000 clutches.

Pacoma's strong revenue growth continued in 1986, increasing 38 per cent over 1985. Sales to OEM customers advanced 54 per cent. Increased production to fulfill higher demand resulted from a site rationalization program that concentrated manufacturing facilities in a single modern factory in Eschwege, Germany.

Production capabilities were enhanced in 1986 by investments in advanced-design machine tooling—lathes with automatic loading and unloading features; state-of-the-art grinders and deep drills. For improved quality control, we installed computerized measuring devices and high-pressure testing equipment for cylinders. To maintain increased factory output, Pacoma also refined logistical systems, all computer-based. These capabilities allow the business to respond effectively to a rising level of customer requirements for just-in-time deliveries.

Another major program involves the integration of new CAD/CAM systems into the production of new cylinders, enabling the firm to develop and maintain high standards of design engineering while reducing part numbers and changeover time. This capability establishes the groundwork for Pacoma to introduce our hydraulic cylinders to the passenger car market—a new market segment with significant potential.

Pacoma's export sales received a major boost with a significant contract from the leading worldwide manufacturer of construction machinery. Sales to the construction equipment market accounted for 55 per cent of hydraulic cylinder sales, compared with 38 per cent in 1985.

Sales to the industrial/materials handling market remained strong, and a major new customer was gained in this sector. Sales to the agricultural machinery sector, however, continued to decline, sliding to 14 per cent of total OEM sales compared with 28 per cent a year ago.

James M. Felker
Senior Vice President
Varity Development

Varity Development

Responding to the Company's strategic initiative in reducing dependency on the farm machinery industry, Varity Development seeks to: expand and diversify certain existing Varity businesses; acquire significant equity in companies having some synergy with existing Varity operations; take minority equity positions in businesses with high growth potential; explore and pursue opportunities to generate added value for shareholders through other entrepreneurial activities.

Varity Development is responsible for: MF Properties, Polygon Reinsurance Company Limited, North American retail finance companies, Panagri (trade and barter), Central Electronics Group, venture capital investments, and orderly consolidation of Dayton Walther.

Real Estate Development

In 1986 the MF Properties group pushed forward with a program to redevelop the 27-acre King Street site in Toronto's core area. Rezoning approval was granted for a total of 5.3 million square feet of commercial, industrial and residential space.

In addition, Varity Development is also encouraging leased occupancy of space in vacated or underutilized Varity factories and other properties elsewhere; this program has achieved considerable success at major sites in the U.S. and France.

Polygon

Polygon is a captive reinsurance company which supports Varity's divisions with services that include protective coverage for product liability, marine cargo, direct damage and business interruption.

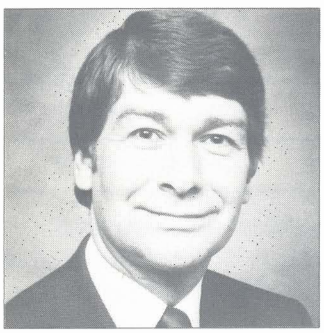
North American Retail Finance Companies

These companies provide financing to our customers using the Massey-Ferguson distribution network. During 1986, third party business was obtained to finance equipment sold by other manufacturers, and these activities will expand in 1987.

Panagri

This trade and barter operation functions to enhance the Company's opportunity to sell products into developing economies; from time to time, these opportunities involve products and services offered by other companies.

During 1986, Panagri concentrated on Tunisia, Zambia and Kenya with solid success and will be playing a greater role in similar areas around the world in 1987.



John Towers
Vice President
Varity International Services

Central Electronics Group

This operation has provided an electronic control system design and development service to the businesses of Varity Corporation and to Massey Combines Corporation (MCC). In 1986, Central Electronics Group (CEG) began offering its products and services in the open market as a stand-alone business unit.

During 1986, CEG electronic systems were incorporated into Massey-Ferguson's revolutionary new 3000 Series tractors, supplying unique technologies for automatic control of key tractor functions. MCC combine harvesters feature CEG products that automatically set header height and forward speed relative to the threshing load.

Varity Enterprises

This group acquires substantial minority positions in companies with high growth potential. With its expertise in manufacturing, marketing, finance, and administration, Varity Enterprises can apply its resources to minimize problems and maximize returns.

Since its origination in mid-1986, Varity Enterprises has developed a portfolio that includes investments in several U.S. and Canadian small businesses, most of which produce, distribute or are otherwise associated with the services sector or higher technology products.

As part of its forward strategy, Varity Enterprises plans to acquire significant positions in companies with up to $50 million in annual sales which have major turnaround potential.

Varity International Services

This centralized organization provides operations support services to Varity Corporation and its businesses from the Central Parts Supply Organization, Systems Services Group, legal services, insurance and risk management, and benefits analysis and management.

The Central Parts Supply Organization (CPSO) provides a parts supply and physical distribution service to the Company's divisions and to Massey Combines Corporation . CPSO is pursuing related third party business associations, with the objective of maximizing the utilization of corporate resources.

Systems Services Group (SSG) manages the Central Data Centres and the worldwide voice and data communications network. The satellite-linked computer network supports the business needs of Varity's divisions and Massey Combines, and increasingly extends these links to customers, dealers and suppliers. In an international environment, communciations forms the basis of decision-making and information exchange. SSG, in addition to providing the computing service, offers a highly advanced electronic mailing system to meet the global needs of Varity Corporation.

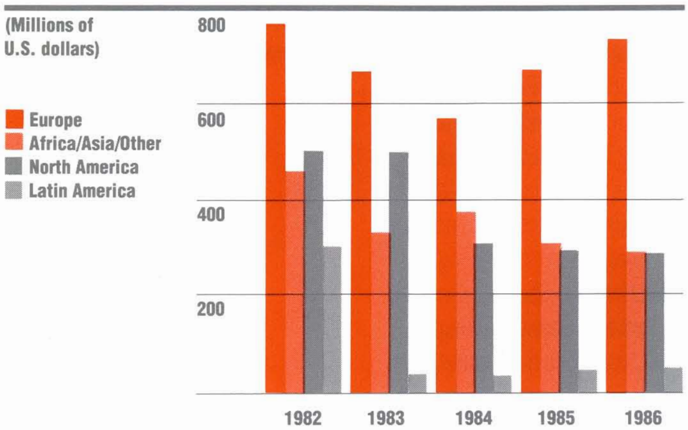
Legal services staff provides a worldwide resource to the Company's divisions with regard to legal, patent and trademark matters.

Through its insurance and risk management services, the Company ensures optimum, cost-effective coverage for its businesses on a global scale. This function is instrumental in promoting proactive risk management systems and techniques throughout the Company.

Varity Benefits Services provides a central resource for employee benefit management and design for all units of the Company. Emphasis is placed on specialist, creative advice as well as internal consulting and management services to achieve economies of scale in benefits programs.

Financial Review

Net Sales in Major Markets



Management Discussion and Analysis (Unaudited)

Results of Operations for the Years Ended
January 31, 1987, 1986 and 1985

Summary

(Millions of U.S. dollars) Fiscal	**1986**	1985	1984
Net sales			
Farm and industrial equipment	**$ 940.5**	$ 946.8	$ 968.7
Engines	**366.4**	326.8	314.1
Transportation and other	**52.4**	14.8	10.8
Total	**$ 1,359.3**	$ 1,288.4	$ 1,293.6
Income (loss) from:			
Continuing operations	**$ (23.3)**	$ 23.9	$ 37.8
Discontinued operations		(20.0)	(30.6)
Net income (loss)	**$ (23.3)**	$ 3.9	$ 7.2
Total assets	**$ 1,504.1**	$ 1,249.8	$ 1,449.2
Shareholders' equity	**$ 342.1**	$ 362.1	$ 310.4

The Company reported a net loss of $23.3 million for the year ended January 31, 1987 (fiscal 1986) compared to net income of $3.9 million and $7.2 million for the years ended January 31, 1986 (fiscal 1985) and January 31, 1985 (fiscal 1984) respectively.

On December 31, 1986, the Company acquired the Dayton Walther Corporation (Dayton Walther), which manufactures and sells transportation and building industry products. The Dayton Walther operating results for one month, along with the assets acquired and liabilities assumed, are included in the Company's fiscal 1986 consolidated financial statements.

Results of Operations

Fiscal 1986 Compared to Fiscal 1985

General

The recession in the agricultural industry in most parts of the world continued to depress the demand for farm machinery and adversely affect the Company's operating results in fiscal 1986. Excessive crop surpluses in many of the exporting countries continued to erode already low commodity prices and farm income. Combined with the uncertainty as to government price support and acreage reduction programs, farmer confidence levels were very low. Farm machinery demand in oil exporting countries declined as low oil prices restricted availability of hard currency to finance purchases. Consequently, worldwide retail unit sales of agricultural tractors were 611,800 units (excluding sales in the Soviet Union, Eastern Europe and China), a 10.0% decrease from fiscal 1985 levels. The market in the United States and Canada continued to erode, with a decrease of 7.8%, while sales in the European market declined 13.0% due in part to increased domestic and foreign pressure for reductions in farm support programs within the European Economic Community. Such sales in remaining world markets declined 9.0%, with only certain South American markets showing modest improvements over fiscal 1985.

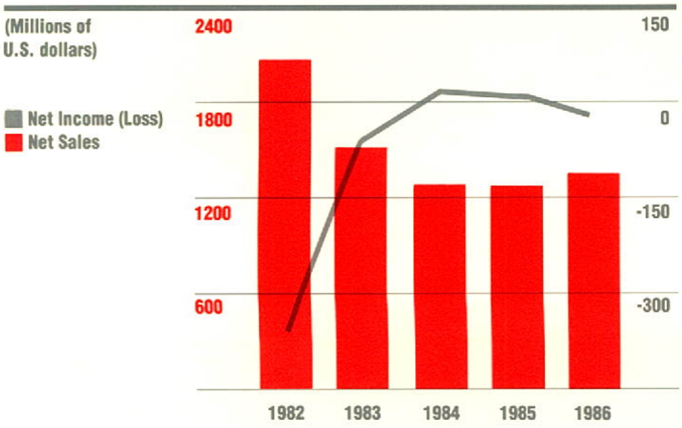
Industry sales of diesel engines in markets in which the Company and its associate companies and licensees compete were somewhat lower, as demand for trucks and agricultural and oil support equipment decreased from fiscal 1985.

The fiscal 1986 worldwide industrial machinery market, with retail unit sales of 47,200 (excluding sales in the Soviet Union, Eastern Europe and China), improved by 7.8% over fiscal 1985 levels, with significant growth of 20.6% and 40.4%, respectively, in the Western European and Latin American markets. Retail unit sales in the United States and Canada improved by 4.0% from fiscal 1985. Such sales outside of North and South America and Western Europe declined by 36.4% during fiscal 1986. Low oil prices restricted activity in the oil exporting countries, while low interest rates continued to stimulate construction activity elsewhere.

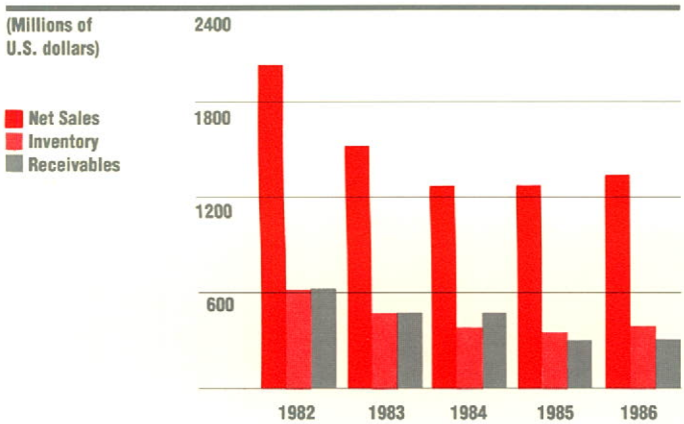
In countries outside Western Europe, the United States and Canada, a substantial proportion of the Company's tractor sales are under contracts with governmental agencies. The volume of purchases by such agencies varies significantly depending on such factors as the availability of hard currency and governmental priorities. The Company's net sales in such countries therefore depend on the overall level of purchases under these contracts, as well as the Company's success in obtaining them. Sales under these contracts can materially impact the Company's results in any given period and therefore make period-to-period comparisons more difficult.

The Company's financial results are also affected by currency fluctuations because its business involves the manufacture, marketing and sale of products in many different countries. The largest portion of the Company's production costs are incurred in the United Kingdom. The Company also incurs significant costs in France, Italy, West Germany and Japan. The Company's net sales, production costs, expenses and profit margins are affected by the relative strength of the currencies in these countries, compared to the currencies in which it sells its products, principally the U.K. pound, the U.S. dollar, the French franc, the Italian lira, the Canadian dollar, the Australian dollar and the West German mark. Since the Company's consolidated accounts are maintained in U.S. dollars, exchange rate fluctuations between the U.S. dollar and the currencies in each of the countries in which the company operates affect the Company's financial statements. In fact, the Company's results in recent years have been influenced by a rapidly strengthening and thereafter by a rapidly weakening U.S. dollar relative to most other currencies, particularly the U.K. pound, the other major European currencies and the Japanese yen. The Company's results of operations are also affected by translation gains and losses on long-term foreign currency denominated assets and liabilities. The amortization of these gains and losses is recorded on the Company's consolidated statements of income as "exchange adjustments".

Net Sales; Net Income (Loss)



Net Sales; Inventories and Receivables

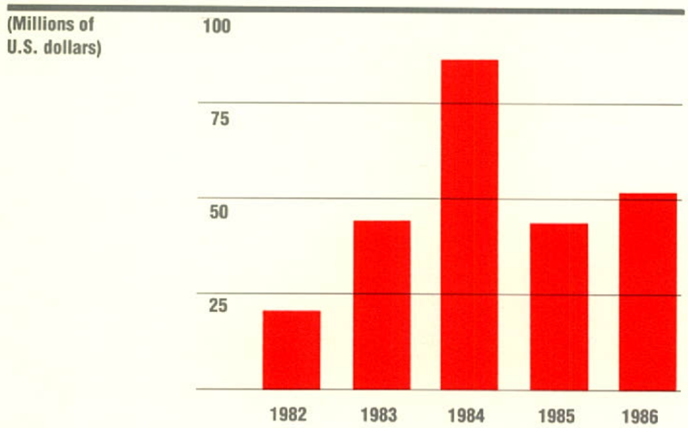


Sales

While the overall industry sales of agricultural equipment declined in fiscal 1986, there was an improvement in the Company's worldwide market share for agricultural tractors from 16.5% in fiscal 1985 to 18.2%. The most significant improvements were in its markets outside the United States, Canada and Europe. Market share in the United States and Canada was stable, while it declined slightly in Europe. The new range of tractors was introduced at the beginning of the fourth quarter and consequently had little influence on market share. The company's market share in industrial machinery also improved, from 9.4% in fiscal 1985 to 10.4% in fiscal 1986, partly due to the availability of new products.

Net sales in fiscal 1986 of $1,359.3 million were 5.5% greater than the $1,288.4 million reported from continuing operations in fiscal 1985. However, after adjusting for foreign currency fluctuations, net sales were approximately 6.7% below those of fiscal 1985. A decline of $21.2 million, or 2.5%, in the Company's tractor and farm equipment operations was more than offset by net sales increases generated by the Company's diesel engine, industrial machinery and component operations. In addition, the operations of Dayton Walther, which were included with the Company's operations for January 1987, contributed $25.1 million in additional net sales. On an overall geographic basis, an 11.8% gain in Western European net sales, resulting from the exchange rate impact of the stronger European currencies offset by lower demand, together with increased net sales in Canada, were somewhat offset by a sales decline in the United States. Other markets were relatively flat, with net sales increases in most markets offset by continued sharp declines in Iran and other West Asian countries and in Australia.

Cash Provided by Operations



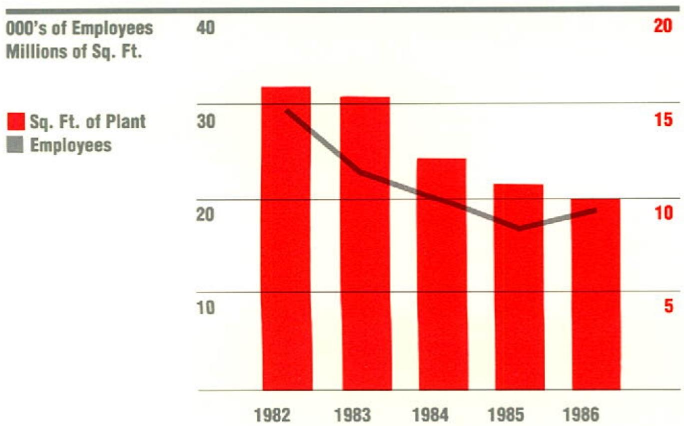
On an industry segment basis, sales of farm and industrial machinery products in fiscal 1986 were $940.5 million, or 0.7% lower than in fiscal 1985, while diesel engine sales of $366.4 million were 12.1% greater. The transportation and other products divisions, which includes the sales of Pacoma hydraulic cylinder business and newly acquired Dayton Walther, had sales of $52.4 million in fiscal 1986, $25.1 million of which were Dayton Walther sales.

On a geographic basis, sales in Europe were $741.5 million, or 11.8% higher than in fiscal 1985 as a result of the exchange rate impact of the stronger European currencies offsetting the lower demand. Sales in the United States and Canada were $282.7 million or 2.4% lower due to the declining market, while sales in the other markets, excluding Latin America, were $284.9 million or 3.4% lower, reflecting weakening economic conditions in most of these countries partly caused by lower petro-dollars. Improved conditions in most South American countries more than offset a decline in Mexico, as sales in Latin America were $50.2 million, or 24.3% greater than in 1985.

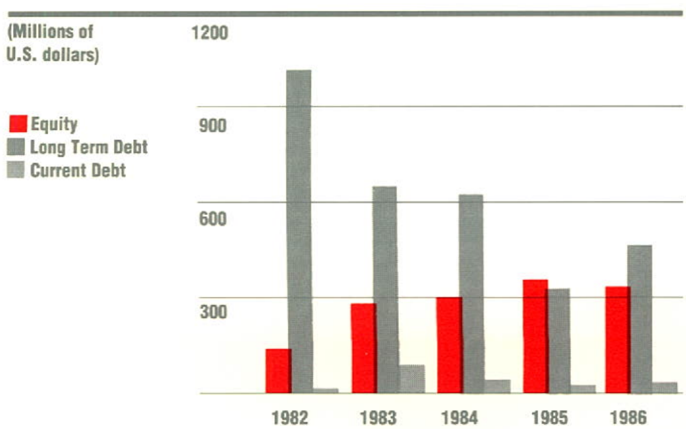
Costs and Expenses

Cost of goods sold, as a percentage of net sales, increased to 83.2% in fiscal 1986, compared to 78.8% in fiscal 1985. A number of factors contributed to this significant deterioration in the Company's gross margin. Production start-up problems in France and the United Kingdom associated with the introduction of the Company's new tractor models increased costs and decreased production, and a seven-week strike in the United Kingdom tractor operations further increased costs. Unit sales of the Company's tractors, diesel engines and industrial machinery were also lower due to the other factors discussed above. The Company's costs were significantly affected by the weakening of the U.S. dollar relative to the currencies of those countries in which the Company's products are produced or purchased, which far outweighed the favorable impact of the weakening of the U.K. pound compared to most other Western European currencies. Since a significantly greater proportion of the Company's net sales than of its costs of good sold is in U.S. and Canadian dollars, changes in the values of the U.S. and

Plant Size and Employment



Capitalization



Canadian dollars have a disproportionate effect on the Company's gross margin. Higher price discounts to stimulate sales and to meet extremely competitive market conditions also had an unfavorable effect on the Company's gross margin.

Marketing, general and administration expenses were $197.5 million (14.5% of net sales) in fiscal 1986 compared to $154.2 million (12.0% of net sales) in fiscal 1985. Approximately $20 million of this $43.3 million increase was attributable to the effect of translating these expenses, most of which were incurred in Western European currencies, into the weaker U.S. dollar. The other major factors contributing to this increase were the inclusion of marketing, general and administration expenses incurred by Dayton Walther and L. Gardner and Sons, both of which were aquired during fiscal 1986, completion of the amortization of pension surplus credits in the United Kingdom in fiscal 1985 and normal inflationary increases. Reorganization costs of $15.2 million in fiscal 1986 represented costs incurred in the Company's continuing program to improve operational efficiencies. Most of these costs were attributable to employment separation allowances associated with the reduction of the Company's labour force in the United Kingdom and the balance reflected costs associated with facility closures, primarily in France. Reorganization costs in fiscal 1985 were $17.6 million.

Engineering and product development costs increased to $29.0 million in fiscal 1986 from $23.3 million in fiscal 1985. A significant portion of this increase was attributable to the effect of translating these costs into the weaker U.S. dollar. The Company's development costs also increased somewhat to support the introduction of its new tractors and diesel engines.

Net interest expense, comprised of interest on long-term debt, interest to unconsolidated finance subsidiaries and other net interest (which includes interest on short-term debt and is net of interest income), decreased to $51.7 million in fiscal 1986 from $53.4 million in fiscal 1985. The interest reduction was mainly the result of reduced borrowing levels and lower interest rates. These improvements were partly offset by an approximately $7 million unfavorable impact of translating interest expense into the weaker U.S. dollar.

Exchange adjustments arise from the amortization of deferred translation gains or losses on long-term foreign-currency denominated monetary items, principally long-term debt. In fiscal 1986, exchange adjustment gains of $4.1 million were primarily due to gains realized on Canadian dollar denominated debt. In fiscal 1985, an exchange adjustment loss of $7.9 million principally reflected the adverse impact of the decline in U.S. and Australian currencies.

Miscellaneous income improved to $24.1 million in fiscal 1986 from $14.6 million in fiscal 1985. A significant majority of this income represented gains realized on the disposal of surplus properties in the United States, Canada, United Kingdom and Australia, income generated by the restructuring of the Company's Australian operations and the realized portion of the gain related to the sale of the Canadian finance subsidiary. Most of the remainder of the fiscal 1986 miscellaneous income was derived from commissions and dividends paid by the Company's associate companies and licensees.

Equity in net income of finance subsidiaries was $13.1 million in fiscal 1986 compared to $5.7 million in fiscal 1985. This significant improvement resulted mainly from a $4.2 million gain realized on the settlement of debt for the Australian finance subsidiary at a discount and a gain attributable to favorably renegotiated financing arrangements for the Canadian finance subsidiary.

Tax recoveries of $0.4 million were primarily comprised of a favorable offset to the tax provision in the U.S. finance subsidiary through the utilization of manufacturing tax losses.

Financial Condition, Liquidity and Capital Resources

Management efforts to strengthen the financial condition of the Company have, in recent years, focused on generating cash from operations, better asset management, improved profitability and strengthening the equity base.

On December 31, 1986, the Company acquired Dayton Walther as part of its program of diversification. This acquisition increased total assets as at January 31, 1987 by $225 million. In June 1986, the Company also acquired L. Gardner and Sons, a small diesel engine manufacturer in the United Kingdom. These acquisitions were financed to a significant extent by additional loans which are tied solely to the businesses acquired.

Cash from operations for fiscal 1986 was $52.0 million compared to $44.3 million generated in fiscal 1985 and $86.9 million in fiscal 1984. This was the fifth consecutive year of reporting cash from operations despite continuing weak and declining market conditions.

Total assets at January 31, 1987 were $1,504.1 or $254.3 million greater than the $1,249.8 million reported at January 31, 1986. This increase included $246 million of additional assets from Dayton Walther and L. Gardner and Sons acquisitions and the approximately $100 million impact of higher European currencies. Excluding the impact of acquisitions and currency fluctuations, total assets decreased by $92 million with receivables and inventories being reduced by 18% and 7%, respectively, through better asset management. The Company's investment in unconsolidated finance subsidiaries increased mainly as a result of fiscal 1986 profits reported by the U.S. and Australian finance subsidiaries.

During the year, the Company spent approximately $64 million on new fixed assets financed largely by funds from operations.

This increased level of capital expenditures was associated with the introduction of new tractor and diesel engine products in 1986. For fiscal 1987, the Company has approved capital expenditure programs of approximately $65.0 million of which $24.0 million has been committed as at January 31, 1987. Proceeds from fixed asset disposals during fiscal 1986 were $19.6 million, $2.7 million of which was used to reduce debt, as required by financing agreements.

Consolidated Statements of Income

Varity Corporation
(Incorporated under the Laws of Canada)

(Millions of U.S. dollars except per share amounts)

Years ended January 31,	**1987**	1986	1985
Net sales	**$ 1,359.3**	$ 1,288.4	$ 1,293.6
Expenses:			
Cost of goods sold	**1,130.9**	1,015.7	1,008.5
Marketing, general and administration	**197.5**	154.2	158.6
Engineering and product development	**29.0**	23.3	24.9
Interest:			
On long-term debt	**34.3**	39.6	38.3
Paid to unconsolidated finance subsidiaries	**21.2**	17.6	20.0
Other, net (Note 15(d))	**(3.8)**	(3.8)	(1.1)
Exchange adjustments	**(4.1)**	7.9	(5.9)
Miscellaneous income	**(24.1)**	(14.6)	(12.9)
Reorganization costs (Note 13)	**15.2**	17.6	8.3
	1,396.1	1,257.5	1,238.7
Income (loss) before items shown below	**(36.8)**	30.9	54.9
Equity in net income of finance subsidiaries (Note 17)	**13.1**	5.7	0.7
Income (loss) from continuing operations before income taxes	**(23.7)**	36.6	55.6
Income tax recovery (provision) (Note 8)	**0.4**	(12.7)	(17.8)
Income (loss) from continuing operations	**(23.3)**	23.9	37.8
Loss from discontinued operations (after recovery of income taxes of $15.4 and $22.8 for the years ended January 31, 1986 and 1985, respectively) (Note 16)		(20.0)	(30.6)
Net income (loss)	**$ (23.3)**	$ 3.9	$ 7.2
Income (loss) per Common Share after Preferred Share dividend entitlements (Notes 14 and 15):			
Income (loss) from continuing operations	**$ (0.21)**	$ 0.02	$ 0.18
Net loss	**$ (0.21)**	$ (0.16)	$ (0.12)

See accompanying Notes

Consolidated Balance Sheets

Varity Corporation
(Millions of U.S. dollars)

January 31,	1987	1986
Assets		
Current assets:		
Cash and bank term deposits	**$ 56.2**	$ 84.7
Due from unconsolidated finance subsidiaries	**9.8**	14.8
Receivables (Note 5)	**320.0**	304.1
Inventories (Note 1 (d))	**416.7**	363.4
Prepaid expenses and other	**32.4**	31.8
Total current assets	**835.1**	798.8
Investments:		
Unconsolidated finance subsidiaries (Note 17)	**117.6**	95.4
Associate companies (Note 4)	**69.9**	67.6
Other	**22.2**	31.9
Total investments	**209.7**	194.9
Fixed assets:		
Land	**13.5**	6.8
Buildings	**179.1**	152.6
Machinery and equipment	**485.9**	362.8
Production tooling	**59.0**	34.2
	737.5	556.4
Accumulated depreciation and amortization	**357.0**	343.8
Net fixed assets	**380.5**	212.6
Other assets and deferred charges	**78.8**	43.5
	$ 1,504.1	$ 1,249.8

On behalf of the Board:
Victor Rice, Director
J. G. Bickford, Director

January 31,	1987	1986
Liabilities		
Current liabilities:		
Bank borrowings	**$ 93.2**	$ 73.8
Current portion of long-term debt (Note 9)	**39.9**	30.7
Accounts payable	**328.2**	265.1
Accrued charges (Note 7)	**166.4**	140.4
Total current liabilities	**627.7**	510.0
Non-current liabilities:		
Long-term debt (Note 9)	**473.8**	334.9
Due to unconsolidated finance subsidiaries	**16.8**	16.2
Pension and other long-term liabilities	**43.7**	26.6
Total non-current liabilities	**534.3**	377.7
Contingent liabilities and commitments (Note 11)		
Shareholders' equity (Notes 10 and 18)		
Preferred Shares (liquidation value: 1987-$380.6; 1986-$366.1)	**194.7**	193.7
Common Shares (1987-165,026,481 shares; 1986-161,038,361 shares)	**140.1**	132.4
Contributed surplus	**794.1**	801.2
Deficit (net of retained earnings of unconsolidated finance subsidiaries: 1987-$39.0; 1986-$29.2)	**(718.0)**	(684.1)
Equity adjustment from foreign currency translation (including equity adjustment from foreign currency translation of unconsolidated finance subsidiaries: 1987-$(1.6); 1986-$ (6.1))	**(68.8)**	(81.1)
	342.1	362.1
	$1,504.1	$1,249.8

See accompanying Notes

Consolidated Statements of Changes in Financial Position

Varity Corporation
(Millions of U.S. dollars)

Years ended January 31,		1987	1986	1985
Cash provided by operations (See Page 23)		**$ 52.0**	$ 44.3	$ 86.9
Other sources of cash:				
Investment transactions:				
Disposal of fixed assets		**19.6**	9.9	8.7
Financing transactions:				
Increases in long-term debt		**44.3**	46.3	36.8
Increases in bank borrowings and current portion of long-term debt		**11.5**	43.0	
Financial Restructurings (Note 3):				
Common Shares issued		**2.7**	6.7	8.0
Preferred Shares issued		**1.0**		
Other paid-in capital			1.4	7.6
Conversion of other paid-in capital to Common Shares			(1.4)	
Costs of restructuring		**(10.4)**	(9.9)	(3.8)
Exercise of warrants				29.6
Total other sources of cash		**68.7**	96.0	86.9
Other uses of cash:				
Investment transactions:				
Acquisition of Dayton Walther Corporation (Note 2):				
Net non-cash assets acquired	**$ 153.8**			
Acquisition financing	**(151.9)**			
Common Shares issued on conversion of promissory note	**(5.0)**	**(3.1)**		
Additions to fixed assets		**64.4**	45.4	39.2
Investment in unconsolidated finance subsidiaries and associate companies		**1.6**	2.2	11.9
Other			3.7	7.4
Financing transactions:				
Reductions in long-term debt		**64.1**	41.7	93.6
Reductions in bank borrowings				41.1
Decrease (increase) in amounts due to unconsolidated finance subsidiary		**0.4**	3.0	(0.9)
Increase (decrease) in other assets and deferred charges		**11.8**	7.6	(5.6)
Dividends on Preferred Shares		**10.0**		
Total other uses of cash		**149.2**	103.6	186.7
Increase (decrease) in cash and bank term deposits during the year		**(28.5)**	36.7	(12.9)
Cash and bank term deposits at beginning of year		**84.7**	48.0	60.9
Cash and bank term deposits at end of year		**$ 56.2**	$ 84.7	$ 48.0

See accompanying Notes

Cash Provided by Operations

Varity Corporation
(Millions of U.S. dollars)

Years ended January 31,	1987	1986	1985
Continuing operations:			
Income (loss) for the year	**$ (23.3)**	$ 23.9	$ 37.8
Items not affecting working capital:			
Depreciation and amortization	**33.9**	28.3	27.0
Exchange adjustments on long-term debt	**3.4**	3.2	(2.7)
Interest expense not involving an outlay of funds	**1.5**	10.3	20.9
Excess (deficiency) of dividends over equity in net income of unconsolidated finance subsidiaries	**(8.4)**	(4.3)	0.5
Other	**(7.7)**	(8.5)	(12.1)
Working capital provided by (used in) continuing operations	**(0.6)**	52.9	71.4
Working capital used in discontinued operations		(17.5)	(28.6)
Working capital provided by (used in) operations	**(0.6)**	35.4	42.8
Changes in non-cash working capital items related to operations:			
Decrease (increase) in current assets:			
Receivables and due from unconsolidated finance subsidiaries	**12.8**	(38.5)	38.2
Inventories	**(10.5)**	(48.4)	97.6
Prepaid expenses and other	**5.3**	(7.3)	10.0
Increase (decrease) in accounts payable, accrued charges and due to unconsolidated finance subsidiaries	**35.6**	105.5	(77.1)
Foreign currency translation adjustment to current assets and liabilities	**9.4**	(2.4)	(24.6)
Cash provided by operations	**$ 52.0**	$ 44.3	$ 86.9

See accompanying Notes

Consolidated Statements of Changes in Shareholders' Equity

	Shares Outstanding				Equity (Millions of U.S. dollars)								
	Former Series A,B,C,D & E Preferred Shares*	Cumulative Redeemable Convertible Preferred Shares: Class I	Class II	Common Shares	Former Series A,B,C,D & E Preferred Shares*	Class I	Class II	Common Shares	Other Paid-in Capital	Contributed Surplus	Deficit	Foreign Currency Translation Adjustment	Total Shareholders' Equity
Balance, January 31, 1984	21,136,000			91,673,530	$ 454.4			$ 97.6	$ 21.2	$ 471.8	$ (691.3)	$ (68.3)	$ 285.4
Exercise of warrants				8,586,050				29.6					29.6
Interest waiver and conversion program				4,133,546				8.0	7.6				15.6
Costs of restructuring										(3.8)			(3.8)
Equity adjustment from foreign currency translation												(23.6)	(23.6)
Net income											7.2		7.2
Balance, January 31, 1985	21,136,000			104,393,126	454.4			135.2	28.8	468.0	(684.1)	(91.9)	310.4
Prior years refinancings:													
Interest waiver and conversion program				3,250,561				5.3	1.4	1.1			7.8
Conversion of other paid-in capital to Common Shares				840,290				1.4	(1.4)				
Costs of restructuring										(0.6)			(0.6)
Equity adjustment from foreign currency translation												10.8	10.8
Net income											3.9		3.9
Shareholders' equity prior to 1986 Restructuring (Note 3)	21,136,000			108,483,977	454.4			141.9	28.8	468.5	(680.2)	(81.1)	332.3
Issue of Class I Preferred Shares and Common Shares on debt conversion		4,583,239		907,800		$91.7		1.6		(5.1)			88.2
Change of Series D Preferred Shares into Class II Preferred Shares and Class II Series B Shares and issue of Common Shares and warrants	(8,000,000)		2,000,000	7,200,000	(166.0)		$36.6	15.3		4.3			(109.8)
Reduction of stated capital accounts of Series C and E Preferred Shares and Common Shares					(191.9)			(119.5)		311.4			
Change of Series A and B Preferred Shares into Common Shares	(3,656,000)			28,531,851	(91.6)			64.3		27.3			
Change of Series C and E to Class II Series A Shares	(9,480,000)		10,176,000		(4.9)		4.9						
Conversion of other paid-in capital to Common Shares				15,914,733				28.8	(28.8)				
Issue of Class I Series A Shares on acquisition of MCC Notes		3,024,304				60.5							60.5
Costs of restructuring										(5.2)	(3.9)		(9.1)
Balance, January 31, 1986		7,607,543	12,176,000	161,038,361		152.2	41.5	132.4		801.2	(684.1)	(81.1)	362.1
Issue of Common Shares on conversion of promissory note				3,137,255				5.0					5.0
Interest waiver and conversion program and 1986 Restructuring		51,670		850,865		1.0		2.7		2.7			6.4
Costs of restructuring										(9.8)	(0.6)		(10.4)
Equity adjustment from foreign currency translation												12.3	12.3
Dividends on Class I Preferred Shares											(10.0)		(10.0)
Net loss											(23.3)		(23.3)
Balance, January 31, 1987		7,659,213	12,176,000	165,026,481		$ 153.2	$ 41.5	$ 140.1		$ 794.1	$ (718.0)	$ (68.8)	$ 342.1

*Consisting of Series A 1,458,000 Shares - $35.7; Series B 2,197,500 Shares - $55.9; Series C 6,000,000 Shares - $124.6; Series D 8,000,000 Shares - $166.0; Series E 3,480,000 Shares - $72.2.

See accompanying Notes

(Millions of U.S. dollars
unless otherwise stated)

1. Summary of Significant Accounting Policies

The consolidated financial statements have been prepared following accounting principles generally accepted in Canada. The significant differences in these consolidated financial statements between United States and Canadian generally accepted accounting principles are explained and reconciled in Note 15 (a).

The consolidated financial statements are presented in U.S. dollars. This currency provides for a more meaningful measurement of operating results in consideration of the international scope of the Company's operations. Such presentation also affords a better basis of comparison with major companies in the industry, the larger of which are U.S. based and report their results in U.S. dollars. There are no material exchange restrictions or controls in Canada relating to the U.S. dollar.

(a) Basis of Consolidation
The consolidated financial statements include the accounts of all subsidiary companies except the wholly-owned finance subsidiaries. The investment in the finance subsidiaries is accounted for by the equity method, as the Company considers that this basis of presentation is more informative than full consolidation. Among other reasons, this basis of presentation affords a comparison with other major companies in the industry, which also do not consolidate their finance subsidiaries. Combined summarized financial information for the finance subsidiaries is set out in Note 17.

Investments in associate companies are carried at cost except for the Company's investment in Massey Combines Corporation (MCC), the accounting for which is discussed in Note 4.

(b) Foreign Currency Translation
Assets and liabilities of subsidiaries which are operationally independent (self-sustaining) are translated at year-end rates of exchange. Translation adjustments that arise due to fluctuations in exchange rates are recorded directly in shareholders' equity. Revenue and expense items are translated at average rates of exchange for the year.

Assets and liabilities of subsidiaries that are financially interdependent (integrated) with the parent Company are translated using the temporal method. Adjustments arising on translation of these subsidiaries' financial statements are included in income. Revenue and expense items are translated at average rates of exchange for the year.

Exchange gains and losses which arise on translation of foreign currency denominated monetary items with a fixed or ascertainable life extending beyond the end of the following fiscal year are deferred and amortized over the remaining life of the related items.

(c) Sales and Receivables
Sales are recorded at the time of shipment to distributors, dealers and other customers. Receivables include non-interest bearing amounts due from dealers, some of which mature beyond one year (subject to earlier settlement when the product is sold by the dealer). These are included in current assets in accordance with accounting practice in the industry.

(d) Inventories
Inventories are valued at the lower of cost or net realizable value. Cost is determined primarily on the first-in, first-out basis for the Company's farm and industrial machinery and engines divisions and the last in, first out basis for newly acquired Dayton Walther Corporation (see Note 2). Cost includes the cost of material plus direct labour and the applicable share of manufacturing overhead.

The major classes of inventory are as follows:

January 31,	1987	1986
Raw materials and work in process	**$ 182.8**	$ 130.4
Finished goods	**233.9**	233.0
	$ 416.7	$ 363.4

(e) Fixed Assets
Additions to fixed assets are recorded at cost. Depreciation of facilities is generally provided on a straight-line basis at rates which are designed to write off the assets over their estimated useful lives as follows:

Buildings	10 to 50 years
Machinery and equipment	3 to 10 years
Production tooling	3 to 5 years

Expenditures for maintenance, repairs and minor renewals are charged to expense as incurred ($14.0 million, $ 9.6 million, and $16.2 million for the years ended January 31, 1987, 1986 and 1985, respectively).

(f) Research and Development Costs
Research and development costs, most of which are included in Engineering and Product Development expenses, are expensed as incurred ($20.8 million, $19.2 million and $20.4 million for the years ended January 31, 1987, 1986 and 1985, respectively).

(g) Pensions
The majority of employees are covered by government and Company pension plans. All Company plans are defined benefit plans. In addition to current service costs, pension expense includes past service costs and the amortization of changes in actuarial liability due to changes in plans and in actuarial assumptions and experience gains and losses. Such changes are amortized over approximately 15 to 25 years, except for the United Kingdom subsidiaries in which actuarial gains and losses are amortized over 3 years. In addition to pension benefits, the Company also provides health care and life insurance benefits to retired employees, primarily in North America. The costs of retiree health care claims and life insurance premiums are recognized as the claims are received and the premiums become due.

(h) Income Taxes
The Company follows the deferral method of tax allocation in accounting for income taxes.

The benefits of loss carry-forwards are generally not recognized until realized. The multinational nature of the Company's operations is such that, on a continuing basis, certain subsidiaries are incurring losses (without recognition of the potential carry-forward tax benefits) at the same time that other subsidiaries are realizing the tax benefit of previous losses. On a consolidated basis these annually recurring tax recoveries, to the extent that they do not exceed the unrecognized tax benefit of losses incurred in the same period, are not considered to be extraordinary in nature and accordingly are reflected as a reduction of current income tax charges when realized.

The Company provides for taxes on dividends anticipated in the future from accumulated earnings of subsidiary companies.

(i) Reclassifications
Certain of the comparative figures have been reclassified to conform to the January 31, 1987 presentation.

2. Acquisition of Dayton Walther Corporation

(a) On December 31, 1986, the Company acquired all the outstanding shares of Dayton Walther Corporation (Dayton Walther). Dayton Walther manufactures and sells wheel components and disc brake products primarily to the original equipment market of the motor vehicle industry (transportation products division) and manufactures and sells products used primarily in the commercial and residential construction industry (building products division).

The Company acquired Dayton Walther for a total purchase price of $154.9 million, which consisted of $147.8 million paid in respect of Dayton Walther's outstanding shares and transaction costs of $7.1 million.

The purchase price has been allocated to the underlying net assets acquired as follows:

Working capital (including cash of $1.1 million)	**$ 38.2**
Fixed assets	**105.5**
Other assets	**16.3**
Long-term debt	**(17.8)**
Net assets acquired	**142.2**
Excess of purchase price over net assets acquired (recorded as goodwill)	**12.7**
	$ 154.9

Acquisition financing was provided by:

Cash	**$ 3.0**
Convertible promissory notes: (b) (i)	**15.0**
(b) (ii)	**5.0**
Bank term loan (c) (i)	**56.9**
Bridge loan (c) (ii)	**75.0**
	$ 154.9

Concurrent with the acquisition, the bank term loan was increased by a further $16.7 million to retire certain Dayton Walther indebtedness of $11.6 million and to provide operating funds of $5.1 million.

(b) Convertible promissory notes:
(i) The $15.0 million convertible promissory note bears interest at an annual rate of 12%, is payable on June 30, 1987 and has been included in bank borrowings. From February 1, 1987 through June 30, 1987, the outstanding principal amount and any accrued interest is convertible into Common Shares at a price of $2.25 per share representing 120% of the December 30, 1986 Common Share closing price. In the event that the note is not repaid by June 30,1987, the annual interest rate thereafter will be the higher of 5% over a floating prime rate or 12% and through June 30, 1992 any outstanding principal and any accrued interest will be convertible into Common Shares at a price of approximately $1.59 per share representing 85% of the December 30, 1986 closing price. Payment of this note is secured by all of the shares of Dayton Walther. Subsequent to year-end, $5.0 million of this note was repaid.
(ii) The $5.0 million convertible promissory note was converted prior to year-end into 3,137,255 Common Shares of the Company at a price of approximately $1.59 per Common Share.

(c) Additional financing was provided as follows:
(i) $75.0 million bank term loan of which $73.6 million was utilized and is repayable commencing October 31, 1987 in quarterly installments with final repayment on October 31, 1993. In addition, the Company has established a $12.0 million revolving credit facility, which was unutilized at January 31, 1987. Both the bank term loan and the revolving credit facility are secured by liens on substantially all of the assets of Dayton Walther; and
(ii) $75.0 million bridge loan due April 30, 1994. The Company has entered into a forward underwriting agreement with the lender under which Dayton Walther will issue senior subordinated notes in an amount sufficient to retire the loan. Completion of the issue is expected during 1987.

Additional details regarding the bank term and bridge loans are set out in Note 9.

(d) The bank term loan arrangements also provide that Dayton Walther maintain assets and net worth at specified levels, preclude dividend payments or other capital distributions to the Company and limit lending and investing activities.

(e) Pro forma consolidated financial information (unaudited)
The consolidated operating results of the Company include a net loss of $0.4 million for Dayton Walther for the month ended January 31, 1987 on sales of $25.1 million. The following pro forma information includes adjustments to give effect to transactions which occurred as a result of the acquisition as if such transactions had occurred at the beginning of the years presented.

The negative impact on the pro forma results for the years ended January 31, 1987 and 1986 is primarily due to the pro forma higher interest expense relating to the acquisition financing. In addition, Dayton Walther's results for the eleven months ended December 31, 1986 includes $5.3 million of costs related to plant closures and $4.8 million of costs related to the start-up of a production facility.

Years ended January 31,	**1987**	1986
Net sales	**$ 1,609.7**	$ 1,568.0
Income (loss) from continuing operations	**(29.9)**	20.6
Net income (loss)	**(29.9)**	0.6
Loss per Common Share from continuing operations in U.S. dollars after Preferred Share dividend entitlements:	**$ (0.24)**	$ (0.01)

If the various transactions relating to the 1986 Restructuring (see Note 3) had occurred on February 1, 1985, the impact on the pro forma results of continuing operations for the year ended January 31, 1986 would have provided pro forma earnings per Common Share of $0.18 (fully diluted—$0.18).

3. Restructurings

(a) 1986 Restructuring
In May 1986, the Company completed a comprehensive financial restructuring (the "1986 Restructuring") which comprised the disposal of its North American combine harvester operations (the "Combines Business") and the restructuring of its debt and capital. The principal features of the 1986 Restructuring, which were given effect in the consolidated financial statements for the year ended January 31, 1986, are described below:

(i) Disposal of the Combines Business
The Combines Business was transferred to MCC effective as of November 2, 1985. The related transactions and determination of the residual value of the Company's continuing investment in MCC are set out below:

Transfer of business and net assets of Combines Business to MCC	$ 296.2
Assumption of related debt by MCC (net of interest rate concessions of $20.4 million)	(186.3)
Exchange of MCC preferred shares on elimination of the Company's former Series D Preferred Shares	(109.8)
Face value of MCC Notes acquired in connection with the issue of Class I Preferred Shares	60.5
Deferral of gain arising on interest rate concessions and reversal of accruals no longer required on disposal of Combines Business	(28.4)
Residual value of investment in MCC (represented by common shares of $0.1 million and Notes with a carrying value of $32.1 million)	$ 32.2

MCC, in which the Company's equity investment represents a 45% minority shareholding, was therefore deconsolidated effective as of November 2, 1985 (see Notes 4 and 16).

(ii) Debt Restructuring
The restructuring of the Company's debt, effective as of January 31, 1986, consisted of the following:
—conversion of $93.3 million of debt into 4,583,239 Class I Preferred Shares and 907,800 Common Shares with a stated value of $91.7 million and $1.6 million respectively. Unamortized costs of $5.1 million relating to the converted debt were charged to contributed surplus;
—transfer of $75.0 million of debt of a consolidated U.S. subsidiary to a U.S. finance subsidiary as part of the refinancing of the Company's U.S. retail financing operations; and

—rescheduling of a substantial portion of the remaining debt and extension of the maturities.

Also in connection with the 1986 Restructuring, in the year ending January 31, 1987, the Company issued a further 363,673 Common Shares with an aggregate value of $0.9 million.

(iii) Share Capital Restructuring
Details of shares issued and outstanding before and after the 1986 Restructuring are contained in the consolidated statement of changes in shareholders' equity. The transactions, which were effective as of January 31, 1986, are summarized as follows:
—all outstanding Series A and B Preferred Shares, on which there were dividend arrears aggregating $25.3 million at January 31, 1986, were changed into 28,531,851 Common Shares;
—all outstanding Series D Preferred Shares were changed into 2,000,000 Class II Preferred Shares and 6,000,000 Class II Series B Shares. These Class II Series B Shares were subsequently purchased for cancellation in exchange for the Company's investment in MCC's preferred shares, 7,200,000 Common Shares of the Company and 12,800,000 Common Share purchase warrants exercisable through May 1991 at Cdn. $5.00 per Common Share;
—the Series C and E Preferred Shares were changed into 10,176,000 Class II Preferred Shares;
—other paid-in capital was converted into 15,914,733 Common Shares upon the exchange of preference shares of certain subsidiaries;
—the estimated costs of the 1986 Restructuring were charged to contributed surplus and retained earnings; and
—foreign exchange gains of $31.6 million realized on the elimination of former series of Preferred Shares were credited to contributed surplus.

Also in connection with the 1986 Restructuring, during the year ended January 31, 1987, an additional $0.6 million of debt was converted into 33,670 Class I Preferred Shares. An additional 18,000 Class I Preferred Shares and 210,000 Common Shares with an aggregate value of $0.8 million were issued as part of a fee paid to a financial advisor to the lenders.

(b) 1981 and 1983 Restructurings
The Company completed two financial restructurings effective July 16, 1981 and March 7, 1983, which involved the issuance of Preferred Shares for cash and previously outstanding debt, the issuance of Common Share purchase warrants, and the issuance of Common Shares and rights to receive Common Shares in settlement of part of the principal amount of certain loans and part of the interest accrued at the dates of the financial restructurings and accruing subsequently.

During the year ended January 31, 1987, 277,192 Common Shares with an aggregate value of $1.4 million were issued in connection with the interest waiver and conversion program under these financial restructurings. In addition, the lenders forgave a further part of the principal amount of certain loans and waived a further portion of the interest accrued at the financial restructuring dates. The forgiveness was treated as a capital transaction and credited to contributed surplus. The fair value of the part of these contributions relating to interest that would otherwise have subsequently accrued was deducted as a discount from the applicable debt and was amortized to interest expense over the life of the interest waiver program.

4. Investment in Associate Companies

(a) The investment in associate companies consists of the following:

January 31,	1987	1986
MCC Notes (Notes 3 and 11)	**$ 32.1**	$ 32.1
Shares of a Brazilian affiliate (Note 11)	**23.8**	23.8
Common shares of various companies	**14.0**	11.7
	$ 69.9	$ 67.6

(b) Investment in MCC
(i) The investment in common shares includes the Company's investment in 45% of the common shares of MCC which is carried at a nominal value. Although the Company has certain obligations in the event of liquidation or winding-up of MCC (see Note 11), it has no obligations to invest additional equity capital nor has it given any guarantees to MCC lenders. Further, at the date it was established, MCC had preferred share capital contributed by parties unrelated to the Company of $109.8 million. Accordingly, the Company has not recorded its cumulative share ($ 45.6 million) of MCC losses to January 31, 1987. To the extent that MCC's future losses exceed the remaining amount of preferred shareholders' equity, $7.6 million at January 31, 1987, the Company will reduce the carrying value of its investment in MCC Notes by its share of such losses. The Company will not recognize its share of any future net income of MCC until its share of any accumulated net income exceeds its share of accumulated unrecorded losses.
(ii) The MCC Notes (face value of $60.5 million) are secured by liens on substantially all of the assets of MCC. The MCC Notes bear a concessionary rate of interest of 6.5% and are to be repaid from January 31, 1988 through January 31, 1998. For the year ended January 31, 1987, the Company was paid $4.0 million of interest on these Notes.
(iii) The Company has several technical and administrative agreements for exchange of services with MCC including the provision of retail financing through the Company's United States and Canadian finance subsidiaries. The consolidated financial statements include $8.2 million and $ 3.9 million charged by the Company to MCC for such services during the years ended January 31, 1987 and 1986, respectively. Included in receivables at January 31, 1987 and 1986 is $13.3 million and $3.9 million, respectively, due from MCC. Subsequent to January 31, 1987, the Company received $3.5 million from MCC. The remaining receivable primarily represents products sold to MCC in which the Company retains a security interest.
(iv) The summarized balance sheets and the summarized statements of operations of MCC are provided below:

Summarized Balance Sheets

January 31,	1987	1986
Current assets	**$ 179.3**	$ 242.2
Fixed and other assets	**70.8**	71.5
Total assets	**$ 250.1**	$ 313.7
Current liabilities	**$ 54.6**	$ 63.0
Long-term debt	**187.9**	183.9
Total liabilities	**242.5**	246.9
Shareholders' equity:		
Preferred shares	**109.8**	109.8
Common shares	**0.1**	0.1
Deficit	**(101.3)**	(39.2)
Equity adjustment from foreign currency translation	**(1.0)**	(3.9)
Total shareholders' equity	**7.6**	66.8
Total liabilities and shareholders' equity	**$ 250.1**	$ 313.7

Summarized Statements of Operations

	Year ended January 31, 1987	Three months ended January 31, 1986
Net sales	**$ 81.4**	$ 13.6
Expenses	**143.5**	52.8
Net loss	**$ 62.1**	$ 39.2

In view of continued depressed and competitive market conditions, MCC continues to take rationalization and restructuring actions designed to reduce its operational break-even point. The management of MCC believe that it will have sufficient internally generated funds and operational flexibility to fund the costs of these actions and the anticipated operating losses of fiscal 1987. Thereafter, however, MCC's viability is dependent upon a number of factors including its ability to renegotiate certain terms of its financing agreements, successful implementation of cost reduction actions and improved market conditions.

5. Receivables

(a) Receivables are presented net of the following provisions:

January 31,	1987	1986
Allowance for doubtful notes and accounts	**$ 17.8**	$ 18.8
Discounts, volume and performance bonuses, returns and other allowances	**12.3**	16.0
	$ 30.1	$ 34.8

(b) Non-interest bearing wholesale receivables from dealers, which mature beyond one year of $6.3 million and $1.1 million at January 31, 1987 and 1986, respectively, are included in accounts receivable.

6. Unused Short Term Lines of Credit

At January 31, 1987, unused short term lines of credit amounted to $116.7 million, including unused discounting facilities of $98.2 million (see Note 11 (b)).

7. Accrued Charges

Accrued charges include employee costs of $50.4 million and $29.7 million for the years ended January 31, 1987 and 1986, respectively.

8. Income Taxes

The relationship between income tax expense and recovery and pre-tax accounting income and loss is affected by the variety of tax rates in the many countries in which the Company operates as well as by investment, loss carry-forward and other tax credits. In addition, the relationship is significantly affected by the fact that the unrealized tax benefits of operating losses have not been recognized. Income taxes for the years ended January 31, 1987, 1986 and 1985 were not significantly affected by tax credits arising from prior years' losses and other tax adjustments relating to prior years.

At January 31, 1987, the Company had tax losses aggregating $1.0 billion available to be carried forward for which potential recoveries have not been recognized in the accounts. These loss carry forwards expire during the years ending January 31 as follows: 1988—$23 million; 1989—$19 million; 1990—$23 million; 1991—$25 million; 1992 and beyond—$910 million. At current tax rates, which incorporate the effects of the U.S. Tax Reform Act of 1986, the tax recoveries, if realized, would amount to approximately $400 million. In addition, unused investment tax credits amounted to $8.5 million at January 31, 1987.

The components of pre-tax income (loss) from continuing operations and income tax expense are as follows:

Years ended January 31,	1987	1986	1985
Pre-tax (loss) income from continuing operations (excluding equity in net income of finance subsidiaries):			
Canada	**$ 15.9**	$ 6.7	$ 1.9
Foreign	**(52.7)**	24.2	53.0
	$ (36.8)	$ 30.9	$ 54.9

Years ended January 31,	1987	1986	1985
Income tax recovery (expense):			
Canadian taxes:			
Current		$ (2.7)	$ (0.6)
Foreign taxes:			
Current	**$ (1.1)**	(9.7)	(17.4)
Deferred	**1.5**	(0.3)	0.2
	$ 0.4	$ (12.7)	$ (17.8)

Income taxes differ from amounts computed by applying the Canadian tax rate of 52% to pre-tax results primarily due to tax benefits not having been recorded on losses and non-taxable items.

No provision has been made for taxes on that portion of undistributed earnings of foreign subsidiaries of approximately $28.1 million and $9.9 million at January 31, 1987 and 1986, respectively, which are considered reinvested on a long-term basis.

9. Long-Term Debt

Amounts are repayable in the currency of the country indicated unless otherwise shown; maturity dates are for fiscal years ending January 31 (e.g. fiscal 1987 represents the period February 1, 1987 to January 31, 1988). Substantially all of the assets of the Company's subsidiaries are pledged as collateral for these loans. Unused long-term lines of credit at January 31, 1987 were $38.3 million.

January 31	1987	1986
Massey-Ferguson Industries Limited (Canada):		
Senior Canadian Notes (Cdn.$44.1 million) bearing interest at Canadian prime or 3/4% above certificate of deposit rate for the first three years and 1/4% above Canadian prime or 1% above certificate of deposit rate thereafter and Senior U.S. Notes ($4.0 million) bearing interest at U.S. prime or 3/4% above Eurodollar rates for the first three years and 1/4% above U.S. prime or 1% above Eurodollar rates thereafter, maturing 1988-1998	**$ 37.0**	$ 35.0
Short-term borrowing facility denominated in Canadian and U.S. dollars, bearing interest at Canadian prime plus 1% and a U.S. dollar base rate plus 1% respectively	**11.9**	8.2
Massey-Ferguson S.A. (France):		
Bank loans maturing 1988-1998 bearing interest at 1.2% above prime	**15.1**	12.6
Bank loans maturing 1988-1998 bearing interest at 2.2% above prime	**25.4**	21.2
French State loan maturing 1987-1998 bearing interest at 6% until 1987 and 8% thereafter plus additional fluctuating interest rate based on cash flow	**16.4**	13.7
Massey-Ferguson Manufacturing Limited (United Kingdom):		
Bank loans maturing 1988-1998 bearing interest at 3/4% above various London interbank market rates plus associated costs	**22.9**	21.4

January 31,	1987	1986
Perkins Engines Group Limited (United Kingdom):		
Bank loans maturing 1988-1998 bearing interest at 3/4% above various London interbank market rates plus associated costs	**30.3**	28.2
Bank loan maturing 1986 bearing interest at 1% above the Sterling base rate		11.8
Varity Holdings Limited (United Kingdom):		
7 1/2% Loan Stock maturing 1992	**12.1**	11.3
Dayton Walther Corporation (U.S.A.):		
Bank term loan maturing 1987-1993 bearing interest at a bank's base lending rate plus 1% or London interbank market rate plus 2% or certificate of deposit rate plus 2 1/4%	**73.6**	
Bridge loan maturing 1994 bearing interest at the 30-day commercial paper rate, as determined by the Federal Reserve Bank of New York plus 7 1/2% until June 30, 1987 and thereafter at the greater of such amount or 13 1/2%	**75.0**	
Massey-Ferguson Inc. (U.S.A.):		
Senior Notes maturing 1988-1998, bearing interest at 3/4% above prime or U.S. dollar interbank offered rates for the first three years and 1% above prime or U.S. dollar interbank offered rates thereafter	**57.3**	60.0
Perkins Engines Inc (U.S.A.):		
Senior Notes maturing 1988-1998 bearing interest at 3/4% above prime or U.S. dollar interbank offered rates for the first three years and 1% above prime or U.S. dollar interbank offered rates thereafter	**16.6**	16.6
General purpose loans:		
9 1/2% Bonds maturing 1991 repayable in U.S. dollars	**34.5**	37.0
Other loans individually less than $10.0 million	**85.6**	88.6
Total long-term debt	**513.7**	365.6
Less: current portion of long-term debt (a)	**(39.9)**	(30.7)
	$ 473.8	$ 334.9

(a) Sinking fund requirements and debt maturities during the next five fiscal years are as follows: 1987— $39.9 million; 1988— $44.7 million; 1989— $45.0 million; 1990— $36.8 million; 1991— $75.2 million.

10. Shareholders' Equity

(a) Authorized, Issued and Outstanding Share Capital
The Company is authorized to issue an unlimited number of each of the following classes of shares:

(i) Class I Shares:
Class I Shares are issuable in series. Shares of one series, the U.S. $1.30 Senior Cumulative Redeemable Convertible Preferred Class I Shares, Series A (Class I Preferred Shares), have been issued and are outstanding.

The holders of Class I Preferred Shares are entitled to receive cumulative dividends at an annual rate of U.S. $1.30 per share, payable quarterly. Each share is convertible at any time into Common Shares at a conversion price of U.S. $2.92 per Common Share, equivalent to 6.8493 Common Shares per Class I Preferred Share. The holders are also entitled to a first preference on liquidation of U.S. $20 per share plus accrued and unpaid cumulative dividends. However, if the Class I Preferred Shares are redeemed within two years following the initial public offering of such shares, the Company may be required to offer a premium on redemption or voluntary liquidation depending on the sale price of the shares in such public offering.

(ii) Class II Shares
Class II Shares are issuable in series. Shares of one series, the Cdn. $1.625 Cumulative Redeemable Convertible Exchangeable Preferred Class II Shares, Series A (Class II Preferred Shares), have been issued and are outstanding.

The holders of the Class II Preferred Shares are entitled to receive cumulative dividends at a maximum annual rate of Cdn. $1.625 per share, payable quarterly. However, dividends will not be payable and will not cumulate on these shares during the period ending January 31, 1991, except in the event and to the extent that consolidated net income exceeds $60.0 million for the immediately preceding fiscal year. This threshold will be removed if the Company reports consolidated net income of at least $75.0 million for each of two fiscal years during the period and an aggregate of at least $165.0 million for both of such years.

The Class II Preferred Shares are junior to the Class I Preferred Shares in dividend and liquidation rights. Each share is convertible at any time into Common Shares at a conversion price of Cdn. $7.50 per Common Share, equivalent to 3.3333 Common Shares per Class II Preferred Share. Each share is redeemable at, and has a liquidation value of, Cdn. $25 plus accrued and unpaid dividends and unpaid additional dividends, if any, for the fiscal year in which such redemption or liquidation occurs.

(iii) Class III Shares
The Class III Shares are issuable in series and none have been issued.

(iv) Common Shares and Warrants
Certain lenders to the Company's French subsidiary are entitled to receive an aggregate of 2,097,600 Common Shares after January 31, 1988 in consideration of past interest concessions.

At January 31, 1987, there were 35,004,198 warrants to purchase Common Shares outstanding which are exercisable at Cdn. $5.00 per Common Share up to and including May 31, 1991, on which date the warrants expire.

Under the Executive Stock Option Plan, there are stock options outstanding as at January 31, 1987 for 3,807,800 Common Shares for key executives and former executives of the Company and subsidiaries, exercisable at prices ranging from Cdn. $2.54 to $4.05 per share. At January 31, 1987, options to purchase 289,877 Common Shares were exercisable. The closing price of the Common Shares on January 31, 1987 on The Toronto Stock Exchange was Cdn. $3.35. The Company has agreed to limit options granted under the Executive Stock Option Plan to 4,000,000 Common Shares (including options currently outstanding).

(b) Restrictions on Dividends, Issue and Reduction of Capital
(i) So long as any Class I or Class II Preferred Shares are outstanding, unless all dividends then payable on these shares (including, in the case of the Class II Preferred Shares, cumulative dividends at the maximum annual rate of Cdn. $1.625 per share) have been declared and paid or amounts set aside for payment, the Company may not, without the prior approval of the holders of the relevant shares:

(1) declare or pay any dividends (other than stock dividends in shares of the Company ranking junior to these shares) on any Common Shares or junior ranking shares;

(2) redeem, purchase, or make any capital distribution in respect of any equal or junior ranking shares; and

(3) issue any shares ranking as to capital or dividends prior to or on a parity with these shares except in accordance with and as limited by the Securities Sales Agreement referred to in (ii) below.

(ii) The Company has entered into a Securities Sales Agreement with the initial holders of Class I and Class II Preferred Shares and certain holders of Common Shares issued in connection with the 1981, 1983 and 1986 Restructurings. The Securities Sales Agreement defines the relative rights of such holders among themselves and in relation to the Company to sell their securities in the public markets. These arrangements will regulate the Company's access to public markets by generally providing a priority of access to such initial holders.

(c) Equity Adjustment from Foreign Currency Translation
Changes in the equity adjustment from foreign currency translation, which have resulted principally from the movement of various currencies relative to the U.S. dollar, are analyzed below:

January 31,	**1987**	1986	1985
Balance, beginning of year	**$ 81.1**	$ 91.9	$ 68.3
Accounts affected during the year:			
Net current assets	**(9.4)**	2.4	24.6
Fixed assets	**(24.9)**	(34.7)	30.6
Long-term debt	**24.0**	29.1	(29.7)
Other, net	**(2.0)**	(7.6)	(1.9)
Balance, end of year	**$ 68.8**	$ 81.1	$ 91.9

11. Contingent Liabilities and Commitments

(a) Covenants, Undertakings and Compliance
(i) In the 1986 Restructuring, the Company renegotiated substantially all of its non-public loan agreements. These agreements provide for financial covenants by the Company on a consolidated basis as well as individually by Varity Corporation and its principal subsidiaries (including the finance subsidiaries). These financial covenants relate to such matters as the maintenance of assets and net worth at specified relationships to each entity's respective indebtedness and maintenance of certain minimum levels of working capital and net worth.

Varity Corporation has also guaranteed substantially all of the borrowings of its subsidiaries. Substantially all of the assets and liabilities are held in subsidiaries and there are significant restrictions on the transfer of assets from the subsidiaries to Varity Corporation under the covenants contained in the 1986 Restructuring agreements.

The provisions discussed above do not apply to Dayton Walther, in respect of whose indebtedness the Company has given no commitment or undertakings other than those given by Dayton Walther itself with respect to its borrowings as set out in Note 2.

Since the 1986 Restructuring, the Company has further negotiated covenants and obtained waivers from lenders with respect to actual or anticipated events of non-compliance with such covenants. After giving effect to these amendments and waivers, the Company and each of its subsidiaries is in compliance in all material respects with its covenants. Management believes that the Company will remain in compliance in all material respects with its covenants during the year ending January 31, 1988, assuming continuation of market conditions in the agricultural equipment markets at current levels, the achievement of certain operating efficiencies, and the absence of adverse changes in currency exchange rates during the balance of the year. However, if events of non-compliance occur, the Company believes that it generally has the ability to renegotiate these covenants, or, if necessary, to repair any such events of non-compliance.

Failure to resolve events of non-compliance could result in lenders declaring loan agreements to be in default, which, by virtue of cross-default provisions, could result in the acceleration of the maturities of substantially all of the outstanding indebtedness of the Company (including that of the Company's finance subsidiaries). If such an acceleration were to occur, it is extremely unlikely, at least in the foreseeable future, that the Company would be able to repay all such indebtedness.

The 1986 Restructuring agreements also contain provisions so that a default under any one agreement may result in an acceleration of debt maturities covered by that agreement and, through various cross-default provisions, may cause acceleration in the maturities of substantially all indebtedness (including that of the finance subsidiaries).

(ii) In connection with the 1986 Restructuring, the Company also gave undertakings to the Governments of Canada and Ontario, which include the following:

(1) The Company will invest at least Cdn. $40 million in incremental projects in Canada by May 1990. As a result of the Dayton Walther acquisition and other investments, approximately Cdn. $32 million of this commitment has been met.

(2) If MCC does not maintain certain specified annual levels of permanent jobs, to an eventual level of 1,500 permanent jobs by 1993, the Company will be required either to create and maintain such jobs or to pay the Governments an aggregate of Cdn. $30,000 for each job that is not maintained. The Company believes that MCC will reach the level required for 1987.

(3) In the event of liquidation or winding-up of MCC within a defined period of time, the Company would be obligated to pay MCC's unfunded pension obligation up to a maximum of approximately $28.4 million (Cdn. $38.0 million). Provided that MCC continues to sustain manufacturing employment at stipulated levels (which it has maintained since May 1986) this undertaking will be limited to approximately $18.7 million (Cdn. $25.0 million) in May 1987. In such an event and absent the liquidation and winding-up of MCC, the Company's obligation will be extinguished in May 1988. The Company has pledged its MCC Notes as collateral for payment of such indemnity.

(iii) The Company has committed to locate export markets for products manufactured by its associate company in Brazil. These commitments extend to 1993. All commitments have been met to date and the Company anticipates that commitments for the period to June 1987 (date of assessment of compliance with the first three-year sales target of $69.0 million) will also be met. Commitments and related non-performance penalties increase significantly after that date. The Company believes it is unlikely that it will incur any significant costs in this regard.

The Company and its Brazilian associate company also agreed to develop plans jointly for the manufacture, marketing and sale of products capable of achieving specified levels of export sales for the associate company. The Company has presented a plan which is now being jointly considered by the Company and the associate company.

(b) Contingent liabilities relating to notes receivable discounted, bills guaranteed and similar obligations were $51.3 million at January 31, 1987.

(c) Approved capital expenditure programs outstanding at January 31, 1987 were $65.0 million including capital commitments of approximately $24.0 million.

12. Business Segment Information

The principal industry segments and geographic regions in which the Company operates are set out below. The farm and industrial machinery segment manufactures and sells farm and industrial tractors, farm balers, other agricultural implements and industrial loaders. The engines segment is engaged in the production and sale of multi-cylinder, multi-purpose diesel engines.

On December 31, 1986, the Company acquired Dayton Walther. This acquisition has expanded the Company's operations to include the transportation products segment (see Note 2). The transportation products segment manufactures and sells wheel components and disc brake products primarily to the original equipment market of the motor vehicle industry.

Other is composed primarily of the building products and components segments. Intersegment and interregional sales are accounted for at prices which the Company believes approximate market.

		Industry Segment						**Geographic Region**			
For the years ended January 31, 1987, 1986 and 1985 (Fiscal 1986, 1985 and 1984 respectively)		Farm and industrial machinery	Engines	Transportation products	Other	Adjustments and eliminations	Consolidated	Canada	U.S.	Europe and other	Adjustments and eliminations
Net sales to unaffiliated customers (includes intersegment sales for industry segment):	**1986**	**$ 940**	**$ 450**	**$ 21**	**$ 32**	**$ (84)**	**$ 1,359**	**$ 58**	**$ 184**	**$ 1,117**	
	1985	947	418		15	(92)	1,288	49	198	1,041	
	1984	969	400		11	(86)	1,294	47	230	1,017	
Interregional sales:	**1986**									**117**	**$ (117)**
	1985								2	107	(109)
	1984							9	21	98	(128)
Unaffiliated customer and interregional sales:	**1986**						**1,359**	**58**	**184**	**1,234**	**(117)**
	1985						1,288	49	200	1,148	(109)
	1984						1,294	56	251	1,115	(128)
Profit (loss) before interest, exchange adjustments, general corporate expense allocation, reorganization costs, income taxes, equity in net income of finance subsidiaries and loss from discontinued operations:	**1986**	**(18)**	**26**	**1**	**1**	**(2)**	**8**		**(29)**	**39**	**(2)**
	1985	70	37			8	115	6	1	100	8
	1984	75	39		1	3	118	(3)	16	102	3
Identifiable assets:	**1986**	**720**	**310**	**177**	**76**	**(16)**	**1,267**	**77**	**399**	**807**	**(16)**
	1985	730	290		21	(28)	1,013	67	235	739	(28)
	1984	680	197		16	(32)	861	111	265	517	(32)
Depreciation and amortization:	**1986**	**16**	**15**	**1**	**2**		**34**				
	1985	13	13		2		28				
	1984	12	13		2		27				
Capital expenditures:	**1986**	**37**	**22**	**1**	**4**		**64**				
	1985	29	14		2		45				
	1984	25	13		1		39				

Years ended January 31,	**1987**	1986	1985
Profit (loss) before items shown below:	**$ 8**	$ 115	$ 118
Interest expense, net	**(52)**	(53)	(57)
Foreign exchange adjustments	**4**	(8)	6
General and corporate expense, net	**18**	(5)	(4)
Reorganization costs	**(15)**	(18)	(8)
Profit (loss) before income taxes, equity in net income of finance subsidiaries and associate companies and loss from discontinued operations	**$ (37)**	$ 31	$ 55
Identifiable assets	**$ 1,267**	$ 1,013	$ 861
Investment in finance subsidiaries and associate companies	**188**	163	194
Corporate assets	**49**	74	54
Discontinued operations			340
	$ 1,504	$ 1,250	$ 1,449

13. Reorganization Costs

The Company reports costs associated with various programs to restructure and rationalize its operations in the consolidated statements of income under the caption"Reorganization costs". The principal components are:

Years ended January 31,	1987	1986	1985
Manpower reductions and relocations	**$ 14.3**	$ 15.3	$ 8.0
Provisions for write down of fixed assets resulting from plant closures (net of gains on disposal of other fixed assets)	**0.9**	2.3	0.3
	$ 15.2	$ 17.6	$ 8.3

14. Income (Loss) per Common Share

Income (loss) per Common Share has been calculated after deducting dividend entitlements on the Class I and Class II Preferred Shares for the year ended January 31, 1987 and dividend entitlements on the former Series A,B,C,D and E Preferred Shares for the years ended January 31, 1986 and 1985. The weighted monthly average numbers of Common Shares used in these calculations are as follows:

Years ended January 31,	
1987	**161,668,386**
1986	107,462,508
1985	101,100,247

Unaudited pro forma information relating to the acquisition of Dayton Walther is set out in Note 2(e).

15. Other Information

(a) Reconciliation Between Canadian and United States Generally Accepted Accounting Principles

The consolidated financial statements are affected by the following differences between generally accepted accounting principles (GAAP) in Canada and in the United States.

(i) The principal and interest reductions that formed part of the 1981, 1983 and 1986 Restructurings and the related costs of restructuring have been treated in these consolidated financial statements as capital transactions by way of credits and charges, respectively, to contributed surplus. Under United States GAAP the benefit of the the interest reductions would have been recognized as reduced interest expense over the revised term of the related debt. The costs of the debt restructurings and gains arising on reduction of principal would be reflected in the consolidated statements of income.

(ii) Actuarial gains and losses and the results of changes in actuarial assumptions in the United Kingdom subsidiaries' pension fund would be amortized over ten years under United States GAAP instead of over three years.

(iii) As required by Canadian GAAP, the Company is deferring and amortizing the exchange translation gains and losses on long-term foreign currency denominated monetary items over the life of the related item. Under United States GAAP, these gains and losses would be credited or charged, as appropriate, to income in the year in which they arose.

The effect of these differences is set out below:

Consolidated Statements of Income

Years ended January 31,	1987	1986	1985
Income (loss) from continuing operations as reported	**$ (23.3)**	$ 23.9	$ 37.8
Add (deduct):			
(i) 1981, 1983 and 1986 Restructurings	**(2.5)**	15.3	11.8
(ii) Marketing, general and administration	**7.7**	(9.3)	(10.2)
(iii) Translation exchange gain (loss) on long-term foreign currency denominated monetary items	**4.5**	3.6	(9.8)
Income (loss) from continuing operations under United States GAAP	**(13.6)**	33.5	29.6
Loss from discontinued operations			
-As reported		(20.0)	(30.6)
-Interest on long-term debt		5.1	5.9
Net income (loss) under United States GAAP	**$ (13.6)**	$ 18.6	$ 4.9
Net loss (after Preferred Share dividend entitlements of $10.0, $21.3 and $19.7 for the years ended January 31, 1987,1986 and 1985, respectively) under United States GAAP attributible to Common Shareholders	**$ (23.6)**	$ (2.7)	$ (14.8)
Income (loss) per Common Share after Preferred Share dividend entitlements:			
From continuing operations	**$ (0.15)**	$ 0.11	$ 0.10
Net loss	**$ (0.15)**	$ (0.03)	$ (0.15)

Consolidated Balance Sheets

	Other assets and deferred charges	Long-term debt	Pension and other long-term liabilities	Contributed surplus	Deficit
January 31,1987, as reported	**$ 78.8**	**$ 473.8**	**$ 43.7**	**$ 794.1**	**$ (718.0)**
Adjustments for items above	**(3.4)**	**80.9**	**29.0**	**(267.6)**	**154.3**
Under United States GAAP	**$ 75.4**	**$ 554.7**	**$ 72.7**	**$ 526.5**	**$ (563.7)**
January 31,1986, as reported	$ 43.5	$ 334.9	$ 26.6	$ 801.2	$ (684.1)
Adjustment for items above	(7.9)	86.1	36.7	(275.3)	144.6
Under United States GAAP	$ 35.6	$ 421.0	$ 63.3	$ 525.9	$ (539.5)

(b) Pension plan information

Pension expense for continuing operations, including amortization of past service costs and expenses of government plans, was $32.9 million, $13.8 million and $12.6 million for the years ended January 31, 1987, 1986 and 1985, respectively. Pension expense relating to discontinued operations was $7.2 million and $10.1 million for the years ended January 31, 1986 and 1985, respectively. According to the latest valuations as of October 31, 1985 (November 30, 1986 for newly aquired Dayton Walther), the actuarially computed value of past service obligations exceeded the market value of pension fund assets and balance sheet accruals by approximately $14.3 million ($7.4 million at January 31, 1986 based on the October 31, 1984 valuation) of which $11.7 million ($5.0 million at January 31, 1986 based on the October 31, 1984 valuation) was vested.

In the U.S., based on the October 31, 1985 actuarial valuation (November 30, 1986 for Dayton Walther), the actuarial present value of accumulated plan benefits was $133.4 million at January 31, 1987 ($80.5 million at January 31,1986 based on the October 31, 1984 valuation) of which $127.9 million ($77.3 million at January 31, 1986 based on the October 31, 1984 valuation) represented vested benefits. Net assets, including balance sheet accruals, available for benefits at January 31, 1987 were $141.5 million ($80.5 million at January 31, 1986 based on the October 31, 1984 valuation). The assumed interest rate used in determining this benefit information was approximately 9.4% (7.5% for Dayton Walther) (9.5% in 1985).

Company pension plans not subject to the Employee Retirement Income Security Act of 1974 are in effect outside the United States, primarily in the United Kingdom, Canada and West Germany. In Canada, the actuarially computed present value of accumulated plan benefits, based on the October 31, 1985 valuation, exceeded the market value of pension fund assets and balance sheet accruals by $1.8 million at January 31, 1987 ($0.9 million at January 31, 1986 based on the October 31, 1984 valuation), of which $0.6 million ($0.5 million at January 31, 1986 based on the October 31, 1984 valuation) was vested. The Company funds pension expense in Canada as required by Canadian law.

During the year ended January 31, 1987, $5.3 million (January 31, 1986 - $4.9 million excluding $2.0 million for discontinued operations) was expensed in respect of health care costs and life insurance premiums for retired employees.

(c) Related party transactions

Net sales include sales discounts of $6.2 million and $7.3 million for the years ended January 31, 1987 and 1986, respectively, paid to unconsolidated finance subsidiaries for low-rate financing and interest waiver programs.

(d) Other interest, net

Other interest, net, reflects interest income of $21.9 million, $17.7 million and $16.5 million for the years ended January 31, 1987, 1986 and 1985, respectively, which has been offset by other interest expense.

16. Discontinued Operations

As discussed in Note 3, the Company deconsolidated MCC effective November 2, 1985. Operating results of the Combines Business for the nine months ended October 31, 1985 and the year ended January 31, 1985 have been shown as "Loss from Discontinued Operations" in the consolidated statements of income for the years ended January 31, 1986 and 1985, respectively. Details of these results are shown below.

Years ended January 31,	1986	1985
Net sales	$ 121.3	$ 175.0
Expenses	156.7	228.4
Loss before income taxes	35.4	53.4
Income tax recovery	15.4	22.8
Net loss	$ 20.0	$ 30.6

17. Unconsolidated Finance Subsidiaries

The finance subsidiaries primarily finance products sold by the Company and its subsidiaries. Subsequent to November 2, 1985, the North American finance subsidiaries also provided retail financing for MCC. The North American finance subsidiaries provide financing to retail purchasers of the Company's farm and industrial equipment. The finance subsidiaries outside North America provide financing for export sales to distributors and, to a lesser extent, help to finance domestic sales to dealers and distributors.

Combined summarized financial information is as follows:

Combined Summarized Statements of Assets and Liabilities

January 31,	**1987**	1986
Assets:		
Cash and short-term investments	**$ 33.6**	$ 35.5
Due from affiliates	**16.8**	16.2
Receivables and other	**435.1**	450.8
	$ 485.5	$ 502.5
Liabilities and shareholders' equity:		
Short-term notes payable	**$ 60.2**	$ 46.2
Due to affiliates	**9.8**	14.8
Accounts payable and accrued charges	**26.2**	38.8
Long-term debt (a)	**271.7**	307.3
	367.9	407.1
Shareholders' equity	**117.6**	95.4
	$ 485.5	$ 502.5

Combined Summarized Statements of Income

Years ended January 31,	**1987**	1986	1985
Revenue	**$ 70.1**	$ 69.5	$ 79.9
Income before extraordinary item	**8.9**	5.7	0.7
Net income	**13.1**	5.7	0.7

(a) Long-term debt
Amounts are repayable in the currency of the country indicated unless otherwise shown; maturity dates are for fiscal years ending January 31 (e.g. fiscal 1987 represents the period February 1, 1987 to January 31, 1988). Unused long-term lines of credit at January 31, 1987 were $8.3 million.

January 31,	1987	1986
MF Finanziaria SpA (Italy): Senior note maturing 1987-1988 bearing interest at London Interbank Offered Rate (LIBOR) plus 2.375%	**$ 2.7**	$ 2.5
MF Finance A.G. (Switzerland): Subordinated bank loans maturing 1989-1995 repayable in various Eurocurrencies bearing interest at 1.25% above applicable Eurocurrency rates	**19.1**	11.7
Massey-Ferguson Finance (Australia) Limited: Senior bank loan maturing 1986 bearing interest at various rates from 19.5% to 21.8%		12.9
Massey-Ferguson Perkins Finance Company Limited (United Kingdom): Senior overdraft maturing 1987 bearing interest at a bank's base rate plus 1.125%	**0.3**	3.7
Senior bank loans repayable in various currencies maturing 1987 bearing interest at LIBOR plus 1.0%	**49.1**	40.9
Rhinanthus Leasing Limited (United Kingdom): Senior bank loans maturing 1987-1993 bearing interest at 13.0% and 11.6%	**24.1**	18.2
Massey-Ferguson Credit Corporation (U.S.A.): Senior Notes maturing 1987-1988 bearing interest at various rates from 5.25% to LIBOR plus 1.625%	**34.8**	121.4
Senior Subordinated Notes maturing 1987-1988 bearing interest at various rates from 7.875% to LIBOR plus 1.0%	**7.1**	21.0
Junior Subordinated Debt maturing 1987-1988 bearing interest at 1.0% above reserve adjusted LIBOR	**75.0**	75.0
Senior Revolving Credit loan maturing 1987-1989 bearing interest at interbank federal funds market rate plus 1.375%	**59.5**	
	$ 271.7	$ 307.3
Senior debt	**$ 170.5**	$ 199.6
Subordinated debt	**101.2**	107.7
Total long-term debt	**$ 271.7**	$ 307.3

Installments due and maturities during the next five years are as follows:
(i) Massey-Ferguson Credit Corporation
—Senior and Senior Subordinated Notes—1987-$5.7 million and 1988-$36.2 million.
—Junior Subordinated Debt (repayment does not begin until Senior and Senior Subordinated notes have been paid in full) 1988-$45.0 million and 1989-$30.0 million.
(ii) All other
—1987-$83.6 million; 1988-$29.9 million; 1989-$15.3 million; 1990-$5.2 million; and 1991-$4.2 million; and 1992 and beyond-$16.6 million.

(b) 1986 Restructuring
Under the 1986 Restructuring (see Note 3), the finance subsidiaries are required to maintain certain financial ratios including maintaining assets at specified relationships to their respective indebtedness and maintenance of minimum levels of working capital and net worth.

The major feature of the 1986 Restructuring affecting the finance subsidiaries relates to the restructuring of Massey-Ferguson Credit Corporation (MFCC). Substantially all of the assets of MFCC at January 31, 1986 have been placed in a liquidating trust for the benefit of the lenders, with MFCC as the residual beneficiary. The liquidating trust assumed all liabilities of MFCC at January 31, 1986 including the Junior Subordinated Debt of $75.0 million. All of the net proceeds from the existing portfolio of retail finance contracts held by the liquidating trust will be applied to repay the liabilities assumed. Ongoing retail financing in the United States is provided by a wholly-owned subsidiary of MFCC for which funding of up to $300 million has been arranged with a new lender.

(c) Formation of new Canadian finance company
Effective January 31, 1987, the Company entered into an agreement with a major lending institution establishing a new Canadian finance company in which the Company holds a 30% interest. As part of this transaction, the Company received consideration of Cdn. $2.8 million. The new finance company has assumed responsibility for providing retail financing of the Company's products in the Canadian market as well as actively pursuing new opportunities.

18. Subsequent Events

(a) On April 9, 1987, the Shareholders approved a reduction of $137.5 million in the Common Share stated capital and the transfer of such amount to contributed surplus.

(b) Pursuant to the Securities Sales Agreement referred to in Note 10 (b)(ii), the Company and certain holders of Class I Preferred Shares propose to enter into an underwriting agreement to sell Class I Preferred Shares.

Auditors' Report

To the Shareholders of
Varity Corporation:

We have examined the consolidated balance sheets of Varity Corporation as at January 31, 1987 and 1986 and the consolidated statements of income, changes in shareholders' equity and changes in financial position for the three years ended January 31, 1987. Our examinations were 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 financial statements present fairly the financial position of Varity Corporation as at January 31, 1987 and 1986 and the results of its operations and changes in its financial position for the three years ended January 31, 1987 in accordance with accounting principles generally accepted in Canada applied on a consistent basis during the period.

Toronto, Canada
April 16, 1987

Clarkson Gordon
Chartered Accountants

Comments by Auditors for U.S. Readers on
Canada-United States Reporting Conflict:

The above opinions are expressed in accordance with standards of reporting generally accepted in Canada. Had the report been prepared in accordance with United States reporting standards, our opinion on the January 31, 1987 financial statements would have been qualified with respect to the outcome of the significant uncertainties referred to in Note 11 (a)(i) to the accompanying consolidated financial statements.

Toronto, Canada
April 16, 1987

Clarkson Gordon
Chartered Accountants

Management's Report on Financial Statements

The accompanying financial statements of the Company were prepared by management within the framework of the accounting policies summarized in Note 1 and in accordance with accounting principles generally accepted in Canada, consistently applied. Management is responsible for all information in the Annual Report. All financial and operating data in the Report are consistent with those contained in the financial statements.

Management is responsible for the integrity and objectivity of the financial statements. In the preparation of these statements, estimates are sometimes necessary when transactions affecting the current accounting period are dependent on the outcome of future events. Such estimates are based on careful judgements and have been properly reflected in the accompanying financial statements. Management has established systems of internal control which are designed to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and to produce reliable accounting records.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board exercises these responsibilities principally through the Audit Committee of the Board, which is composed of directors who are not employees of the Company. The Committee meets periodically with management, the internal and the external auditors to satisfy itself that their responsibilities are properly discharged and to review the financial statements.

The external auditors conduct an independent examination in accordance with generally accepted auditing standards, and express their opinion on the financial statements. Their examination includes a review and evaluation of the systems of internal control and appropriate tests and procedures designed to provide reasonable assurance that the financial statements are presented fairly. The external auditors have full and free access to the Audit Committee of the Board.

Management recognizes its responsibility for conducting the Company's affairs in compliance with established financial standards and applicable laws, and for the maintainance of proper standards of conduct in its activities.

April 16, 1987

Victor Rice
Chairman and Chief Executive Officer

Vince D. Laurenzo

Vincent D. Laurenzo
President

J. Keith Robson
Vice President, Comptroller and Planning

Supplementary Information (Unaudited)

(a) Quarterly condensed unaudited income statements for the years ended January 31, 1987 and 1986 are presented below.

(Millions of U.S. dollars except per share amounts)	1986 Quarter				1985 Quarter			
	1	2	3	4	1	2	3	4
Net sales	$ 346.2	$ 363.4	$ 256.2	$ 393.5	$ 268.7	$ 335.8	$ 332.7	$ 351.2
Gross profit	67.2	66.9	34.4	59.9	58.8	71.3	74.4	68.2
Expenses	62.0	60.2	61.5	66.3	50.0	58.5	56.7	59.0
Reorganization costs				15.2		7.6		10.0
Income (loss) before items shown below	5.2	6.7	(27.1)	(21.6)	8.8	5.2	17.7	(0.8)
Equity in net income of finance subsidiaries	0.8	2.4	7.0	2.9	2.0	0.3	0.2	3.2
Income (loss) from continuing operations before income taxes	6.0	9.1	(20.1)	(18.7)	10.8	5.5	17.9	2.4
Income tax (provision) recovery	(0.1)		0.4	0.1	(4.1)	(4.7)	(4.8)	0.9
Income (loss) from continuing operations	5.9	9.1	(19.7)	(18.6)	6.7	0.8	13.1	3.3
Loss from discontinued operations (net of tax recovery)					(6.3)	(6.7)	(7.0)	
Net income (loss)	$ 5.9	$ 9.1	$ (19.7)	$ (18.6)	$ 0.4	$ (5.9)	$ 6.1	$ 3.3
Income (loss) per common share after Preferred Share dividend entitlements (in U.S. Dollars)*:								
Income (loss) from continuing operations	$ 0.02	$ 0.04	$ (0.14)	$ (0.13)	$ 0.01	$ (0.05)	$ 0.07	$ (0.01)
Net income (loss)	$ 0.02	$ 0.04	$ (0.14)	$ (0.13)	$ (0.05)	$ (0.11)	$ 0.01	$ (0.01)

* The sum of quarterly results per common share does not equal the annual loss per common share because quarterly changes in the weighted average number of common shares outstanding are not proportional to changes in quarterly results.

(b) At March 31, 1987, 165,026,481 Varity Corporation Common Shares were registered in the names of approximately 32,000 shareholders, based on the records of the Share Transfer Agent.

The principal trading market for these shares are Toronto and New York. The following table sets out the high and low sale prices of the stock on the Toronto and New York Stock Exchanges for the fiscal periods indicated.

	1986		1985	
	High	Low	High	Low
Toronto				
First quarter	Cdn. $ 3.60	Cdn. $ 2.54	Cdn. $ 4.80	Cdn. $ 2.75
Second quarter	4.80	2.80	3.30	2.60
Third quarter	3.30	2.50	3.70	2.95
Fourth quarter	3.40	2.48	3.45	2.85
New York				
First quarter	U.S. $ 2-5/8	U.S. $ 1-3/4	U.S. $ 3-1/2	U.S. $ 2
Second quarter	3-1/2	2	2-1/2	1-7/8
Third quarter	2-3/8	1-3/4	2-3/4	2-1/8
Fourth quarter	2-1/2	1-3/4	2-1/2	2

Restrictions on Dividends, Issue and Reduction of Capital

So long as any Class I or Class II Preferred Shares are outstanding and unless all dividends then payable on these Shares have been declared and paid or amounts set aside for payment, the Company may not, without the prior approval of the holders of these Shares:
(1) declare or pay any dividends (other than stock dividends in shares of the Company ranking junior to these Shares) on any common or junior shares;
(2) redeem, purchase, or make any capital distribution in respect of any junior shares.
(3) issue any shares ranking as to capital or dividends prior to or on a parity with these Shares.

Further, the Company has also entered into registration rights and sales sequencing agreements with the initial holders of Class I Preferred Shares, Class II Preferred Shares and holders of Common Shares issued in connection with the 1981, 1983 and 1986 Restructurings.

(c) Selected Financial Data

(Millions of U.S. dollars except per share data)	Years ended January 31,				Three months ended January 31,	Year ended October 31,
	1987	1986	1985 (4)	1984 (4)	1983 (4)	1982 (4)
Net sales	$ 1,359	$ 1,288	$ 1,294	$ 1,535	$ 313	$ 2,058
Income (loss) from continuing operations (before extraordinary item): (2)						
Canadian accounting principles	(23)	24	38	(68)	(94)	(413)
U.S. accounting principles (1)	(14)	34	30	(60)	(90)	(403)
Income (loss) per common share from continuing operations after Preferred Share dividend entitlements (before extraordinary item):						
Canadian accounting principles	(0.21)	0.02	0.18	(0.93)	(1.74)	(8.95)
U.S. accounting principles (1)	(0.15)	0.11	0.10	(0.83)	(1.66)	(8.75)
Total assets						
Canadian accounting principles	1,504	1,250	1,450	1,581	1,843	2,069
U.S. accounting principles (1)	1,501	1,242	1,439	1,580	1,843	2,069
Long-term debt:						
Canadian accounting principles	474	335	637	653	1,025	1,025
U.S. accounting principles (1)	555	421	753	791	1,130	1,134
Redeemable Preferred Shares			454	454	454	454
Contingent liabilities and commitments (3)						

(1) See Note 15 (a) to the Consolidated Financial Statements for a reconciliation of U.S. and Canadian generally accepted accounting principles as they apply to the Consolidated Financial Statements.
(2) Includes reorganization costs of $15.2 million, $17.6 million, $8.3 million and$15.9 million for the years ended January 31, 1987, 1986, 1985 and 1984 respectively, $170.8 million in the year ended October 31, 1982.
(3) See Note 11 to the Consolidated Financial Statements for discussion of contingent liabilities and committments.
(4) The Company has reclassified its consolidated statements of income for the year ended January 31, 1985 to show the results of the Combines division as discontinued operations (see Notes 3, 4 and 16 to the Consolidated Financial Statements). It was not practicable to similarly adjust earlier figures.

(d) U.S. dollar as reporting currency

Varity Corporation is a holding company incorporated in Canada with over 100 subsidiaries incorporated in many different countries. The Company manufactures and sells farm and industrial machinery and diesel engines through subsidiaries and through associates in which it holds minority interests. The Company's major manufacturing plants are located in the United Kingdom, France, Germany and Italy. The manufacturing plants of its associates are all over the world.

Since 1970 the Company's reporting currency has been the U.S. dollar. The Company believes it is justified in using the U.S. dollar as its reporting currency for the following reasons:

1. The primary economic environment in which Varity Corporation operates is international. The Company operates in about ten currencies and clearly needs a stable yardstick currency for measuring the financial results of its operations.

Since 1970 the Canadian Government has allowed the Canadian dollar to "float". As a consequence, the Company believed then and does now that the U.S. dollar is a more stable yardstick for measuring its international operations. Since the U.S. dollar is the basic international currency to which all others relate, and since it is one of the major currencies of the Company's operations, the U.S. dollar is felt to be the appropriate reporting currency.

2. Although Varity Corporation is a Canadian company, the following indicators for the fiscal year ended January 31, 1987 demonstrates its multinational nature:

	Canada	Other
Identifiable assets located in	6%	94%
Total debt denominated in currency of	9%	91%
Sales and operating revenues billed in currency of	5%	95%
Common shares held in	31%	69%

In addition, a very large part of the Company's intercompany sales, as well as export sales to other countries made from subsidiaries outside the U.S. are also denominated in U.S. dollars. From these indicators it is concluded that the Company is more internationally oriented than Canadian oriented.

3. For internal reporting purposes at Varity Corporation, business thinking and planning, management decision-making and management reporting are carried out in terms of U.S. dollars because it provides the most meaningful frame of reference. To use another currency for external reporting purposes would be impractical.

4. Varity Corporation's primary economic environment is similar to that of its principal competitors: Deere, Case/International Harvester, Allis Chalmers/Deutz and Ford (all domestic SEC registrants). The use of the U.S. dollar reporting currency reflects this. If Varity Corporation were to prepare Canadian dollar financial statements, uniformity of reporting currency with these competitors would be lost. This would hamper investors in assessing the Company vis-a-vis its principal competitors.

5. Foreign currency translation considerations also are intertwined with reporting currency considerations. Using the functional currency approach in Statement No. 52 of the Financial Accounting Standards Board, all of the Company's major operations use the local currency as their functional currency. However, when the business of the Company as a whole is considered, the only logical currency for measuring operation is the U.S. dollar. Revenues earned in U.S. dollars are considerably higher than those earned in Canadian dollars.

In addition to the above, it should be noted that there are no exchange restrictions or controls in Canada, relating to the U.S. dollar and that the Company publishes its financial statements for all of its shareholders in U.S. dollars.

Financial Statistics (i)

(Millions of U.S. dollars except per share data)		Years ended January 31,				Three months ended January 31,	Years ended October 31,			
		1987	1986	1985 (ii)	1984	1983 (iv)	1982	1981	1980 (v)	1979 (v)
Summary of operations										
Net sales	$	**1,359**	1,288	1,294	1,535	313	2,058	2,646	3,132	2,973
Gross profit	$	**228**	273	285	284	10	250	313	556	573
Net expenses (excluding interest)	$	**198**	171	165	253	65	317	263	520	392
Interest expense (net)	$	**52**	53	57	90	43	186	265	240	149
Reorganization costs	$	**15**	18	8	16		171	5	29	95
Income tax recovery (expense)	$		(13)	(18)	1	2	3	9	10	6
Equity in net income of finance subsidiaries	$	**13**	6	1	6	2	8	16	23	21
Income (loss) from continuing operations (ii)	$	**(23)**	24	38	(68)	(94)	(413)	(195)	(200)	(36)
Loss from discontinued operations (ii)(v)	$		(20)	(31)					(25)	(23)
Income (loss) before extraordinary item	$	**(23)**	4	7	(68)	(94)	(413)	(195)	(225)	(59)
Extraordinary item	$									95
Net income (loss)	$	**(23)**	4	7	(68)	(94)	(413)	(195)	(225)	37
Operating income (loss) (iii)	$	**(8)**	22	16	(52)	(85)	(205)	(218)	(120)	45
Preferred Share dividends	$	**10**					16	45		
Financial condition										
Working capital	$	**207**	289	559	556	670	723	994	256	467
Additions to fixed assets (vi)	$	**64**	45	39	36	5	47	44	46	77
Depreciation and amortization (vi)	$	**34**	28	27	37	14	71	81	80	88
Total assets	$	**1,504**	1,250	1,449	1,581	1,844	2,069	2,503	2,828	2,745
Current ratio		**1.3**	1.6	2.3	2.0	2.1	2.0	2.2	1.1	1.3
Asset turnover ratio		**0.9**	1.0	0.9	1.0	0.2	1.0	1.1	1.1	1.1
Debt/equity ratio		**1.6**	1.2	2.3	2.8	7.8	5.0	2.1	4.6	2.1
Liabilities and shareholders' equity										
Current	$	**628**	510	432	560	610	746	844	1,851	1,469
Other	$	**534**	378	707	736	1,090	1,087	1,089	624	699
Shareholders' equity	$	**342**	362	310	285	143	237	570	353	578
Return on closing equity	%	**(6.7)**	1.0	2.3	(23.8)	(65.8)	(174.6)	(34.2)	(63.8)	6.4
As a per cent of sales										
Cost of goods sold, at average exchange rates	%	**83.2**	78.8	78.0	81.5	89.8	83.0	82.1	82.0	80.1
Effect of foreign currency exchange rate changes	%					7.0	4.9	6.1	0.2	0.6
Gross margin	%	**16.8**	21.2	22.0	18.5	3.2	12.1	11.8	17.7	19.3
Marketing, general and administrative	%	**14.5**	12.0	12.3	14.2	22.6	16.8	15.6	12.9	11.8
Engineering and product development	%	**2.2**	1.8	1.9	2.3	3.0	2.3	2.2	1.9	2.0
Reorganization costs	%	**1.1**	1.4	0.6	1.0		8.3	0.2	0.9	3.2
Net income (loss)	%	**(1.7)**	0.3	0.6	(4.4)	(30.1)	(20.1)	(7.4)	(7.2)	1.2
Operating income (loss) (iii)	%	**(1.7)**	1.7	1.2	(3.4)	(27.1)	(10.0)	(8.2)	(3.8)	1.5
Per Common Share ($U.S.)										
Net sales	$	**8.24**	7.96	12.39	16.74	5.46	36.39	61.50	171.62	162.90
Income (loss) from continuing operations (ii) (after Preferred Share dividend entitlements)	$	**(0.21)**	0.02	0.18	(0.93)	(1.74)	(8.95)	(8.60)	(11.39)	(2.38)
Net income (loss) (after Preferred Share dividend entitlements)	$	**(0.21)**	(0.16)	(0.12)	(0.93)	(1.74)	(8.95)	(8.60)	(12.79)	(1.58)
Toronto Stock Exchange quotes										
High ($Cdn.)	$	**4.80**	4.80	6-1/8	8-1/4	5-1/8	3.40	6-7/8	13-5/8	15-1/2
Low ($Cdn.)	$	**2.48**	2.60	3.00	3.70	2.35	1.95	2.40	5-3/4	9-1/2
Shareholders/employees (at year end)										
Shareholders—Common		**31,666**	30,568	31,155	30,912	31,871	32,961	34,897	28,351	29,926
—Preferred		**66**	66	4,515	5,025	6,568	6,934	7,918	9,669	10,613
Employees		**18,969**	17,251	20,262	23,751	30,095	29,749	39,789	41,690	56,233
Common Shares outstanding (thousands)		**165,026**	161,038	104,393	91,674	57,389	56,551	43,025	18,250	18,250
Preferred Shares outstanding (thousands)		**19,835**	19,779	21,136	21,136	21,136	21,136	17,463	3,825	3,825

(i) See selected Financial Data on Page 37
(ii) The Company has reclassified its consolidated statements of income for the year ended January 31, 1985 to show the results of the Combines division as discontinued operations (see Notes 3, 4 and 16 to the Consolidated Financial Statements). It was not practicable to similarly adjust earlier figures.
(iii) Operating income (loss) is defined as total revenue less those recurring expenses which are within the control of management. It excludes extraordinary items and reorganization costs pertaining to continuing operations. Effective February 1, 1983, exchange adjustments are included in operating income (loss).
(iv) In certain instances, three month data is not comparable to the summary of yearly statistical data.
(v) Results for 1980 and 1979 include the construction machinery business as discontinued operation.
(vi) Excludes that portion relating to discontinued Combines division for the year ended January 31, 1986.

Sales Statistics

(Millions of U.S. dollars)	Years ended January 31,					Three months ended January 31,	Years ended October 31,**				
	1987		1986	1985**	1984**	1983**	1982	1981	1980	1979	1978
	% of Total	**Amount $**	$	$	$	$	$	$	$	$	$
Net sales by markets											
North America											
Canada	**5.1**	**68.7**	60.1	63.0	173.3	12.9	144.2	184.7	219.4	217.8	180.0
United States	**15.7**	**214.0**	229.5	254.1	319.1	29.7	360.9	594.0	819.5	839.1	635.1
Total	**20.8**	**282.7**	289.6	317.1	492.4	42.6	505.1	778.7	1,038.9	1,056.9	815.1
Europe											
United Kingdom	**19.5**	**265.8**	259.9	226.3	244.1	51.8	264.3	198.9	296.9	339.2	321.0
France	**10.1**	**136.9**	126.2	109.0	142.8	41.8	172.1	169.8	227.2	199.8	182.9
Italy	**6.7**	**90.8**	71.8	74.4	76.1	15.7	118.5	137.4	210.9	155.1	122.0
West Germany	**6.3**	**85.2**	69.4	50.7	86.2	12.3	87.3	107.3	157.2	178.9	188.4
Scandinavia	**6.0**	**81.3**	71.0	62.1	69.2	19.2	78.5	90.4	113.6	84.5	104.0
Benelux	**1.8**	**25.1**	22.3	16.5	16.6	5.0	19.9	18.0	28.3	25.8	32.8
Austria	**1.3**	**17.4**	13.0	12.2	12.4	2.5	12.3	10.3	17.8	13.8	13.2
Spain	**0.7**	**9.5**	5.4	2.8	3.7	0.8	4.9	4.1	8.2	10.8	12.0
Other	**2.2**	**29.5**	24.4	17.2	16.1	3.2	26.6	31.3	56.7	44.3	46.1
Total	**54.6**	**741.5**	663.4	571.2	667.2	152.3	784.4	767.5	1,116.8	1,052.2	1,022.4
Latin America											
Brazil	**0.6**	**8.7**	2.5	2.7	3.6	39.4	231.6	307.2	306.0	317.9	249.6
Mexico	**0.4**	**5.0**	16.9	20.0	22.6	0.7	30.1	67.8	75.3	53.8	42.6
Other	**2.7**	**36.5**	21.0	12.1	10.8	5.2	42.1	59.1	97.6	85.7	72.5
Total	**3.7**	**50.2**	40.4	34.8	37.0	45.3	303.8	434.1	478.9	457.4	364.7
Africa											
Libya	**2.2**	**29.8**	20.1	29.9	42.7	11.5	33.4	45.4	27.9	24.2	12.5
South Africa	**1.8**	**24.7**	19.4	23.7	26.7	3.6	63.3	108.9	66.2	64.1	73.9
Other	**3.7**	**50.0**	40.2	34.2	34.6	14.0	75.1	78.5	70.4	48.7	56.5
Total	**7.7**	**104.5**	79.7	87.8	104.0	29.1	171.8	232.8	164.5	137.0	142.9
Near East	**5.0**	**68.8**	62.2	63.8	75.4	19.4	82.2	208.0	70.7	49.6	67.8
West Asia	**3.5**	**47.7**	77.7	121.9	68.2	9.9	75.3	71.0	79.1	45.0	58.9
East Asia	**2.1**	**28.6**	21.5	13.4	21.8	3.9	27.2	23.2	52.6	56.4	62.4
Australasia	**2.6**	**35.3**	53.9	83.6	69.0	10.8	108.3	131.0	130.6	118.5	96.8
Total	**100.0**	**1,359.3**	1,288.4	1,293.6	1,535.0	313.3	2,058.1	2,646.3	3,132.1	2,973.0	2,631.0
Net sales by quarters											
First	**25.5**	**346.2**	268.7	314.7	403.3	313.3	480.6	531.6	711.1	567.7	503.8
Second	**26.7**	**363.4**	335.8	349.0	401.1		558.0	720.7	844.7	743.0	723.1
Third	**18.8**	**256.2**	332.7	316.4	368.6		518.2	689.4	731.4	787.7	651.1
Fourth	**29.0**	**393.5**	351.2	313.5	362.0		501.3	704.6	844.9	874.6	753.0
Total	**100.0**	**1,359.3**	1,288.4	1,293.6	1,535.0	313.3	2,058.1	2,646.3	3,132.1	2,973.0	2,631.0
Net sales by products											
Farm and industrial machinery											
Tractors	**43.3**	**588.6**	576.5	610.3	665.0	152.7	896.8	1,125.0	1,315.1	1,256.6	1,107.8
Grain harvesting**					231.5	22.0	245.3	353.3	460.1	445.1	341.7
Hay harvesting**					17.1	3.0	25.4	39.6	50.6	46.1	49.8
Industrial machines	**7.0**	**95.4**	80.4	71.8	52.9	14.0	82.6	138.6	164.3	195.7	170.8
Other products	**3.7**	**50.5**	73.4	63.8	67.0	12.1	93.5	126.1	174.5	176.3	209.3
Parts	**15.2**	**206.0**	216.5	222.8	247.3	51.5	315.9	327.1	368.7	349.2	305.6
Total	**69.2**	**940.5**	946.8	968.7	1,280.8	255.3	1,659.5	2,109.7	2,533.3	2,469.0	2,185.0
Engines											
Engines	**27.2**	**369.4**	342.5	336.4	296.6	65.7	448.9	608.9	743.6	650.9	560.9
Parts	**5.9**	**80.7**	76.5	63.3	51.7	16.0	76.8	90.5	87.9	76.7	67.8
Elimination of intercompany net sales	**(6.1)**	**(83.7)**	(92.2)	(85.6)	(105.3)	(23.7)	(127.1)	(162.8)	(232.7)	(223.6)	(182.7)
Total	**27.0**	**366.4**	326.8	314.1	243.0	58.0	398.6	536.6	598.8	504.0	446.0
Transportation	**1.5**	**20.7**									
Other products											
Building products	**0.3**	**4.5**									
Components*	**3.2**	**44.0**	27.0	27.7	34.2						
Elimination of intercompany net sales	**(1.2)**	**(16.8)**	(12.2)	(16.9)	(23.0)						
Total	**2.3**	**31.7**	14.8	10.8	11.2						
Total	**100.0**	**1,359.3**	1,288.4	1,293.6	1,535.0	313.3	2,058.1	2,646.3	3,132.1	2,973.0	2,631.0

* Prior to January 31, 1984, included in Farm and industrial machinery
**The Company has reclassified its consolidated statements of income for the year ended January 31,1985, to show the results of the Combines division as discontinued operations (see Notes 3, 4 and 16 to the Consolidated Financial Statements). It was not practicable to similarly adjust earlier figures.

World Headquarters
595 Bay Street, Toronto, Ontario
M5G 2C3 Canada

Common Shares

Transfer Agents and Registrars
National Trust Company, Toronto, Montreal, Winnipeg, Calgary, Vancouver;
Canadian Imperial Bank of Commerce, New York and London, England.

Stock Exchanges
The Common Shares of Varity Corporation are traded under the symbol VAT in Canada and the United States. The shares are listed on the Toronto, Montreal and Vancouver Stock Exchanges in Canada, on the New York Stock Exchange in the United States, and on the London Stock Exchange in England.

These shares have unlisted trading privileges in the United States on the Midwest Stock Exchange, the Philadelphia Stock Exchange, the Boston Stock Exchange and the Pacific Stock Exchange. The shares are also traded on the Amsterdam Stock Exchange in the form of Dutch Bearer Certificates.

Preferred Shares

Transfer Agents and Registrars
National Trust Company, Toronto, Montreal, Winnipeg, Calgary, Vancouver;
Canadian Imperial Bank of Commerce, New York.

Stock Exchanges
The Class I and Class II Shares of Varity Corporation have not been listed for trading.

Warrants

The Warrants of Varity Corporation are listed on the Toronto Stock Exchange and trade under the symbol VAT.WT. They also trade in the United States on NASDAQ under the symbol VATWF. The Warrants are exercisable at Cdn $5.00 and have an expiry date of May 31, 1991.

Dividends

So long as any Class I Series A or Class II Series A Shares are outstanding, unless all cumulative and "additional" dividends then payable on the shares have been declared and paid or amounts set aside for payment, the Company may not, without the prior approval of the holders of these shares:

(1) declare or pay any dividends (other than stock dividends in shares of the Company ranking junior to these shares) on any common or junior shares;

(2) redeem, purchase, or make any capital distribution in respect of any junior shares; or

(3) issue any shares ranking as to capital or dividends prior to or on a parity with these shares.

Further, the Company has also entered into registration rights and sales sequencing agreements with the initial holders of Class I Series A Preferred Shares, Class II Series A Preferred Shares, and holders of Common Shares issued in connection with the Restructuring Plan of 1986 and previous refinancings in 1981 and 1983. The agreements define the relative rights of such holders among themselves and in relation to the Company to sell their securities in the public markets. These arrangements will regulate the Company's access to public markets by providing a priority of access to such initial holders.

Additional Shareholder Information

There are no restrictions on the export or import of capital which might affect the remittance of dividends, interest or other payments to non-resident holders of the Company's securities.

The Investment Canada Act requires prior approval by the Government of Canada of the acquisition by, or transfer to, non-residents of Canada of direct or indirect control of a Canadian business entity, such as the Company. The Act does not apply to the purchase of shares or securities of a corporation where such purchases would not give the purchasers effective control of the corporation.

Interest paid on the Company's debt securities held by non-Canadian persons may be subject to Canadian withholding tax, depending upon the terms and provisions of such securities. Dividends on shares of the Company held by non-Canadian persons will be subject to Canadian non-resident withholding tax.

Additional Statistical Data

January 31,	1987	1986
Number of employees	**18,969**	17,251
Number of registered shareholders		
Common	**31,666**	30,568
Preferred	**66**	66
Shares outstanding (thousands)		
Common	**165,026**	161.038
Preferred:		
Class I	**7,659**	7,603
Class II	**12,176**	12.176
Warrants outstanding (thousands)	**35,004**	35,004

Directors and Management

Board of Directors

Victor Rice [1 3 4]
Chairman and Chief Executive Officer, Varity Corporation

John N. Abell [1]
Vice Chairman, Wood Gundy Inc.

J. G. Bickford [1 2]
Executive Vice President, Canadian Imperial Bank of Commerce

William A. Corbett [1 3 4]
Partner, Fraser & Beatty

T. N. Davidson
Chairman, PCL Industries Limited

H. N. R. Jackman [1 2 4]
Chairman, The Empire Life Insurance Company

Vincent D. Laurenzo [1]
President, Varity Corporation

W. D. McKeough
Director, Various corporations

A. M. Runciman
Director, Power Financial Corporation

W. R. Teschke
Director, Canada Development Investment Corporation

J. Page R. Wadsworth [1 2 3]
Farmer

Hon. Robin H. Warrender
Chairman and Chief Executive, London Wall Holdings PLC

L. R. Wilson [1 2 3]
President and Chief Executive Officer, Redpath Industries Limited

Headquarters Management

Victor Rice
Chief Executive Officer

Vincent D. Laurenzo
President

Neil D. Arnold
Vice President and Treasurer and Chairman Americas Companies

Peter N. Barton
Vice President Business Development

Michael G. Bird
Vice President and Chairman European Companies

Roger C. Clarke
Vice President and Chairman Varity World Trade Limited

James M. Felker
Senior Vice President Varity Development

John P. McCarter
Secretary

Jack R. Nowling
Vice President Communications and External Affairs

J. Keith Robson
Vice President Comptroller and Planning

John Towers
Vice President Varity International Services

James Vance
Senior Vice President and Senior Business Advisor

Operations Management

Massey-Ferguson Group
John D. Sword
President

MF Industrial Machinery
Richard E. Robson
President

Massey-Ferguson Australia
Adri Verhagen
President

Perkins Engines
John F. Devaney
President

Pacoma Components
Horst Braxmaier
President

Dayton Walther
Bob M. Brown
President

1 Executive Committee
2 Audit Committee
3 Human Resources Committee
4 Nominating Committee

Design Metafour (Toronto)
Printed in Canada

Varity Corporation
World Headquarters
595 Bay Street
Toronto, Ontario, Canada
M5G 2C3