AVCORP

BETTER SOLUTIONS

# Annual Report
# **2016**

www.avcorp.com

**ABOUT AVCORP INDUSTRIES INC.** The Avcorp Group designs and builds major airframe structures for some of the world's leading aircraft companies, including BAE Systems, Boeing, Bombardier, Lockheed Martin and Subaru Corporation (formerly Fuji Heavy Industries). The Avcorp Group has more than 50 years of experience, over 700 skilled employees and 636,000 square feet of facilities. Avcorp Structures & Integration located in Delta British Columbia, Canada is dedicated to metallic and composite aerostructures assembly and integration; Avcorp Engineered Composites located in Burlington Ontario, Canada is dedicated to design and manufacture of composite aerostructures, and Avcorp Composite Fabrication located in Gardena California, USA has advanced composite aerostructures fabrication capabilities for composite aerostructures. The Avcorp Group offers integrated composite and metallic aircraft structures to aircraft manufacturers, a distinct advantage in the pursuit of contracts for new aircraft designs, which require lower-cost, light-weight, strong, reliable structures. Comtek Advanced Structures Ltd., at our Burlington, Ontario, Canada location also provides aircraft operators with aircraft structural component repair services for commercial aircraft.

Avcorp Composite Fabrication Inc. is wholly owned by Avcorp US Holdings Inc. Both companies are incorporated in The State of Delaware, USA, and are wholly owned subsidiaries of Avcorp Industries Inc.

Comtek Advanced Structures Ltd., incorporated in the Province of Ontario, Canada, is a wholly owned subsidiary of Avcorp Industries Inc.

Avcorp Industries Inc. is a federally incorporated reporting company in Canada and traded on the Toronto Stock Exchange (TSX:AVP).

# management discussion & analysis

This Management Discussion and Analysis has been prepared as of June 29, 2017, and should be read in conjunction with the Company's consolidated financial statements and notes thereto for the year ended December 31, 2016.

## Description of Business

Avcorp Industries Inc. (the "Company", "Avcorp" or the "Avcorp Group") supplies major airframe structures to aircraft manufacturers and to their suppliers. Our capabilities are product design, tool design, metal and composite parts fabrication, assembly and repair, all of which are governed by strong program management.

The Company currently operates from two locations in Canada and one location in the United States. Located in Delta, British Columbia, Avcorp Industries Inc., named as Avcorp Structures & Integration ("ASI"), is dedicated to metallic and composite aerostructures assembly and integration. Within Comtek Advanced Structures Ltd. ("Comtek"), located in Burlington, Ontario, exists two named divisions:, Comtek, dedicated to aircraft structural component repair services, and Avcorp Engineered Composites ("AEC") dedicated to design and manufacture of composite aerostructures. Located in Gardena, California, Avcorp Composite Fabrication Inc. ("ACF") is dedicated to advanced composite aerostructures fabrication.

Avcorp Industries Inc. is a federally incorporated reporting company in Canada and traded on the Toronto Stock Exchange (TSX:AVP).

Avcorp Composite Fabrication Inc. is wholly owned by Avcorp US Holdings Inc. Both companies are incorporated in The State of Delaware and are subsidiaries of Avcorp Industries Inc.

Comtek Advanced Structures Ltd., incorporated in the Province of Ontario is a wholly owned subsidiary of Avcorp Industries Inc.

Avcorp is in compliance with industry standard quality certifications.

## 2016 Highlights

Key fiscal year 2016 financial results include:

- Signing significant new contracts during the year at each operating unit increasing order backlog to $826 million, an increase of 82%.
- Completing numerous process improvement initiatives, restructuring activities and contract renegotiations have significantly reduced production costs on a go forward basis. Operating and warranty issues at ACF have been the largest cause of losses for the Company, significantly contributing to consolidated net loss of $15,964,000 (December 31, 2015: $12,154,000 net loss).
- Renegotiating a significantly unfavourable production contract, reducing the period of performance by four years.
- Ratified a new six-year collective agreement at the Gardena facility, providing for stability in labour force, and labour cost certainty, through to 2022.
- Obtaining additional financial support from a majority shareholder during 2016 and the first quarter of 2017 through term debt amounting to USD$5.9 million.
- Entering into a Memorandum of Understanding with the University of British Columbia to pursue an innovative partnership by establishing a Learning Factory for Advanced Composites.

## Highlights Subsequent to Year-End

Since December 31, 2016 key developments include:

- On May 26, 2017, the Company signed a loan agreement to replace the current agreement with a Canadian Chartered Bank, supported by a major and material customer, to access a USD$58 million operating line of credit.
- On April 3, 2017, the Company collected the final amount of consideration receivable from SGL Carbon SE ("SGL") for the acquisition of the US-based composite Aerostructures division of Hitco, a subsidiary of Frankfurt-listed SGL ("Hitco"), amounting to USD$9.2 million.
- The Lessor of the Industrial Centre at Gardena California, where ACF has its manufacturing facilities, received an offer from a third party to purchase the Industrial Centre. On March 28, 2017 Avcorp exercised its right of first refusal under the lease agreement by providing notice to the Lessor that it proposes to purchase the property on

the same terms and conditions as presented in the Offer. Avcorp has up to 270 days from the date of providing such notice to present and close a sale transaction with the Lessor. In addition, Avcorp entered into a Memorandum of Understanding and a Letter Agreement with Stockdale Acquisitions LLC to negotiate a joint venture agreement for the ultimate acquisition and development of the property in exchange for a long term lease by Avcorp of a portion of the property on favourable economic terms. On June 26, 2017, Avcorp provided notice to the Lessor of the Industrial Centre at Gardena California that it has elected not to proceed with the acquisition of the property.

## Financial Overview

### Three-Year Results

The following table provides selected financial information for the three years to December 31, 2016.

**THREE-YEAR RESULTS**

*(unaudited, prepared in accordance with IFRS, expressed in thousands of Canadian dollars except per share amounts)*

| FOR THE YEAR ENDED DECEMBER 31 | 2016[2] | 2015[3] Restated | 2014 |
|---|---|---|---|
| **OPERATIONS** | | | |
| Revenue | **$183,707** | $80,416 | $67,104 |
| EBITDA[1] | **(9,767)** | (8,093) | (6,129) |
| Operating loss | **(16,405)** | (11,623) | (8,038) |
| Net loss | **(15,964)** | (12,154) | (7,950) |
| Basic and diluted loss per share | **(0.05)** | (0.04) | (0.03) |
| **FINANCIAL POSITION** | | | |
| Net capital expenditures | **6,840** | 959 | 1,001 |
| Total assets | **133,039** | 160,091 | 35,482 |
| Bank indebtedness and term debt | **25,040** | 1,886 | 1,236 |
| Shareholders' (deficit) equity | **(6,883)** | 6,784 | 17,377 |
| Net book value per share | **(0.02)** | 0.02 | 0.06 |
| Ratio: current assets/current liabilities | **0.94** | 1.40 | 1.43 |
| Shares outstanding at period end | **307,141,184** | 305,555,184 | 302,633,184 |

1. EBITDA = earnings before interest, taxes, depreciation and amortization. This is not a recognized term under International Financial Reporting Standards ("IFRS").
2. It should be noted that in 2016, the loss and EBITDA incorporated substantial costs incurred which have yet to be recovered from the seller of Hitco. No recovery of these costs has been recorded, as an estimated amount cannot be reasonably determined at this time.
3. Finalization adjustments made to the preliminary purchase price allocation, for the December 18, 2015 Hitco acquisition, reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date. The measurement period adjustments predominately relate to updating fair value estimates.

Avcorp's recurring contracted revenue base remains strong as customers continue to place orders within existing long-term supply agreements. 2016 revenues have increased by $103,291,000 (128%) over 2015 with Avcorp's business acquisition contributing $117,733,000 to the 2016 revenues which includes the amoritization and contract renegotiation of the unfavourable contract liability of $33,019,000 into 2016 revenues (2015: $356,000); while 2015 revenues had increased by 20% over 2014 revenues.

2016 saw a significant growth in customer order backlog to in excess of $855 million as a result of production contracts and orders placed by the Boeing Company ("Boeing") and Subaru Corporation ("Subaru") (formerly Fuji Heavy Industries).

Specifically, these contract additions consist of the following:

- Production of Spoilers for the Boeing 737 MAX program. This will be one of the most significant contracts in Avcorp's order backlog. The addition of the Spoiler production will result in considerable increases to Avcorp's existing plant and equipment utilization for the coming years. The 737 MAX is Boeing's new, more fuel-efficient single-aisle airplane, with first delivery anticipated next year.
- Production of Metal Bond Panels for the Boeing 777X. This award is the first contract for Avcorp with Boeing's new 777X program. The 777X will be the world's largest and most fuel-efficient twin-engine commercial airplane, with first delivery anticipated in 2020.

- Production and supply of Doors for the Boeing Next-Generation 737 and 737 MAX. This contract creates beneficial production synergies that complement Avcorp's current 737 Wheel Well Fairing high-rate production program, including daily just-in-time deliveries to 737 assembly lines.
- Production of Tanker Fairings for the KC-46 Program; the Boeing Tanker built on a 767 platform. This assembly leverages Avcorp's integration capabilities utilizing composite and metallic materials.
- Production of complex composite structural components for Subaru that will be assembled for the Boeing 787 center wing box. Production, will take place at the ACF facility located in Gardena, California, and production volumes are expected to grow by as much as 50% over historical supply rates.

Deliveries of business and commercial aircraft structures and components rose in 2016 over 2015, with the sale of composite fabricated structures contributing $67,218,000 to the commercial aircraft revenues. Production of assembly structures for the defence market increased slightly in 2016 relative to 2015 levels.

Composite structures repairs and composite floor panel production and deliveries continued to grow with revenue growth of 14% in 2016 over 2015, a continuation of the growth that occured in 2015 over 2014.

During 2016 the Company continued with its strategic approach for securing business growth in the composite aircraft structures assembly market, to further diversify its aerostructures market position, leveraging its 2015 acquisition of Hitco. The Hitco acquisition, which required significant turn-around expenditures and was severly burdened with operational inefficiencies and extensive legacy product warranty obligations, reduced Earnings Before Interest, Taxes, Depreciation & Amortization ("EBITDA"). Consequently, 2016 EBITDA was $1,674,000 lower than 2015. The increase in operating losses in 2015 over 2014, and in 2016 over 2015 are a direct result of the costs incurred in 2015 to execute the Hitco acquisition, and in 2016 as a result of turn-around costs and losses from legacy product quality issues from the Hitco acquisition. Although expenditures have now been reduced, the Company continues to consume resources for the Hitco turn-around.

Capital expenditures during the three year period presented have been limited to upgrading manufacturing equipment and capabilities, in particular for new program introductions, as well as information technology assets; with $5,982,000 of capital expenditures incurred at Avcorp's Gardena facility in order to rectify equipment deficiencies and improve the effectiveness of operational capabilities.

### Quarterly Results

The following table provides selected unaudited quarterly consolidated financial information for the eight most recent fiscal quarters to December 31, 2016 prepared in accordance with IAS 34 – Interim Financial Reporting ("IAS 34") as issued by the International Accounting Standards Board ("IASB").

**QUARTERLY RESULTS**

*(unaudited, prepared in accordance with IFRS, expressed in thousands of Canadian dollars except per share amounts)*

| | 2016 | | | | 2015 | | | |
|---|---|---|---|---|---|---|---|---|
| **FOR THE THREE MONTHS ENDED** | **Dec 31**[2] | Sep 30[2,3] Restated | Jun 30[2,3] Restated | Mar 31[2,3] Restated | Dec 31[3] Restated | Sep 30 | Jun 30 | Mar 31 |
| Revenue | **$46,183** | $47,349 | $50,234 | $39,941 | $22,776 | $21,610 | $20,369 | $15,661 |
| Operating income (loss) | **9,233** | (12,060) | (6,010) | (7,568) | (5,796) | (2,030) | (1,125) | (2,672) |
| EBITDA[1] | **10,679** | (9,736) | (4,853) | (5,857) | (4,566) | (556) | (623) | (2,348) |
| Net income (loss) | **8,762** | (11,286) | (6,180) | (7,260) | (6,205) | (2,053) | (1,135) | (2,761) |
| EBITDA per share[1] | | | | | | | | |
| Basic | **0.04** | (0.03) | (0.02) | (0.02) | (0.02) | (0.00) | (0.00) | (0.01) |
| Diluted | **0.04** | (0.03) | (0.02) | (0.02) | (0.02) | (0.00) | (0.00) | (0.01) |
| Net (loss) income per share | | | | | | | | |
| Basic | **0.03** | (0.04) | (0.03) | (0.02) | (0.02) | (0.01) | (0.00) | (0.01) |
| Diluted | **0.03** | (0.04) | (0.03) | (0.02) | (0.02) | (0.01) | (0.00) | (0.01) |
| Long-term debt | **1,646** | 1,674 | 1,650 | 1,649 | 1,646 | 1,634 | 1,542 | 1,434 |

1. EBITDA = earnings before interest, taxes, depreciation and amortization. This is not a recognized term under International Financial Reporting Standards ("IFRS"), refer to page 12.
2. It should be noted that in 2016, the loss and EBITDA incorporated substantial costs incurred which have yet to be recovered from the seller of Hitco. No recovery of these costs has been recorded, as an estimated amount cannot be reasonably determined at this time.
3. Finalization adjustments made to the preliminary purchase price allocation, for the December 18, 2015 Hitco acquisition, reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date. The measurement period adjustments predominately relate to updating fair value estimates.

Comparative quarterly revenue in 2016 was greater than that for 2015 primarily as a result of revenues generated from the Company's acquisition of the Gardena operations at the end of 2015, as well as a consistent growth in business occurring in the Burlington facility. 2016 revenues included amortization and contract renegotiation of the unfavourable contract liability of $33,019,000 (2015: $356,000). 2016 operational losses have increased significantly over 2015 operational losses as Gardena legacy product quality issues and operational inefficiencies have hampered efforts to reduce the US facility losses.

### 2016 and 2015 Results Overview

During the year ended December 31, 2016 Avcorp Group revenues totalled $183,707,000 compared with $80,416,000 in revenue for the previous year. The December 18, 2015 acquisition of Hitco has added $117,733,000 to current year revenues which includes the amortization and contract renegotiation of the unfavourable contract liability of $33,019,000.

The Company operates within "general terms agreements" with its customers. These agreements are typically for five years or longer. The contracts provide for long lead-time orders; the civil aerospace business is also slightly seasonal as some aircraft manufacturers reduce or suspend production in December and for a period of time during the summer months.

Effective December 18, 2015, Avcorp completed the acquisition of the US-based composite Aerostructures division of Hitco, a subsidiary of Frankfurt-listed SGL. The Acquisition was completed pursuant to the terms of an asset purchase agreement that was entered into on July 20, 2015, and subsequent amendments to December 18, 2015. Pursuant to the Agreement, Avcorp's subsidiary, Avcorp Composite Fabrication Inc., purchased the assets of the division of Hitco which produces composite structural parts for commercial and military aerostructures. Avcorp was indemnified, under the Agreement, by Hitco and SGL for all losses related to product quality and warranty claims with respect to finished goods delivered by Hitco before the closing date and certain manufactured goods manufactured by Hitco before the closing date that were designated as conforming inventory. Avcorp and Hitco entered into service agreements to assist in rectifying and resolving Hitco-related product claims, subject to reimbursement in advance by Hitco.

2016 revenues arising from the assignment by all customers of commercial aerospace contracts to Avcorp Industries Inc. in conjunction with the December 18, 2015 Hitco acquisition have generated $67,218,000 in revenue (December 31, 2015: $1,750,000). These contracts support customer production of commercial aircraft. Manufacturing of the composite parts occurs in Avcorp Group's acquired **Gardena facility**. The Gardena facility was assigned defence aerospace contracts by Hitco's customers upon the finalization of the acquisition. These contracts generated $17,486,000 of revenue during the year ended 2016 for ACF (December 31, 2015: $107,000).

The **Burlington facility** continued its consistent production and delivery of composite floor panels in supply to Bombardier Aerospace's Global 5000/6000 and Global 7000/8000 programs during the current year, with a 98% increase in production for these contracts in 2016 over 2015. Full rate production for these programs establishes the wholly owned subsidiary as a leading manufacturer of composite floor panels. Composite floor panel revenues arising from aftermarket or spare component sales decreased by 5% during 2016 relative to 2015; while composite floor panel revenues derived from sales to original equipment manufacturers ("OEM") decreased slightly (2%) during the same twelve month period; both primarily as a result of a shift in customer demand. Comtek's long-term relationships with aircraft operators has resulted in a significant 36% increase in revenues in 2016 relative to the same period in 2015, indicating that its growth in composite and metal aircraft structure repair revenues continues to provide a strong operating cash flow from this market segment. In summary, Avcorp's Burlington operations increased revenue in 2016 relative to 2015 by $2,453,000 (14%).

**Delta facility** revenues, for all programs generated by legacy production contracts, have decreased by $14,548,000 during the current year relative to the previous year. Although production volumes have decreased, program revenue mix has remained consistent in 2016 relative to 2015 for production contracts manufactured out of the Delta facility. Revenue from the production and delivery for business jet programs has decreased by approximately $3,246,000; defence programs experienced a shift in production demand causing this revenue source to fall by approximately $8,365,000; while commercial aircraft production supply remained relatively consistent during 2016 as compared to 2015.

Avcorp's Delta location continues to actively pursue production contracts on aerospace programs throughout North America, Asia, and Europe both in the commercial and defence aerospace sectors. These production contracts consist of complex metal bond and multi-material structural assemblies that complement Avcorp's capability as a strategic integrated supplier within the aerospace industry. In 2016 the following new production contract awards were announced:

- Spoilers for the Boeing 737 MAX program. This will be one of the most significant contracts in Avcorp's order backlog. The addition of the Spoiler production will result in considerable increases to Avcorp's existing plant and equipment utilization for the coming years. The 737 MAX is Boeing's new, more fuel-efficient single-aisle airplane, with first delivery anticipated next year.
- Metal Bond Panels for the Boeing 777X. This award is the first contract for Avcorp with Boeing's new 777X program. The 777X will be the world's largest and most fuel-efficient twin-engine commercial airplane, with first delivery anticipated in 2020.
- Doors for the Boeing Next-Generation 737 and 737 MAX. This contract creates beneficial production synergies that complement Avcorp's current 737 Wheel Well Fairing high-rate production program, including daily just-in-time deliveries to 737 assembly lines.
- Boeing F/A-18 Flight Control Surfaces; this contract award reinforces Avcorp's existing capability as a strategic integrated supplier for metal bond products within the aerospace industry.
- Tanker Fairings for the KC-46 Program; the Boeing Tanker built on a 767 platform. This assembly leverages Avcorp's integration capabilities utilizing composite and metallic materials.
- Complex composite structural components for Subaru that will be assembled for the Boeing 787 centre wing box. Subaru is a tier-one supplier to major original equipment manufacturers ("OEM") of commercial and defence aircrafts around the world. These components are being manufactured in the Company's Gardena facility.
- Expanded scope of production on the Lockheed Martin F-35 Carrier Variant Outboard Wing ("CV-OBW").

On a year-to-date basis, for the period ending December 31, 2016, the Avcorp Group recorded losses from operations totaling $16,405,000 from $183,707,000 revenue, which include costs incurred and yet to be recovered under the Hitco acquisition agreement, as compared to $11,623,000 operating losses from $80,416,000 revenue for the previous year.

Certain product quality and warranty claims by customers arising from Hitco's deliveries made before the closing date of Hitco acquisition, although indemnified under the asset purchase agreement with Hitco and SGL, adversely impacted operations and caused excessive personnel costs, and administrative and legal expenditures at Avcorp's Gardena facility during the year. These costs have yet to be recovered and are included in all the expenses for 2016.

The financial results presented for the year ended December 31, 2016 do not take into account any recovery provision for these operational expenditures for which the Company believes it is indemnified for under its asset purchase agreement, and ancillary agreements, with SGL. These expenditure recovery amounts are not finalized and cannot be practicably quantified at this time.

Operating losses due to production at the Gardena facility amounted to approximately $4,078,000 during the year ended December 31, 2016 (December 31, 2015: $1,510,000) which includes the amortization and contract renegotiation of the unfavourable contract liability of $38,937,000 into income (December 31, 2015: $356,000), due primarily to certain unfavourable customer contracts assumed with the December 18, 2015 Hitco acquisition, pre-existing operational inefficiencies at the Gardena facility, and losses from unexpected legacy product quality and warranty claim stemming from Hitco delivered product.

An unfavourable contract liability accruing for certain customer contracts, for which unavoidable costs are expected to exceed the corresponding revenue earned, amounted to $100,582,000 upon the Hitco acquisition; of which $56,969,000 remains unamortized as at December 31, 2016. The unfavourable contract liability is amortized into income on a units-of-production basis over the expected life of the contract. The amount of unfavourable contract liability amortized into income during the year ended December 31, 2016 was $38,937,000 (December 31, 2015: $356,000). The company has renegotiated certain contract delivery requirements resulting in lower delivery commitments under the unfavourable contacts, reducing the provision as at December 31, 2016. This contract renegotiation has resulted in a $7,792,000 reduction in the unfavourable contract liability for 2016. The unamortized unfavourable contract liability is accrued in US dollars and therefore the unamortized balance will vary from quarter to quarter as the estimated provision is adjusted for foreign currency fluctuations.

Over the course of 2016 and through 2017, certain of the smaller loss making contracts are being wound down eliminating the associated losses. The remaining significant loss making contract has been the focus of a comprehensive Company initiative under which management has commenced planning with a customer to facilitate an orderly transition of this significant loss making contract away from Avcorp's Gardena facility.

Although recent customer contract awards will continue to increase facility utilization, there remains significant levels of unutilized plant capacity within the Company's Delta, British Columbia facility. The Company has expensed $4,408,000 of overhead costs during the year (December 31, 2015: $4,906,000) in respect of unutilized plant capacity. The amount of overhead costs expensed, as a result of unutilized capacity, will fluctuate from quarter to quarter as production in support of deliveries varies. Revenue growth in this facility would benefit Company profitability via a contribution to the recovery of fixed overhead expenditures. Avcorp is engaged with aerospace OEM's as well as industry tier 1 suppliers in North America, Asia and Europe in collaborative production initiatives that support the Company's recent transition to composite manufacturing capabilities, further leveraging existing production capacity and investments.

During the year ended December 31, 2016, cash flows from operating activities, excluding the impact of changes in non-cash working capital, utilized $59,091,000 of cash as compared with utilization of $8,101,000 of cash during the year ended December 31, 2015 as restated. Cash flows from operating activities were most significantly impacted as a result of operating losses incurred from the integration and production costs expended for the newly acquired Hitco operations, losses arising from unfavourable customer contracts assumed, and operational, administrative, and legal expenditures incurred at Avcorp's Gardena facility as a direct result of product quality and warranty claims on product delivered pre-Hitco acquisition.

Changes in non-cash working capital during the current year increased cash flows from operating activities by $8,744,000 (December 31, 2015: $11,442,000 decrease) primarily as the Company collected accounts receivable, extended payment terms to suppliers, and customer payments made on production contracts in advance of deliveries.

Also, pursuant to the Hitco acquisition, the Company assumed a customer advance for pre-funding of product deliveries. The customer advance is re-paid as the Company delivers to its customer, ordered products for a specific program. The customer advance is subject to an access and security agreement along with a general security agreement entered into with the Company's bank and the customer. The remaining unamortized customer advance has been discounted to arrive at the December 31, 2016 amount of $11,573,000 (December 31, 2015: $18,528,000) of which it is estimated $8,034,000 will be amortized during the next twelve months. The Company re-paid and amortized into income $6,955,000 of the customer advance during the year ended December 31, 2016 (December 31, 2015: $425,000).

As at December 31, 2016, the Company had $3,960,000 cash on hand (December 31, 2015: $14,484,000) and had utilized $17,111,000 of its operating line of credit (December 31, 2015: $Nil). The Company has a working capital deficit of $5,439,000 as at December 31, 2016 which has decreased from the December 31, 2015 $30,962,000 surplus. Working capital surplus is the difference between current assets and current liabilities. The Company's accumulated deficit as at December 31, 2016 is $93,791,000 (December 31, 2015: $77,827,000).

### ACF Gardena Start-up

The Gardena facility defence programs' transition by Avcorp have been successful and are continuing to meet customer delivery requirements, and have not experienced the extraordinary unanticipated issues relative to process quality and operational disruptions of ACF's commercial programs. The planned improvement initiatives for the defence programs, including the F-35 program for Lockheed Martin, continue and are performing as forecasted. This has resulted in an award of a follow-on contract from Lockheed Martin that was previously announced.

The start-up, post-acquisition of the ACF commercial operations in Gardena, faced several significant unanticipated challenges during the first quarter of 2016, which continued to have an adverse financial impact through to the fourth quarter of 2016. Operational losses incurred at the Gardena facility amounted to $4,078,000 for the year ended December 31, 2016. This included amortization and contract renegotiation of the unfavourable contract liability of $38,937,000 into income in 2016 (December 31, 2015: $356,000). Product quality and warranty claims on product delivered by Hitco pre-acquisition, although indemnified under the asset purchase agreement with Hitco and SGL, further adversely impacted operations and caused excessive personnel costs, and administrative and legal expenditures at ACF's Gardena facility during the year. These costs have yet to be recovered and are included in all the costs for 2016.

As a result of legacy quality issues raised by customers on Hitco products delivered prior to the acquisition, a substantial and large number of items were identified that required corrective action. These items accounted for substantial expenditures, including extra contract personnel beyond normal production levels, for which losses ACF has yet to be indemnified by Hitco or SGL.

The majority of the corrective actions commenced in the second quarter of 2016 which continued into the third and fourth quarters, will allow the Gardena operations to achieve fully contracted output levels. Avcorp's key commercial customers have worked collaboratively with Avcorp to mitigate production schedules risks and support the earliest resolution of the outstanding process and product issues.

During February 2016, the Gardena ACF operations also experienced power outages, over which ACF had no control, resulting in the partial suspension of manufacturing operations for the commercial programs under production. This power outage accounted for lower than planned sales and the loss of some in-process material. The power outage and the unanticipated corrective actions created a build-up of order backlog, which deferred anticipated first quarter revenues, and form part of subsequent quarter deliveries.

The complexity and challenge of executing the production start-up and improvement plans for the Gardena operations increased from pre-acquisition estimates. Avcorp continues to work successfully with its commercial aerospace customers to update plans and commitments to ensure support for their programs and maintain purchase order schedules.

Over the course of 2016 and through 2017, certain of the smaller loss making contracts are being wound down eliminating the associated losses, with the period of performance on the most significant loss-making contract reduced by four years. What will be the remaining significant loss making contract has been the focus of a comprehensive Company initiative under which management has commenced discussions and planning with a major customer for an orderly and protected transition of this significant loss making contract from Avcorp's Gardena facility. Contract revisions are in process which will ultimately improve Avcorp's financial performance.

## Revenue

During the year ended December 31, 2016 Avcorp Group revenues totalled $183,707,000 compared with $80,416,000 revenue for the previous year; a significant 128% revenue increase as compared to 2015. Revenues earned from the newly acquired operations have added $117,733,000 to current year revenues, which includes the amortization and contract renegotiation of the unfavourable contract liability of $33,019,000 into 2016 revenues (2015: $356,000).

**Operating segment revenues are as follows:**

### REVENUE DISTRIBUTION

*(unaudited, prepared in accordance with IFRS, expressed in thousands of Canadian dollars)*

| FOR THE YEAR ENDED DECEMBER 31 | **2016** | | 2015[2] Restated | |
|---|---|---|---|---|
| | **Revenue** | **% of Total** | Revenue | % of Total |
| Avcorp Industries Inc. | **$46,483** | **25.3** | $61,031 | 75.9 |
| Comtek Advanced Structures Ltd. | **19,491** | **10.6** | 17,038 | 21.2 |
| Avcorp Composite Fabrication Inc.[1] | **117,733** | **64.1** | 2,347 | 2.9 |
| Total | **183,707** | **100.0** | 80,416 | 100.0 |

1. ACF revenue includes amortization and contract renegotiation of the unfavourable contract liability of $33,019,000 in 2016 (December 31, 2015: $356,000).
2. Finalization adjustments made to the preliminary purchase price allocation, for the December 18, 2015 Hitco acquisition, reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date. The measurement period adjustments predominately relate to updating fair value estimates.

The Company operates within "general terms agreements" with its customers. These agreements are typically for five years or longer. The contracts provide for long lead-time orders; the civil aerospace business is also slightly seasonal as some aircraft manufacturers reduce or suspend production in December and for a period of time during the summer months.

The **Delta facility** revenues generated by legacy production contracts have decreased by $14,548,000 during the current year relative to the previous year. The program revenue base has remained relatively consistent in 2016 relative to 2015 for production contracts manufactured out of the Delta facility. However, the delivery schedules for defence programs and a reduction in demand for business jet components has caused revenues for the year to be less than in 2015.

Avcorp's Delta location continues to actively pursue production contracts on aerospace programs throughout North America, Asia, and Europe both in the commercial and defence aerospace sectors. These efforts have commenced producing value as noted in the 2015 contract awards, awards for the expanded scope of production on the Lockheed Martin F-35 CV-OBW, as well as production and supply of 767-2C Panoramic Camera Fairings, as part of The Boeing Company's KC-46 Tanker program.

The 2015 contract awards have been followed up with significant contract awards in 2016. These production contracts consist of complex metal bond and multi-material structural assemblies that complement Avcorp's capability as a strategic integrated supplier within the aerospace industry. The new contracts include:

- Production of Spoilers for the Boeing 737 MAX program. This will be one of the most significant contracts in Avcorp's order backlog. The addition of the Spoiler production will result in considerable increases to Avcorp's existing plant and equipment utilization for the coming years. The 737 MAX is Boeing's new, more fuel-efficient single-aisle airplane, with first delivery anticipated next year.
- Production of Metal Bond Panels for the Boeing 777X. This award is the first contract for Avcorp with Boeing's new 777X program. The 777X will be the world's largest and most fuel-efficient twin-engine commercial airplane, with first delivery anticipated in 2020.
- Production and supply of Doors for the Boeing Next-Generation 737 and 737 MAX. This contract creates beneficial production synergies that complement Avcorp's current 737 Wheel Well Fairing high-rate production program, including daily just-in-time deliveries to 737 assembly lines.
- Production of Boeing F/A-18 Flight Control Surfaces. This contract award reinforces Avcorp's existing capability as a strategic integrated supplier for metal bond products within the aerospace industry.
- Production of complex composite structural components for Subaru that will be assembled for the Boeing 787 centre wing box. Subaru is a tier-one supplier to major OEMs of commercial and defence aircrafts around the word. This contract is held by Avcorp's Delta operations with the composite structural components manufactured in the Gardena facility.

Stable production flows and effective plant and equipment utilization have allowed the **Burlington facility** to achieve cost effective production of composite floor panels in supply to Bombardier Aerospace's Global 5000/6000 and Global 7000/8000 programs during 2016, which resulted in a 98% increase in revenues over 2015 for this program. Full rate production for these programs establishes the wholly owned subsidiary as a leading manufacturer of composite floor panels. Composite floor panel revenues arising from aftermarket or spare component sales decreased by 5% in 2016 relative to 2015; concurrently composite floor panel revenues derived from sales to original equipment manufacturers have also experienced a sales reduction, with a decrease of 2%. Comtek's long term relationships with aircraft operators has resulted in a significant 36% increase in revenues in 2016 relative to the same period in 2015, indicating that its growth in composite and metal aircraft structure repair revenues continues to provide a strong operating cash flow from this market segment.

Effective December 18, 2015, Avcorp completed the acquisition of Hitco. The acquisition was completed pursuant to the terms of an asset purchase agreement that was entered into on July 20, 2015, and subsequent amendments to December 18, 2015. Pursuant to the Agreement Avcorp's subsidiary, ACF, (the Group's **Gardena facility**) purchased the assets of the division of Hitco which produces composite structural parts for commercial and military aerostructures.

The acquisition of Hitco's Aerostructures composite division has provided Avcorp the unique opportunity to transform the Avcorp Group's existing metal fabrication and integrated assembly business by broadening the product range and strengthening Avcorp's composite capabilities. Advanced composite fabrication capabilities, provided by this acquisition, will enhance Avcorp Group's ability to participate in large aerospace assembly programs which combine mixed material components.

Current year revenues arising from the assignment by all customers of commercial aerospace contracts to Avcorp Industries Inc., in conjunction with the December 18, 2015 Hitco acquisition have generated $67,218,000 in revenue (December 31, 2015: $1,750,000). These contracts support customer production of commercial aircraft. Manufacturing of these composite parts occurs in Avcorp Group's Gardena facility. The Gardena facility was assigned defence aerospace contracts by Hitco's customers upon the finalization of the acquisition. These contracts generated $17,486,000 of revenue during 2016 for ACF (December 31, 2015: $107,000).

Deliveries and quality performance as at December 31, 2016 for Canadian manufacturing operations were at customer required levels. The manufacturing operations have achieved, and continue to maintain, top quality and delivery ratings for the majority of their programs.

In conjunction with the Hitco acquisition, Hitco and its ultimate parent SGL have the contractual responsibility and liability for certain losses incurred by Avcorp in connection with quality and warranty claims pertaining to finished goods delivered by Hitco before the closing date and certain finished goods manufactured by Hitco before the closing date that were designated as conforming inventory. Immediately after the Hitco acquisition, a thorough quality and delivery review and audit was conducted of Hitco's Gardena manufacturing operations by ACF, which has produced improvement plans together with its customers. ACF continues to work collaboratively with customers to ensure any quality and delivery issues are fully resolved at the earliest date.

Revenues from Avcorp Group customers are as follows:

**REVENUE DISTRIBUTION**

*(unaudited, prepared in accordance with IFRS, expressed in thousands of Canadian dollars)*

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | | 2015[1] Restated | |
|---|---|---|---|---|
| | **Revenue** | **% of Total** | Revenue | % of Total |
| BAE Systems | **$5,352** | **2.9** | $14,115 | 17.6 |
| Boeing[2] | **74,848** | **40.7** | 31,194 | 38.8 |
| Bombardier | **14,883** | **8.1** | 16,578 | 20.6 |
| Lockheed Martin | **12,493** | **8.6** | - | - |
| Subaru Corporation | **15,789** | **6.8** | - | - |
| Other | **27,323** | **14.9** | 18,173 | 22.6 |
| Amortization and contract renegotiation of the unfavourable contract liability | **33,019** | **18.0** | 356 | 0.4 |
| Total | **183,707** | **100.0** | 80,416 | 100.0 |

1. Finalization adjustments made to the preliminary purchase price allocation, for the December 18, 2015 Hitco acquisition, reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date. The measurement period adjustments predominately relate to updating fair value estimates.
2. Includes Boeing program partner revenue.

The Avcorp Delta BC facility is the single source supplier for the F-35 CV-OBW assembly under contract with **BAE Systems ("BAES")**, and delivers directly to Lockheed Martin. The Outboard Wing is the foldable portion of the wing on the carrier version of the F-35 aircraft which allows for handling and storage of the aircraft on the aircraft-carrier's deck and hangers, while keeping its long-range and low-landing-speed flight characteristics. The CV-OBW is regarded as one of the more complex assemblies that the Canadian aerospace industry contributes to the F-35 program. Production rates for the F-35 CV-OBW were reduced in 2016 relative to 2015. Production contracts have been secured through to March 2019, with discussions underway with the customer to secure constant production through to the second quarter of 2020. The Company announced that further to the contract award from Lockheed Martin announced on October 15, 2015 for the expanded scope on the F-35 CV-OBW, Avcorp has received a firm order for the remaining units in the next two production phases, referred to as Low Rate Initial Production ("LRIP") Nine and LRIP Ten. Avcorp's established New Product Introduction ("NPI") process will ensure the successful knowledge and skills transfer from **Lockheed Martin**, required for the intricate work of paint preparation and complex installation of control surfaces and systems such as the outboard leading edge flaps, ailerons, fairings and sub-systems. The delivery of the first shipset to Lockheed Martin's Final Assembly and Check Out facility in Fort Worth, Texas, USA was in August 2016, with subsequent confirmed orders extending out to 2018.

Avcorp's Gardena California facility provides substantial content for all three models of the F-35 fighter aircraft. Fabricated components include: wing skins, upper and lower, nacelles, access panels, and a strap component that serves as a structural backbone to the aircraft. Avcorp fabricates these complex structures through a combination of both automated robotic fiber placement and hand laid graphic fabric methods. Avcorp is under a multi-year contract with Lockheed Martin Corporation, who release order quantity and schedule requirements that coincide with their fiscal year. The current period of performance extends through May 1, 2018. Follow on contract value is anticipated, assuming acceptable quality and delivery performance. Revenues for this long-term defence program totalled $12,781,000 for the year ended December 31, 2016 (December 31, 2015: $48,000).

Shipments of large metallic assemblies to **Boeing Commercial Airplane Group ("Boeing")**, primarily for the 737 commercial jet program, decreased slightly (2%) during 2016 relative to 2015. Concurrently, deliveries of fabricated parts to Boeing increased slightly (3%). During 2016, Avcorp delivered its first significant quantity of shipsets of composite fabricated aerostructures parts for Boeing programs from its acquired Gardena production facility. 2016 revenues for these composite parts totalled $39,425,000 (December 31, 2015: $1,619,000). Total revenues generated for the Company from various Boeing Commercial aircraft programs amounted to $70,722,000 (December 31, 2015: $27,246,000). The Company also delivers components to **Boeing Defense, Space & Security ("Boeing DSS")** for the Chinook CH47 helicopter. During the year ended December 31, 2016 the Company generated $4,126,000 of revenues in supply to Boeing DSS, a slight increase in revenues recorded for the same period in 2015 (December 31, 2015: $3,948,000). The Avcorp Delta BC facility announced on October 26, 2015 that it has been awarded the production contract for the supply of Boeing 767-2C Panoramic Camera Fairings. Furthermore, the Delta facility was able to secure the production contract for the Boeing 767 Flap Track Fairings. Both new programs were in the production set-up phase during 2016 and are expected to generate revenues in 2017. The Company continues to work towards obtaining additional new contracts supporting Boeing commercial jet programs as well as other Boeing DSS defence programs.

Revenues from **Bombardier Aerospace ("Bombardier")** programs decreased during the current year relative to the year ended December 31, 2015 as restated. Shipments of large assemblies for the CL605 business jet program decreased by 37% during the current year, while the Company experienced a 56% increase in its deliveries of composite floor panels to Bombardier, as Avcorp adjusted production to match Bombardier demand. Avcorp Group's primary source of revenues from Bombardier in 2017 will continue to be from components for the CL605 and CL850 business jets, composite floor panels for the CRJ and Q400 aircraft programs, as well as a sustained rate of production of composite floor panels for Bombardier's Global 5000/6000 and Global 7000/8000 programs.

Avcorp's deliveries to **Subaru Corporation ("Subaru")** (formerly Fuji Heavy Industries) of large complex composite structural components which are integrated into the centre wing box in support of the Boeing 787 commercial jet program totalled $15,789,000 for the current year (December 31, 2015: $Nil). This is a significant commercial production contract being manufactured in the Gardena facility. This long term agreement represents an important relationship with a long-standing industry tier one supplier.

Composite aircraft structure repair revenues out of Comtek continued with a strong performance, as current 2016 revenues increased 36% over revenues in the previous year. The Group also supplies Canadian aircraft retro-fit programs out of its Delta facility, and large composite structures in support of various US defence programs out of its Gardena facility. These Other revenues are of significant importance to the Group's operations as they generated $27,323,000 in revenue during the year ended December 31, 2016 (December 31, 2015: $18,173,000).

**Defence program revenues** for Avcorp during 2016 totalled $27,545,000 (December 31, 2015: $18,530,000); 17.9% of total revenues (December 31, 2015: 23.2%). **Commercial program revenues** continue to provide the majority of the Company's revenue (December 31, 2016: 82.1%; December 31, 2015: 76.8%) amounting to $123,143,000 for 2016 and $61,530,000 for 2015. The Group continues to move forward with its revenue diversification between commercial and defence aerospace programs.

### Gross Profit

Gross profit (revenue less cost of sales) for the year ended December 31, 2016 was positive 4.6% of revenue compared to positive 10.1% of revenue for the year ended December 31, 2015 as restated. Included in the calculation of gross profit is the amortization and contract renegotiation of the unfavourable contract liability of $36,936,000 (2015: $356,000).

Gross profit as a percentage of revenues has decreased during 2016 relative to 2015 primarily as a result of significant start-up operational deficiencies and production process inefficiencies for Avcorp's acquired Hitco operations and from the unexpected challenges described below.

The start-up, post-acquisition of the operations in Gardena, faced several unanticipated challenges during the first half of 2016. As a result of legacy quality issues raised by customers, a number of items were identified that required corrective action. These items accounted for substantial expenditures beyond normal production costs. Staffing levels during the third and fourth quarters 2016 for the Gardena facility continued to remain very high relative to production deliveries as the operations utilized production resources to implement customer supported corrective actions. Consequently, gross margin on production contracts manufactured out of the Gardena facility, inclusive of legacy operational deficiency rectification costs, amounted to $4,440,000 for the year (December 31, 2015: $515,000 negative).

Many corrective actions have been implemented. As legacy operational deficiencies are rectified, additional operational improvements were made in the second half of 2016 and into 2017, thereby allowing the Gardena operations to achieve fully contracted output levels. Avcorp's key commercial customers have worked collaboratively with Avcorp to mitigate production schedule risks and support the earliest resolution of the outstanding process and product issues.

Delta and Burlington production contracts, which pre-existed the Hitco acquisition, produced a gross margin for the year ended December 31, 2016 of $3,934,000 as compared with $8,652,000 for 2015; a $4,718,000 decrease, primarily caused by decreases in customer demand for business jet and defence aircraft.

There remain within operations significant levels of unutilized plant capacity. The Company has expensed $4,408,000 of overhead costs during the year (December 31, 2015: $4,906,000) in respect of unutilized plant capacity.

### Administration and General Expenses

As a percentage of revenue, administration and general expenses decreased to 13.3% for the year ended December 31, 2016 from 24.0% for the year ended December 31, 2015 as restated. Although 2015 acquisition-related legal and professional service fees were significant, in 2016 a full year of administrative and general expenses arising from the Company's Gardena facility contributed to increased expenditures of this type. In absolute terms, administration and general costs increased by $5,151,000 during the year relative to the prior year. Additionally, legal and professional services incurred during the year have been substantial as the Company administers various contracts and agreements assigned from and ancillary to its asset purchase agreement with Hitco and Frankfurt-listed SGL, which became effective on December 18, 2015.

### Foreign Exchange Gain or Loss

Avcorp Group recorded a $717,000 foreign exchange gain during 2016 (December 31, 2015: $323,000 gain) as a result of holding US dollar-denominated cash, receivables, payables and debt.

### Earnings Before Interest, Taxes, Depreciation & Amortization

Avcorp Group presents earnings before interest, taxes, depreciation and amortization ("EBITDA") to assist the Company's stakeholders with their assessment of its financial performance. EBITDA is a financial measure not recognized as a term under IFRS. However, the Company's management believes that the Company's stakeholders consider this metric to be useful information to assist them in evaluating profitability.

EBITDA was negative $9,767,000 for the year ended December 31, 2016 compared to negative EBITDA of $8,093,000 for the year ended December 31, 2015 as restated. Significant pre-existing operational deficiencies and excessive cost structure within the acquired Hitco operations have resulted in poor production contract performance and adversely affected Group earnings for 2016.

Included in the calculation of EBITDA is the amortization and contract renegotiation of the unfavourable contract liability of $38,937,000 into revenue in 2016 (2015: $356,000).

The financial results presented for the year ended December 31, 2016 do not take into account any recovery provision for the operational expenditures for which the Company believes it is indemnified for under its asset purchase agreement with Hitco and SGL. These expenditure recovery amounts are not finalized and cannot be practicably quantified at this time.

The start-up, post-acquisition, of the new operations in Gardena faced several unanticipated challenges during the first quarter 2016. As a result of legacy quality issues raised by customers, a number of items were identified that required corrective action. These items accounted for substantial expenditures beyond normal production costs.

The complexity and challenge of executing the production start-up and improvement plans for the Gardena operations increased from the pre-acquisition estimates. Avcorp has worked successfully with the commercial aerospace customers to update plans and commitments to ensure support for their programs and a return to purchase order schedules by the end of third quarter of 2016.

Over the course of 2016 and 2017 certain of the smaller loss making contracts are being wound down eliminating the associated losses. What will be the remaining significant loss making contract has been the focus of a comprehensive Company initiative under which management has commenced planning with a major customer for an orderly and protected transition of this significant loss making contract from Avcorp's Gardena facility. Contract revisions are completed for the significant loss making contract, which have significantly reduced the required period of delivery.

**EBITDA**[1]

*(unaudited, expressed in thousands of Canadian dollars)*

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015[2] Restated |
|---|---|---|
| Income loss for the year | **$(15,964)** | $(12,154) |
| Interest expense and financing charges | **353** | 860 |
| Income tax expense | **-** | - |
| Depreciation | **3,915** | 1,680 |
| Amortization of development costs and intangibles | **1,929** | 1,521 |
| | **(9,767)** | (8,093) |

1. This is not a recognized term under International Financial Reporting Standards.
2. Finalization adjustments made to the preliminary purchase price allocation, for the December 18, 2015 Hitco acquisition, reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date. The measurement period adjustments predominately relate to updating fair value estimates.

### Finance Costs

Total interest and financing charges on both short- and long-term debt for the year ended December 31, 2016 were $339,000, net of $14,000 interest income (December 31, 2015: $4,000), compared with net $856,000 expense for the year ended December 31, 2015 as restated.

### Income Taxes

Avcorp Group has not incurred a tax expense during the three and twelve months ending December 31, 2016 (December 31, 2015: $Nil) nor recorded a tax benefit as it is not more likely than not that the benefit would be recognized.

### Income or Loss

Loss for the year ended December 31, 2016 was $15,964,000 compared to a loss of $12,154,000 for the year ended December 31, 2015 as restated. The loss recorded for the year relative to 2015, is primarily a result of significant start-up operational inefficiencies for Avcorp's acquired Hitco operations, as well as legal and professional services incurred during the year which have been substantial as the Company administers various contracts and agreements assigned from and ancillary to its asset purchase agreement with Hitco and Frankfurt-listed SGL, which became effective on December 18, 2015. Significant pre-existing operational deficiencies and excessive cost structure within the newly acquired Hitco operations have resulted in poor production contract performance and significantly adversely affected Group earnings.

The financial results presented for the year ended December 31, 2016 do not take into account any recovery provision for those operational expenditures, for which the Company believes it is indemnified for under its asset purchase agreement with Hitco and SGL. These expenditure recovery amounts are not finalized and cannot be practicably quantified at this time.

Included in the calculation of loss is the amortization and contract renegotiation of the unfavourable contract liability of $33,019,000 into revenue in 2016 (2015: $356,000).

### Liquidity and Capital Resources

At year end Avcorp Group's operating line of credit provides for a total utilization of $21,000,000. Avcorp Group ended the year with bank operating line utilization of $17,111,000 offset by $3,960,000 cash compared to utilization of $Nil and $14,484,000 cash on hand at December 31, 2015. Based on net collateral provided to its bank, Avcorp Group is able to draw $21,000,000 on its operating line of credit as at December 31, 2016 (December 31, 2015: $8,805,000).

On June 23, 2016, the Company's bank extended its banking agreement from June 30, 2016 to December 31, 2016.

Effective November 11, 2016, the Company entered into an amendment to its existing facility whereby the bank extended the term of the credit facility from December 31, 2016 to April 15, 2017, and, increased the maximum availability to $21 million, subject to existing draw down provisions and margin calculations, which may reduce the credit available. The additional credit availability was provided utilizing certain consideration receivable as security and which maximum availability is reduced upon collection of such certain consideration receivable.

On September 23, 2016, Avcorp entered into a non-revolving term loan agreement ("loan") with Panta Canada B.V. ("Panta") to fund the Company to a maximum aggregate principal amount of USD$5,000,000. The Company received an advance on September 23, 2016 of USD$2,000,000 ($2,612,000), October 25, 2016 of USD$1,500,000 ($1,983,000), and November 15, 2016 of USD$1,500,000 ($2,020,000).

In conjunction with receiving advances under this term loan, the Company issued Panta 30,714,118 common share purchase warrants ("warrants") on a pro-rata basis, with each warrant entitling the holder to acquire one common share at an exercise price of $0.07 per common share, exercisable for a period of 24 months following the date of issuance.

Effective February 17, 2017, the Company entered into an amendment to its existing credit facility with a Canadian chartered bank whereby the bank extended the credit facility from April 15, 2017 to July 30, 2017.

Effective March 2, 2017, the Company entered into an amendment to its existing credit facility with a Canadian chartered bank whereby the permanent block against available credit was reduced from $2,500,000 to $1,800,000.

Effective March 31, 2017 the Company entered into an amendment to its existing credit facility with a Canadian chartered bank whereby the following amendments were made;

- the permanent block against available credit of $1,800,000 was removed;
- availability under the facility was increased to USD$23,000,000 subject to draw down provisions which have been amended to include eligible receivables and inventories of Avcorp Composite Fabrication Inc.; and
- the debt facility will bear interest at a rate equal to the bank's prime rate plus 0.75%.

On March 17, 2017, Avcorp entered into a loan agreement ("Loan") with Panta bearing interest of 8% per annum to fund the Company to a maximum aggregate principal amount of USD$907,000 maturing on May 15, 2017. The Loan was drawn down in two tranches dated March 21, 2017 and March 27, 2017. The Loan was repaid on April 4, 2017 from the proceeds of consideration receivable from the Hitco acquisition. Panta is Avcorp's majority shareholder owning approximately 65.5% of the issued and outstanding common shares on December 31, 2016. Panta is wholly owned by Panta Holdings B.V. Both companies are incorporated in The Netherlands and Mr. Jaap Rosen Jacobson, a director of the Company, is the sole shareholder of Panta Holdings B.V.

On April 4, 2017, Avcorp received the USD$9,220,000 remaining consideration receivable from the acquisition of Hitco. USD$6,511,000 of the consideration payment was utilized to repay a portion of the debt facility with a Canadian Chartered bank. A further amount of USD$907,000 was utilized to repay the Loan with Panta.

On April 7, 2017, a term loan entered into with Panta become due and payable for the principal amount of USD$5,000,000 and USD$187,000 of accrued and unpaid interest. As at that date the Company and Panta amended the term loan to provide for a maturity date which is the earlier of the date on which credit is available to be drawn by the Company under the Expanded Loan with a Canadian Chartered bank, and July 6, 2017, with interest continuing at 8% per year. The Company incurred a USD$100,000 amendment fee in this regard.

On May 26, 2017, the Company entered into a loan agreement to expand its loan facility with a Canadian Chartered bank ("the Expanded Loan"). This loan agreement amends, restates and replaces the loan agreement entered into on September 27, 2012. The Expanded Loan provides an additional borrowing capacity of up to USD$35,000,000 increasing its existing, as at March 31, 2017, USD$23,000,000 revolving loan in total up to USD$58,000,000. The Expanded Loan matures on June 30, 2020.

Interest rate for advances made up to the maximum of the allowable borrowing base on the existing USD$23,000,000 revolving loan:

- RBP plus 0.75% per annum
- RBUSBR plus 0.75% per annum
- BA Equivalent Rate plus 2.25% per annum
- LIBOR Rate plus 2.25% per annum

Interest rate for advances made on the additional borrowing capacity up to USD$58,000,000.

- RBP plus 0.00% per annum
- RBUSBR plus 0.00% per annum
- BA Equivalent Rate plus 0.875% per annum
- LIBOR Rate plus 0.875% per annum

Drawdown under the USD$35,000,000 additional borrowing capacity is supported by a major and material customer of the Company by way of a guarantee.

The Company will provide the guarantor, as consideration for the guarantee, a fee equal to 5.375% of the weighted average outstanding balance of the guaranteed portion over each full twelve (12) month period commencing on the funding date plus, for the partial year thereafter, 5.375% of the weighted average outstanding balance of the guaranteed portion multiplied by the number of days in the partial year divided by three hundred sixty (360). The fee will be payable on the date.

The Expanded Loan is subject to the existing security agreements with a Canadian Chartered bank and with its guarantor. This debt facility is secured by a charge and specific registration over all of the assets of the Company.

Management is actively working to secure additional production orders, extension to its banking agreements, will continue to work with existing common shareholders, and will seek additional financing as necessary.

### Cash Flows from Operating Activities

Net cash flows from operating activities, before consideration of changes in non-cash working capital, were $59,091,000 during the year ended December 31, 2016 as compared to utilizing $8,101,000 of cash during the year ended December 31, 2015 as restated. Cash flows from operating activities were most significantly impacted as a result of operational losses incurred under customer contracts assigned with the December 18, 2015 Hitco acquisition, as well as legal and professional services incurred during the year which have been substantial as the Company administers various contracts and agreements ancillary to its asset purchase agreement with Hitco and Frankfurt-listed SGL, which became effective on December 18, 2015.

Non-cash operating assets and liabilities provided $8,744,000 of cash during the current year, compared to utilizing $11,442,000 of cash during the year ended 2015; primarily from collection of accounts receivable, inventory sold during the year, as well as extended payment terms provided by certain suppliers. Avcorp Group continues to closely monitor accounts receivable and work with its customers in order to ensure cash is collected on a timely basis. Amortization of a certain customer advance, assumed via the Hitco acquisition, utilized $6,955,000 (December 31, 2015: $425,000), while pre-payment of production deliveries by a customer provided the Company with $6,473,000 in funding for 2016 (December 31, 2015: $2,963,000 utilization).

### Cash Flows from Investing Activities

During the year ended December 31, 2016, Avcorp Group collected $26,296,000 in consideration receivable. The remaining $12,251,000 (USD$9,220,000) consideration receivable from the Hitco acquisition as at December 31, 2016 was received on April 13, 2017. Avcorp Group purchased capital assets totalling $5,129,000 compared with $959,000 during the year ended December 31, 2015 as restated. Avcorp Group continues to minimize its capital expenditures in order to conserve cash, with only operation critical expenditures being made; however significant capital expenditures were made at Avcorp's Gardena facility during the year in order to rectify equipment deficiencies and improve the effectiveness of operational capabilities.

During 2016 and 2015, the Company commenced the new program introduction process in support of the newly awarded production contracts. The start-up of new production contracts requires significant investments in hard and soft tooling. Such tooling investments amounted to $2,617,000 in 2016 (December 31, 2015: $1,405,000).

### Cash Flows from Financing Activities

Avcorp Group finances working capital through a combination of bank debt and equity financings.

Cash flows from financing activities provided $23,527,000 of cash during the current year compared with providing $468,000 of cash in 2015. The Company's operating line was $17,111,000 drawn as at December 31, 2016 providing an equivalent amount of cash during the year (December 31, 2015: $Nil).

Under the SADI program from the Government of Canada, the Company was able to secure $111,000 in project financing (December 31, 2015: $432,000).

On September 19, 2016, Avcorp entered into a non-revolving term loan agreement with Panta to fund the Company to a maximum aggregate principal amount of $6,616,000 (USD$5,000,000).

During the year, the Company repaid long-term debt consisting of $240,000 of equipment financing (December 31, 2015: $5,391,000).

During the second quarter 2016 holders of the Company's stock options exercised 960,500 stock options at a price of $0.085 and 625,500 stock options at a price of $0.05 resulting in the issuance of 1,586,000 common shares with a value of $113,000.

On December 31, 2016, the ratio of the Company's current assets to current liabilities was 0.94:1 (December 31, 2015: 1.40:1).

### Contractual Obligations

**PAYMENTS DUE BY PERIOD**

*(unaudited, expressed in thousands of Canadian dollars)*

| | **Total** | 2017 | 2018-2020 | 2021-2022 | Post 2022 |
|---|---|---|---|---|---|
| Finance lease obligations | **$147** | $47 | $100 | $- | $- |
| Term loan | **6,384** | 6,236 | 148 | - | - |
| Other long-term obligations[1] | **1,398** | - | 134 | 71 | 1,193 |
| Purchase obligations[2] | **46,895** | 41,855 | 4,779 | 261 | - |
| Total contractual obligations | **54,824** | 48,138 | 5,161 | 332 | 1,193 |

1. This amount represents obligations the Company has with Industrial Technologies Office.
2. Purchase obligations include payments for the Company's operating and property leases, as well as committed contractual operational purchase order obligations outstanding.

The Company expects that payment of contractual obligations will come from funds generated by operations, utilization of the bank operating line of credit, cash on hand and proceeds from debt and equity financings.

The Company does not have any off-balance sheet liabilities or transactions that are not recorded or disclosed in the consolidated financial statements.

## Capital Stock

As at December 31, 2016, there were 307,141,184 common shares, 60,977,436 common share purchase warrants, and 52,225,500 stock options issued and outstanding.

### Common Shares

During the second quarter 2016 holders of the Company's stock options exercised 960,500 stock options at a price of $0.085 and 625,500 stock options at a price of $0.05 resulting in the issuance of 1,586,000 common shares with a value of $113,000.

September 19, 2016: Grant of 12,285,647 Warrants expiring September 19, 2018 at $0.07 to Panta.

October 24, 2016: Grant of 9,214,235 Warrants expiring October 24, 2018 at $0.07 to Panta.

November 10, 2016: Grant of 9,214,236 Warrants expiring November 10, 2018 at $0.07 to Panta.

Panta Canada B.V., is 100% owned by Panta Holdings B.V. and is Avcorp's majority shareholder owning approximately 65.5% of issued and outstanding common shares as of December 31, 2016.

No common shares were issued by the Company during the fourth quarter 2016.

The Company is authorized to issue an unlimited number of common shares as well as an unlimited number of first preferred and second preferred shares, issuable in series, the terms of which will be determined by the Company's directors at the time of creation of each series. There were 307,141,184 common shares issued at December 31, 2016. The book value of common shares issued and outstanding as at December 31, 2016 was $80,302,000 (December 31, 2015: $80,158,000).

## Accounting standards issued but not yet effective

The following is a brief summary of the new standards issued but not yet effective:

### IFRS 15 – Revenue from Contracts with Customers

The International Accounting Standards Board ("IASB") and the US Financial Accounting Standards Board ("FASB") (collectively, "the Boards") have jointly issued a new revenue standard, IFRS 15 Revenue from Contracts with Customers, that will supersede virtually all revenue recognition requirements in IFRS and US GAAP.

IFRS 15 establishes principles to address the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers.

This standard is required to be applied for accounting periods beginning on or after January 1, 2018, with earlier adoption permitted. The Company has not yet assessed the impact of the standard or determined whether it will adopt the standard early.

### IFRS 9 – Financial Instruments

In July 2014, the IASB issued the final version of IFRS 9 Financial Instruments which reflects all phases of the financial instruments project and replaces IAS 39 Financial Instruments: Recognition and Measurement and all previous versions of IFRS 9. The standard introduces new requirements for classification and measurement, impairment, and hedge accounting. IFRS 9 is effective for annual periods beginning on or after January 1, 2018, with early application permitted. Retrospective application is required, but comparative information is not compulsory. The adoption of IFRS 9 will have an effect on the classification and measurement of the Group's financial assets, but no impact on the classification and measurement of the Group's financial liabilities.

### IFRS 16 - Leases

In January 2016, the IASB issued IFRS 16 – Leases which replaces IAS 17 – Leases and its associated interpretative guidance. IFRS 16 applies a control model to the identification of leases, distinguishing between a lease and a service contract on the basis of whether the customer controls the asset being leased. For those assets determined to meet the definition of a lease, IFRS 16 introduces significant changes to the accounting by lessees, introducing a single, on-balance sheet accounting model that is similar to current finance lease accounting, with limited exceptions for short-term leases or leases of low value assets. Lessor accounting remains similar to current accounting practice. The standard is effective for annual periods beginning on or after January 1, 2019, with early application permitted for entities that apply IFRS 15. The Company has not yet assessed the impact the final standard is expected to have on its consolidated financial statements.

### IAS 7 – Statement of Cash Flows

In 2016, the IASB issued amendments to IAS 7, Statement of Cash Flows ("IAS 7"). The amendments are intended to clarify IAS 7 to improve information provided to users of financial statements about an entity's financing activities. They are effective for annual periods beginning on or after January 1, 2017, with earlier adoption permitted. The adoption of IAS 7 amendments will require additional disclosure in the Company's consolidated financial statements.

### IFRS 2 – Share Based Payments

In 2016, the IASB issued the final amendments to IFRS 2, Share-based Payments ("IFRS 2") that clarify the classification and measurement of share-based transactions, consisting of: accounting for cash-settled share-based payment transactions that include a performance condition; classification of share-based payment transactions with net settlement features; accounting for modifications of share-based payment transactions from cash-settled to equity-settled. The amendments are effective for annual periods beginning on or after January 1, 2018, with earlier adoption permitted. The amendments are to be applied prospectively. However, retrospective application is allowed if this is possible without the use of hindsight. The Company is in the process of evaluating the impact of adopting these amendments on the Company's consolidated financial statements.

### IFRIC Interpretation 22 – Foreign Currency Transactions and Advance Consideration

In 2016, the IASB issued IFRIC Interpretation 22, Foreign Currency Transactions and Advance Consideration ("IFRIC 22"), which provides requirements about which exchange rate to use in reporting foreign currency transactions (such as revenue transactions) when payment is made or received in advance. IFRIC 22 is effective for annual periods beginning on or after January 1, 2018, with earlier adoption permitted. On initial application, entities have the option to apply either retrospectively or prospectively. The Company is in the process of evaluating the impact of adopting these amendments on the Company's consolidated financial statements.

## Operations Overview

### Delivery and Quality Performance

Deliveries and quality performance as at December 31, 2016 for Canadian manufacturing operations were at customer required levels. The manufacturing operations have achieved, and continue to maintain, top quality and delivery ratings for the majority of their programs.

In conjunction with the Hitco acquisition, Hitco and its ultimate parent, SGL, have the contractual responsibility and liability for certain losses incurred by Avcorp in connection with quality and warranty claims pertaining to finished goods delivered by Hitco before the closing date and certain finished goods manufactured by Hitco before the closing date that were designated as conforming inventory. Immediately after the Hitco acquisition, a thorough quality and delivery review and audit was conducted of Hitco's Gardena manufacturing operations by ACF, which has produced improvement plans together with its customers. ACF continues to work collaboratively with customers to ensure any quality and delivery issues are resolved at the earliest date. ACF is on schedule to meet all the targets established in the improvement plans with its customers.

### Order Backlog

Avcorp Group operates within "general terms agreements" with its customers. These agreements are typically for five years or longer.

The Company's agreements with Boeing Commercial Airplane Group extend from January 2013 to December 2017; new production contracts entered into during 2015 and 2016 extend to 2028 and 2025 respectively. Production contracts underlying Boeing's general term agreements, which were assigned to Avcorp with the Hitco acquisition, extend to 2019.

Agreements with Boeing Defense, Space and Security extend from 2013 into 2019 with established minimum base delivery quantity requirements.

The Bombardier and Subaru agreements extend for the life of the individual aircraft programs.

Agreements with Lockheed Martin extend into 2018, with negotiations occurring for follow-on orders to existing statements of work through to 2020.

Agreements with BAE Systems (Operations) Limited extend into 2019 and continue to generate additional sales order backlog.

The Company defines order backlog as the value of purchase orders it expects to receive from these agreements based on manufacturers' projections and current degrees of exclusivity. Order backlog is a financial measure not recognized as a term under IFRS. However, Avcorp's management believes that the Company's stakeholders consider this metric to be useful information to assist them in evaluating profitability. The order backlog, as at December 31, 2016, is $826 million in consideration of attaining full award values, compared to $453 million as at December 31, 2015. The changes in order backlog are as follows:

- $154 million decrease in order backlog resulting from revenues recorded during the year ended December 31, 2016;
- $523 million increase in order backlog due to increases in the production rates, contract renewals for various existing programs, and contract awards; and
- $4 million increase in order backlog resulting from change in the value of the Canadian dollar relative to the US dollar for the Company's US dollar denominated sales. Refer to comments on currency risk.

### Supply Chain

Supplier quality and delivery performance continued to meet targeted levels during the year; the Company continues to monitor supplier performance in all aspects of quality, delivery and price. The Company works closely with its supply chain to ensure a stable, uninterrupted delivery of compliant products and is making changes in product sourcing processes where necessary.

During 2014 the company qualified certain suppliers in support of its in-house transition to increasingly value-added production processes. These suppliers support the Company by providing manufacturing capabilities, to which Avcorp has transitioned in 2015; the process is a critical cost reduction process which continued through 2016.

The capacity and delivery performance of a limited number of critical vendors continues to be closely monitored to mitigate risks to assembly start dates. Risk mitigation plans have been implemented. The securing of additional long-term contracts with key suppliers continues.

### Working Capital Utilization

Total current assets less total current liabilities were in a deficit position of $5,439,000 at December 31, 2016 and in a surplus position of $30,962,000 at December 31, 2015. Working capital decreased during 2016 as cash was utilized in operating activities to mitigate significant pre-existing operational deficiencies and excessive cost structure within the acquired Hitco operations which resulted in poor production contract performance and adversely affected Group earning for 2016.

## Financial Resources

Avcorp Group has invested in its chosen strategies of organic growth, capabilities acquisition, lean manufacturing and strategic outsourcing. Management believes that significant investments necessary to better position Avcorp Group in the aerospace industry have and continue to be made, and that those investments along with the expected continued financial support of shareholders and lenders position the Company to be able to face and mitigate risks associated with the business.

## Non-Financial Resources

The Company's non-financial resources relate to the Company's human resources, operating equipment, business systems, technologies, processes and qualifications. The Company does not have any extended enterprise relationships such as special purpose entities or joint ventures.

### Human Resources

The Company has the appropriate human resources at all levels of the organization. The board of directors has considerable aerospace industry, investment, and financial expertise. The management team is experienced in the industry and in all aspects of operations.

The number of employees at December 31, 2016 was 722 (December 31, 2015: 776). Employees have appropriate qualifications and experience to perform their duties and the Company provides ongoing training and opportunities for employee growth.

### Equipment, Systems, Technologies and Processes

Manufacturing equipment and information technology assets have been consistently upgraded and further deployed, increasing reliability and utility.

## Risk Assessment

The principal risks that Avcorp Group faces are summarized as follows:

- additional financing is required to maintain and grow its business;
- no agreement on extension of customer contracts, or terminated customer programs are not replaced;
- increases in material costs, primarily aluminum plate, composite materials, titanium, sandwich panels and assembly hardware, and subcontractor costs, without equivalent price protection in customer contracts;
- reduction in production rates of aircraft manufacturers and delays in program introduction;
- consolidation and globalization by competitors;
- potential failure to achieve cost-reduction objectives relative to changes in revenue levels;
- the trend to greater use of composite material in primary structures in each new generation of aircraft; and
- decrease in the value of the Canadian dollar, relative to the US dollar, has an adverse effect on the Canadian dollar equivalent value of those Company procured goods and services which are denominated in US dollars.

The Company's view is that with its strategic plan in place and the continued integration of composite design and manufacturing capabilities, the Company should be in a position to face and mitigate these risks. However, there can be no assurance that the Company will be successful with all initiatives.

### Additional Financing

Avcorp Group's growth strategy requires continued access to capital. From time to time, the Company may require additional financing to enable it to:

- finance unanticipated working capital requirements;
- finance transitional operating losses incurred upon integration of newly acquired entities;
- finance new program development and introduction;
- develop or enhance existing services and capabilities; or
- respond to competitive pressures.

The Company cannot provide assurance that, if it needs to raise additional funds, such funds will be available on favourable terms, or at all. If the Company cannot raise adequate funds on acceptable terms, its business could be materially harmed.

On May 26, 2017, the Company entered into a loan agreement to expand its existing facility to provide for an additional borrowing capacity of up to USD$35,000,000 until June 30, 2020.

### Customer Contracts

The Company is exposed to the risk that existing customer fixed-term contracts are not renewed at expiration date. Avcorp Group operates within "general terms agreements" with its customers. These agreements are typically for five years or longer. The Company's agreements with Boeing CA extend from current date, with various expiry timelines, through to the end of 2028. Agreements with Boeing DSS have been renewed and established which extend from 2013 into 2019 with minimum base quantity requirements. It is the Company's objective to successfully renew Boeing production contracts in advance of expiry dates.

The Bombardier and Subaru agreements extend for the life of the individual aircraft programs.

BAE and Lockheed Martin customer contracts extend into 2019. The Company is currently negotiating the extension of follow-on contracts.

The Company continues to face the financial risk that the wind-down in previous years of certain program contracts have not been replaced on a timely basis thereby causing the Company to continue to bear significant levels of expenses related to under-utilized operational capacity. The Company has restructured its business development strategy in order to best mitigate this risk and is now commencing to be awarded new customer production contracts.

### Procured Materials and Parts

The Company is engaging suppliers and customers to properly align production requirements and pricing, ensuring uninterrupted delivery of compliant products with a cost structure closely matching product pricing. Changes in forecasts are closely monitored in order to promptly adjust procured materials and parts quantities with the objective of limiting unwanted inventory build-up.

### Aircraft Production Rates

The following industry and program trends impact the Company:

- Company research indicates that the aerostructures markets for commercial aircraft and larger business jets would continue to grow beyond 2016. The lighter business jets' market is expected to show modest growth.
- Growth in air travel rates has and will further increase production rates on the Boeing 737 and Airbus A320 platforms in the coming years. The regional aircraft market remains soft around current rates.
- Bombardier Challenger CL650 aircraft production requirements were reduced in 2016 relative to 2015. The 2017 CL650 production build has increased relative to 2016 and is forecasted to remain flat through 2020.
- The global market for defence aircraft slowed growth through 2016. It appears a priority on defence would be continued throughout 2017.
- The F-35 remains, on a global scale, one of the largest Defence Airplane programs for the foreseeable future.
- Offset opportunities created by Canadian Government procurement within military aerospace programs such as the Boeing F-18 and Airbus C295 FWSAR could lead to additional revenue opportunities from this aerospace sector.

### Competitors

The long-term trend continues towards more intense competition from larger entities having operations in Asia, Mexico and Europe, while original equipment manufacturers continue to increase the size and amount of outsourced components. It can be expected that consolidation on Tier 1 and Tier 2 levels will continue to take place. The Company continues to examine opportunities for mergers or acquisitions, on a global basis, that would improve competitiveness and acquire vertical strengths or additional strategic capabilities.

### Cost Reductions

Approximately 68% of Avcorp Group's cost of sales is related to labour and overhead and 32% related to procurement of raw materials and finished parts. The Company's wage rates are generally lower than its western European and north western United States competitors and higher than those in the south eastern

United States, Asia, Eastern Europe and Mexico. On July 30, 2013 the labour force, at the Delta facility, ratified a new six-year collective agreement. The agreement was ratified by a two-thirds majority, with the agreement expiring on March 31, 2019. Subsequent to the Hitco acquisition the Company and the labour force, in Gardena, agreed to a four month extension of the current collective agreement, which was to expire February 29, 2016. On June 29, 2016 the labour force at the Gardena facility ratified a new six-year collective agreement, adding language that allows for High Performance Work Teams and incentive bonus payments for accomplishing annual targets regarding operational and quality performance.

The Company continues to focus on cost reductions for direct labour, material and overhead costs. These cost reductions will be achieved through continuous improvements in the internal and external parts supply chain using lean manufacturing technology, through continued negotiation of long-term agreements with the majority of key suppliers, through increased efficiency of plant capacity augmented by technological improvements, and through continued focus on cost targets at all levels of the organization. All discretionary spending is reviewed and controlled by senior management, with expenditures focused on expediting new commercial program business growth and launching of long-term defence programs. However, fixed overhead costs continue to have an adverse impact on the Company's cost structure during this period of reduced revenues. This will be mitigated by increased revenue and facility utilization.

### Composite Materials

Through its subsidiary Comtek, the Company has ongoing operations expertise in the design and competitive manufacture and repair of advanced composite aerostructures which provides the opportunity for the Company to compete in a market which is trending, with each new generation of aircraft, to greater use of composite material in primary structures. As well, the Company's Delta location is supplementing its current operations with composite qualification, leveraging existing production capacity and investments.

Effective December 18, 2015, Avcorp completed the acquisition of Hitco. The Acquisition was completed pursuant to the terms of an asset purchase agreement that was entered into on July 20, 2015, and subsequent amendments to December 18, 2015. Pursuant to the Agreement Avcorp's subsidiary, Avcorp Composite Fabrication Inc., purchased the assets of the division of Hitco which produces composite structural parts for commercial and military aerostructures.

The acquisition of Hitco's Aerostructures composite division has provided a unique opportunity to transform the Avcorp Group's existing metal fabrication and integrated assembly business by broadening the product range and strengthening our composite capabilities. Advanced composite fabrication capabilities, provided by this acquisition, enhances Avcorp Group's ability to participate in large aerospace assembly programs which combine mixed material components.

### US Dollar Revenues

Avcorp Group sells a significant proportion of its products in US dollars, partially from its Canadian operations and entirely within its United States operations, at prices which are often established well in advance of manufacture and shipment dates. As the value of the Canadian dollar decreases, the equivalent value of US dollar denominated revenues increases; conversely, the cost of US dollar denominated purchases will increase. The Company is continuing to structure new agreements with customers which mitigate the risk associated with currency fluctuations. It should be noted that a significant portion of the Company's purchases of raw materials, supplier fabricated parts, as well as equipment purchases, are denominated in US dollars.

## Outlook

Variability of the Canadian dollar relative to the US dollar continues to cause the value of the Company's current order backlog to fluctuate. Also, the Company continues to work towards securing additional defence program production contracts in order to augment and diversify its backlog. The Company began delivering products under its defence contracts in 2009 and continues to negotiate long-term supply agreements. Both defence and commercial production contracts are being renewed, with select new customer agreements extending into 2025. The Company expects to finance investment in the start-up of new production programs primarily by milestone payments from customers, though this cannot be assured. Avcorp Group may require financing for capital expenditures required for new programs.

Boeing is the Company's largest customer in 2016, followed by Subaru, Bombardier, Lockheed Martin and BAE Systems. The Company forecasts its 2017 revenues to increase above 2016 levels as the Gardena facility programs reach full rates of production, and Delta ramps up production for newly awarded contracts.

The Company forecasts its working capital financing requirements for 2017 to be met by the current availability of the operating line of credit and the current working capital surplus. Working capital financing has been supplemented, as well, by shareholder loans and consideration received as a result of the Hitco acquisition. However, further debt and equity financing may be required.

Effective February 17, 2017, the Company entered into an amendment to its existing credit facility with a Canadian chartered bank whereby the bank extended the credit facility from April 15, 2017 to July 30, 2017.

Effective March 2, 2017, the Company entered into an amendment to its existing credit facility with a Canadian chartered bank whereby the permanent block against available credit was reduced from $2,500,000 to $1,800,000.

Effective March 31, 2017 the Company entered into an amendment to its existing credit facility with a Canadian chartered bank whereby the following amendments were made;

- the permanent block against available credit of $1,800,000 was removed.
- availability under the facility was increased to USD$23,000,000 subject to draw down provisions which have been amended to include eligible receivables and inventories of Avcorp Composite Fabrication Inc.
- the debt facility will bear interest at a rate equal to the bank's prime rate plus 0.75%.

On March 17, 2017, Avcorp entered into a loan agreement ("Loan") with Panta bearing interest of 8% per annum to fund the Company to a maximum aggregate principal amount of USD$907,000 maturing on May 15, 2017. The Loan was drawn down in two tranches dated March 21, 2017 and March 27, 2017. The Loan was repaid on April 4, 2017 from the proceeds of the consideration receivable. Panta is Avcorp's majority shareholder owning approximately 65.5% of the issued and outstanding common shares on December 31, 2016. Panta is wholly owned by Panta Holdings B.V. Both companies are incorporated in The Netherlands and Mr. Jaap Rosen Jacobson, a director of the Company, is the sole shareholder of Panta Holdings B.V.

On April 4, 2017, Avcorp received the USD$9,220,000 remaining consideration receivable from the acquisition of Hitco USD$6,511,000 of the consideration payment was utilized to repay a portion of the debt facility with a Canadian Chartered bank. A further amount of USD$907,000 was utilized to repay the Loan with Panta.

On April 7, 2017, a term loan entered into with Panta become due and payable for the principal amount of USD$5,000,000 and USD$187,000 of accrued and unpaid interest. As at that date the Company and Panta amended the term loan to provide for a maturity date which is the earlier of the date on which credit is available to be drawn by the Company under the Expanded Loan with a Canadian Chartered bank, and July 6, 2017, with interest continuing at 8% per year. The Company incurred a USD$100,000 amendment fee in this regard.

On May 26, 2017, the Company entered into a loan agreement to expand its loan facility with a Canadian Chartered bank ("the Expanded Loan"). This loan agreement amends, restates and replaces the loan agreement entered into on September 27, 2012. The Expanded Loan provides an additional borrowing capacity of up to USD$35,000,000 increasing its existing, as at March 31, 2017, USD$23,000,000 revolving loan in total up to USD$58,000,000. The Expanded Loan matures on June 30, 2020.

Interest rate for advances made up to the maximum of the allowable borrowing base on the existing USD$23,000,000 revolving loan:

- RBP plus 0.75% per annum
- RBUSBR plus 0.75% per annum
- BA Equivalent Rate plus 2.25% per annum
- LIBOR Rate plus 2.25% per annum

Interest rate for advances made on the additional borrowing capacity up to USD$58,000,000.

- RBP plus 0.00% per annum
- RBUSBR plus 0.00% per annum
- BA Equivalent Rate plus 0.875% per annum
- LIBOR Rate plus 0.875% per annum

Drawdown under the USD$35,000,000 additional borrowing capacity is supported by a major and material customer of the Company by way of a guarantee.

The Company will provide the guarantor, as consideration for the guarantee, a fee equal to 5.375% of the weighted average outstanding balance of the guaranteed portion over each full twelve (12) month period commencing on the funding date plus, for the partial year thereafter, 5.375% of the weighted average outstanding balance of the guaranteed portion multiplied by the number of days in the partial year divided by three hundred sixty (360). The fee will be payable on the date.

The Expanded Loan is subject to the existing security agreements with a Canadian Chartered bank and with its guarantor. This debt facility is secured by a charge and specific registration over all of the assets of the Company.

The Lessor of the Industrial Centre at Gardena California, where Avcorp Composite Fabrication Inc. has its manufacturing facilities, received an offer from a third party to purchase the Industrial Centre. On March 28, 2017 Avcorp exercised its right of first refusal under the lease agreement by providing notice to the Lessor that it proposes to purchase the property on the same terms and conditions as presented in the Offer. Avcorp has up to 270 days from the date of providing such notice to present and close a sale transaction with the Lessor. Avcorp is not committed to purchase the property and is currently evaluating its options with respect to the property.

### Transactions with Related Parties

During 2015 a performance guarantee was provided on production contracts with a certain customer by Panta Holdings B.V. whose wholly owned subsidiary, Panta Canada B.V., is Avcorp's majority shareholder owning approximately 65.5% of the issued and outstanding common shares on December 31, 2016. Both companies are incorporated in The Netherlands. Mr. Jaap Rosen Jacobson, a director of Avcorp is the sole shareholder of Panta Holding B.V. The performance guarantee was calculated as a percentage of revenues generated from production contracts with this certain customer. Accordingly, the fees varied with fluctuations in sales to this certain customer. Fees paid, in that respect, to Panta Holdings B.V. during the year ended December 31, 2016 amounted to $330,000 (December 31, 2015: $1,334,000). Fees payable to Panta Holdings B.V. as at December 31, 2016 are $Nil (December 31, 2015: $330,000). These fees are included in the Consolidated Statements of Loss and Comprehensive Loss as cost of sales and amount to $Nil for the year ended December 31, 2016 (December 31, 2015: $1,363,000). This performance guarantee was extinguished as at December 18, 2015.

During the year ended December 31, 2016, consulting services were provided by certain directors. Fees paid to certain directors, or companies with which they have beneficial ownership, during the year ended December 31, 2016 amounted to $337,000 (December 31, 2015: $395,000). Fees payable to certain directors or Companies with which they have beneficial ownership, as at December 31, 2016 are $376,000 (December 31, 2015: $12,000). These fees are included in the Consolidated Statements of Loss and Comprehensive Loss as administrative and general expenses and amount to $701,000 for the year ended December 31, 2016 (December 31, 2015: $387,000).

Key management includes Executive Officers for all operating facilities. The compensation paid or payable to key management for employee services is shown below.

**KEY MANAGEMENT COMPENSATION**

*(unaudited, expressed in thousands of Canadian dollars)*

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Salaries and other short-term employee benefits | **$2,186** | $3,252 |
| Contributions to defined contribution plan | **69** | 40 |
| Option-based awards | **1,332** | 912 |
| | **3,587** | 4,204 |

The balance of loans receivable from key management as at December 31, 2016 is $15,000 (December 31, 2015: $15,000). These loans are unsecured and payable on demand.

On September 19, 2016, Avcorp entered into a non-revolving term loan agreement ("loan") with Panta to fund the Company to a maximum aggregate principal amount of USD$5,000,000 due on April 7, 2017. The Company received its first advance on September 23, 2016 of USD$2,000,000 ($2,612,000). On October 25, 2016, Panta provided a second advance in the amount of USD$1,500,000 ($1,983,000) and a third advance on November 15, 2016 in the amount of USD$1,500,000 ($2,020,000).

The Company's acceptance of this loan was subject to a 3% commitment fee (USD$150,000) paid by the Company to Panta Canada B.V. from proceeds of the first advance.

In conjunction with receiving advances under the term loan, the Company issued Panta 30,714,118 common share purchase warrants ("warrants") on a pro-rata basis, each warrant is exercisable for a period of 24 months following the date of issuance with respect to one common share at an exercise price of $0.07 per common share. The Company issued 12,285,647 such warrants on September 19, 2016, 9,214,235 such warrants on October 24, 2016, and 9,214,236 such warrants on November 10, 2016. The warrants were valued at fair value on date of issue using the Black Scholes option pricing model.

On March 17, 2017, Avcorp entered into a loan agreement ("Loan") with Panta Canada B.V. ("Panta") bearing interest of 8% per annum to fund the Company to a maximum aggregate principal amount of USD$907,000 maturing on May 15, 2017. The Loan was drawn down in two tranches dated March 21, 2017 and March 27, 2017. The Loan was repaid on April 4, 2017 from the proceeds of the consideration receivable.

On April 7, 2017, a term loan entered into with Panta become due and payable for the principal amount of USD$5,000,000 and USD$187,000 of accrued and unpaid interest. As at that date the Company and Panta amended the term loan to provide for a maturity date which is the earlier of the date on which credit is available to be drawn by the Company under the Expanded Loan with a Canadian Chartered bank, and July 6, 2017, with interest continuing at 8% per year. The Company incurred a USD$100,000 amendment fee in this regard.

These transactions were conducted in the normal course of business and were accounted for at the exchange amount.

### Business Acquisition

Effective December 18, 2015, Avcorp completed the acquisition of Hitco (the "Acquisition"). The Acquisition was completed pursuant to the terms of an asset purchase agreement (the "Agreement") that was entered into on July 20, 2015, with subsequent amendments to December 18, 2015. Pursuant to the Agreement Avcorp's subsidiary, Avcorp Composite Fabrication Inc., purchased the assets of the division of Hitco which produces composite structural parts for commercial and military aerostructures (the "Business").

Through the Acquisition, Avcorp acquired the composite Aerostructures division of Hitco but did not acquire any assets of Hitco's materials division that is responsible for the production of specialty materials. The Acquisition included all of the assets, properties and rights held by Hitco related to the Business including:

- inventory, packaging materials, and consumables of the Business;
- fixed assets, equipment and tooling assets primarily used in the Business;
- accounts or notes receivable related to the Business;
- prepaid expenses and deposits primarily related to the Business;
- the intellectual property of the Business together with all of the goodwill associated with the intellectual property;
- the goodwill related to the Business, together with the exclusive right to hold Avcorp out as carrying on the Business in succession to Hitco;
- the right to use the name "Hitco Carbon Composites" or any variation thereof in connection with the Business; and
- several purchase contracts held by Hitco.

The Acquisition excluded any real property owned by Hitco and all assets of Hitco not related to the Business, including assets related to Hitco's business division that produces specialty materials.

Pursuant to the Agreement, Hitco and SGL are subject to a non-competition clause within the United States and a non-solicitation clause for a period of five years. As part of the Acquisition, Avcorp also leased certain real property owned by Hitco, which Avcorp will use to conduct the Business.

As a result of potential product quality and warranty claims, in addition to the liabilities assumed in the transaction, the Company may be involved in, or subject to, other disputes, claims and proceedings that arise in connection with the business acquired, including some that Avcorp asserts against others. The ultimate resolution of, and liability and costs related to these matters, at this time is undeterminable.

Pursuant to the asset purchase agreement, Hitco's direct and indirect parent companies have guaranteed certain of Hitco's obligations to Avcorp under the Agreement, including Hitco's indemnity obligations to Avcorp for Avcorp's losses stemming from product quality and warranty claims pertaining to finished goods delivered by Hitco before the closing date and certain finished goods manufactured by Hitco before the closing date that were designated as conforming inventory.

Included in the finalized unfavourable contract liability balance of $100,582,000 is an amount related to extraordinary inspection costs incurred by the Company in order to address certain product quality and warranty claims associated with non-conforming inventory discovered subsequent to the closing of the Acquisition. The extraordinary inspection costs have been recognized based on management's best estimate and there exists significant measurement uncertainty relating to potential future product quality and warranty claims. Although the ultimate result and timing of potential additional claims and the amounts at which they may be settled cannot be determined, management believes that there is a possibility that the costs that may be incurred to settle these claims to be material. Management intends to pursue recovery of the direct and incremental expenses incurred in relation to this matter.

Included in the finalized unfavourable contract liability balance is a provision for management's best estimate of the expected costs for the foregoing product quality and warranty claims however the Company has not disclosed the information usually required by IAS 37 Provisions, Contingent Liabilities and Contingent Assets on the grounds that it can be expected to prejudice seriously the outcome of possible litigation related to this matter.

Consideration provided by Avcorp for the Acquisition of the assets was principally the assumption of liabilities by Avcorp, including the current trade payables and ongoing contractual obligations of the Business.

As at the date of this report, no agreements to merge with or acquire another entity have been entered into.

### Fourth Quarter

The following summarizes unaudited financial results for the fourth quarter 2016.

Operating income for the fourth quarter of 2016 was $9,233,000 from $46,183,000 in revenues, as compared to operating loss of $5,796,000 from $22,776,000 in revenues for the quarter ended December 31, 2015. The Company expensed $1,317,000 of overhead costs during the fourth quarter 2016 (2015: $1,225,000) in respect of unutilized plant capacity. During the fourth quarter 2016, the Company incurred no additional expenditures related to the Hitco Aerospace division acquisition (Fourth Quarter 2015: $3,592,000). Included in the calculation of operating income for the fourth quarter 2016 is the amortization and contract renegotiation of the unfavourable contract liability of $13,658,000 into income (Fourth quarter 2015: $356,000).

During the fourth quarter 2016, the Company renegotiated the contractual period of performance for the most significant loss making contract reducing the delivery term by four years.

In the fourth quarter 2016, the Company announced that it has been awarded a long-term production contract with Subaru, a tier-one supplier to major OEMs of commercial and defence aircraft around the world. Production of complex composite structural components for Subaru that will be assembled for the Boeing 787 center wing box. Avcorp, which will produce the components from its Composite Fabrication facility located in Gardena, California, expects that production volumes will grow by as much as 50% over historical supply rates.

### Critical Accounting Estimates and Judgment

The preparation of consolidated financial statements in conformity with IFRS requires management to make estimates and judgments that affect the amounts which are reported in the consolidated financial statements during the reporting period. Estimates and other judgments are evaluated at each reporting date and are based on management's experience and other factors, including expectations about future events that are believed to be reasonable under the circumstances. The critical estimates and judgements utilized in preparing the Company's consolidated financial statements affect the assessment of net recoverable amounts, net realizable values and fair values, and the determination of functional currency of the Canadian operations of the group. Any changes in estimates and assumptions could have a material impact on the assets and liabilities at the date of the statement of financial position. The Company reviews its estimates and assumptions on an ongoing basis and uses the most current information available and exercises careful judgement in making these estimates and assumptions.

- Functional currency: The functional currency for the Company and its subsidiaries is the currency of the primary economic environment in which each operates. The Company has determined that the functional currency for the Company and all its subsidiaries except for Avcorp US Holdings Inc. and Avcorp Composite Fabrication Inc. is the Canadian dollar. The functional currency for Avcorp US Holdings Inc. and Avcorp Composite Fabrication Inc. is the US dollar. The determination of functional currency may require certain judgements to determine the primary economic environment. The Company reconsiders the functional currency used when there is a change in events and conditions which determined the primary economic environment.
- Impairments: The recoverable amount of intangible assets, development costs and property, plant and equipment is based on estimates and assumptions regarding the expected market outlook and cash flows from each CGU or group of CGUs. In order to estimate the fair value of indefinite-lived intangible assets and goodwill resulting from business combinations, the Company typically estimates future revenue, considers market factors and estimates future cash flows. Based on these key assumptions, judgments and estimates, the Company determines whether to record an impairment charge to reduce the value of the asset carried on the consolidated statement of financial position to its estimated fair value. Assumptions, judgments and estimates about future values are complex and often subjective. They can be affected by a variety of factors, including external factors such as industry and economic trends, and internal factors such as changes in the Company's business strategy or internal forecasts. Although the Company believes the assumptions, judgments and estimates made in the past have been reasonable and appropriate, different assumptions, judgments and estimates could materially affect the Company's reported financial results.
- Going Concern: Management assesses the Company's ability to continue as a going concern at each reporting date, using all quantitative and qualitative information available. This assessment, by its nature, relies on estimates of future cash flows and other future events, whose subsequent changes would materially impact the validity of such an assessment.

- Capitalization of development costs: When capitalizing development costs the Company must assess the technical and commercial feasibility of the projects and estimate the useful lives of resulting products. Determining whether future economic benefits will flow from the assets and therefore the estimates and assumptions associated with these calculations are instrumental in (i) deciding whether project costs can be capitalized, and (ii) accurately calculating the useful life of the projects for the Company.
- Unfavorable contracts liability: At the acquisition date valued the unfavorable contracts liability at fair value using certain assumptions that would arise in a market participant view. The Company estimates the expected shipsets or production when assessing the liability, together with the discounts rate and period of performance under the varying contracts and service agreements. The cash flows are discounted over the period of performance using a discount rate commensurate with the risk associated with the liability.
- Fair value of assets and liabilities acquired in a business combination: The Company accounted for the acquisition of ACF using the acquisition method when control is transferred to the Company. The consideration received is generally measured at fair value, as are the identifiable net liabilities assumed. The fair value of the liabilities assumed is determined using valuation techniques that require estimation of the estimated cash flows, discount rates and estimated operating margins.
- Inventories are valued at the lower of cost and net realizable value. The costs of inventory involve estimates in determining the allocation of fixed and variable production overhead. These estimates involved include determination of normal production capacity and nature of expenses to be allocated. Additionally inventory is reviewed monthly to ensure the carrying value does not exceed net realizable value. If so, a write-down is recognized. The write-down may be reversed if the circumstances which caused it no longer exist.

## Financial Instruments and Other Instruments

### Market Risk

Market risk is the risk that changes in the market prices, such as foreign exchange rates and interest rates, will affect the Company’s income or the value of its holdings of financial instruments. The Company’s policy is not to utilize derivative financial instruments for trading or speculative purposes. The Company may utilize derivative instruments in the management of its foreign currency and interest rate exposures.

### Currency Risk

Currency risk arises because the amount of the local currency receivable or payable for transactions denominated in foreign currencies may vary due to changes in exchange rate (“transaction exposures”) and because the non-Canadian dollar denominated financial statements of the Company’s subsidiaries may vary on consolidation into the reporting currency of Canadian dollars (“translation exposures”).

The Company sells a significant proportion of its products in US dollars at prices which are often established well in advance of manufacture and shipment dates. In addition, the Company purchases a significant proportion of its raw materials and components in US dollars at prices that are usually established at the order date. The Company’s operations are based in Canada and in the US. As a result of this, the Company is exposed to currency risk to the extent that fluctuations in exchange rates are experienced. The amount of foreign exchange gain recorded in 2016 was $717,000 as compared to a $323,000 gain for the year ended December 31, 2015 as restated.

The Company had the following US dollar denominated balances:

**CURRENCY RISK**

*(unaudited, expressed in thousands of US dollars)*

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Bank cash position | **US$1,205** | US$6,007 |
| Accounts receivable | **15,123** | 16,629 |
| Consideration receivable | **9,124** | 28,458 |
| Accounts payable net of prepayments | **1,574** | 1,557 |
| Customer advance | **8,619** | 13,387 |
| Bank indebtedness | **4,250** | - |
| Term debt | **4,560** | - |

With other variables unchanged, each $0.10 strengthening (weakening) of the US dollar against the Canadian dollar would result in an increase (decrease) of approximately $645,000 in net income for the year ended December 31, 2016 (December 31, 2015: $3,615,000 increase (decrease) in net income) as a result of holding a US dollar net asset position.

### Credit Risk

Credit risk is the risk of a financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligation. The Company manages credit risk for trade and other receivables through a financial review of the credit worthiness of the prospective customer along with credit monitoring activities. The majority of the Company's trade receivables reside with Boeing Commercial Airplane Group ("Boeing"), Boeing Defense, Space & Security ("BDS"), Bombardier Aerospace ("Bombardier"), BAE Systems (Operations) Limited ("BAE"), Lockheed Martin ("LM"), and Subaru Corporation ("Subaru") (formerly Fuji Heavy Industries Ltd.). The maximum exposure to credit risk is represented by the amount of accounts receivable in the consolidated statements of financial position.

As at the consolidated statements of financial position date 69.8% (December 31, 2015: 69.5%) of the Company's trade accounts receivable are attributable to these customers.

The Company is exposed to credit risk if counterparties to our trade receivables are unable to meet their obligations. The concentration of credit risk from our customers is minimized because the Company have an original equipment manufacturer and tier one aerospace customer base as at December 31, 2016. The customers are predominately large, well-capitalized, and long established entities with a low risk of non-payment. The Company regularly monitors our credit risk and credit exposure.

Consideration receivable arising from a 2015 business acquisition is guaranteed by the seller and a Canadian chartered bank.

### Liquidity Risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company seeks to manage liquidity risk through the management of its capital structure and financial leverage.

Accounts payable and accrued liabilities are all due within the next twelve months.

The Company's operating line of credit is due on demand.

### Interest Rate Risk

The Company is exposed to interest rate risk on the utilized portion of its operating line of credit at rates of bank prime plus 0.5%. The maximum operating line of credit availability is $21,000,000 of which $17,111,000 is utilized as at December 31, 2016 (December 31, 2015: $Nil). The Company lowers interest rate costs by managing utilization of the operating lines of credit to the lowest amount practical. For the year ended December 31, 2016, with other variables unchanged, a 1% change in the bank prime interest rate would have a $171,000 (December 31, 2015: $Nil) impact on net earnings and cash flow.

The Company primarily finances the purchase of long-lived assets at fixed interest rates.

### Capital Risk

The Company's objectives when managing capital are to safeguard its ability to continue as a going concern and to provide an adequate return to shareholders, while satisfying other stakeholders.

The Company includes long-term debt, preferred shares and capital stock in its definition of capital, as shown in the Company's consolidated statements of financial position.

The Company's primary objective in its management of capital is to ensure that it has sufficient financial resources to fund ongoing operations and new program investment. In order to secure this capital the Company may attempt to raise funds via issuance of debt and equity, or by securing strategic partners.

## Other Items

### Internal Controls over Financial Reporting

The CEO and the Chief Financial Officer ("CFO") have designed, or caused to be designed under their supervision, the Company's internal controls over financial reporting ("ICFR") in order to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with International Financial Reporting Standards ("IFRS").

The CEO and CFO have evaluated the effectiveness of the Company's ICFR as at December 31, 2016 based on Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). During the course of this review, the CEO and CFO determined that there were material weaknesses in the Company's ICFR related to the accounting for the complex accounting transaction arising from the 2015 Hitco acquisition and the related tax complexities and issues that may result in inaccuracies in financial reporting. Management mitigated these weaknesses by utilizing outside consultants for assistance, by developing in-house expertise and/or by recruiting personnel with the necessary expertise; however, such mitigating procedures did not constitute a compensating control for the purposes of National Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings. Based on the review of the Company's ICFR, the CEO and CFO determined that there was a reasonable possibility that the above deficiencies could have resulted in a material misstatement not being prevented or detected on a timely basis and therefore concluded they were material weaknesses.

To remediate the foregoing specific issue for future reporting periods, the Company has undertaken to engage additional, qualified financial reporting expertise to assist with this complex accounting matter, as well as developed the expertise of in-house staff ensuring that the Company's tax accounting resources, processes and controls are designed and operating effectively.

### Disclosure Controls and Procedures ("DCP")

For the year ended December 31, 2016, the CEO and the CFO have designed, or caused to be designed under their supervision, the Company's DCP to provide reasonable assurance that material information relating to the Company and its consolidated subsidiaries has been recorded, processed, summarized and disclosed in a timely manner in accordance with regulatory requirements and good business practices and that the Company's DCP will enable the Company to meet its ongoing disclosure requirements.

As described above, the Company has determined that there was a material weakness in the design of its ICFR. As a result, the CEO and CFO have determined that, as a result, for the same reasons, the Company's DCP were also ineffective for this specific issue as at December 31, 2016. This issue has been remediated as described above.

### Limitation of Controls and Procedures

The Company's CEO and CFO, believe that any DCP and ICFR, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, they cannot provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been prevented or detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by unauthorized override to the control. The design of any control system also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any control system will succeed in achieving its stated goals under all potential future conditions. Accordingly, because of the inherent limitations in a cost effective, control system, misstatements due to error or fraud may occur and not be detected.

### Changes to DCP and ICFR

The Company is required to disclose herein any change in the Company's internal control over financial reporting that occurred during the period beginning January 1, 2016 and ended on December 31, 2016 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting. No material changes in the Corporation's internal control over financial reporting were identified during such period that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

### Forward Looking Statements

This management discussion and analysis should be read in conjunction with the Company's audited consolidated financial statements. Certain statements in this report and other oral and written statements made by the Company from time to time are forward-looking statements, including those that discuss strategies, goals, outlook or other non-historical matters; or projected revenues, income, returns or other financial measures. These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from those contained in the statements, including the following: (a) the ability of the Company to renegotiate its debt agreements under which it is in default; (b) the extent to which the Company is able to achieve savings from its restructuring plans; (c) uncertainty in estimating the amount and timing of restructuring charges and related costs; (d) changes in worldwide economic and political conditions that impact interest and foreign exchange rates; (e) the occurrence of work stoppages and strikes at key facilities of the Company or the Company's customers or suppliers; (f) government funding and program approvals affecting products being developed or sold under government programs; (g) cost and delivery performance under various program and development contracts; (h) the adequacy of cost estimates for various customer care programs including servicing warranties; (i) the ability to control costs and successful implementation of various cost reduction programs; (j) the timing of certifications of new aircraft products; (k) the occurrence of further downturns in customer markets to which the Company products are sold or supplied or where the Company offers financing; (l) changes in aircraft delivery schedules, cancellation of orders or changes in production scheduling; (m) the Company's ability to offset, through cost reductions, raw material price increases and pricing pressure brought by original equipment manufacturer customers; (n) the availability and cost of insurance; (o) the Company's ability to maintain portfolio credit quality; (p) the Company's access to debt financing at competitive rates; and (q) uncertainty in estimating contingent liabilities and establishing reserves tailored to address such contingencies.

# report of **management**

The accompanying consolidated financial statements of Avcorp Industries Inc. and all other information contained in the Management Discussion and Analysis are the responsibility of management. The consolidated financial statements were prepared in conformity with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") appropriate in the circumstances, in a manner consistent with the previous year, and include some amounts based on management's best judgments and estimates. The financial information contained elsewhere in this Management Discussion and Analysis is consistent with that in the consolidated financial statements.

Management is responsible for maintaining a system of internal accounting controls and procedures to provide reasonable assurance. As at the end of the period covered by this report, management identified material weaknesses as described in the Management Discussion and Analysis under the heading "Other Items". During the period covered by this report, there has been no change in internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

| | | | |
|---|---|---|---|
|  | **EDWARD MERLO**<br>Chief Financial Officer and Corporate Secretary |  | **PETER GEORGE**<br>Executive Officer and Group Chief Executive Officer |

# Independent Auditor's Report

June 29, 2017

To the Shareholders of
Avcorp Industries Inc.

We have audited the accompanying consolidated financial statements of Avcorp Industries Inc., which comprise the consolidated statement of financial position as at December 31, 2016, and the consolidated statements of loss and comprehensive loss, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

**Management's Responsibility for the Consolidated Financial Statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

**Auditor's Responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audit is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Avcorp Industries Inc. as at December 31, 2016, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

**Restated Comparative Information**

The consolidated financial statements of Avcorp Industries Inc. for the year ended December 31, 2015 (prior to the restatement of the comparative information described in Note 32 to the consolidated financial statements) were audited by another auditor who expressed an unmodified opinion on those statements on April 11, 2016.

As part of our audit of the consolidated financial statements of Avcorp Industries Inc. for the year ended December 31, 2016, we also audited the adjustments described in Note 32 that were applied to restate the consolidated financial statements for the year ended December 31, 2015. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the consolidated financial statements of Avcorp Industries Inc. for the year ended December 31, 2015 other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance on the consolidated financial statements for the year ended December 31, 2015 taken as a whole.

**Emphasis of Matter**

Without qualifying our opinion, we draw attention to Note 1 to the consolidated financial statements, which indicates that as of December 31, 2016, the Company had a shareholders' deficiency of $6,883,000 and an accumulated deficit of $93,791,000 and for the year ended December 31, 2016, the Company had a consolidated net loss of $15,964,000 and negative cash flows from operations of $50,347,000. These conditions, along with other matters as set forth in Note 1, indicate the existence of material uncertainties that may cast significant doubt about the Company's ability to continue as a going concern.

*/s/ Deloitte LLP*
Chartered Professional Accountants

June 29, 2017
Vancouver, Canada

## CONSOLIDATED STATEMENTS OF FINANCIAL POSITION

*(expressed in thousands of Canadian dollars)*

| AS AT DECEMBER 31 | 2016 | 2015 restated (note 32) |
|---|---|---|
| **ASSETS** | | |
| **Current assets** | | |
| Cash (note 15) | **$3,960** | $14,484 |
| Accounts receivable (note 9) | **26,262** | 30,124 |
| Consideration receivable (note 10) | **12,251** | 26,624 |
| Inventories (note 11) | **44,259** | 35,502 |
| Prepayments and other assets (note 20) | **4,144** | 1,563 |
| | **90,876** | 108,297 |
| **Non-current assets** | | |
| Prepaid rent and security (note 20) | **146** | 449 |
| Consideration receivable (note 10) | **-** | 12,096 |
| Development costs (note 12) | **5,200** | 3,187 |
| Property, plant and equipment (note 13) | **31,930** | 29,640 |
| Intangibles (note 14) | **4,887** | 6,422 |
| **Total assets** | **133,039** | 160,091 |
| **LIABILITIES AND EQUITY** | | |
| **Current liabilities** | | |
| Bank indebtedness (note 15) | **17,111** | - |
| Accounts payable and accrued liabilities (note 17) | **32,122** | 28,107 |
| Current portion of term debt (note 21) | **6,283** | 240 |
| Customer advance (note 16) | **8,034** | 8,282 |
| Deferred program revenues (note 18) | **13,861** | 4,924 |
| Unfavourable contracts liability (note 19) | **18,904** | 35,782 |
| | **96,315** | 77,335 |
| **Non-current liabilities** | | |
| Deferred gain and lease inducement (note 20) | **246** | 391 |
| Term debt (note 21) | **1,646** | 1,646 |
| Customer advance (note 16) | **3,539** | 10,246 |
| Unfavourable contracts liability (note 19) | **38,065** | 63,689 |
| Deferred program revenues (note 18) | **111** | - |
| | **139,922** | 153,307 |
| **(Deficiency) Equity** | | |
| Capital stock (note 23) | **80,302** | 80,158 |
| Contributed surplus (note 23d) | **6,744** | 4,453 |
| Accumulated other comprehensive loss | **(138)** | - |
| Accumulated deficit | **(93,791)** | (77,827) |
| | **(6,883)** | 6,784 |
| **Total liabilities and (deficiency) equity** | **133,039** | 160,091 |

Nature of operations and going concern (note 1)
Subsequent events (note 33)

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

**Approved by the Board of Directors on June 29, 2017**

David Levi
Chairman

Eric Kohn TD
Committee Chair, Audit & Corporate Governance Committee

## CONSOLIDATED STATEMENTS OF LOSS AND COMPREHENSIVE LOSS

*(expressed in thousands of Canadian dollars, except number of shares and per share amounts)*

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 restated (note 32) |
|---|---|---|
| **Revenues** (notes 19 and 31) | **$183,707** | $80,416 |
| **Cost of sales** (note 5) | **175,333** | 72,279 |
| **Gross profit** | **8,374** | 8,137 |
| Administrative and general expenses (note 5) | **24,429** | 19,278 |
| Office equipment depreciation (note 5) | **350** | 482 |
| **Operating Loss** | **(16,405)** | (11,623) |
| Finance costs – net (note 26) | **339** | 856 |
| Foreign exchange (gain) (note 7) | **(717)** | (323) |
| Net (gain) on sale of equipment | **(63)** | (2) |
| **Loss before income tax** | **(15,964)** | (12,154) |
| Income tax expense (note 28) | **-** | - |
| **Net loss for the year** | **(15,964)** | (12,154) |
| Other comprehensive loss | **(138)** | - |
| **Net loss and total comprehensive loss for the year** | **(16,102)** | (12,154) |
| **Loss per share:** | | |
| Basic and diluted loss per common share (note 30) | **(0.05)** | (0.04) |
| Basic and diluted weighted average number of shares outstanding (000's) (note 30) | **306,611** | 302,889 |

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

## CONSOLIDATED STATEMENTS OF CASH FLOWS

*(expressed in thousands of Canadian dollars)*

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 restated (note 32) |
|---|---|---|
| **Cash flows from (used in) operating activities** | | |
| Net loss for the year | **$(15,964)** | $(12,154) |
| Adjustment for items not affecting cash: | | |
| Interest expense | **322** | 210 |
| Depreciation | **3,915** | 1,680 |
| Development cost amortization | **604** | 1,521 |
| Intangible assets amortization | **1,325** | - |
| Non-cash financing cost accretion | **31** | 485 |
| Gain on disposal of equipment | **(15)** | - |
| Provision for unfavourable contracts | **(38,937)** | (356) |
| Provision for loss-making contracts | **(77)** | (77) |
| Provision for doubtful accounts | **189** | - |
| Provision for obsolete inventory | **(8,653)** | 245 |
| Stock based compensation | **1,158** | 930 |
| Unrealized foreign exchange | **(2,860)** | (461) |
| Other items | **(129)** | (124) |
| Cash flows (used in) operating activities before changes in non-cash working capital | **(59,091)** | (8,101) |
| Changes in non-cash working capital | | |
| Accounts receivable | **7,129** | (6,063) |
| Inventories | **(614)** | (2,902) |
| Prepayments and other assets | **(4,297)** | (135) |
| Prepaid security | **303** | (301) |
| Accounts payable and accrued liabilities | **6,705** | 1,347 |
| Customer advance payable | **(6,955)** | (425) |
| Deferred program revenues | **6,473** | (2,963) |
| **Net cash (used in) operating activities** | **(50,347)** | (19,543) |
| **Cash flows from (used in) investing activities** | | |
| Cash received upon business acquisition | **-** | 32,826 |
| Proceeds from consideration receivable | **22,429** | - |
| Proceeds from sale of equipment | **60** | - |
| Purchase of equipment | **(5,129)** | (959) |
| Payments relating to development costs and tooling | **(2,617)** | (1,405) |
| **Net cash from (used in) investing activities** | **14,743** | 30,462 |
| **Cash flows from (used in) financing activities** | | |
| Increase in bank indebtedness | **17,111** | - |
| Payment of interest | **(184)** | (169) |
| Proceeds from term debt | **6,727** | 5,882 |
| Proceeds from issuance of common shares | **113** | 146 |
| Repayment of term debt | **(240)** | (5,391) |
| **Net cash from financing activities** | **23,527** | 468 |
| **Net (decrease) increase in cash** | **(12,077)** | 11,387 |
| **Net foreign exchange difference** | **1,553** | (62) |
| **Cash - Beginning of the year** | **14,484** | 3,159 |
| **Cash - End of the year** | **3,960** | 14,484 |

Supplementary Cash Flow Information (note 27)

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

## CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

*(expressed in thousands of Canadian dollars, except number of shares)*

| | Capital Stock | | | | | |
|---|---|---|---|---|---|---|
| | **Number of Shares** | **Amount** | **Contributed Surplus** | **Deficit** | **Accumulated Other Comprehensive Income** | **Total Equity (Deficiency)** |
| Balance December 31, 2014 | 302,633,184 | $79,921 | $3,129 | $(65,673) | $ - | $17,377 |
| Issue of common shares (note 23b) | 2,922,000 | 146 | - | - | - | 146 |
| Stock based compensation expense (note 24) | - | - | 930 | - | - | 930 |
| Transfer to share capital on exercise of stock options | - | 91 | (91) | - | - | - |
| Fair value of warrants issued (note 21b) | - | - | 485 | - | - | 485 |
| Net loss for the year – restated (note 32) | - | - | - | (12,154) | - | (12,154) |
| Balance December 31, 2015 – restated (note 32) | 305,555,184 | 80,158 | 4,453 | (77,827) | - | 6,784 |
| Issue of Common Shares (note 23a) | 1,586,000 | 113 | - | - | - | 113 |
| Stock-based compensation expense (note 24) | - | - | 1,578 | - | - | 1,578 |
| Forfeiture of issued stock options | - | - | (420) | - | - | (420) |
| Transfer to share capital on exercise of stock options | - | 31 | (31) | - | - | - |
| Fair value of warrants issued (note 21b) | - | - | 1,164 | - | - | 1,164 |
| Unrealized currency gain on translation for the year | - | - | - | - | (138) | (138) |
| Net loss for the year | - | - | - | (15,964) | - | (15,964) |
| **Balance December 31, 2016** | **307,141,184** | **80,302** | **6,744** | **(93,791)** | **(138)** | **(6,883)** |

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

## 1. Nature of Operations and Going Concern

Avcorp Industries Inc. (the "Company" or "Avcorp") is a Canadian-based manufacturer within the aerospace industry, and a single source supplier for engineering design, manufacture and assembly of subassemblies and complete major structures for aircraft manufacturers.

The Company currently operates from two locations in Canada and one location in the United States. Located in Delta, British Columbia, Avcorp Industries Inc., named as Avcorp Structures & Integration ("ASI"), is dedicated to metallic and composite aerostructures assembly and integration. Within Comtek Advanced Structures Ltd. ("Comtek") located in Burlington, Ontario, exists two named divisions: Comtek, dedicated to aircraft structural component repair services, and Avcorp Engineered Composites ("AEC") dedicated to design and manufacture of composite aerostructures. Located in Gardena, California, Avcorp Composite Fabrication Inc. ("ACF") is dedicated to advanced composite aerostructures fabrication.

Avcorp Composite Fabrication Inc. is wholly owned by Avcorp US Holdings Inc. Both companies are incorporated in the State of Delaware and are wholly owned subsidiaries of Avcorp Industries Inc.

Comtek Advanced Structures Ltd., incorporated in the Province of Ontario is a wholly owned subsidiary of Avcorp Industries Inc.

The Company's governing corporate statute is the Canada Business Corporations Act (the "CBCA").

The consolidated financial statements of the Company for the year ended December 31, 2016 were authorized for issue in accordance with a resolution of its Board of Directors on June 29, 2017.

During the year ended December 31, 2016, the Company incurred a net loss of $15,964,000 (December 31, 2015: $12,154,000), had negative operating cash flows of $50,347,000 (December 31, 2015: $19,543,000) and a shareholders' deficiency of $6,883,000 as of December 31, 2016. Management assesses the Company's ability to continue as a going concern at each reporting date, using all quantitative and qualitative information available. Material uncertainties have been identified which may cast significant doubt upon the Company's ability to continue as a going concern. This assessment, by its nature, relies on estimates of future cash flows and other future events, whose subsequent changes would materially impact the validity of such an assessment.

The Company's ability to continue as a going concern is dependent upon its ability to continue to raise adequate financing and achieve significant improvements in operating results in the future. In assessing whether the going concern assumption was appropriate, management took into account all relevant information available about the future, which was at least, but not limited to, the 12 month period from the date of this report. The Company, in conjunction with its Board of Directors' Finance Sub-Committee, is currently implementing various financing strategies which include:

- On May 26, 2017, the Company entered into a loan agreement to expand its loan facility with a Canadian Chartered bank ("the Expanded Loan"). This loan agreement amends, restates and replaces the loan agreement entered into on September 27, 2012 (note 15). The Expanded Loan provides an additional borrowing capacity of up to USD$35,000,000 increasing its existing, as at March 31, 2017, USD$23,000,000 revolving loan (note 33c) in total up to USD$58,000,000. The Expanded Loan matures on June 30, 2020.
- As demonstrated throughout the year ended December 31, 2016 and the first quarter of fiscal 2017 the Company has worked closely with Panta Canada B.V., its parent company, to provide short term financing to meet peak financing needs.

The Company, in conjunction with is Board of Directors' Finance Sub-Committee, is also implementing various operational strategies which include:

- Operating and warranty issues at ACF have been the largest cause of the Company's 2016 losses. Technical quality issues which were discovered by the Company soon after the Hitco acquisition created additional compliance costs during 2016. Management has resolved these technical quality issues such that they will not re-occur in 2017 and going forward. Furthermore, the Company has received notification from its customers that these quality issues have been appropriately resolved. All personnel resources and support service provider costs incurred during 2016 as a result of these issues have been terminated. The significant product scrap and re-work costs have been processed and expensed and one-time expenditures for equipment recalibration and performing backlogged maintenance have been completed in 2016.

- Numerous process improvements initiatives, restructuring activities and supplier contract renegotiations have significantly reduced production costs on a go forward basis. These cost reduction initiatives have included significant headcount reductions the latest of which was announced in April 2017.
- Contract renegotiations with customers and new customer contracts have reduced certain unfavourable contract obligations and provided improved contract terms on a go forward basis.

Management believes that based on the Expanded Loan, and various operating and contract improvements which have been implemented, the Company will be in a position to meet its obligations as they come due.

The assessment of the Company's ability to execute its strategy of reducing operating costs and funding future working capital requirements involves significant judgement. Estimates and assumptions regarding future operating costs, revenue and profitability levels and general business and customer conditions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. After taking into account the above factors, management believes that they have adequate resources to meet the Company's obligations for the foreseeable future.

## 2. Basis of Preparation and Measurement

The consolidated financial statements of the Company have been prepared in accordance with International Financial Reporting Standards ("IFRS").

The consolidated financial statements have been prepared on a historical cost basis. The consolidated financial statements are presented in Canadian dollars and all values are rounded to the nearest thousand (000), except where otherwise indicated.

## 3. Summary of Significant Accounting Policies

The significant accounting policies used in the preparation of these consolidated financial statements are described below. These policies have been consistently applied to all periods presented, unless otherwise stated.

### Basis of consolidation

The financial statements of the Company consolidate the accounts of Avcorp Industries Inc. and its subsidiaries Comtek Advanced Structures Ltd., Avcorp US Holdings Inc., and Avcorp Composite Fabrication Inc. (the "Group"). All material intercompany transactions, balances and unrealized gains and losses from intercompany transactions are eliminated on consolidation.

The consolidated financial statements comprise the financial statements of the Group and its subsidiaries as at December 31, 2016. Control is achieved when the Group is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Specifically, the Group controls an investee if, and only if, the Group has:

- Power over the investee (i.e. existing rights that give it the current ability to direct the relevant activities of the investee);
- Exposure, or rights, to variable returns from its involvement with the investee; and
- The ability to use its power over the investee to affect its returns.

Generally, there is a presumption that a majority of voting rights result in control. Consolidation of a subsidiary begins when the Group obtains control over the subsidiary and ceases when the Group loses control of the subsidiary. Assets, liabilities, income and expenses of a subsidiary acquired or disposed of during the year are included in the consolidated financial statements from the date the Group gains control until the date the Group ceases to control the subsidiary.

When necessary, adjustments are made to the financial statements of subsidiaries to bring their accounting policies into line with the Group's accounting policies. All intra-group assets and liabilities, equity, income, expenses and cash flows relating to transactions between members of the Group are eliminated in full on consolidation.

### Business combinations

Business combinations are accounted for using the acquisition method. The cost of an acquisition is measured as the aggregate of the consideration transferred, which is measured at acquisition date fair value. Acquisition-related costs are expensed as incurred and included in administrative expenses.

### Foreign currency translation

- Functional and presentation currency: Foreign currency items included in the consolidated financial statements of each consolidated entity in the Avcorp Industries Inc. group are measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). The consolidated financial statements are presented in Canadian dollars, which is the Company's functional currency. The functional currency of the Company's subsidiary, Comtek, is also determined to be Canadian dollars. The functional currency of the Company's subsidiary, Avcorp US Holdings Inc., and ACF is determined to be US dollars.
- On consolidation, the assets and liabilities of foreign operations are translated into Canadian dollars at the rate of exchange prevailing at the reporting date and their consolidated statement of income are translated at average exchange rates prevailing during the period. The exchange differences arising on translation for consolidation are recognized in other comprehensive income ("OCI"). On disposal of a foreign operation, the component of OCI relating to that particular foreign operation is reclassified to consolidated income.
- Any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition are treated as assets and liabilities of the foreign operation and translated at the spot rate of exchange at the reporting date.
- Transactions and balances: Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Generally, foreign exchange gains and losses resulting from the settlement of foreign currency transactions and from the translation at period-end exchange rates of monetary assets and liabilities denominated in currencies other than an operation's functional currency are recognized in the consolidated statement of income.

### Fair value measurement

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. When determining fair value measurements for assets and liabilities required to be recorded at fair value, the Company considers the principal or most advantageous market in which it would transact and also considers assumptions that market participants would use when pricing an asset or liability. The fair value hierarchy has three levels of inputs that may be used to measure fair value: Level 1—Unadjusted quoted prices in active markets for identical assets or liabilities; Level 2—Unadjusted quoted prices in active markets for similar assets or liabilities, or unadjusted quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability; and Level 3—Unobservable inputs for the asset or liability. The Company has not applied fair value measurements to any of its financial instruments.

### Financial instruments

a) Financial assets

Financial assets include, in particular, cash and cash equivalents, accounts receivables, other assets and consideration receivable.

Financial assets are recognized at the contract date and initially measured in accordance with IAS 39, Financial Instruments: Recognition and Measurement. The measurement of financial assets subsequent to initial recognition depends on whether the financial instrument is held for trading, held-to-maturity, available-for-sale, or whether it falls in the loans and receivables category. The assignment of an asset to a measurement category is performed at the time of acquisition and is primarily determined by the purpose for which the financial asset is held.

Held for trading instruments are held at fair value. Changes in fair value are included in the consolidated statement of loss unless the instrument is included in a cash flow hedge. If the instruments are included in a cash flow hedging relationships, which are effective, changes in value are taken to equity. When the hedged forecast transaction occurs, amounts previously recorded in equity are recognized in the statement of loss. The Company has no such financial instruments.

Held-to-maturity instruments are measured at amortized cost using the effective interest method.

Available-for-sale assets are held at fair value. Changes in fair value arising from changes in exchange rates are included in the statement of loss. All other changes in fair value are taken to equity. On disposal, the accumulated changes in value recorded in equity are included in the gain or loss recorded in the statement of loss. The Company has no such financial instruments.

Loans and receivables are held at amortized cost and not revalued (except for changes in exchange rates which are included in the statement of loss) unless they are included in a fair value hedge accounting relationship. Where such a relationship exists, the instruments are revalued in respect of the risk being hedged. If instruments held at amortized cost are hedged, generally by interest rate swaps, and the hedges are effective, the carrying values are adjusted for changes in fair value, which are included in the statement of loss. The Company's financial assets in this category are: cash and cash equivalents, accounts receivables, consideration receivable and other assets.

At each statement of financial position date, the carrying amounts of financial assets that are not measured at fair value through profit or loss are assessed to determine whether there is any substantial objective indication of impairment. The amount of impairment loss is recognized in the statement of loss. If impairment is indicated for available-for-sale financial assets, the amounts previously recognized in equity are eliminated from other comprehensive income up to the amount of the assessed impairment loss and recognized in the consolidated statement of loss.

b) De-recognition of financial assets

Transfers of receivables in securitization transactions are recognized as sales when the contractual right to receive cash flows from the assets has expired; or when the Company has transferred its contractual right to receive the cash flows of the financial assets, and either: substantially all the risks and rewards of ownership have been transferred; or the Company has neither retained nor transferred substantially all the risks and rewards, but has not retained control.

c) Financial liabilities

Financial liabilities often entitle the holder to return the instrument to the issuer in return for cash or another financial asset. These include, in particular, bank indebtedness, accounts payables, finance lease liabilities and term debt.

Financial liabilities are measured at their fair value at the time of acquisition, which is normally equivalent to the net loan proceeds. Transaction costs directly attributable to the acquisition are deducted from the amount of all financial liabilities that are not measured at fair value through profit or loss subsequent to initial recognition. If a financial liability is interest free or bears interest at below the market rate, it is recognized at an amount below the settlement price or nominal value. The financial liability initially recognized at fair value is amortized subsequent to initial recognition using the effective interest method.

## Inventories

Inventories are stated at the lower of cost and net realizable value. Cost for procured materials is determined using an average cost method. The cost of finished goods and work-in-progress comprises raw materials, direct labour, other direct costs and related production overheads (based on normal operating capacity) including applicable depreciation on property, plant and equipment and amortization of intangible assets. Net realizable value is the estimated selling price less applicable selling expenses.

## Property, plant and equipment

Property, plant and equipment are stated at cost less accumulated depreciation and accumulated impairment losses. Cost includes expenditures that are directly attributable to the acquisition of the asset. Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost can be measured reliably. The carrying amount of a replaced asset is derecognized when replaced. Repairs and maintenance costs are charged to the consolidated statement of income during the period in which they are incurred.

An estimation is made of the useful life of property, plant and equipment. The useful life is measured in terms of years of production, and depreciated on a straight line basis.

| | |
|---|---|
| Computer hardware and software | 2 - 10 years |
| Machinery and equipment | 5 - 15 years |
| Leasehold improvements | end of leases up to 2020 |

The Company allocates the amount initially recognized in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part. The useful lives of the assets are reviewed annually and adjusted if appropriate. The amortization expense in property, plant and equipment is recognized in the statement of profit or loss in the expense category that is consistent with the function of the property, plant and equipment.

### Intangible Assets

Intangible assets acquired separately are measured on initial recognition at cost. The cost of intangible assets acquired in a business combination is their fair value at the date of acquisition. Following initial recognition, intangible assets are carried at cost less any accumulated amortization and accumulated impairment losses. Internally generated intangibles, excluding capitalized development costs, are not capitalized and the related expenditure is reflected in profit or loss in the period in which the expenditure is incurred.

Intangible assets with finite lives are amortized over the useful economic life and assessed for impairment whenever there is an indication that the intangible asset may be impaired. The amortization period and the amortization method for an intangible asset with a finite useful life are reviewed at least at the end of each reporting period. Changes in the expected useful life or the expected pattern of consumption of future economic benefits embodied in the asset are considered to modify the amortization period or method, as appropriate, and are treated as changes in accounting estimates. The amortization expense on intangible assets with finite lives is recognized in the statement of profit or loss in the expense category that is consistent with the function of the intangible assets.

### Research and development costs

Research costs are expensed as incurred. Development costs, which are currently all tooling and new program introduction costs incurred on long-term programs that meet the criteria for deferral, are capitalized and amortized straight-line over the number of shipsets management believes is a reasonable estimate of units to be sold for the program.

### Segment Reporting

Management has determined the operating segments based on information regularly reviewed for the purposes of decision making, allocating resources and assessing performance by the Company's chief operating decision maker; the Chief Executive Officer (CEO). The Company evaluates the financial performance of its operating segments primarily based on operating income or loss.

### Impairment of non-financial assets

The Company assesses, at each reporting date, whether there is an indication that an asset may be impaired. If any indication exists, or when annual impairment testing for an asset is required, the Company estimates the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash generating unit's ("CGU") fair value less costs of disposal and its value in use. The Company's CGUs are ASI, Comtek, and ACF. The recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. When the carrying amount of an asset or CGU exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount.

In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. In determining fair value less costs of disposal, recent market transactions are taken into account. If no such transactions can be identified, an appropriate valuation model is used. These calculations are corroborated by valuation multiples, quoted share prices for publicly traded companies or other available fair value indicators.

The Company bases its impairment calculation on detailed budgets and forecast calculations, which are prepared separately for each of the Company's CGUs to which the individual assets are allocated. These budgets and forecast calculations generally cover a period of five years. A long-term growth rate is calculated and applied to project future cash flows after the fifth year.

An assessment is made at each reporting date to determine whether there is an indication that previously recognized impairment losses no longer exist or have decreased. If such indication exists, the Company estimates the asset's or CGU's recoverable amount. A previously recognized impairment loss is reversed only if there has been a change in the assumptions used to determine the asset's recoverable amount since the last impairment loss was recognized. The reversal is limited so that the carrying amount of the asset does not exceed its recoverable amount, nor exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognized for the asset in prior years. Such reversal is recognized in the statement of profit or loss unless the asset is carried at a revalued amount, in which case, the reversal is treated as a revaluation increase.

### Employee benefits

- Post-employment benefit obligations: Employees of companies included in these consolidated financial statements have entitlements under Company pension plans which are defined contribution pension plans.

  The cost of defined contribution pension plans is charged to expense as the contributions become payable.

- Stock based compensation: The Company grants stock options to certain employees. Stock options vest over three to ten years and all expire over five to ten years after grant date. Each tranche in an award is considered a separate award with its own vesting period and grant date fair value. Fair value of each tranche is measured at the date of grant using the Black-Scholes option pricing model.

  Compensation expense is recognized over the tranche's vesting period based on the number of awards expected to vest, by increasing contributed surplus. The number of awards expected to vest is reviewed at least quarterly, with any impact being recognized immediately.

- Termination benefits: The Company recognizes termination benefits when it is demonstrably committed to either terminating the employment of current employees according to a detailed formal plan without possibility of withdrawal, or providing benefits as a result of an offer made to encourage voluntary termination. Benefits falling due more than twelve months after the end of the reporting period are discounted to their present value where the effect is material.

### Provisions and unfavourable contracts liability

In connection of the US-based composite Aerostructures division of Hitco Carbon Composites Inc. ("Hitco"), a subsidiary of Frankfurt-listed SGL Carbon SE ("SGL") (note 32) the Company assumed existing long-term and short-term customer contracts. Based on our review of these contracts, the Company concluded that the terms of the contracts to be unfavourable, than could be realized in market transactions, as of the date of the acquisition. As a result, the Company recognized contract liabilities, assumed, based on the present value of the difference between the contractual cash flows of the unfavorable contracts and the estimated cash flows to fulfil the obligation under the terms of the existing contracts from the acquisition date. The liabilities principally relate to long-term life of program contracts that were initially executed in the years prior to the acquisition (note 32).

The Company measured these liabilities under the measurement provisions of IFRS 13, Fair Value Measurements, which is based on the price to transfer the obligation to a market participant at the measurement date, assuming that the liabilities will remain outstanding in the marketplace. Fair value estimates are based on a complex series of judgments about future events and uncertainties and rely heavily on estimates and assumptions. The judgments used to determine the estimated fair value assigned to each long-term contracts can materially impact our results of operations.

Included in revenue is the non-cash amortization of acquired contract liabilities recognized as fair value adjustments through purchase accounting from the acquisition of ACF. For the year ended December 31, 2016, the Company recognized net amortization of contract liabilities of $38,937,000 (December 31, 2015: $356,000). The balance of the liability as of December 31, 2016 is $56,969,000 and, is based on the expected delivery schedule of the underlying contracts. The unfavorable contract liability is amortized on a units-of-production basis over the expected lives of the contracts, the longest of which at the acquisition date was expected to be December 31, 2023, however in the current fiscal year the Company successfully renegotiated one of the major contracts attributing to the unfavorable contracts liability such that the term of the contract was reduced from December 31, 2023 to December 31, 2019.

### Revenue

Revenue is recognized when it is probable that the economic benefits will flow to the Company and delivery has occurred, the sales price is fixed or determinable, and collectability is reasonably assured. These criteria are generally met at the time the product is shipped and delivered to the customer and, depending on the delivery conditions, title and risk of the product have passed to the customer.

The term 'bill and hold' sale is used to describe a transaction where delivery is delayed at the customer's request, but the customer takes title and accepts billing. Revenue is recognized when the customer takes title, provided it is probable that delivery will be made, the item is on hand, identified and ready for delivery to the customer at the time the sale is recognized, the customer specifically acknowledges the deferred delivery instructions, and the usual payment terms apply.

Revenue is measured based on the price specified in the sales contract, net of discounts.

The Company's major revenue streams arise from the production and supply of major airframe structures and aircraft parts to aircraft manufacturers, the repair of aircraft components, aircraft product design and production tooling design and manufacture.

The nature of the Company's operating cycle for the manufacture and delivery of highly engineered aerospace parts and components is one in which significant order and production lead-times exist. There exists a high degree of variability within the length of operating cycles for the various manufactured components, aircraft programs, and customers. The Company's operating cycle commences with receipt, from its customers, of a purchase order for production of a component and culminates when the Company has received full payment from the customer for the product it has delivered. The individual product component operating cycles can range from twelve weeks to greater than sixty weeks. Costs incurred for proto-type design, as well as hard and soft tooling expenditures for new program introduction can occur over a two year period. Given this variability, since no single operating cycle is clearly identifiable, the Company has concluded that the operating cycle is twelve months.

Certain program inventories have been funded by a customer, whereby the associated deferred program revenues will be recorded as revenue upon delivery of units of production.

Additionally, customers have funded non-recurring costs incurred during the introduction of new production programs. These costs are deferred as development costs and will be amortized to the consolidated statement of loss straight-line on a units-of-production basis over the expected life of the programs, in conjunction with the associated deferred revenue upon commencement of production.

Deferred program revenues are classified as current or non-current based on the estimated timing of when the related revenues are realized. This period of deferred revenue realization can extend, dependent on the amortization of the related costs, over one or more fiscal years.

### Cost of sales

Cost of sales includes the cost of production, including materials, direct labour, overhead expenses as well as applicable depreciation and amortization.

### Income tax

a) Current income tax

Current income tax assets and liabilities for the current year are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted, at the reporting date in the countries where the Company operates and generates taxable income.

Current income tax relating to items recognized directly in equity is recognized in equity and not in the statement of loss. Management periodically evaluates positions taken in the tax returns with respect to situations in which applicable tax regulations are subject to interpretation and establishes provisions where appropriate.

b) Deferred income tax

Deferred income tax is provided using the liability method on deductible temporary differences between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes at the reporting date.

Deferred income tax liabilities are recognized for all taxable temporary differences, except:

- taxable temporary differences associated with investments in subsidiaries, when the timing of the reversal of the temporary differences can be controlled and it is probable that the temporary differences will not reverse in the foreseeable future.

Deferred income tax assets are recognized for all deductible temporary differences, the carry forward of unused tax credits and any unused tax losses to the extent that it is probable that taxable profit will be available against which the deductible temporary differences and the carry forward of unused tax credits and unused tax losses can be utilized.

The carrying amount of deferred income tax assets is reviewed at each reporting date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilized. Unrecognized deferred income tax assets are reassessed at each reporting date and are recognized to the extent that it has become probable that future taxable profits will allow the deferred income tax asset to be recovered.

Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply in the year when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the reporting date.

Deferred income tax relating to items recognized outside profit or loss is recognized outside profit or loss. Deferred income tax items are recognized in correlation to the underlying transaction either in other comprehensive income or directly in equity.

Deferred income tax assets and deferred income tax liabilities are offset if a legally enforceable right exists to set off current tax assets against current income tax liabilities and the deferred income taxes relate to the same taxable entity and the same taxation authority.

### Capital Stock

Common shares are classified as equity. Incremental costs directly attributable to the issuance of shares are recognized as a deduction from equity.

### Earnings per share

Basic earnings per share ("EPS") is calculated by dividing the net loss for the year by the weighted average number of common shares outstanding during the year.

Diluted EPS is calculated by adjusting the weighted average number of common shares outstanding for dilutive instruments. The number of shares included with respect to options, warrants and similar instruments is computed using the treasury stock method. The Company's potentially dilutive common shares comprise stock options granted to employees and warrants.

### Leases

Leases are classified as finance or operating leases. A lease that transfers substantially all the benefits and risks incidental to the ownership of property is classified as a finance lease. All other leases are accounted for as operating leases whereby lease payments are expensed on a straight-line basis over the term of the lease. Gains and losses arising on sale and leaseback transactions, when the leaseback is classified as a finance lease, are deferred and amortized in proportion to the amortization of the leased asset when material. Lease inducements received are recorded as a deferred credit and amortized as a reduction of lease expense over the term of the lease.

### Accounting standards issued but not yet effective

The following is a brief summary of the new standards issued but not yet effective:

### IFRS 15 – Revenue from Contracts with Customers

The International Accounting Standards Board ("IASB") and the US Financial Accounting Standards Board ("FASB") (collectively, "the Boards") have jointly issued a new revenue standard, IFRS 15 *Revenue from Contracts with Customers*, that will supersede virtually all revenue recognition requirements in IFRS and US GAAP.

IFRS 15 establishes principles to address the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers.

This standard is required to be applied for accounting periods beginning on or after January 1, 2018, with earlier adoption permitted. The Company has not yet assessed the impact of the standard or determined whether it will adopt the standard early.

### IFRS 9 – Financial Instruments

In July 2014, the IASB issued the final version of IFRS 9 *Financial Instruments* which reflects all phases of the financial instruments project and replaces IAS 39 *Financial Instruments: Recognition and Measurement* and all previous versions of IFRS 9. The standard introduces new requirements for classification and measurement, impairment, and hedge accounting. IFRS 9 is effective for annual periods beginning on or after January 1, 2018, with early application permitted. Retrospective application is required, but comparative information is not compulsory. The adoption of IFRS 9 will have an effect on the classification and measurement of the Group's financial assets, but no impact on the classification and measurement of the Group's financial liabilities.

### IFRS 16 - Leases

In January 2016, the IASB issued IFRS 16 – Leases which replaces IAS 17 – Leases and its associated interpretative guidance. IFRS 16 applies a control model to the identification of leases, distinguishing between a lease and a service contract on the basis of whether the customer controls the asset being leased. For those assets determined to meet the definition of a lease, IFRS 16 introduces significant changes to the accounting by lessees, introducing a single, on-balance sheet accounting model that is similar to current finance lease accounting, with limited exceptions for short-term leases or leases of low value assets. Lessor accounting remains similar to current accounting practice. The standard is effective for annual periods beginning on or after January 1, 2019, with early application permitted for entities that apply IFRS 15. The Company has not yet assessed the impact the final standard is expected to have on its consolidated financial statements.

### IAS 7 – Statement of Cash Flows

In 2016, the IASB issued amendments to IAS 7, Statement of Cash Flows ("IAS 7"). The amendments are intended to clarify IAS 7 to improve information provided to users of financial statements about an entity's financing activities. They are effective for annual periods beginning on or after January 1, 2017, with earlier adoption permitted. The adoption of IAS 7 amendments will require additional disclosure in the Company's consolidated financial statements.

### IFRS 2 – Share Based Payments

In 2016, the IASB issued the final amendments to IFRS 2, Share-based Payments ("IFRS 2") that clarify the classification and measurement of share-based transactions, consisting of: accounting for cash-settled share-based payment transactions that include a performance condition; classification of share-based payment transactions with net settlement features; accounting for modifications of share-based payment transactions from cash-settled to equity-settled. The amendments are effective for annual periods beginning on or after January 1, 2018, with earlier adoption permitted. The amendments are to be applied prospectively. However, retrospective application is allowed if this is possible without the use of hindsight. The Company is in the process of evaluating the impact of adopting these amendments on the Company's consolidated financial statements.

### IFRIC Interpretation 22 – Foreign Currency Transactions and Advance Consideration

In 2016, the IASB issued IFRIC Interpretation 22, Foreign Currency Transactions and Advance Consideration ("IFRIC 22"), which provides requirements about which exchange rate to use in reporting foreign currency transactions (such as revenue transactions) when payment is made or received in advance. IFRIC 22 is effective for annual periods beginning on or after January 1, 2018, with earlier adoption permitted. On initial application, entities have the option to apply either retrospectively or prospectively. The Company is in the process of evaluating the impact of adopting these amendments on the Company's consolidated financial statements.

## 4. Critical Accounting Estimates and Judgements

The preparation of consolidated financial statements in conformity with IFRS requires management to make estimates and judgments that affect the amounts which are reported in the consolidated financial statements during the reporting period. Estimates and other judgments are evaluated at each reporting date and are based on management's experience and other factors, including expectations about future events that are believed to be reasonable under the circumstances. The critical estimates and judgements utilized in preparing the Company's consolidated financial statements affect the assessment of net recoverable amounts, net realizable values and fair values, and the determination of functional currency of the Canadian operations of the group. Any changes in estimates and assumptions could have a material impact on the assets and liabilities at the date of the statement of financial position. The Company reviews its estimates and assumptions on an ongoing basis and uses the most current information available and exercises careful judgement in making these estimates and assumptions.

- Functional currency: The functional currency for the Company and its subsidiaries is the currency of the primary economic environment in which each operates. The Company has determined that the functional currency for the Company and all its subsidiaries except for Avcorp US Holdings Inc. and ACF is the Canadian dollar. The functional currency for Avcorp US Holdings Inc. and ACF is the US dollar. The determination of functional currency may require certain judgements to determine the primary economic environment. The Company reconsiders the functional currency used when there is a change in events and conditions which determined the primary economic environment.

- Impairments: The recoverable amount of intangible assets, development costs and property, plant and equipment is based on estimates and assumptions regarding the expected market outlook and cash flows from each CGU or group of CGUs. In order to estimate the fair value of indefinite-lived intangible assets and goodwill resulting from business combinations, the Company typically estimates future revenue, considers market factors and estimates future cash flows. Based on these key assumptions, judgments and estimates, the Company determines whether to record an impairment charge to reduce the value of the asset carried on the consolidated statement of financial position to its estimated fair value. Assumptions, judgments and estimates about future values are complex and often subjective. They can be affected by a variety of factors, including external factors such as industry and economic trends, and internal factors such as changes in the Company's business strategy or internal forecasts. Although the Company believes the assumptions, judgments and estimates made in the past have been reasonable and appropriate, different assumptions, judgments and estimates could materially affect the Company's reported financial results.
- Going concern: Management assesses the Company's ability to continue as a going concern at each reporting date, using all quantitative and qualitative information available. This assessment, by its nature, relies on estimates of future cash flows and other future events, whose subsequent changes would materially impact the validity of such an assessment.
- Capitalization of development costs: When capitalizing development costs the Company must assess the technical and commercial feasibility of the projects and estimate the useful lives of resulting products. Determining whether future economic benefits will flow from the assets and therefore the estimates and assumptions associated with these calculations are instrumental in (i) deciding whether project costs can be capitalized, and (ii) accurately calculating the useful life of the projects for the Company.
- Unfavorable contracts liability: At the acquisition date valued the unfavorable contracts liability at fair value using certain assumptions that would arise in a market participant view. The Company estimates the expected shipsets or production when assessing the liability, together with the discounts rate and period of performance under the varying contracts and service agreements. The cash flows are discounted over the period of performance using a discount rate commensurate with the risk associated with the liability.
- Fair value of assets and liabilities acquired in a business combination: The Company accounted for the acquisition of ACF using the acquisition method when control is transferred to the Company. The consideration received is generally measured at fair value, as are the identifiable net liabilities assumed. The fair value of the liabilities assumed is determined using valuation techniques that require estimation of the estimated cash flows, discount rates and estimated operating margins.
- Inventories are valued at the lower of cost and net realizable value. The costs of inventory involve estimates in determining the allocation of fixed and variable production overhead. These estimates involved include determination of normal production capacity and nature of expenses to be allocated. Additionally inventory is reviewed monthly to ensure the carrying value does not exceed net realizable value. If so, a write-down is recognized. The write-down may be reversed if the circumstances which caused it no longer exist.
- On a periodic basis the Company reviews its plant capacity and estimates the portion of its under-utilized overhead expenditures. The Company has expensed $4,408,000 of overhead costs during the current year (December 31, 2015: $4,906,000) in respect of unutilized plant capacity. These amounts are included in the Consolidated Statements of Loss and Comprehensive Loss as costs of sales.

## 5. Expenses by Nature

The Consolidated Statements of Loss and Comprehensive Loss presents expenses by function. Accordingly, amortization and depreciation is not presented as a separate line on the statement, but is included within cost of sales to the extent that it relates to manufacturing machinery and equipment, as well as leasehold improvements.

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

Expenses by nature:

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Salary, wages and benefits | **$77,010** | $36,754 |
| Raw materials, purchased parts and consumables | **68,084** | 33,908 |
| Contracted services and consulting | **19,431** | 3,806 |
| Plant equipment rental and maintenance | **5,950** | 561 |
| Utilities | **5,848** | 1,127 |
| Rent | **4,332** | 2,585 |
| Depreciation | **3,915** | 1,680 |
| Transportation | **2,992** | 991 |
| Other expenses and conversion of costs into inventory | **2,768** | 2,987 |
| Office equipment rental/maintenance | **2,130** | 709 |
| Travel costs | **1,728** | 1,123 |
| Legal and audit fees | **1,484** | 2,248 |
| Bad debt expense | **1,328** | - |
| Amortization of intangible assets | **1,325** | - |
| Insurance | **659** | 359 |
| Amortization of development costs | **604** | 1,521 |
| Office suppliers | **278** | - |
| Royalties | **246** | 318 |
| Performance Guarantee fees | **-** | 1,362 |
| | **200,112** | 92,039 |

## 6. Capital Risk Management

The Company's objectives when managing capital are to safeguard its ability to continue as a going concern and to provide an adequate return to shareholders, while satisfying other stakeholders.

The Company includes long-term debt, preferred shares and capital stock in its definition of capital, as shown in the Company's consolidated statements of financial position.

The Company's primary objective in its management of capital is to ensure that it has sufficient financial resources to fund ongoing operations and new program investment. In order to secure this capital the Company may attempt to raise funds via issuance of debt and equity, or by securing strategic partners.

## 7. Financial Risk Management

The Company is exposed to certain financial risks including market risk, currency risk, credit risk, liquidity risk, interest rate risk and price risk. The note presents information about the Company's risk to each of these risks; its objectives, policies and processes for measuring and managing risk.

a) Market Risk

Market risk is the risk that changes in the market prices, such as foreign exchange rates and interest rates, will affect the Company's income or the value of its holdings of financial instruments. The Company's policy is not to utilize derivative financial instruments for trading or speculative purposes. The Company may utilize derivative instruments in the management of its foreign currency and interest rate exposures.

b) Currency Risk

Currency risk arises because the amount of the local currency receivable or payable for transactions denominated in foreign currencies may vary due to changes in exchange rate ("transaction exposures") and because the non-Canadian dollar denominated financial statements of the Company's subsidiaries may vary on consolidation into the reporting currency of Canadian dollars ("translation exposures").

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

The Company sells a significant proportion of its products in US dollars at prices which are often established well in advance of manufacture and shipment dates. In addition, the Company purchases a significant proportion of its raw materials and components in US dollars at prices that are usually established at the order date. The Company's operations are based in Canada and in the US. As a result of this, the Company is exposed to currency risk to the extent that fluctuations in exchange rates are experienced. The amount of foreign exchange gain recorded for the year ended December 31, 2016 is $717,000 (December 31, 2015: $323,000).

The Company had the following US dollar denominated balances:

| **FOR THE YEAR ENDED DECEMBER 31** | **2016** | 2015 |
|---|---|---|
| Bank cash position | **US$1,205** | US$6,007 |
| Accounts receivable | **15,123** | 16,629 |
| Consideration receivable | **9,124** | 28,458 |
| Accounts payable net of prepayments | **1,574** | 1,557 |
| Customer advance | **8,619** | 13,387 |
| Bank indebtedness | **4,250** | - |
| Term debt | **4,560** | - |

With other variables unchanged, each $0.10 strengthening (weakening) of the US dollar against the Canadian dollar would result in an increase (decrease) of approximately $645,000 in net income for the year ended December 31, 2016 (December 31, 2015: $3,615,000 increase (decrease) in net income) as a result of holding a US dollar net asset position.

c) Credit Risk

Credit risk is the risk of a financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its contractual obligation. The Company manages credit risk for trade and other receivables through a financial review of the credit worthiness of the prospective customer along with credit monitoring activities. The majority of the Company's trade receivables reside with Boeing Commercial Airplane Group ("Boeing"), Boeing Defense, Space & Security ("BDS"), Bombardier Aerospace ("Bombardier"), BAE Systems (Operations) Limited ("BAE"), Lockheed Martin ("LM"), and Subaru Corporation ("Subaru") (formerly Fuji Heavy Industries Ltd.). The maximum exposure to credit risk is represented by the amount of accounts receivable in the consolidated statements of financial position.

As at the consolidated statements of financial position date 69.8% (December 31, 2015: 69.5%) of the Company's trade accounts receivable are attributable to these customers.

The Company is exposed to credit risk if counterparties to our trade receivables are unable to meet their obligations. The concentration of credit risk from our customers is minimized because the Company have an original equipment manufacturer and tier one aerospace customer base as at December 31, 2016. The customers are predominately large, well-capitalized, and long established entities with a low risk of non-payment. The Company regularly monitors our credit risk and credit exposure.

The following table provides the change in allowance for doubtful accounts for trade receivables:

| | **2016** | 2015 |
|---|---|---|
| Balance as at January 1 | **$137** | $- |
| Additions | **1,517** | 137 |
| Use | **(1,328)** | - |
| Balance as at December 31 | **326** | 137 |

The following table provides aged trade receivables:

| | **2016** | 2015 |
|---|---|---|
| Current | **$13,954** | $13,132 |
| 31 – 60 days | **2,953** | 8,682 |
| 61 – 90 days | **3,077** | 5,712 |
| Over 90 days | **4,221** | 2,289 |
| Total | **24,205** | 29,815 |

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

Consideration receivable arising from a 2015 business acquisition (notes 10 and 32) is guaranteed by the seller and a Canadian chartered bank.

d) Liquidity Risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company seeks to manage liquidity risk through the management of its capital structure and financial leverage.

Accounts payable and accrued liabilities are all due within the next twelve months.

The Company's operating line of credit is due on demand (note 15). Term debt repayments are as outlined in note 21.

The table below categorizes the Company's non-derivative financial liabilities into relevant maturity periods based on the remaining period from the consolidated statements of financial position date to the contractual maturity date. The amounts disclosed in the table are the contractual undiscounted cash flows.

Subsequent to year end, the Company entered into agreements to expand its loan facilities (note 33).

| | | | | **December 31, 2016** |
|---|---|---|---|---|
| | **Less than 3 months** | **3 months to 1 year** | **2 – 5 years** | **Over 5 years** |
| Bank indebtedness (note 15) | $17,111 | $- | $- | $- |
| Term debt (note 21) | 39 | 6,942 | 454 | 1,192 |
| Trade payables (note 17) | 24,835 | - | - | - |

| | | | | December 31, 2015 |
|---|---|---|---|---|
| | **Less than 3 months** | **3 months to 1 year** | **2 – 5 years** | **Over 5 years** |
| Bank indebtedness (note 15) | $- | $- | $- | $- |
| Term debt (note 21) | 105 | 134 | 409 | 1,237 |
| Trade payables (note 17) | 19,765 | 1,316 | - | - |

e) Interest Rate Risk

The Company is exposed to interest rate risk on the utilized portion of its operating line of credit at rates of bank prime plus 0.5%. The maximum operating line of credit availability is $21,000,000 (note 15) of which $17,111,000 is utilized as at December 31, 2016 (December 31, 2015: $Nil). The Company lowers interest rate costs by managing utilization of the operating lines of credit to the lowest amount practical. For the year ended December 31, 2016, with other variables unchanged, a 1% change in the bank prime interest rate would have a $171,000 (December 31, 2015: $Nil) impact on net earnings and cash flow.

The Company primarily finances the purchase of long-lived assets at fixed interest rates.

f) Price Risk

Certain of the Company's contracts contain derivative financial instruments to reduce exposure to price risk associated with its revenues and costs of certain procured items.

Sales Contracts

A number of the Company's sales contracts have a price adjustment clause where the final sales price is determined by certain indices in a period prior to the date of sale. As a result, the final sales price will change as these underlying indices change. This price adjustment clause is an embedded derivative that is recorded at fair value, with changes in fair value recorded within administrative and general expenses, as amounts are not material, until the date of sale. As at December 31, 2016, the Company has $4,303,000 (December 31, 2015: $7,527,000) of firmly committed orders that include price adjustment clauses of this nature. $1,000 has been recorded as a derivative loss for the year ended December 31, 2016 as compared to a $1,000 loss for the year ended December 31, 2015 as restated as a result of the change in the fair value of the underlying embedded derivatives.

Included in prepayments and other assets is $1,000 of inflation derivatives assets arising from the Company's sales contracts having price adjustment clauses within their terms (December 31, 2015: $1,000).

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

g) Financial Assets and Liabilities by Category

Categories of financial instruments

Under IFRS, financial instruments are classified into one of the following categories: financial assets at fair value through profit or loss, loans and receivables, available-for-sale financial assets, financial assets and liabilities held for trading, financial liabilities at fair value through profit or loss, and other financial liabilities at amortized cost.

All financial instruments, including derivatives, are included on the consolidated statement of financial position, which are measured at fair value except for loans and receivables and other financial liabilities, which are measured at amortized costs. Held for trading investments are subsequently measured at fair value and all gains and losses are included in net income in the period in which they arise. Available-for-sale financial instruments are subsequently measured at fair value with revaluation gains and losses included in other comprehensive income until the instruments are derecognized or impaired.

As at December 31, 2016 and 2015, the Company's financial assets and liabilities are categorized as follows:

| | | | | **December 31, 2016** |
|---|---|---|---|---|
| | **Loans and receivables** | **Total financial assets** | **Other financial liabilities (at amortized costs)** | **Total** |
| **Financial Assets** | | | | |
| Cash | $3,960 | $- | $- | $3,960 |
| Accounts receivable | 26,262 | - | - | 26,262 |
| Consideration receivable | 12,251 | - | - | 12,251 |
| Inflation derivative | - | 1 | - | 1 |
| **Financial Liabilities** | | | | |
| Bank indebtedness | 17,111 | - | - | 17,111 |
| Accounts payable | - | - | 32,122 | 32,122 |
| Current portion of term debt | - | - | 6,283 | 6,283 |
| Customer advance | - | - | 11,573 | 11,573 |

| | | | | December 31, 2015 |
|---|---|---|---|---|
| | **Loans and receivables** | **Total financial assets** | **Other financial liabilities (at amortized costs)** | **Total** |
| **Financial Assets** | | | | |
| Cash | $14,484 | $- | $- | $14,484 |
| Accounts receivable | 30,124 | - | - | 30,124 |
| Consideration receivable | 26,624 | - | - | 26,624 |
| Inflation derivative | - | 1 | - | 1 |
| **Financial Liabilities** | | | | |
| Accounts payable | - | - | 27,087 | 27,087 |
| Current portion of term debt | - | - | 240 | 240 |
| Customer advance | - | - | 18,528 | 18,528 |

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

## 8. Fair Value Measurement

At December 31, 2016 and 2015, the fair values of cash, accounts receivable, other assets, consideration receivable (short term portion), accounts payable, bank indebtedness and current portion of term debt approximated their carrying values because of the short-term nature of these instruments.

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | | 2015 | |
|---|---|---|---|---|
| | Carrying value | Fair value | Carrying value | Fair value |
| **Financial assets** | | | | |
| Consideration receivable – long term portion | **$-** | **$-** | $12,760 | $12,096 |
| **Financial liabilities** | | | | |
| Term debt | **1,646** | **1,646** | 1,646 | 1,646 |

Fair value hierarchy

The Company's financial assets and liabilities recorded at fair value on the consolidated statements of financial position have been categorized into three categories based on a fair value hierarchy. Fair value of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Assets and liabilities in Level 2 include valuations using inputs other than the quoted prices for which all significant inputs are based on observable market data, either directly or indirectly. Level 3 valuations are based on inputs that are not based on observable market data.

The fair value hierarchy requires the use of observable market inputs whenever such inputs exist. A financial instrument is classified to the lowest level of the hierarchy for which a significant input has been considered in measuring fair value. The Company does not have any financial assets or financial liabilities carried at fair value as at December 31, 2016.

## 9. Accounts Receivable

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Trade receivables | **$24,205** | $29,815 |
| Input tax credits | **1,887** | 230 |
| Accrued receivables | **170** | 79 |
| | **26,262** | 30,124 |

The average trade receivables days outstanding is 59 days as at December 31, 2016 (December 31, 2015: 33 days; the December 31, 2015 trade receivables days outstanding does not include assumed trade receivables from the December 18, 2015 acquisition of Hitco).

The carrying amount of accounts receivable pledged as security under the Company's operating line of credit (note 15) as at December 31, 2016 is $23,325,000 (December 31, 2015: $27,230,000).

The carrying amounts of the Company's trade and accrued receivables are denominated in the following currencies:

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| US dollar | **US$16,592** | US$18,487 |
| Canadian dollar | **3,986** | 4,538 |

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

## 10. Consideration Receivable

On December 18, 2015, in conjunction with the acquisition of Hitco (note 32), Avcorp received $32,826,000 (USD$23,540,000) in cash consideration with $38,720,000 (USD$28,457,000 undiscounted) consideration receivable as at December 31, 2015. The consideration receivable as at December 31, 2016 on a discounted basis is $12,251,000 (USD$9,220,000 undiscounted). The consideration receivable took the form of:

- Avcorp received $5,864,000 (USD$4,237,000) in cash from SGL, the parent company of Hitco on January 4, 2016 in payment of past due trade payables assumed by Avcorp on acquisition close date;
- Avcorp received $14,048,000 (USD$10,000,000) in cash from SGL, the parent company of Hitco on January 31, 2016;
- Avcorp received $2,517,000 (USD$1,971,000) in cash from SGL, the parent company of Hitco on August 24, 2016. Avcorp extinguished another $3,867,000 (USD$3,029,000) of the consideration receivable through expenses and payments that SGL paid on Avcorp's behalf; and
- Avcorp received $12,378,000 net in cash from SGL, parent company of Hitco on April 4, 2017. The USD$9,220,000 undiscounted gross consideration receivable is guaranteed by SGL as well as a Canadian chartered bank (note 33g).

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Opening balance | **$38,720** | $- |
| Additions (note 32) | **-** | 38,720 |
| Receipts | **(26,296)** | - |
| Accretion | **510** | - |
| Foreign exchange | **(683)** | - |
| | **12,251** | 38,720 |
| Less current portion | **12,251** | 26,624 |
| Non-current portion | **-** | 12,096 |

## 11. Inventories

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 restated (note 32) |
|---|---|---|
| Raw materials | **$21,121** | $25,061 |
| Work-in-progress | **25,696** | 24,490 |
| Finished products | **4,495** | 10,163 |
| Inventory obsolescence | **(7,053)** | (24,212) |
| | **44,259** | 35,502 |

The amount of inventory expensed in cost of sales during the year ended December 31, 2016 amounted to $168,062,000 (December 31, 2015: $65,852,000). The carrying value of inventory pledged as security under the Company's operating line of credit (note 15) as at December 31, 2016 is $20,828,000 (December 31, 2015: $14,460,000).

On a periodic basis the Company provides for its anticipated losses under existing contractual commitments to its customers by comparing its anticipated future costs of production to its contracted future revenues. The December 31, 2016 provision for anticipated losses was $37,000 (December 31, 2015: $114,000). Work in progress inventory noted in the above table has been presented net of these provisions for anticipated losses.

Certain program inventories have been funded by a customer, whereby the associated deferred program revenues will be recorded as revenue upon delivery of units of production.

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

## 12. Development Costs

Development costs represent hard and soft tooling, and prototype design costs incurred for various customer programs.

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Opening balance | **$3,187** | $3,303 |
| Additions | **2,617** | 1,405 |
| Amortization | **(604)** | (1,521) |
| | **5,200** | 3,187 |

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Cost | **$11,180** | $8,564 |
| Accumulated amortization | **(5,980)** | (5,377) |
| Net book amount | **5,200** | 3,187 |

Customers have funded non-recurring costs incurred during the introduction of new production programs. These costs are deferred as development costs and are amortized to income in conjunction with the associated production activities, upon commencement of production, on a units-of-production basis over the expected life of the programs.

## 13. Property, Plant and Equipment

| | Machinery and equipment | Computer hardware and software | Leasehold improvements | Total |
|---|---|---|---|---|
| **Year ended December 31, 2015 – restated** (note 32) | | | | |
| Opening net book amount | $6,525 | $1,204 | $475 | $8,204 |
| Additions (note 32) | 22,602 | 322 | 192 | 23,116 |
| Disposals – cost | (133) | (28) | - | (161) |
| Disposals – accumulated depreciation | 133 | 28 | - | 161 |
| Depreciation charge | (1,079) | (460) | (141) | (1,680) |
| **Closing net book amount** | 28,048 | 1,066 | 526 | 29,640 |
| **At December 31, 2015** | | | | |
| Cost | 52,026 | 7,725 | 1,352 | 61,103 |
| Accumulated depreciation | (23,978) | (6,659) | (826) | (31,463) |
| **Net book amount** | 28,048 | 1,066 | 526 | 29,640 |
| **Year ended December 31, 2016** | | | | |
| Opening net book amount | 28,048 | 1,066 | 526 | 29,640 |
| Additions | 5,827 | 386 | 623 | 6,836 |
| Disposals – cost | (86) | (43) | - | (129) |
| Disposals – accumulated depreciation | 76 | 8 | - | 84 |
| Depreciation charge | (3,259) | (460) | (196) | (3,915) |
| Currency translation adjustment | (582) | (4) | - | (586) |
| **Closing net book amount** | 30,024 | 953 | 953 | 31,930 |
| **At December 31, 2016** | | | | |
| Cost | 57,180 | 8,065 | 1,975 | 67,220 |
| Accumulated depreciation | (27,156) | (7,112) | (1,022) | (35,290) |
| **Net book amount** | 30,024 | 953 | 953 | 31,930 |

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

The Company has $67,000 in commitments at December 31, 2016 (December 31, 2015: $221,000) to purchase property, plant and equipment in 2017.

Included in computer hardware and software are assets held under finance leases at a cost of $24,000 (December 31, 2015: $104,000) having accumulated depreciation of $10,000 (December 31, 2015: $85,000).

Included in machinery and equipment are assets held under finance leases at a cost of $237,000 (December 31, 2015: $930,000) having accumulated depreciation of $38,000 (December 31, 2015: $54,000).

## 14. Intangibles

| | Lease | Customer contract – re-compete | Total |
|---|---|---|---|
| **Year ended December 31, 2015 – restated** (note 32) | | | |
| Opening net book amount | $ - | $ - | $ - |
| Additions (note 32) | 748 | 5,674 | 6,422 |
| Amortization charge | - | - | - |
| **Closing net book amount** | 748 | 5,674 | 6,422 |
| **At December 31, 2015 – restated** (note 32) | | | |
| Cost | 748 | 5,674 | 6,422 |
| Accumulated depreciation | - | - | - |
| **Net book amount** | 748 | 5,674 | 6,422 |
| **Year ended December 31, 2016** | | | |
| Opening net book amount | 748 | 5,674 | 6,422 |
| Additions | - | - | - |
| Amortization charge | (239) | (1,086) | (1,325) |
| Currency translation adjustment | (26) | (184) | (210) |
| **Closing net book amount** | 483 | 4,404 | 4,887 |
| **At December 31, 2016** | | | |
| Cost | 725 | 5,505 | 6,230 |
| Accumulated amortization | (242) | (1,101) | (1,343) |
| **Net book amount** | 483 | 4,404 | 4,887 |

## 15. Bank Indebtedness

On September 27, 2012 the Company entered into a loan agreement with a Canadian chartered bank for a $12,000,000 principal amount secured debt facility. The debt facility bears interest at a rate equal to the bank's prime rate plus 0.5%.

The debt facility is secured by a charge and specific registration over all of the assets of the Company.

As a condition of obtaining this operating line of credit, the following term is in effect:

- A permanent block of $2,500,000 against available credit (note 33b).

On June 23, 2016, the Company's bank extended its banking agreement from June 30, 2016 to December 31, 2016.

Effective November 11, 2016, the Company entered into an amendment to its existing facility whereby the bank extended the term of the credit facility from December 31, 2016 to April 15, 2017, and, increased the maximum availability to $21,000,000, subject to existing draw down provisions and margining calculations, which may reduce the credit available. The additional credit availability was provided utilizing certain consideration receivable as security and which maximum availability was reduced upon collection of such certain consideration receivable (note 10).

Effective February 17, 2017, the Company entered into another amendment to its existing facility whereby the bank extended the credit facility from April 15, 2017 to July 30, 2017 (note 33a).

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

On March 31, 2017, The Company entered into an amendment to its existing facility whereby the bank increased the maximum availability to USD$23,000,000 until July 30, 2017 (note 33c).

On May 26, 2017, the Company entered into a loan agreement to expand its existing facility to provide for an additional borrowing capacity of up to USD$35,000,000 until June 30, 2020 (note 33d).

The Company ended the year with bank operating line utilization of $17,111,000 offset by $3,960,000 cash compared to utilization of $Nil with $14,484,000 cash on hand as at December 31, 2015. Based on net collateral provided to its bank, the Company was able to draw up to an additional $4,901,000 on its operating line of credit as at December 31, 2016 (December 31, 2015: $8,805,000).

## 16. Customer advance

On December 18, 2015, in conjunction with the acquisition of Hitco, the Company assumed a customer advance for pre-funded product deliveries. The customer advance is re-paid as the Company delivers to the customer. The customer advance is subject to an access and security agreement along with a general security agreement entered into with the Company's bank and a customer.

The remaining unamortized customer advance has been discounted to arrive at the December 31, 2016 amount of $11,573,000 (December 31, 2015: $18,528,000) of which it is estimated $8,034,000 (December 31, 2015: $8,282,000) will be amortized during the next twelve months. The Company amortized into revenue $6,287,000 of the customer advance during the year ended December 31, 2016 (December 31, 2015: $283,000).

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 restated (note 32) |
|---|---|---|
| Opening balance | **$18,528** | $- |
| Additions | **-** | 18,953 |
| Amortization | **(6,287)** | (283) |
| Foreign exchange | **(668)** | (142) |
| | **11,573** | 18,528 |
| Less: Current portion | **8,034** | 8,282 |
| Non-current portion | **3,539** | 10,246 |

## 17. Accounts Payable and Accrued Liabilities

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 restated (note 32) |
|---|---|---|
| Trade payables | **$24,835** | $21,080 |
| Payroll-related liabilities | **5,793** | 5,022 |
| Performance guarantee fees | **-** | 330 |
| Restructuring provision | **371** | 207 |
| Purchase tax payable | **-** | 1,020 |
| Other | **1,123** | 448 |
| | **32,122** | 28,107 |

## 18. Deferred Program Revenues

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Opening balance | **$4,924** | $7,782 |
| Additions | **15,043** | 12,699 |
| Realized | **(5,995)** | (15,557) |
| | **13,972** | 4,924 |
| Less: Current portion | **13,861** | 4,924 |
| Non-current portion | **111** | - |

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

Certain program inventories have been funded by a customer, whereby the associated deferred program revenues will be recognized as revenue upon delivery of units of production.

Additionally, customers have funded non-recurring costs incurred during the introduction of new production programs. These costs are deferred as development costs and will be amortized to income, on a units-of-production basis over the expected life of the programs, in conjunction with the associated deferred revenue upon commencement of production.

## 19. Unfavourable Contracts Liability

On December 18, 2015, in conjunction with the acquisition of Hitco, the Company assumed an unfavorable contract liability on certain long term revenue contracts for which unavoidable costs are expected to exceed the corresponding revenues earned. The unfavorable contracts liability is amortized into income on a units-of-production basis over the expected life of the contracts which are contracted up to December 31, 2019 and as costs are incurred.

As at December 31, 2016, the remaining unamortized unfavourable contracts liability amounted to $56,969,000 (December 31, 2015: $99,471,000).

| **FOR THE YEAR ENDED DECEMBER 31** | **2016** | 2015 restated (note 32) |
|---|---|---|
| Opening net book amount | **$99,471** | $- |
| Additions | **-** | 100,582 |
| Amortization and contract renegotiation | **(38,937)** | (356) |
| Foreign exchange | **(3,565)** | (755) |
| Closing net book amount | **56,969** | 99,471 |
| Less: Current portion | **18,904** | 35,782 |
| Non-current portion | **38,065** | 63,689 |

The result of the renegotiation of certain contract delivery requirements was a reduction of future delivery commitments. Management performed a cumulative catch-up revenue adjustment of $7,792,000 in 2016 further reducing the provision as at December 31, 2016. The remaining provision is to be amortized over the reduced contractual life of the contract. The effect of this adjustment is to adjust the per unit amortization charge of finished goods already shipped to reflect the updated amortization charge per unit had the amended agreement existed as at the commencement date of the contract.

## 20. Deferred Gain, Lease Inducement and Prepaid Rent

On July 17, 2003, the Company sold its land and building in Delta for gross proceeds of $16,000,000, representing $14,500,000 received in cash for the property and $1,500,000 as a lease inducement credit. Concurrently, the Company entered into a 15-year leaseback agreement with the purchaser of the property. A $712,000 gain arising on disposal of property in 2003 was recorded as a deferred gain and is being amortized to income over the life of the lease. The unamortized balance of the gain is $73,000 as at December 31, 2016 (December 31, 2015: $121,000). The amount of prepaid rent the Company has as at December 31, 2016 is $146,000 (December 31, 2015: $146,000).

Concurrent with the sale and leaseback transaction recorded in 2003, the Company recorded a lease inducement credit of $1,500,000. The lease inducement credit is being amortized against rental expense over the term of the lease. It has an unamortized balance of $173,000 as at December 31, 2016 (December 31, 2015: $270,000).

The prepayments and other assets are composed of prepaid insurance, prepaid IT licenses and deposits to purchase inventory.

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

## 21. Term Debt

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Finance leases (a) | **$147** | $278 |
| Term loans (b) (c) | **6,384** | 371 |
| SADI (d) | **1,398** | 1,237 |
| | **7,929** | 1,886 |
| Less: Current portion | **6,283** | 240 |
| | **1,646** | 1,646 |

a) Finance Leases

There are various equipment leases that have a weighted average interest rate of 7.60% per annum (2015: 7.77%). The leases are secured by way of a charge against specific assets. The leases are repayable in equal installments over periods up to 60 months (note 22).

b) Term Loan

On September 19, 2016, Avcorp entered into a non-revolving term loan agreement ("loan") with Panta Canada B.V. ("Panta") to fund the Company to a maximum aggregate principal amount of USD$5,000,000 due on April 7, 2017. The Company received its first advance on September 23, 2016 of USD$2,000,000 ($2,612,000). On October 25, 2016, Panta provided a second advance in the amount of USD$1,500,000 ($1,983,000) and a third advance on November 15, 2016 in the amount of USD$1,500,000 ($2,020,000).

Panta is Avcorp's majority shareholder owning approximately 65.5% of the issued and outstanding common shares on December 31, 2016. Panta is wholly owned by Panta Holdings B.V. Both companies are incorporated in The Netherlands and Mr. Jaap Rosen Jacobson, a director of the Company, is the sole shareholder of Panta Holdings B.V.

The Company's acceptance of this loan was subject to a 3% commitment fee (USD$150,000) paid by the Company to Panta from proceeds of the first advance.

In conjunction with receiving advances under the term loan, the Company issued Panta 30,714,118 common share purchase warrants ("warrants") on a pro-rata basis, each warrant is exercisable for a period of 24 months following the date of issuance with respect to one common share at an exercise price of $0.07 per common share. The Company issued 12,285,647 such warrants on September 19, 2016, 9,214,235 such warrants on October 24, 2016, and 9,214,236 such warrants on November 10, 2016. The warrants were valued at fair value on date of issue using the Black Scholes option pricing model.

The assumptions used in the valuation of the warrants were as follows:

| | 2016 |
|---|---|
| Number of warrants | **30,714,118** |
| Risk-free rate (%) | **0.52** |
| Dividend yield (%) | **-** |
| Expected lives (years) | **2** |
| Volatility (%) | **112.1%** |

| FOR THE YEAR ENDED DECEMBER 31 | 2016 |
|---|---|
| Principle amount of term loan | **$6,617** |
| Accrued interest | **87** |
| Less: Fair value of warrants issued | **(1,164)** |
| Add: Foreign exchange gain | **42** |
| Accretion | **541** |
| | **6,123** |

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

The loan bears interest at 8% per year, is subordinated to existing security agreements and could be prepaid without interest and penalties. The interest rate will increase to 15% per year, and all outstanding indebtedness including unpaid interest, will continue to accrue such interest, after the loan maturity date until paid in full. The loan and all accrued interest was due and payable on April 7, 2017 (note 33h).

c) Term Loan

On March 13, 2015, the Company completed a secured term loan with a principal amount of $450,000. The Company received full funding from the loan on March 26, 2015. The purpose of the loan was to finance machinery and equipment required for new production programs at its Burlington ON facility.

The term loan has been provided by a Canadian chartered bank. The loan has a four year term; it is secured by a general security agreement constituting a first ranking security interest in all personal property of the Company and a first ranking and specific interest in the equipment financed. Export Development Canada (“EDC”) has guaranteed 50% of the aggregate borrowings outstanding under the loan. The fee associated to the guarantee provided by EDC is equal to 3% of 50% of the outstanding loan amount. Interest is calculated and paid monthly at a rate of bank prime plus 1%. The loan will be repaid over 48 months by way of blended principal and interest payments. The balance outstanding for this term loan as at December 31, 2016 is $261,000 (December 31, 2015: $371,000).

d) SADI

On April 23, 2014, the Company secured funding for certain non-recurring expenditures and manufacturing equipment. The Government of Canada under the Strategic Aerospace and Defence Initiative (“SADI”) program has committed up to $4.4 million for funding of program eligible costs. The contribution amount represents 40% funding for eligible costs.

The contribution agreement has the following terms:

- The maximum amount to be repaid by the Company is 1.5 times the amount contributed by the Government of Canada;
- Repayments are to occur over a 15 year term, commencing two years following the fiscal year end, in which the contributions are completed; and
- Amounts repayable are unsecured.

$1,398,000 was drawn on this facility as at December 31, 2016 (December 31, 2015: $1,237,000).

## 22. Obligations and Commitments Under Finance and Operating Leases

The Company has committed to payments under certain capital and operating leases relating to manufacturing machinery and equipment, and building lease costs. Future minimum lease payments required in each of the next five fiscal years and thereafter are:

| **FOR THE YEAR ENDED DECEMBER 31** | **2016** | | 2015 | |
|---|---|---|---|---|
| | **Operating** | **Finance** | Operating | Finance |
| 2016 | **$-** | **$-** | $2,905 | $145 |
| 2017 | **2,892** | **56** | 2,842 | 56 |
| 2018 | **3,246** | **56** | 3,254 | 56 |
| 2019 | **479** | **46** | 437 | 46 |
| 2020 | **255** | **7** | 258 | 7 |
| 2021 | **130** | **-** | 134 | - |
| Thereafter | **-** | **-** | - | - |
| Total future minimum lease payments | **7,002** | **165** | 9,830 | 310 |
| Less: Imputed interest | **n/a** | **(18)** | n/a | (33) |
| Balance of obligation under finance leases included in term debt (note 21a) | **n/a** | **147** | n/a | 277 |

For the year ended December 31, 2016, an amount of $2,897,000 representing payments under operating leases was expensed (December 31, 2015: $2,695,000).

As at December 31, 2016 the Company had $38,963,000 of committed contractual operational purchase order obligations outstanding (December 31, 2015: $17,685,000).

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

## 23. Capital Stock

The Company is authorized to issue an unlimited number of common shares as well as an unlimited number of first preferred and second preferred shares, issuable in series, the terms of which will be determined by the Company's directors at the time of creation of each series. There were 307,141,184 common shares issued at December 31, 2016. The book value of common shares issued and outstanding as at December 31, 2016 was $80,302,000 (December 31, 2015: $80,158,000).

Common shares issued or reserved:

| | **Number of shares** | **Amount** |
|---|---|---|
| December 31, 2014 | 302,633,184 | 79,921 |
| Share issue | | |
| Cash (b) | 2,922,000 | 146 |
| Transfer from contributed surplus on exercise of stock options (b) | - | 91 |
| December 31, 2015 | 305,555,184 | 80,158 |
| Share issue | | |
| Cash (a) | 1,586,000 | 113 |
| Transfer from contributed surplus on exercise of stock options (a) | - | 31 |
| December 31, 2016 | 307,141,184 | 80,302 |

a) During the second quarter 2016 holders of the Company's stock options exercised 960,500 stock options at a price of $0.085 and 625,500 stock options at a price of $0.05 resulting in the issuance of 1,586,000 common shares with a value of $113,000.

b) During the fourth quarter 2015 holders of the Company's stock options exercised 2,922,000 stock options at a price of $0.05 resulting in the issuance of 2,922,000 common shares with a value of $146,000.

c) The Company's incentive stock option plan is administered by the Board of Directors. It is a rolling share option plan wherein 10% of the issued and outstanding common shares at the time an option is granted are reserved for issuance.

A summary of the Company's stock options issued as of December 31, 2016 and December 31, 2015, and changes during the periods ending on those dates, are presented below.

| **FOR THE YEAR ENDED DECEMBER 31** | **2016** | | 2015 | |
|---|---|---|---|---|
| | **Options** | **Weighted average exercise price** | Options | Weighted average exercise price |
| Outstanding – Beginning of year | **34,653,500** | **$0.09** | 31,474,500 | $0.09 |
| Granted | **29,370,500** | **0.089** | 8,523,000 | 0.085 |
| Expired | **(1,250,000)** | **0.05** | (2,422,000) | 0.05 |
| Exercised | **(1,586,000)** | **0.071** | (2,922,000) | 0.05 |
| Forfeited | **(8,962,500)** | **0.158** | - | - |
| Outstanding – End of year | **52,225,500** | **0.79** | 34,653,500 | 0.09 |

Options granted during the current year vest over a period of two years.

The following table summarizes stock options which are exercisable as at December 31, 2016:

| | **Number** | **Weighted average remaining contractual life (years)** | **Weighted average exercise price** |
|---|---|---|---|
| $0.085 - $0.100 | 14,603,750 | 6.74 | 0.096 |

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

d) The Company's contributed surplus is comprised as follows:

| **FOR THE YEAR ENDED DECEMBER 31** | **2016** | 2015 |
|---|---|---|
| Beginning of year | **$4,453** | $3,129 |
| Stock-based compensation expense | **1,158** | 930 |
| Fair value of warrants issued | **1,164** | 485 |
| Transfer of share capital on exercise of stock options | **(31)** | (91) |
| End of year | **6,744** | 4,453 |

The stock-based compensation expense is included in the Consolidated Statements of Loss and Comprehensive Loss as administrative and general expenses and amounts to $1,158,000 (December 31, 2015: $930,000).

In conjunction with receiving advances under a term loan (note 21b), the Company issued Panta 30,714,118 common share purchase warrants ("warrants") on a pro-rata basis, each warrant is exercisable for a period of 24 months following the date of issuance with respect to one common share at an exercise price of $0.07 per common share. The Company issued 12,285,647 such warrants on September 19, 2016, 9,214,235 such warrants on October 24, 2016, and 9,214,236 such warrants on November 10, 2016.

e) A summary of the Company's warrants issued as of December 31, 2016 and December 31, 2015, and changes during the periods ending on those dates, are presented below.

| **FOR THE YEAR ENDED DECEMBER 31** | **2016** | 2015 |
|---|---|---|
| Outstanding – Beginning of year | **30,263,318** | - |
| Granted (i) (ii) | **30,714,118** | 30,263,318 |
| Expired | **-** | - |
| Exercised | **-** | - |
| Outstanding – End of year | **60,977,436** | 30,263,318 |

i. August 17, 2015: Grant of 12,105,327 Warrants expiring August 17, 2017 at $0.07 to Panta.

September 9, 2015: Grant of 6,052,664 Warrants expiring September 9, 2017 at $0.07 to Panta.

September 23, 2015: Grant of 12,105,327 Warrants expiring September 23, 2017 at $0.07 to Panta.

ii. September 19, 2016: Grant of 12,285,647 Warrants expiring September 19, 2018 at $0.07 to Panta.

October 24, 2016: Grant of 9,214,235 Warrants expiring October 24, 2018 at $0.07 to Panta.

November 10, 2016: Grant of 9,214,236 Warrants expiring November 10, 2018 at $0.07 to Panta.

## 24. Stock Based Compensation

The Company records compensation expense for the fair value of the stock options granted under its incentive stock option plan using the Black-Scholes option-pricing model. This model determines the fair value of stock options granted and amortizes it to earnings over the vesting period.

The fair value of 29,370,500 options granted during the year ended December 31, 2016 was $2,164,000 (December 31, 2015: $350,000).

The assumptions used in the valuation of stock options were as follows:

| | **2016** | 2015 |
|---|---|---|
| Number of options | **29,370,500 Options** | 8,523,000 Options |
| Risk-free rate (%) | 1.35 | 0.75 |
| Dividend yield (%) | - | - |
| Expected Lives (years) | 5 | 5 |
| Volatility (%) | 57.70 | 56.60 |

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

The amount of stock-based compensation expense, for options granted in current and prior periods, amortized to earnings during the year ended December 31, 2016 was $1,158,000 (2015: $930,000). Stock-based compensation expense has been included in the Consolidated Statements of Loss and Comprehensive Loss as administrative and general expenses.

The Black-Scholes option-pricing model used by the Company to calculate option values was developed to estimate the fair value of freely tradeable, fully transferable options without vesting restrictions, which significantly differ from the Company's stock option awards. Changes in the subjective input assumptions can materially affect the fair value estimate, and therefore, the existing models do not necessarily provide a reliable, single measure of the fair value of options granted by the Company.

## 25. Defined Contribution Plan

The total cost recognized and paid for the Company's defined contribution plan is as follows.

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Defined contribution plan | **$1,280** | $ 1,338 |

The Company's contribution to the plan is calculated on a percentage of employee wages. The range of percentages is 1.5% to 9.5%. The plan is available to all employees. Defined contribution plan expenses have been included in the Consolidated Statements of Loss and Comprehensive Loss as administrative and general expenses and cost of sales.

## 26. Finance Costs

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Interest on finance leases | **$14** | $28 |
| Interest on other term debt | **63** | 54 |
| Interest on bank indebtedness | **158** | 152 |
| Interest on related party debt | **87** | 126 |
| Non-cash financing cost accretion | **31** | 500 |
| Interest expense | **353** | 860 |
| Interest income | **(14)** | (4) |
| Net interest expense | **339** | 856 |

## 27. Supplementary Cash Flow Information

Non-cash financing and investing activities:

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Equipment acquired under capital lease | **$-** | $119 |
| Equipment acquired through accounts payable | **1,707** | - |
| Accounts payable settled with consideration receivable | **3,867** | - |

## 28. Income Tax

The provision for income tax (recovery) expense is based on the combined Canadian federal and provincial annual income tax rate expected for the full financial year of 26%.

Deferred income tax assets are recognized for deductible temporary differences, unused tax losses, and unused tax credits to the extent that the realization of the related tax benefit through future taxable profits is probable. The Company did not recognize deferred income tax assets of $26,399,000 (2015: $20,925,000) in respect of losses amounting to $70,788,000 (2015: $46,842,000) which expire beginning in 2026 through 2036, unclaimed research and development costs of $10,830,000 (2015: $10,830,000) with no expiry, investment tax credits of $1,726,000 (2015: $3,330,000) which expire beginning in 2017 through 2032, and deductible temporary differences of $23,133,000 (2015: $18,921,000).

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

The company has recognized $Nil (2015: $Nil) in deferred income tax liabilities in relation to the fair value of the intangible lease.

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Statutory tax rate | **26.00%** | 26.00% |
| Recovery at statutory rate | **$(4,187)** | $(3,160) |
| Change in unrecognized deferred income tax assets | **5,042** | 3,033 |
| Benefit of losses not previously recognized | **(477)** | (234) |
| Tax rate differences | **(807)** | (85) |
| Other permanent differences | **429** | 446 |
| Tax expense | **-** | - |

## 29. Related Party Transactions

a) During 2015 a performance guarantee was provided on production contracts with a certain customer by Panta Holdings B.V. whose wholly owned subsidiary, Panta Canada B.V., is Avcorp's majority shareholder owning approximately 65.5% of the issued and outstanding common shares on December 31, 2016. Both companies are incorporated in The Netherlands. Mr. Jaap Rosen Jacobson, a director of Avcorp is the sole shareholder of Panta Holding B.V. The performance guarantee was calculated as a percentage of revenues generated from production contracts with this certain customer. Accordingly, the fees varied with fluctuations in sales to this certain customer. Fees paid, in that respect, to Panta Holdings B.V. during the year ended December 31, 2016 amounted to $330,000 (December 31, 2015: $1,334,000). Fees payable to Panta Holdings B.V. as at December 31, 2016 are $Nil (December 31, 2015: $330,000). These fees are included in the Consolidated Statements of Loss and Comprehensive Loss as cost of sales and amount to $Nil for the year ended December 31, 2016 (December 31, 2015: $1,363,000). This performance guarantee was extinguished as at December 18, 2015.

b) During the year ended December 31, 2016, consulting services were provided by certain directors. Fees paid to certain directors, or companies with which they have beneficial ownership, during the year ended December 31, 2016 amounted to $337,000 (December 31, 2015: $395,000). Fees payable to certain directors or Companies with which they have beneficial ownership, as at December 31, 2016 are $376,000 (December 31, 2015: $12,000). These fees are included in the Consolidated Statements of Loss and Comprehensive Loss as administrative and general expenses and amount to $701,000 for the year ended December 31, 2016 (December 31, 2015: $387,000).

c) Key management compensation

Key management includes Executive Officers for all operating facilities. The compensation paid or payable to key management for employee services is shown below.

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Salaries and other short-term employee benefits | **$2,186** | $3,252 |
| Contributions to defined contribution plan | **69** | 40 |
| Option-based awards | **1,332** | 912 |
| | **3,587** | 4,204 |

d) Loans to related parties

The balance of loans receivable from key management as at December 31, 2016 is $15,000 (December 31, 2015: $15,000). These loans are unsecured and payable on demand.

Other related party transactions are disclosed elsewhere in these consolidated financial statements (note 21b).

These transactions were conducted in the normal course of business and were accounted for at the exchange amount.

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

## 30. Earnings per share

Basic earnings per share amounts are calculated by dividing the net income for the year attributable to common equity holders of the parent by the weighted average number of common shares outstanding during the year.

Diluted earnings per share amounts are calculated by dividing the net profit attributable to common equity holders of the parent by the weighted average number of common shares outstanding during the year plus the weighted average number of common shares that would be issued on conversion of all the dilutive potential common shares into common shares.

The following reflects the share data used in the basic and diluted earnings per share computations:

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | 2015 |
|---|---|---|
| Weighted average number of common shares for basic earnings per share | **306,611,069** | 302,889,360 |
| Effect of dilution: | | |
| Warrants | **-** | - |
| Share options | **-** | - |
| Weighted average number of ordinary shares adjusted for the effect of dilution | **306,611,069** | 302,889,360 |

There have been no other transactions involving common shares or potential common shares between the reporting date and the date of authorization of these consolidated financial statements.

## 31. Economic Dependence and Segmented Information

The Company reports financial performance based on three reportable segments as detailed below. The Company's Chief Operating Decision Maker ("CODM") utilizes Operating Income Loss as a primary measure of profitability to evaluate performance of its segments and allocate resources:

- The Avcorp Structures & Integration ("ASI") segment, which is dedicated to metallic and composite aerostructures assembly and integration.
- The Comtek Advanced Structures Ltd. ("Comtek") segment, within which exist two divisions dedicated to aircraft structural component repair services, and Avcorp Engineered Composites ("AEC") dedicated to design and manufacture of composite aerostructures.
- The Avcorp Composite Fabrication Inc. ("ACF") segment is dedicated to advanced composite aerostructures fabrication.

No operating segments have been aggregated to form the above reportable operating segments. Corporate includes general corporate administrative costs and any other costs not identifiable with one of the Company's segments.

The Executive Management Committee monitors the operating results of its business units separately for the purpose of making decisions about resource allocation and performance assessment. Segment performance is evaluated based on operating profit or loss and is measured consistently with operating profit or loss in the Consolidated Statements of Loss and Comprehensive Loss.

a) Sales to five major customers for the year ended December 31, 2016 (December 31, 2015: top three major customers), which comprise several programs and contracts, accounted for approximately 67.1% (December 31, 2015: 77.0%) of sales.

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | | 2015 | |
|---|---|---|---|---|
| | **Revenue** | **% of Total** | Revenue | % of Total |
| BAE Systems | **$5,352** | **2.9** | $14,115 | 17.6 |
| Boeing[1] | **74,848** | **40.7** | 31,194 | 38.8 |
| Bombardier | **14,883** | **8.1** | 16,578 | 20.6 |
| Lockheed Martin | **12,493** | **8.6** | - | - |
| Subaru Corporation (formerly Fuji Heavy Industries) | **15,789** | **6.8** | - | - |
| Other | **27,323** | **14.9** | 18,173 | 22.6 |
| Amortization and contract renegotiation of the unfavourable contract liability (note 19) | **33,019** | **18.0** | 356 | 0.4 |
| Total | **183,707** | **100.0** | 80,416 | 100.0 |

1. Includes Boeing program partner revenue

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

b) The Company's sales are distributed amongst the following geographical locations:

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | | 2015 | |
|---|---|---|---|---|
| | **Revenue** | **% of Total** | Revenue | % of Total |
| Canada | **$21,616** | **11.8** | $24,928 | 31.0 |
| USA | **96,767** | **52.6** | 37,152 | 46.2 |
| Europe | **14,184** | **7.7** | 15,686 | 19.6 |
| Asia | **17,438** | **9.5** | 1,550 | 1.9 |
| Australia | **515** | **0.3** | 581 | 0.7 |
| Other | **168** | **0.1** | 163 | 0.2 |
| Amortization and contract renegotiation of the unfavourable contract liability (note 19) | **33,019** | **18.0** | 356 | 0.4 |
| Total | **183,707** | **100.0** | 80,416 | 100.0 |

c) The Company operates in one industry that involves the manufacture and sale of aerospace products. All of the Company's operations and assets are in Canada and in the United States.

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | | 2015 | |
|---|---|---|---|---|
| | **Total Assets** | **% of Total** | Total Assets | % of Total |
| Canada | **$61,664** | **46.4** | $88,754 | 55.4 |
| USA | **71,375** | **53.6** | 71,337 | 44.6 |
| Total | **133,039** | **100.0** | 160,091 | 100.0 |

The Company operates from two locations in Canada and one in the United States. Located in Delta, British Columbia, Avcorp Industries Inc., named as Avcorp Structures & Integration ("ASI"), is dedicated to metallic and composite aerostructures assembly and integration. Within Comtek Advanced Structures Ltd. ("Comtek"), located in Burlington, Ontario, exists two divisions dedicated to aircraft structural component repair services, and Avcorp Engineered Composites ("AEC") dedicated to design and manufacture of composite aerostructures. Located in Gardena, California, Avcorp Composite Fabrication Inc. ("ACF") is dedicated to advanced composite aerostructures fabrication.

Revenues, income loss and total assets are distributed by operating segment as noted in the tables below. Intercompany revenues and cost of sales are eliminated from the operating results presented.

| FOR THE YEAR ENDED DECEMBER 31, 2016 | Total | ASI | Comtek | ACF | Corporate |
|---|---|---|---|---|---|
| Revenue | **$183,707** | $46,483 | $19,491 | $117,733 | $- |
| Cost of sales | **175,333** | 46,729 | 15,311 | 113,293 | - |
| Gross (loss) profit | **8,374** | (246) | 4,180 | 4,440 | - |
| Selling, general, and admin expense | **24,429** | 6,849 | 2,795 | 8,506 | 6,279 |
| Depreciation and amortization | **350** | 281 | 57 | 12 | - |
| Operating (loss) gain | **(16,405)** | (7,376) | 1,328 | (4,078) | (6,279) |

| **FOR THE YEAR ENDED DECEMBER 31, 2015 – restated** (note 32) | Total | ASI | Comtek | ACF | Corporate |
|---|---|---|---|---|---|
| Revenue | **$80,416** | $61,031 | $17,038 | $2,347 | $- |
| Cost of sales | **72,279** | 56,692 | 12,725 | 2,862 | - |
| Gross (loss) profit | **8,137** | 4,339 | 4,313 | (515) | - |
| Selling, general, and admin expense | **19,278** | 6,255 | 2,344 | 995 | 9,684 |
| Depreciation and amortization | **482** | 432 | 50 | - | - |
| Operating (loss) income | **(11,623)** | (2,348) | 1,919 | (1,510) | (9,684) |

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | | 2015 restated (note 32) | |
|---|---|---|---|---|
| | **Total Assets** | **% of Total** | Total Assets | % of Total |
| Avcorp Industries Inc. | **$38,700** | **29.1** | $40,731 | 25.4 |
| Comtek Advanced Structures Ltd. | **10,632** | **8.0** | 9,232 | 5.8 |
| Avcorp Composite Fabrication Inc. | **71,375** | **53.6** | 71,337 | 44.6 |
| Corporate | **12,332** | **9.3** | 38,791 | 24.2 |
| Total | **133,039** | **100.0** | 160,091 | 100.0 |

| FOR THE YEAR ENDED DECEMBER 31 | 2016 | | 2015 restated (note 32) | |
|---|---|---|---|---|
| | **Total Liabilities** | **% of Total** | Total Liabilities | % of Total |
| Avcorp Industries Inc. | **$21,308** | **15.2** | $12,625 | 8.2 |
| Comtek Advanced Structures Ltd. | **3,537** | **2.5** | 2,926 | 1.9 |
| Avcorp Composite Fabrication Inc. | **90,749** | **64.9** | 136,888 | 89.3 |
| Corporate | **24,328** | **17.4** | 868 | 0.6 |
| Total | **139,922** | **100.0** | 153,307 | 100.0 |

## 32. Business Acquisition

Effective December 18, 2015, Avcorp completed the acquisition of Hitco (the "Acquisition"). The Acquisition was completed pursuant to the terms of an asset purchase agreement (the "Agreement") that was entered into on July 20, 2015, with subsequent amendments to December 18, 2015. Pursuant to the Agreement Avcorp's subsidiary, ACF, purchased the assets of the division of Hitco which produces composite structural parts for commercial and military aerostructures (the "Business").

Through the Acquisition, Avcorp acquired the composite Aerostructures division of Hitco but did not acquire any assets of Hitco's materials division that is responsible for the production of specialty materials. The Acquisition included all of the assets, properties and rights held by Hitco related to the Business including:

- inventory, packaging materials, and consumables of the Business;
- fixed assets, equipment and tooling assets primarily used in the Business;
- accounts or notes receivable related to the Business;
- prepaid expenses and deposits primarily related to the Business;
- the intellectual property of the Business together with all of the goodwill associated with the intellectual property;
- the goodwill related to the Business, together with the exclusive right to hold Avcorp out as carrying on the Business in succession to Hitco;
- the right to use the name "Hitco Carbon Composites" or any variation thereof in connection with the Business; and
- several purchase contracts held by Hitco.

The final purchase price allocation for the acquisition as set forth in the table below reflects various fair value estimates and analysis, including the final work performed related to the fair values of certain tangible assets and liabilities acquired and the valuation of intangible assets acquired.

As a result of potential product quality and warranty claims, in addition to the liabilities assumed in the transaction, the Company may be involved in, or subject to, other disputes, claims and proceedings that arise in connection with the business acquired, including some that Avcorp asserts against others. The ultimate resolution of, and liability and costs related to these matters, at this time is undeterminable.

Pursuant to the asset purchase agreement, Hitco's direct and indirect parent companies have guaranteed certain of Hitco's obligations to Avcorp under the Agreement, including Hitco's indemnity obligations to Avcorp for Avcorp's losses stemming from product quality and warranty claims pertaining to finished goods delivered by Hitco before the closing date and certain finished goods manufactured by Hitco before the closing date that were designated as conforming inventory.

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

Included in the finalized unfavourable contract liability balance of $100,582,000 is an amount related to extraordinary inspection costs incurred by the Company in order to address certain product quality and warranty claims associated with non-conforming finished goods discovered subsequent to the closing of the Acquisition. The extraordinary inspection costs have been recognized based on management's best estimate and there exists significant measurement uncertainty relating to potential future product quality and warranty claims. Although the ultimate result and timing of potential additional claims and the amounts at which they may be settled cannot be determined, management believes that there is a possibility that the costs that may be incurred to settle these claims are material. Management intends to pursue recovery of the direct and consequential damages incurred in relation to this matter.

Included in the finalized unfavourable contract liability balance is a provision for management's best estimate of the expected costs for the foregoing product quality and warranty claims however the Company has not disclosed the information usually required by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* on the grounds that it can be expected to prejudice seriously the outcome of possible litigation related to this matter.

Consideration provided by Avcorp for the Acquisition of the assets was principally the assumption of liabilities by Avcorp, including the current trade payables and ongoing contractual obligations of the Business.

The Acquisition has been accounted for as a business combination, using the acquisition method. The purchase consideration provided was allocated to the fair values of the identifiable assets acquired and liabilities assumed as follows:

| | December 18, 2015 | | |
|---|---|---|---|
| | As Previously Reported | Adjustment | Final |
| Cash | $32,826 | $- | $32,826 |
| Consideration receivable | 39,013 | - | 39,013 |
| **Consideration** | **71,839** | **-** | **71,839** |
| **Assets purchased** | | | |
| Accounts receivable | 18,799 | - | 18,799 |
| Inventories and prepayments | 19,763 | (748) | 19,015 |
| **Current Assets** | **38,562** | **(748)** | **37,814** |
| Equipment | 22,112 | (242) | 21,870 |
| Intangible – lease | 3,109 | (2,356) | 753 |
| Intangible – customer contract re-compete | 10,040 | (4,323) | 5,717 |
| Intangible – customer order backlog | 3,068 | (3,068) | - |
| Goodwill | - | - | - |
| **Total assets purchased** | **76,891** | **(10,737)** | **66,154** |
| **Liabilities assumed** | | | |
| Accounts payable and accrued liabilities | 17,431 | 1,027 | 18,458 |
| Customer advance | 23,428 | (4,475) | 18,953 |
| Unfavourable contracts liability | 90,654 | 9,928 | 100,582 |
| Deferred income tax liability | 1,244 | (1,244) | - |
| **Total liabilities assumed** | **132,757** | **5,236** | **137,993** |
| **Net liabilities** | **(55,866)** | **(15,973)** | **(71,839)** |
| **Gain on acquisition** | **15,973** | **(15,973)** | **-** |

The finalization adjustments made to the preliminary purchase price allocation reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of the date. The measurement period adjustments predominately relate to updating fair value estimates in the following areas:

- Working capital (inventories, prepayments, accounts payable and accrued liabilities): The fair value of these items was adjusted to reflect the valuation of amounts recorded at acquisition date based on information obtained subsequent to the acquisition date.

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

- Intangible – lease: Management obtained more relevant market value information in order to determine the fair value estimate of the lease assumed in Gardena.
- Intangible – customer contract re-compete and customer backlog: The fair value of these intangible assets were adjusted to reflect more accurate profitability assessments of the underlying contracts obtained subsequent to the acquisition.
- Customer advance and unfavourable contracts liability: Management obtained additional information on the profitability of the related programs subsequent to the acquisition. This additional profitability information has been reflected in the updated fair value estimates of these items. The adjustments to these items resulted in additional revenue in the year ended December 31, 2015, relating to the amortization and foreign currency adjustment of the balances for products shipped in the 2015 fiscal period.
- Deferred income tax liability: The estimate of deferred tax liability has been adjusted to reflect the adjusted fair value of the intangible – lease.
- Gain on acquisition: The net impact of the foregoing adjustments resulted in an elimination of the gain on acquisition previously reported.

The Company incurred acquisition-related costs of $3,827,000 in the year ended December 31, 2015 as restated relating to external legal fees, consulting fees and due diligence costs that are included in administration and general expenses.

The effects of the adjustments made to the consolidated financial statements to finalize the Company's accounting for the Acquisition are presented below.

| | December 31, 2015 | | |
|---|---|---|---|
| | As Previously Reported | Adjustment | Restated |
| **ASSETS** | | | |
| **Current assets** | | | |
| Inventories | $36,383 | $(881) | $35,502 |
| Prepayments and other assets | 1,424 | 139 | 1,563 |
| **Non-current assets** | | | |
| Property, plant and equipment | 29,880 | (240) | 29,640 |
| Intangibles | 16,095 | (9,673) | 6,422 |
| **LIABILITIES AND EQUITY** | | | |
| **Current liabilities** | | | |
| Accounts payable and accrued liabilities | 27,087 | 1,020 | 28,107 |
| Customer advance | 10,408 | (2,126) | 8,282 |
| Unfavourable contracts liability | 11,335 | 24,447 | 35,782 |
| **Non-current liabilities** | | | |
| Deferred gain and lease inducement | 392 | (1) | 391 |
| Customer advance | 12,697 | (2,451) | 10,246 |
| Unfavourable contracts liability | 78,636 | (14,947) | 63,689 |
| Deferred tax liability | 1,235 | (1,235) | - |
| **(Deficiency) Equity** | | | |
| Accumulated deficit | (62,465) | (15,362) | (77,827) |

*(all figures in tables are expressed in thousands of Canadian dollars, except per share amounts)*

| | December 31, 2015 | | |
|---|---|---|---|
| | As Previously Reported | Adjustment | Restated |
| **Revenues** | $79,925 | $491 | $80,416 |
| **Cost of sales** | 72,279 | - | 72,279 |
| **Gross profit** | 7,646 | 491 | 8,137 |
| Administrative and general expenses | 19,278 | - | 19,278 |
| Office equipment depreciation | 482 | - | 482 |
| **Operating Loss** | (12,114) | 491 | (11,623) |
| Finance costs – net | 856 | - | 856 |
| Foreign exchange (gain) | (203) | (120) | (323) |
| Net (gain) on sale of equipment | (2) | - | (2) |
| (Gain) on acquisition | (15,973) | 15,973 | - |
| **Loss before income tax** | 3,208 | (15,362) | (12,154) |
| Income tax expense | - | - | - |
| **Net loss for the year** | 3,208 | (15,362) | (12,154) |
| Other comprehensive loss | - | - | - |
| **Net loss and total comprehensive loss for the year** | 3,208 | (15,362) | (12,154) |

## 33. Subsequent events

a) Effective February 17, 2017, the Company entered into an amendment to its existing credit facility with a Canadian chartered bank whereby the bank extended the credit facility from April 15, 2017 to July 30, 2017 (note 15).

b) Effective March 2, 2017, the Company entered into an amendment to its existing credit facility with a Canadian chartered bank whereby the permanent block against available credit was reduced from $2,500,000 to $1,800,000 (note 15).

c) Effective March 31, 2017 the Company entered into an amendment to its existing credit facility with a Canadian chartered bank whereby the following amendments were made;

- the permanent block against available credit of $1,800,000 was removed.
- availability under the facility was increased to USD$23,000,000 subject to draw down provisions which have been amended to include eligible receivables and inventories of Avcorp Composite Fabrication Inc.
- the debt facility will bear interest at a rate equal to the bank's prime rate plus 0.75% (note 15).

d) On May 26, 2017, the Company entered into a loan agreement to expand its loan facility with a Canadian Chartered bank ("the Expanded Loan"). This loan agreement amends, restates and replaces the loan agreement entered into on September 27, 2012 (note 15). The Expanded Loan provides an additional borrowing capacity of up to USD$35,000,000 increasing its existing, as at March 31, 2017, USD$23,000,000 revolving loan (note 33c) in total up to USD$58,000,000. The Expanded Loan matures on June 30, 2020.

Interest rate for advances made up to the maximum of the allowable borrowing base on the existing USD$23,000,000 revolving loan:

- RBP plus 0.75% per annum
- RBUSBR plus 0.75% per annum
- BA Equivalent Rate plus 2.25% per annum
- LIBOR Rate plus 2.25% per annum

Interest rate for advances made on the additional borrowing capacity up to USD$58,000,000.

- RBP plus 0.00% per annum
- RBUSBR plus 0.00% per annum
- BA Equivalent Rate plus 0.875% per annum
- LIBOR Rate plus 0.875% per annum

Drawdown under the USD$35,000,000 additional borrowing capacity is supported by a major and material customer of the Company by way of a guarantee.

The Company will provide the guarantor, as consideration for the guarantee, a fee equal to 5.375% of the weighted average outstanding balance of the guaranteed portion over each full twelve (12) month period commencing on the funding date plus, for the partial year thereafter, 5.375% of the weighted average outstanding balance of the guaranteed portion multiplied by the number of days in the partial year divided by three hundred sixty (360). The fee will be payable on the maturity date.

The Expanded Loan is subject to the existing security agreements with a Canadian Chartered bank and with its guarantor. This debt facility is secured by a charge and specific registration over all of the assets of the Company.

e) On March 17, 2017, Avcorp entered into a loan agreement ("Loan") with Panta bearing interest of 8% per annum to fund the Company to a maximum aggregate principal amount of USD$907,000 maturing on May 15, 2017. The Loan was drawn down in two tranches dated March 21, 2017 and March 27, 2017. The Loan was repaid on April 3, 2017 from the proceeds of the consideration receivable as set out in note 33g. Panta Canada B.V. is Avcorp's majority shareholder owning approximately 65.5% of the issued and outstanding common shares on December 31, 2016. Panta Canada B.V. is wholly owned by Panta Holdings B.V. Both companies are incorporated in The Netherlands and Mr. Jaap Rosen Jacobson, a director of the Company, is the sole shareholder of Panta Holdings B.V.

f) The Lessor of the Industrial Centre at Gardena California, where ACF has its manufacturing facilities, received an offer from a third party to purchase the Industrial Centre. On March 28, 2017 Avcorp exercised its right of first refusal under the lease agreement by providing notice to the Lessor that it proposes to purchase the property on the same terms and conditions as presented in the Offer. Avcorp has up to 270 days from the date of providing such notice to present and close a sale transaction with the Lessor. In addition, Avcorp entered into a Memorandum of Understanding and a Letter Agreement with Stockdale Acquisitions LLC to negotiate a joint venture agreement for the ultimate acquisition and development of the property in exchange for a long term lease by Avcorp of a portion of the property on favourable economic terms. On June 26, 2017, Avcorp provided notice to the Lessor of the Industrial Centre at Gardena California that it has elected not to proceed with the acquisition of the property.

g) On April 3, 2017, Avcorp received the USD$9,220,000 remaining consideration receivable from the acquisition of Hitco (note 10). USD$6,511,000 of the consideration payment was utilized to repay a portion of the debt facility with a Canadian Chartered bank (note 15). A further amount of USD$907,000 was utilized to repay the Loan with Panta (note 33e).

h) On April 7, 2017, a term loan entered into with Panta become due and payable for the principal amount of USD$5,000,000 and USD$187,000 of accrued and unpaid interest. As at that date the Company and Panta amended the term loan to provide for a maturity date which is the earlier of the date on which credit is available to be drawn by the Company under the Expanded Loan with a Canadian Chartered bank, and July 6, 2017, with interest continuing at 8% per year. The Company incurred a USD$100,000 amendment fee in this regard.

# AVCORP INDUSTRIES INC.

## BOARD OF DIRECTORS AND OFFICERS

David Levi (1)(2)
CHAIRMAN OF THE BOARD
Executive Chairman
GrowthWorks Capital Ltd.
Vancouver, British Columbia

Eric Kohn TD (1*)
DIRECTOR
Managing Partner
Barons Financial Services SA
Geneva, Switzerland

Kees de Koning (3)
DIRECTOR
Nootdorp, The Netherlands

Elizabeth Otis (2)(3)
DIRECTOR
Palm Springs, California

Jaap Rosen Jacobson (3*)
DIRECTOR
President
Panta Holdings B.V.
Mijdrecht, The Netherlands

Peter George
DIRECTOR
Avcorp Group Chief Executive Officer
Lake Tapps, Washington

Edward Merlo
DIRECTOR and CORPORATE SECRETARY
Avcorp Group Chief Financial Officer
Richmond, British Columbia

## MANAGEMENT

Ken McQueen
Avcorp Group Vice President, Human Resources
New Westminster, British Columbia

Brent Collver
President
Comtek Advanced Structures Ltd.
Oakville, Ontario

Marty Jones
General Manager – Defence
Avcorp Composite Fabrication Inc.
Redondo Beach, California

Amandeep Kaler
General Manager
Avcorp Structures & Integration
Surrey, British Columbia

Jim Renaud
General Manager – Commercial
Avcorp Composite Fabrication Inc.
Huntington Beach, California

(1) Member of the Audit and Corporate Governance Committee
(2) Member of the Compensation and Nominating Committee
(3) Member of the Finance Committee

* Designates the Committee Chair
Ray Castelli resigned from the Board of Directors on March 16, 2017

# DIRECTORY

### Legal Counsel

McMillan LLP
Barristers & Solicitors
Vancouver, British Columbia

### Auditors

Deloitte LLP
Chartered Professional Accountants
Vancouver, British Columbia

### Shares Listed

Toronto Stock Exchange
Symbol AVP

### Registrar and Transfer Agent

CST Trust Company
Vancouver, British Columbia

### Bank

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Richmond, British Columbia

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