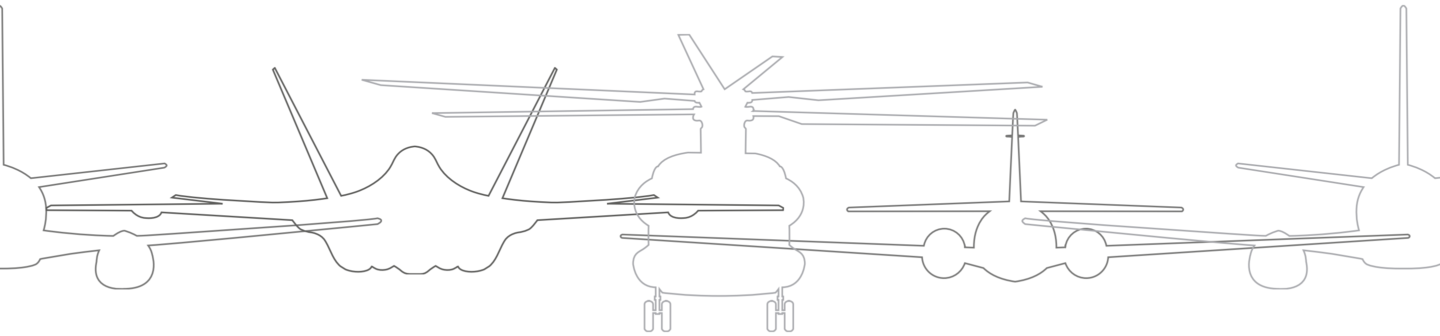
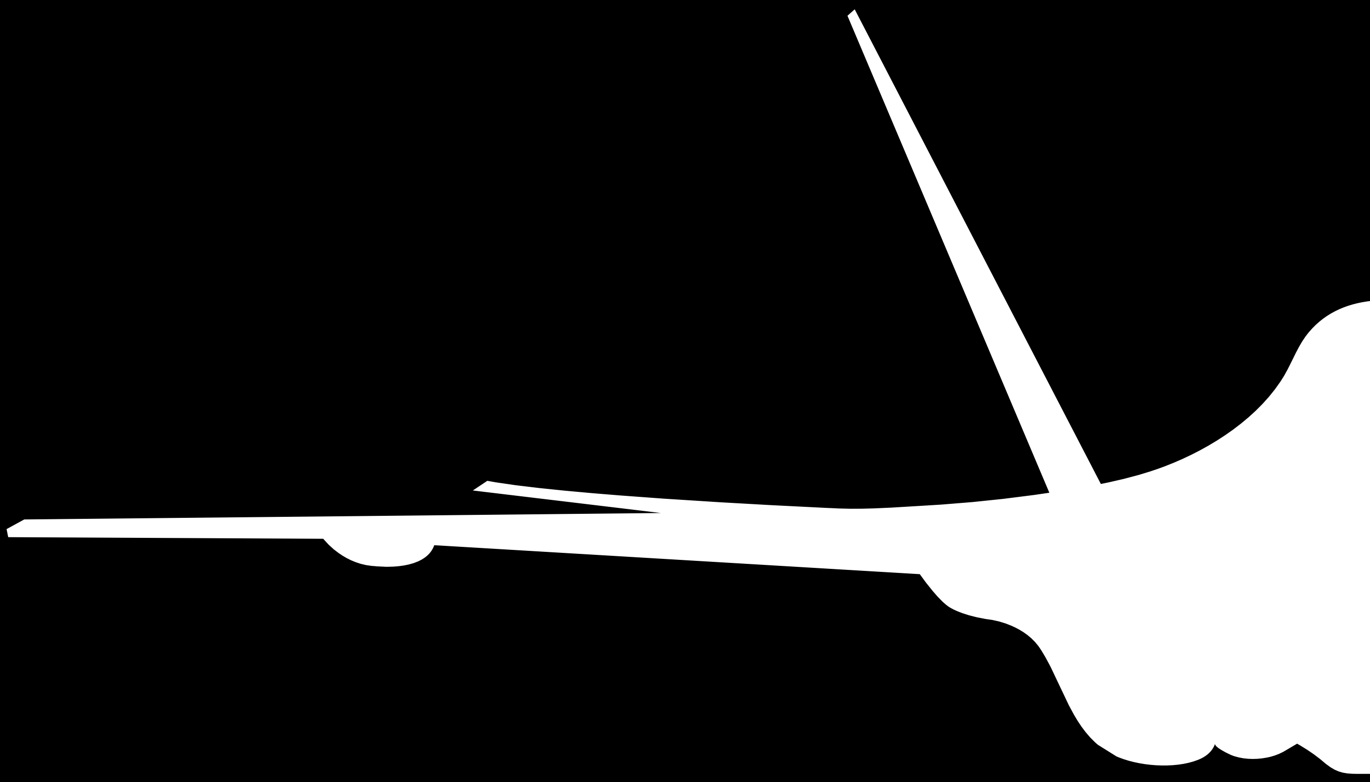
Avcorp Industries Inc. 2007 Annual Report



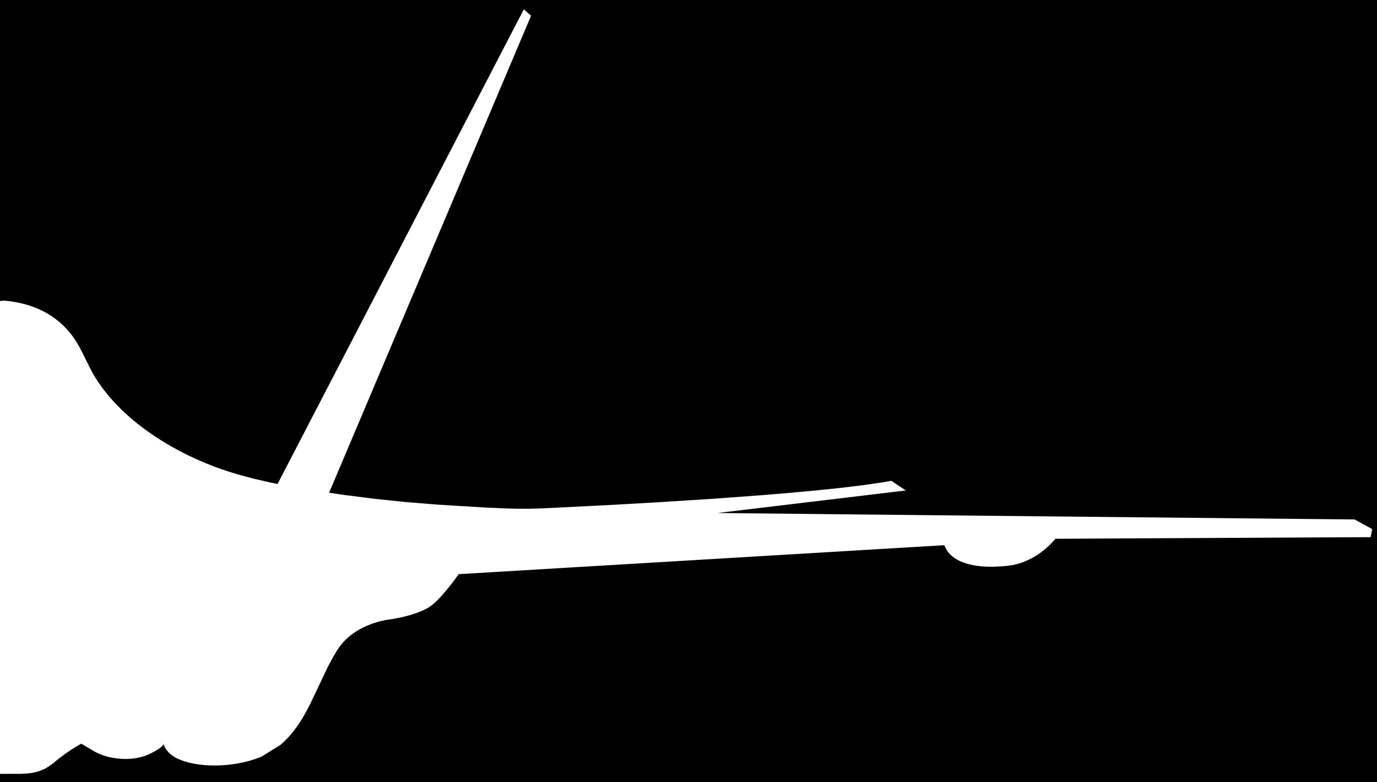
Avcorp

Where we're going.
How we'll get there.



Where we're going.

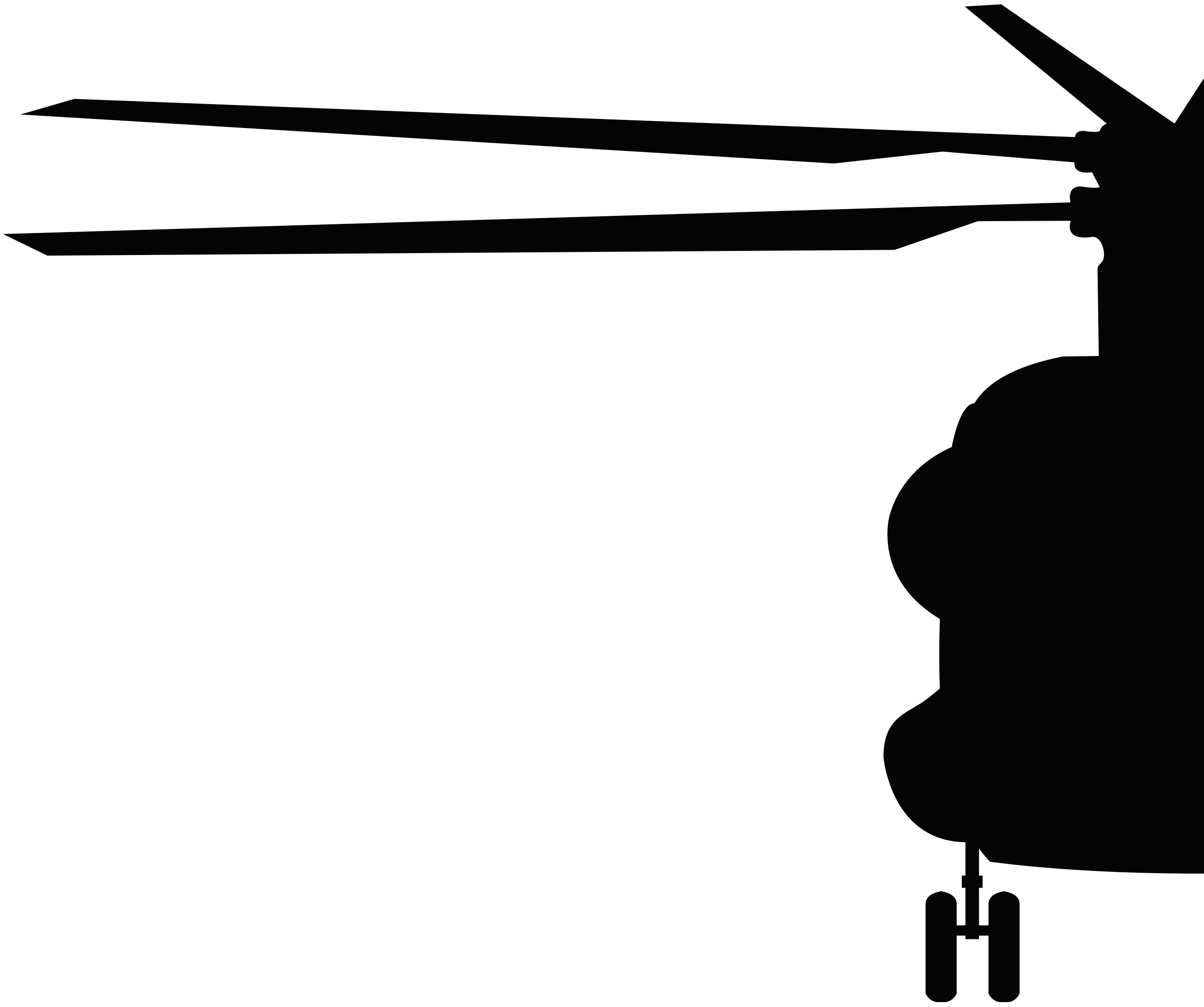
The aerospace industry is constantly changing and adjusting to many variable factors such as fuel prices, competing airlines, new entrants and consolidations. To build our economic future, we've laid the groundwork that allows us to control the things we can and adapt quickly and agilely to the ones we can't. We're building on our core capabilities



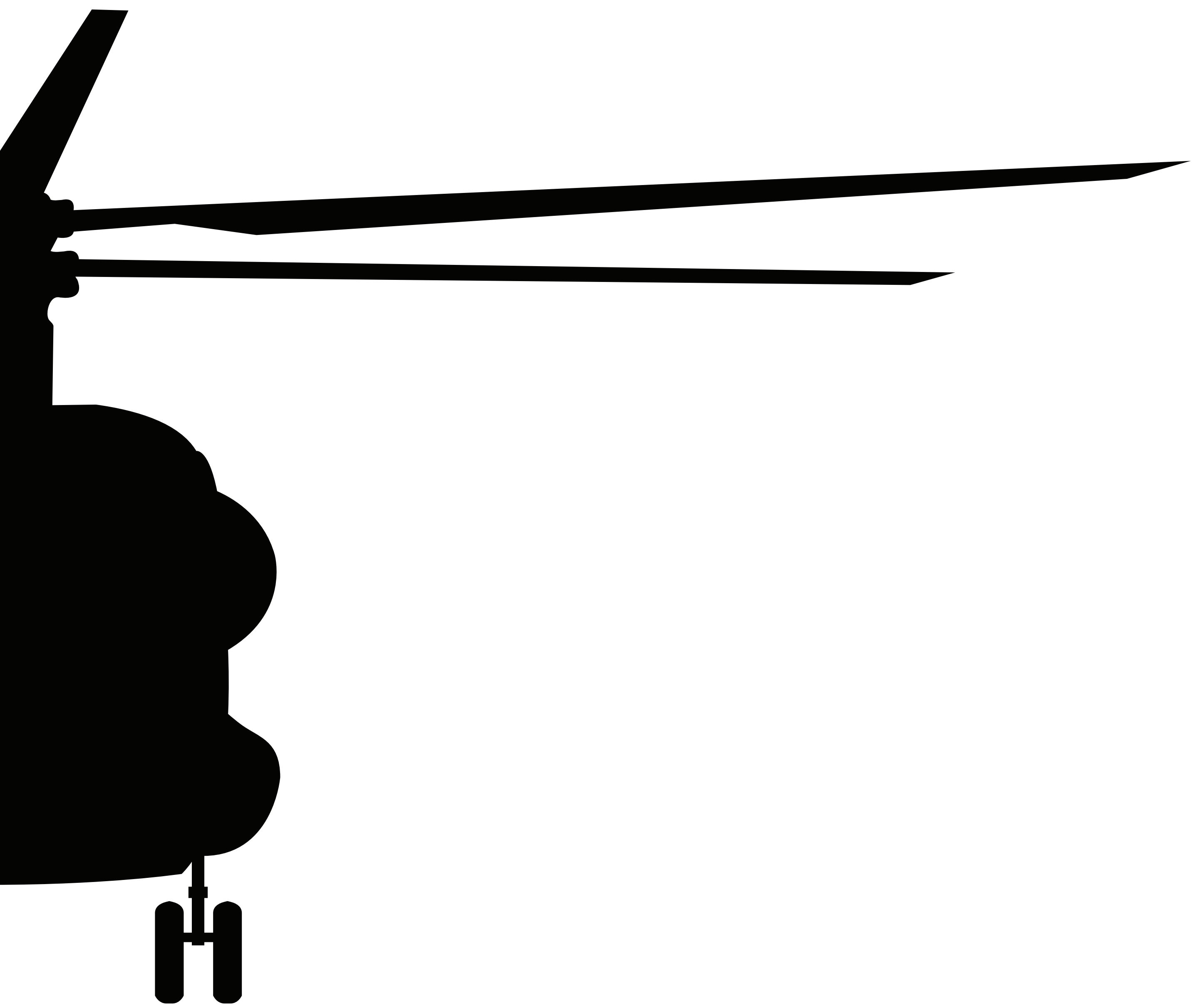
through acquisitions and new talent. We’ve obtained new customers such as Honda and Lockheed Martin. We’ve entered the military market and we’ve re-entered the rotorcraft market. We’re confident that we have equipped ourselves for challenge.

How we'll get there.

Our flight plan is simple, build the best components, develop the smartest, leanest programs and keep our customers coming back for more. We've added to our capabilities by acquiring expertise in design and manufacture of



advanced composite structures. We have a dedicated workforce, a tireless management team and a seasoned board of aerospace professionals. We're adding new clients and expanding on our existing programs.



About us.

Avcorp designs and builds major airframe structures for some of the world's leading aircraft companies, including Boeing, Bombardier, and Cessna. With 50 years of experience, more than 750 skilled employees and 385,000 square feet of facilities, Avcorp 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, lightweight, strong, reliable structures. Avcorp is a Canadian public company traded on the Toronto Stock Exchange (TSX. “AVP”).

The past year was a challenging one for Avcorp and perhaps a precursor to the economic order we now operate in. After 50 years in business it does not appear to be getting any easier.

In 2007, we saw a 20% appreciation of the Canadian dollar which affected both our operating profit and gross revenue. Gone are the days of a $0.65 Canadian dollar versus the US dollar and the automatic built in advantages that come with doing business in Canada.

The improvements we achieved in productivity and efficiency in 2007 were quickly eroded by a rising dollar. This is the economic reality of the world we live in but this unfortunately does not tell the whole story. There will always be another company in another country prepared to do the work cheaper and inducements or enticements to attract that work. We have to learn to adapt to compete in this changing marketplace.

With a booming aerospace industry come the pressures of delivery, labour rates, supplies, availability of materials and competition from emerging markets. We must control and improve on the things we can, while adapting to the ones we can't. The results we experienced in the latter part of 2007 taught us that we cannot rely on past achievements but rather continue to adapt and change.

In 2007, we issued approximately $2 million in additional equity and saw approximately $4 million of preferred shares convert to equity at prices well in excess of the current market and therefore with minimal dilution to the existing equity or shareholder base. That was the good news but during the year our share price was cut in half and that was not good news.

At the end of 2007, we purchased Comtek Advanced Structures Ltd., which added expertise in the design and manufacture of advanced composite structures. A necessary and positive step forward, the purchase took nine months to close, during which period, we were able to make the merger relatively seamless. The 90 employees of Comtek are a valuable addition to the Avcorp family, as well as adding work from Airbus and Goodrich as a new customer.

During the year we added Honda Aircraft Company with work on the Wing Structural Assembly for the new HondaJet. We also re-entered into the rotorcraft market with additional work to our military order book to supply subassemblies for the Boeing Chinook CH-47 Multi-Mission Heavy Lift Transport Helicopter for Boeing Integrated Defense Systems. While this new work took considerable time and investment to secure, it will not show up in a material way on our financial statements for some time to come. The payback for this type of work comes years down the road. This is one of the many challenges we face from investments being made now that will not show material results for some time to come.

The contracts we are bidding on are larger in scope and require a greater investment than ever before. Add to that our changing economic landscape and it is easy to understand the challenge we now face.

While we have loyal and understanding shareholders, our performance in 2007 has not been good enough.

We need to do a better job in adapting to our changing market. We have laid the foundation but cannot rely on past accomplishments when the market we operate in is changing with such rapidity. We as a Board recognize this and the Executive Committee, which includes seasoned aerospace professionals Kees de Koning and Liz Otis, has worked tirelessly in addressing the needed changes and assisting management. For that commitment, I am very grateful. We are well equipped to continue to make the changes that are necessary to compete.

These are very interesting, exciting and indeed challenging times at Avcorp. We are strategically positioned to take advantage of the opportunities and have a dedicated and committed workforce to make a difference.

Michael Scholz, CHAIRMAN, MARCH 23, 2008

Over the past two years, employees and management of Avcorp have given great efforts to continue the productivity improvements begun in 2006. Significant improvements in implementing lean techniques and improving part logistics have been realized, the effects of which were overshadowed in the second half of 2007 by the dramatically weakened dollar.

Diligent hard work by all of our employees contributed to a realized productivity increase of approximately 12% compared to 2005.

In 2007, our revenue increased to a new high of $110 million due to shipping an increased number of major structures and improving productivity.

We commissioned new production equipment for non-destructive testing of metal bonded assemblies, a state-of-the-art milling machine centre, a computer-controlled coordinate measuring machine and a waterjet cutting machine, all of which increase our capabilities to manage the entire workflow for metal bonded assemblies and to machine more complex hardware, and establish a capability for detailed sheet-metal profiling.

At the same time, we invested in education of our personnel and in attracting skilled and capable resources to enable us to increase the implementation of our continuous improvement programs. Like all BC companies, we have been addressing the realities of an active employment market, where increased competition challenges our ability to retain and recruit at the pace and level required to support our customer programs.

In 2007, we successfully implemented a state-of-the-art Product Lifecycle Management (PLM) system, thereby improving Configuration Control and Program Management, specifically in start-up programs. We extended our range of Nadcap quality certifications to include Ultrasonic Inspection, our AS9100 certification was renewed for a period of three years, and we received Transport Canada certification in accordance with new CAR561 requirements.

All metrics for customer satisfaction improved during 2007, despite the challenges of managing a Supply Chain increasingly stretched to capacity due to the overall Aerospace market environment.

In closing the acquisition of Comtek Advanced Structures Ltd., we took an important step in realizing our strategic goal to extend our capabilities with proprietary composite technology. With this acquisition we added Airbus to our program portfolio and Goodrich as a Customer.

In 2008, we will continue to build on the achievements of the past two years with focus on the continuous improvement of parts flow and the strengthening of our Supply Chain management capabilities. Where necessary we will invest in leadership development.

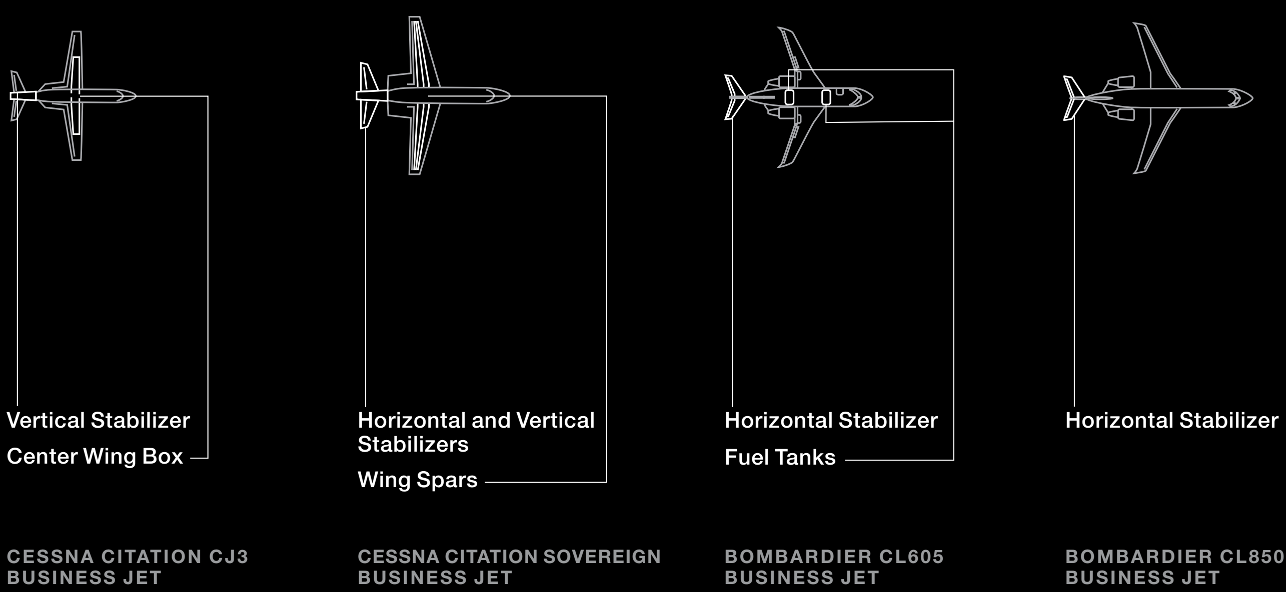
The first shipsets for new programs for Honda, Cessna and Boeing Integrated Defense Systems will be delivered in 2008. During 2007 and continuing into 2008, much time and energy has and will be dedicated to preparation for these first deliveries. In all phases, we have and will be keeping in close communication with our customers. Much attention continues to be given to the risk assessment and risk management and mitigation aspect of this non-recurring preparation.

At the same time, attention will be given to integrate Comtek and to expand on the potential of providing integrated composite and metallic aircraft structures to aircraft manufacturers, a distinct advantage in the pursuit of contracts for new aircraft designs, which require lightweight, strong, reliable structures.

By adding new Market Segments and new Programs to our portfolio, and by focusing on clearly identified Manufacturing Technologies, Avcorp will not only grow but also change. We are well underway to strengthening our ability as an agile and reliable sub-tier supplier to the major integrators in the Aerospace industry, to understanding their requirements and to translating these into quality competitive Aerospace Structures.

I thank our employees, the Board and shareholders for their continued support of Avcorp as it positions itself for improved competitiveness in a changing economic environment. We rely on all of them to realize our ambitions for 2008 and beyond.

Mark van Rooij, CEO, MARCH 23, 2008

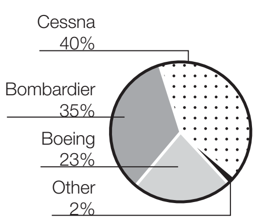


Our capabilities.

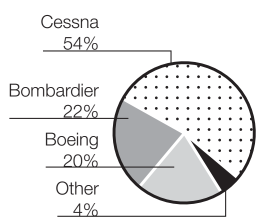
Avcorp offers a wide range of services including: engineering design and certification, airworthiness certification, tool design/build, major structural assembly, resin infusion (VARTM), hybrid fibre-metal laminate, metal bond, sheet

metal detail and sub-assembly, 3-4-5-axis machining, maintenance/repair of composite products, supply chain management, program and project management.

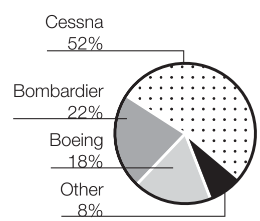
Revenue by Customer



2005 **$79.5 million**

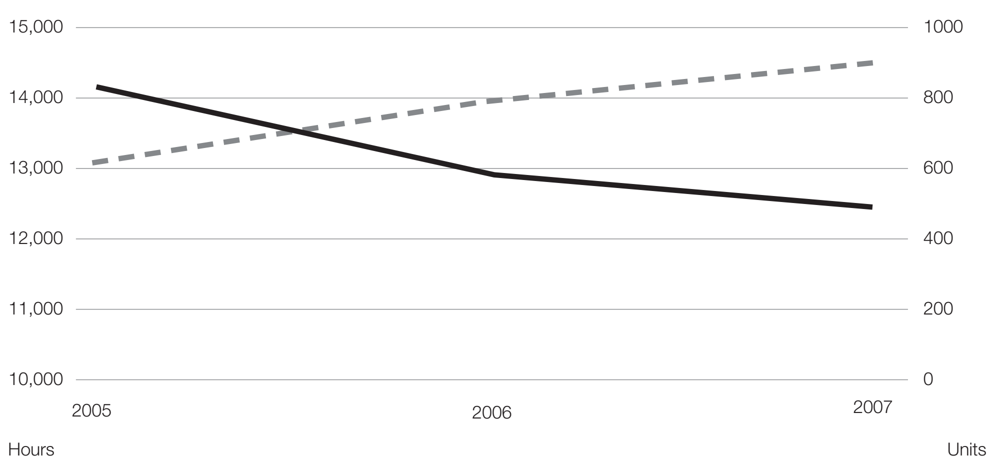


2006 **$103.9 million**



2007 **$110.3 million**

Total Hours per Combined Major Assembly Units and Total Units Shipped



Management Discussion & Analysis

This Management Discussion and Analysis has been prepared as of March 28, 2008 and should be read in conjunction with the Company's financial statements and notes thereto for the year ended December 31, 2007.

Description of Business

Avcorp Industries Inc. (the Company) is an important supplier of subcontract design, fabrication and assembly services to major aircraft manufacturers. Management is dedicated to creating positive economic value added for shareholders while satisfying all other stakeholders. We are doing so by improving productivity, enhancing organizational capabilities and ensuring that growth opportunities have a positive impact on the bottom line.

Financial Overview

THREE-YEAR RESULTS

The following table provides selected financial information for the three years to December 31, 2007.

THREE-YEAR RESULTS

unaudited, prepared in accordance with Canadian GAAP, expressed in thousands of Canadian dollars except per share amounts, ratios and shares outstanding

DECEMBER 31	**2007**	2006	2005
Operations			
Revenues	**$ 110,283**	$ 103,850	$ 79,484
EBITDA[1,2]	**4,155**	7,003	(5,919)
Operating income (loss) before tax	**205**	3,483	(11,691)
Net income (loss)	**(1,719)**	1,450	(14,380)
Basic income (loss) per share	**(0.06)**	0.06	(0.78)
Diluted income (loss) per share	**(0.06)**	0.06	(0.78)
Financial Position			
Net capital expenditures	**5,020**	2,111	1,721
Total assets	**60,304**	48,617	42,807
Bank indebtedness and long-term debt	**20,096**	11,258	24,322
Shareholders' equity	**18,519**	18,693	139
Book value per share	**0.59**	0.67	0.01
Ratio: debt/equity	**1.09**	0.60	174.98
Ratio: current assets/current liabilities	**1.16**	1.48	0.80
Shares outstanding at period end	**31,445**	27,837	22,419

1 EBITDA = earnings before interest, taxes, depreciation and amortization
2 EBITDA is not a recognized term under Canadian generally accepted accounting principles (GAAP)

QUARTERLY RESULTS

The following table provides selected quarterly financial information for the eight most recent fiscal quarters to December 31, 2007.

QUARTERLY RESULTS

unaudited, prepared in accordance with Canadian GAAP, expressed in thousands of Canadian dollars except per share amounts

FOR THE THREE MONTHS ENDED	2007				2006			
	DEC 31	**SEP 30**	**JUN 30**	**MAR 31**	DEC 31	SEP 30	JUN 30	MAR 31
Revenue	**$ 26,878**	**$ 26,696**	**$ 29,352**	**$ 27,357**	$ 25,944	$ 25,199	$ 25,874	$ 26,833
EBITDA[1,2]	**(1,282)**	**1,500**	**2,308**	**1,629**	1,642	1,935	1,700	1,726
Net income (loss)	**(2,943)**	**32**	**817**	**375**	365	698	265	122
EBITDA per share[1,2]								
Basic	**(0.04)**	**0.05**	**0.08**	**0.06**	0.06	0.08	0.07	0.08
Diluted	**(0.04)**	**0.04**	**0.07**	**0.05**	0.05	0.07	0.07	0.07
Net income (loss) per share								
Basic	**(0.10)**	**0.00**	**0.03**	**0.01**	0.01	0.03	0.01	0.01
Diluted	**(0.10)**	**0.00**	**0.02**	**0.01**	0.01	0.03	0.01	0.01
Long-term debt	**6,761**	**6,419**	**5,064**	**5,041**	4,957	5,387	11,973	7,311

1 EBITDA = earnings before interest, taxes, depreciation and amortization
2 EBITDA is not a recognized term under GAAP

2007 AND 2006 RESULTS OVERVIEW

During the year ended December 31, 2007, the Company recorded earnings from operations of $205,000 on $110,283,000 revenue, as compared to $3,483,000 from $103,850,000 revenue for the preceding year. 2007 saw a 6% increase in revenue over 2006. During this period the Company delivered 921 major structures to its customers, a 15% increase over the 801 units which were delivered during 2006. The strengthening of the Canadian dollar as compared to the US dollar, relative to the rates of exchange in effect during 2006, has adversely reduced revenues by $4,153,000 and beneficially reduced costs of US dollar bought-in goods by $1,390,000. A selling price reduction on a certain program commenced January 1, 2007. The price reduction had the effect of lowering gross margin by $1,371,000 during the year. The impact of this program's selling price reduction coupled with the strengthening of the Canadian dollar has caused the Company to increase its provision for loss making contracts by $1,039,000 for the year (December 31, 2006: $724,000 recovery).

On a year-to-date basis, the Company recorded a $1,719,000 net loss from $110,283,000 revenue, as compared to $1,450,000 net income from $103,850,000 revenue for 2006. Income from unrealized derivative gains amounted to $170,000 for the year ended December 31, 2007 (December 31, 2006: $Nil). Cash flows from operating activities provided $3,071,000 of cash, as compared to $5,006,000 during the previous year. The Company has a working capital surplus of $4,417,000 as at December 31, 2007 (December 31, 2006: $9,600,000) and an accumulated deficit of $53,204,000 at December 31, 2007 (December 31, 2006: $50,605,000).

During 2007, the following changes were made to the terms and security of the Company's operating line of credit:

- increase of the operating line of credit to $15,000,000;
- interest at prime plus 0.375%, 0.50%, 0.675%, or 0.75% determined on a quarterly basis according to specific measures of the ratio of debt to tangible net worth;
- foreign-exchange-forward facility having a notional risk for credit purposes of $3,528,000 to purchase foreign-exchange-forward contracts for major currencies up to an aggregate $3,528,000, with a maximum maturity of 12 months;
- release of the guarantee of the indebtedness of the Company by a Canadian financial institution; and
- increase in margining capacity.

In the course of acquiring Comtek Advanced Structures Ltd. the Company established an additional $2,000,000 operating line of credit having interest at prime plus 0.75% per annum.

At December 31, 2007, the Company had utilized $11,279,000 of these facilities (December 31, 2006: $5,564,000).

During the year ended December 31, 2007, holders of preferred shares converted 378,200 preferred shares resulting in the issue of 2,439,241 common shares at $1.55 per common share. At December 31, 2007, 821,800 preferred shares remain having a book value of $7,672,000.

Also during 2007, the Company entered into a placement of 840,000 units at $2.20 per unit; 287,500 units were subscribed for by insiders of the Company. Each unit consists of one share and one warrant, where one warrant entitles the holder the right to purchase one additional share at $2.40 per share for a 24-month period from the closing date. Gross proceeds from the placement amounted to $1,848,000.

On December 31, 2007, the Company concluded its agreement to acquire the shares of Comtek Advanced Structures Ltd. This acquisition will add ongoing operations and expertise in the design and competitive manufacture of advanced composite aerostructures, plus provide access to new aerospace markets for the Company.

With reference to a previous announcement made March 7, 2007 for the purchase of a machining business in British Columbia, the Company has decided not to proceed with this acquisition focusing instead on investing in its own machining capabilities.

For the year ended December 31, 2007, the Company recorded a net loss for the year of $1,719,000 (December 31, 2006: $1,450,000, net income). The Company has a working capital surplus of $4,417,000 as at December 31, 2007 (December 31, 2006: $9,600,000) and an accumulated deficit of $53,204,000 at December 31, 2007 (December 31, 2006: $50,605,000).

As at December 31, 2007, the Company was not in compliance with its debt servicing covenant associated with the convertible debenture held by Export Development Canada (note 13a to the financial statements). The Company has obtained a waiver from the debenture holder for this non-compliance. Also at December 31, 2007, the Company was not in compliance with its financial covenants associated with the term loan held by the Business Development Bank of Canada (note 13c to the financial statements). The Company has obtained a waiver from the debt holder for these non-compliances. In addition, the Company has a potential exposure to fund rework for a defective product in an amount of $1,454,000 which is expected to occur over a four to five year period (note 21c to the financial statements).

Management believes that the financing activities undertaken to date, and the ongoing efforts to reduce costs and improve productivity and working capital usage, make the use of the going concern basis appropriate; however, there can be no assurance that the Company will be successful with all initiatives.

While these financial statements have been prepared using Canadian generally accepted accounting principles (GAAP) applicable to a going concern, which contemplates the realization of assets and liquidation of liabilities during the normal course of operations, in the event that the Company is unable to obtain additional financing if required, and without the continued support of significant shareholders (note 24 to the financial statements), there is significant doubt about the Company's ability to continue as a going concern as a consequence of the adverse conditions and events described above.

These financial statements do not reflect adjustments to the carrying value of assets and liabilities, the reported revenues and expenses, and balance sheet classifications used that would be necessary if the going concern assumption were not appropriate; such adjustments could be material.

Revenue

Revenue for the year ended December 31, 2007 was $110,283,000 (December 31, 2006: $103,850,000). Revenues from the Company's customers are as follows.

REVENUE DISTRIBUTION

unaudited, prepared in accordance with Canadian GAAP, expressed in thousands of Canadian dollars

	2007		2006	
YEAR ENDED DECEMBER 31	**REVENUE**	**% OF TOTAL**	REVENUE	% OF TOTAL
Boeing	**$ 19,327**	**17.5**	$ 21,084	20.3
Bombardier	**24,025**	**21.8**	22,698	21.9
Cessna	**57,666**	**52.3**	55,447	53.4
Other	**9,265**	**8.4**	4,621	4.4
Total	**110,283**	**100.0**	103,850	100.0

The strengthening of the Canadian dollar as compared to the US dollar, relative to rates of exchange in effect during 2006, has caused revenues to reduce by $4,153,000.

Deliveries to Cessna Aircraft Company (Cessna) increased by 6% to 290 major structures in 2007, relative to 2006. However, a selling price reduction on a certain program, coupled with the strengthening in the Canadian dollar, have caused revenues to increase by a lesser amount relative to 2006. The primary sources of revenue from Cessna are from deliveries of components for the Citation Sovereign business jet and the Citation CJ3 business jet. A continuation of the current production rates for components of the Citation Sovereign and the Citation CJ3 is expected for 2008.

Deliveries to Boeing Commercial Airplane Group (Boeing) of smaller discrete parts have decreased from the preceding year, while shipments of larger assemblies for the 737 aircraft have increased by 9%. The primary source of revenue from Boeing is from the 737 aircraft. The Company continues to work towards obtaining additional new contracts supporting 737, 747, 767, 777 and 787 commercial jet programs.

Sales to Bombardier Aerospace (Bombardier) during the current year increased by 6% relative to the year ended December 31, 2006. The Company saw a slight decrease in Bombardier sales from regional jet product lines, with a more significant reduction in sales to Bombardier for components belonging to business jet programs. An increase in the scope of work performed for two aircraft primarily caused revenues for this year to exceed last year. The Company's primary source of revenues from Bombardier in 2008 will be from components on the CL605 and CL850 business jets. Bombardier has terminated for convenience, its contracts with the Company for delivery of components on the CRJ700/900 Series regional jet. It is expected that deliveries of components for CRJ700/900 Series regional jets will cease during the first half of 2008.

Sales from other customers grew significantly in 2007, as compared to the year ended December 31, 2006, primarily as a result of increased deliveries of Boeing 757 commercial jet wing adapter plugs for winglet retrofits. Deliveries of these components are expected to continue in 2008 at a somewhat reduced rate.

In 2008, it is anticipated that revenues from Cessna business jet programs, Bombardier business and regional jet programs, Boeing commercial jet programs and revenues from other customers will remain relatively constant in proportion and value to 2007.

Gross Profit

Gross profit (revenue less cost of sales) for the year ended December 31, 2007 was 10.7% of revenue as compared to 13.8% of revenue for the year ended December 31, 2006.

The strengthening of the Canadian dollar against the US dollar, relative to rates of exchange in effect during 2006, has caused a $4,153,000 reduction in revenues and an estimated benefit of $1,390,000 in reduction of cost of sales, thereby reducing gross margin for the year by approximately $2,763,000 as compared to 2006.

A selling price reduction on a certain Cessna program commenced on January 1, 2007. The price reduction had the effect of lowering gross margin by $1,371,000 during the year relative to 2006. A year on year 14% reduction in this program's production hours has partially mitigated the impact of its reduced revenues. Assembly labour hours have decreased as operating improvements continue to take effect. However, operational performance improvements have been slightly diminished as the Company continues to experience high levels of workforce overtime.

Material costs increased slightly in spite of the comparative advantage the strengthening of the Canadian dollar has had on bought-in material costs because of significant increases in the cost of titanium and assembly hardware.

The strengthening of the Canadian dollar relative to the US dollar and the selling price reduction on a certain Cessna program has caused the Company to provision $1,061,000 for expected future losses on its existing Cessna order book.

Administration and General Expenses

As a percentage of revenue, administration and general expenses increased from 7.5% for the year ended December 31, 2006 to 8.7% for this year. Administrative and general expenses have increased for the year ended December 31, 2007 relative to last year, primarily due to staffing increases in the Company's business support departments.

Foreign Exchange Gain

The Company recorded a $1,321,000 foreign exchange gain during 2007 (December 31, 2006: $3,000 loss) as a result of holding foreign-currency-denominated receivables, payables and debt.

Other Income

The Company uses derivative financial instruments to reduce its exposure to foreign currency and price risk associated with its revenues and costs of certain procured items.

Foreign Exchange Forward Contracts

Foreign exchange exposure to US dollar sales, purchases, and related receivables and payables is in part managed by the use of foreign-exchange-forward contracts. On January 4, 2007, the Company entered into a 12-month USD$12,000,000 foreign-exchange-forward contract with the provider of its operating line of credit of which a one-month USD$1,000,000 foreign-exchange-forward contract remains as at December 31, 2007. The Company has marked to market its unrealized foreign-exchange-forward contracts as at December 31, 2007 and recorded a gain of $171,000 in unrealized derivative gains during the year ended December 31, 2007 (December 31, 2006: $Nil). The realized foreign-exchange-forward contract gains for 2007 amounted to $1,178,000.

All other financial instruments have been recorded at cost or amortized cost, subject to impairment reviews, such as the investment in Eclipse Aviation Corporation.

Earnings Before Interest, Taxes, Depreciation & Amortization

Earnings before interest, taxes, depreciation and amortization (EBITDA) were $4,155,000 for the year ended December 31, 2007 compared to $7,003,000 for the year ended December 31, 2006. The decrease in EBITDA, relative to the previous year, is primarily attributable to the adverse impact of the strengthening Canadian dollar on gross margins and provisions made for loss making contracts.

EBITDA

unaudited, prepared in accordance with Canadian GAAP, expressed in thousands of Canadian dollars

YEAR ENDED DECEMBER 31	**2007**	2006
Income (loss) for the period	**$ (1,719)**	$ 1,450
Interest expense and financing charges	**2,094**	2,033
Income tax expense	**—**	—
Depreciation	**3,395**	3,138
Amortization	**385**	382
	4,155	7,003

EBITDA is a term, that does not have a standardized meaning under Canadian generally accepted accounting principles (GAAP).

Interest and Financing Charges
Total interest and financing charges on both short- and long-term debt, some to related parties, for the year ended December 31, 2007 was $2,094,000 as compared to $2,033,000 for the previous year.

Income Taxes
The Company has not incurred a tax expense during the current year (December 31, 2006: $Nil).

Income
The Company incurred a $1,719,000 net loss for the year ended December 31, 2007 as compared to $1,450,000 net income for the year ended December 31, 2006. The reduction in income over that of the previous year resulted from various factors discussed above.

Liquidity and Capital Resources
The Company ended the year with bank operating line utilization of $11,279,000 compared to $5,564,000 as at December 31, 2006.

Cash Flows from Operating Activities
Cash provided from operating activities, before consideration of changes in non-cash items relating to operating activities, was $3,071,000 for the year ended December 31, 2007 compared to cash provided of $5,006,000 for last year.

Non-cash operating assets and liabilities utilized $1,323,000 cash during the current year, compared to a utilization of $4,238,000; this was primarily due to planned inventory reductions taking effect in 2007.

Cash Flows from Investing Activities
During the year, the Company purchased capital assets totalling $5,020,000 as compared to $2,111,000 during the year ended December 31, 2006. The purchases consisted of manufacturing equipment to augment capacity, capability, and increase operating efficiencies; and a continued upgrading of the information technology infrastructure. Additionally, the Company invested $744,000 (December 31, 2006: $873,000) in improving the production efficiencies of various program lines.

On May 31, 2007, the Company entered into a $2,000,000 convertible loan agreement with Comtek Advanced Structures Ltd. as part of its proposed acquisition of Comtek. During the year ended December 31, 2007, the Company advanced Comtek Advanced Structures Ltd. $1,850,000 under the convertible loan agreement, of which $1,500,000 was converted into shares of the acquired company on December 31, 2007, when the acquisition of Comtek Advanced Structures Ltd. was finalized.

In addition to the $1,850,000 invested into Comtek Advanced Structures Ltd., the Company assumed and repaid $150,000 of shareholder loans on behalf of Comtek Advanced Structures Ltd., and made payments totalling $73,000 to a group of its shareholders.

Cash Flows from Financing Activities
The Company finances working capital through a combination of bank debt and other financial instruments.

During 2007, the Company's operating line of credit was increased from $10,000,000 to $15,000,000.

In the course of acquiring Comtek Advanced Structures Ltd. the Company established an additional $2,000,000 operating line of credit with its Canadian chartered bank. The Company assumed $925,000 of Comtek Advanced Structures Ltd. bank indebtedness on closing of the business acquisition.

The Company received $800,000 in shareholder loans and $58,000 from Technology Partnerships Canada.

Proceeds on disposals of equipment and from the sale of equipment arising on sale-leaseback transactions amounted to $1,903,000.

In addition to $744,000 debenture principal and interest repayments during 2007, the Company repaid $1,837,000 of current and long-term debt consisting of $694,000 in equipment financing, $343,000 in royalty payments, and $800,000 in shareholder loans.

The Company issued 3,608,097 common shares and 840,000 warrants during the year ended December 31, 2007 for cash proceeds of $2,091,000 (note 15 to the financial statements). The cost of issuing the capital stock during 2007 was $67,000.

Dividends paid on the preferred shares issued on July 10, 2006 amounted to $920,000 for the year ended December 31, 2007 (December 31, 2006: $526,000).

The Company's ratio for current assets to current liabilities, declined from 1.48:1 at December 31, 2006 to 1.16:1 at December 31, 2007.

Contractual Obligations

PAYMENTS DUE BY PERIOD

unaudited, prepared in accordance with Canadian GAAP, expressed in thousands of Canadian dollars

	TOTAL	2008	2009 – 2011	2012 – 2 013	POST 2013
Convertible debentures	$ 4,497	$ 400	$ 4,097	$ —	$ —
Capital lease obligation	2,806	733	1,736	337	—
Term loan	331	90	241	—	—
Purchase obligation [1,2]	23,910	1,674	7,396	4,409	10,431
Other long-term obligations [3]	1,183	833	350	—	—
Total contractual obligations	**32,727**	**3,730**	**13,820**	**4,746**	**10,431**

[1] Purchase obligations include payments for the Company's operating and property leases.
[2] During 2003, the Company entered into a 15-year leaseback agreement with the purchaser of its property. As part of the consideration from the sale of the property, the Company received a $1,500,000 rent credit to be applied to rent in 2008 should the Company meet certain conditions.
[3] Fees payable as consideration for a performance guarantee have been excluded, as their continuance is subject to annual review (note 24 to the financial statements). This amount represents obligations the Company has with Technology Partnerships Canada.

The Company expects that payment of contractual obligations will come from funds generated by operations and utilization of the bank operating line of credit.

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

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, issueable in series, the terms of which will be determined by the Company's directors at the time of creation of each series. There were 31,444,724 common shares issued and 322,387 reserved at December 31, 2007. The book value of common shares issued and outstanding as at December 31, 2007 was $64,050,000.

As at March 28, 2008, there were 32,119,724 common shares, 821,800 preference shares, 1,527,880 warrants and 939,667 options issued and outstanding.

Recent Accounting Pronouncements

These financial statements for the year ended December 31, 2007 have been prepared using accounting policies consistent with the audited financial statements for the year ended December 31, 2006 except for the following.

Effective January 1, 2007, the Company adopted the Canadian Accounting Standards Board accounting standards dealing with the recognition, measurements and disclosure of financial instruments, hedges and comprehensive income. These new standards are as follows.

Financial instruments – Recognition and measurement

This standard prescribes when a financial asset, financial liability, or non-financial derivative is to be recognized on the balance sheet and whether fair value or cost-based measures are used. It also specifies how financial instrument gains and losses are to be presented (note 3a to the financial statements).

Hedges

This standard establishes when and how hedge accounting may be applied. Specifically, hedge accounting may be applied only when gains, losses, revenues and expenses on a hedging item would otherwise be recognized in net income in a different period than gains, losses, revenues and expenses are recognized on the hedged item. The Company has also determined that the derivative instruments put in place (note 3a to the financial statements) do not meet the requirements to qualify them as hedges. Accordingly, such instruments that do not qualify for hedge accounting are required to be marked to market with changes in their fair value recognized as unrealized gains and losses in the statement of operations, in the period in which they occur.

Comprehensive Income

This standard provides guidance for the reporting and presentation of other comprehensive income. Comprehensive income represents the change in equity of an enterprise during a period from transactions and other events arising from non-owner sources. Examples of some items that would be included in other comprehensive income are changes in the fair value of available for sale assets and the effective portion of the change in fair value cash flow hedging instruments. Adoption of this new standard did not result in any amounts being recorded in comprehensive income.

Effective January 1, 2007, the Company adopted the revised “Accounting Changes” generally accepted accounting policy, which requires that:

- a voluntary change in accounting principle can be made if, and only if, the changes result in more reliable and relevant information;
- changes in accounting policies are accompanied with disclosures of prior period amounts and justification for the change; and
- for changes in estimates, the nature and amount of the change should be disclosed.

The Company has not made any voluntary change in accounting principles since the adoption of the revised standard.

New accounting pronouncements not yet adopted. Effective January 1, 2008, the Company will adopt new Canadian Institute of Chartered Accountants (CICA) standards 1535, 3031 and 3862 and, effective January 1, 2009, standard 3064. The Company is considering the effect these standards may have on its financial statements.

- Section 1535 – Capital Disclosures: This section requires the Company to disclose its objectives, policies and processes for management capital.
- Section 3031 – Inventories: This section prescribes the accounting treatment for inventories and provides guidance on the determination of cost and subsequent recognition as an expense, including any write-down to net realizable value.
- Section 3862 – Financial Instruments: This section enhances the disclosure requirements on the nature and extent of risks arising from financial instruments and how the Company manages those risks.
- Section 3064 – Goodwill and Intangible Assets: This section replaces CICA 3062, “Goodwill and Intangible Assets”, and establishes revised standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. The new standard also provides guidance for the treatment of pre-production and start-up costs and requires that these costs be expensed as incurred.

Operations Overview

DELIVERY AND QUALITY PERFORMANCE

Deliveries as at December 31, 2007, were at planned levels for Cessna, Bombardier and Boeing programs with the following exceptions.

Difficulties encountered in continuing to secure a supply of parts for a Bombardier program which will be terminated during the first half of 2008 have caused deliveries for this program to fall behind schedule. The Company is managing this by expediting parts from the vendors and within its own production facility.

Quality and schedule problems from a specific supplier have caused deliveries on a Cessna program to fall behind plan. The Company and its customer are both actively involved with the supplier in correcting this issue.

All other program deliveries were on schedule or not impacting customer requirements.

Quality problems from a specific supplier have caused a requirement for an inspection and possible rework for all delivered components to a non-original equipment manufacturer (OEM) customer. Provisions in the amount of $1,454,000 for management's estimate of the costs of inspection and rework along with a possible equivalent claim against the supplier have been recorded in the accompanying financial statements.

ORDER BACKLOG

The Company operates within "general terms agreements" with its customers. These agreements are typically for five years or longer. The Company's contracts with Boeing extend from January 2007 to December 2011. The Bombardier and Cessna agreements extend for the life of the programs, with the exception of the Bombardier CRJ700/900 program for which Bombardier has imposed a termination for convenience that will end the contract during the first half of 2008.

The Company defines order backlog as the value of purchase orders it expects to receive from these contracts based on manufacturers' projections and current degrees of exclusivity. The order backlog as at December 31, 2007 was $478 million, compared to $392 million as at December 31, 2006. The changes in order backlog are as follows:

- $159 million increase in order backlog primarily due to production rate increases and extended production lives of various existing programs;
- $110 million decrease in order backlog from revenues recorded during 2007; and
- $37 million increase in order backlog from acquisition of Comtek Advanced Structures Ltd.

Order backlog size is affected by changes in foreign exchange rates. Please refer to comments on currency risk.

SUPPLY CHAIN SAVINGS

With the exception of a limited number of vendors, for which the Company is managing on a day-to-day basis with on-site personnel, vendor delivery and quality performance met targeted levels during the year. Raw material aluminum plate delivery risk was mitigated by revised inventory levels and through dual sourcing key commodities. Several key machining vendors continued to experience capacity issues which had an impact on internal assembly start dates during the fourth quarter. It is expected that these conditions will continue into the first quarter of 2008. Hardware savings resulting from a long-term purchase contract were at planned levels, although general industry hardware costs will place pressure on 2008 pricing. The securing of additional long-term contracts with key suppliers continues.

WORKING CAPITAL UTILIZATION

Working capital, defined as cash plus accounts receivable and inventories less current bank financing and accounts payable, has decreased during the year (December 31, 2007: $3,879,000; December 31, 2006: $8,726,000). It should be noted that this is a non-GAAP measure. Total current assets less total current liabilities has decreased from a surplus of $9,600,000 at December 31, 2006 to a surplus of $4,417,000 at December 31, 2007. The increased working capital utilization is primarily due to the investment made in Comtek Advanced Structures Ltd., purchases of property, plant and equipment, and repayment of long-term debt.

FINANCIAL RESOURCES

The Company has invested in its chosen strategies of organic growth, lean manufacturing and strategic sourcing. Management believes that the significant investments necessary to better position the Company in the aerospace industry have been made, and that those investments along with the expected continued financial support of shareholders and lenders has positioned 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, systems, technologies and processes. 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, 2007 was 766 (December 31, 2006: 658). The increase in the number of employees relative to last year is attributable to the staffing for a New Product Introduction (NPI) team and the acquisition of Comtek Advanced Structures Ltd. (note 26 to the financial statements). 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

A number of internal projects are underway, with the aim of further increasing productivity to desired levels. With the establishment of a New Product Introduction team along with formal NPI processes, the Company is readying itself to take on the growth expected from new contracts.

Technology upgrades in high-speed machining are continuing into 2008. Non-destructive (ultrasonic) testing equipment has been purchased and is fully operational. This investment allows the Company to further augment its quality assurance systems, bring currently out-sourced work in-house, thereby reducing costs and satisfy customer requirements.

Given the capacity constraints in the supply chain market for machined parts during 2007 and into 2008, the Company will also be investing in additional capacity where it has been demonstrated that there is a chronic shortage of reliable supply. Bringing additional currently-outsourced work in-house will help lower costs by reducing shortages and capturing margin currently in supplier prices.

Information technology assets have been consistently upgraded and further deployed, increasing reliability and utility. Viruses and/or worms or other outages minimally affected the Company's systems.

BUSINESS ACQUISITIONS

On March 6, 2007, the Company entered into a preliminary agreement to acquire all of the shares of a machining business. The agreement was subject to completion of due diligence and a definitive agreement by May 15, 2007, with closing scheduled for June 30, 2007. Closing was not completed as the Company has decided not to proceed with this acquisition focusing instead on investing in its own machining capabilities.

On April 2, 2007, the Company entered into a preliminary agreement to acquire all of the shares of a composite aerostructures manufacturing business. The acquisition closed on December 31, 2007.

Prior to the closing date of December 31, 2007, the Company advanced Comtek Advanced Structures Ltd. $1,850,000 under the terms of a convertible loan agreement, which was subsequently applied as cash consideration in the purchase price.

In addition to the $1,850,000 invested into Comtek Advanced Structures Ltd., the Company assumed and repaid $150,000 of shareholder loans on behalf of Comtek Advanced Structures Ltd., and made payments totalling $73,000 to a group of its shareholders.

A majority of the principals of Comtek Advanced Structures Ltd. will remain and have agreed to assign their shares to the Company for 450,000 Company warrants, exercisable over a three-year period from closing, at an exercise price of $2.60 in year 1, $3.00 in year 2, and $3.50 in year 3. Comtek Advanced Structures Ltd. minority shareholders received 37,880 Company warrants, exercisable over an 18-month period from closing, at an exercise price of $2.50. The fair value of the 487,880 warrants issued to Comtek Advanced Structures Ltd. shareholders is $73,000. The Black-Scholes warrant-pricing model used by the Company to calculate warrant values utilizes subjective input assumptions whose change can materially affect the fair value estimate, and therefore, the existing models do not necessarily provide a reliable, simple measure of the fair value of warrants issued by the Company.

The Company also issued 99,458 common shares to the shareholders of Comtek Advanced Structures Ltd. The $129,000 fair value of these common shares was estimated at the Company's December 31, 2007 market closing price of $1.30 per common share.

In addition, the Company has agreed to pay to the principal shareholders of Comtek Advanced Structures Ltd. one-third of the composite business' EBITDA for the year ending December 31, 2010, which is payable two-thirds in cash and one-third in the Company shares at the then current market price.

The costs of completing this acquisition amounted to $102,000.

The transaction was completed on December 31, 2007 and has been negotiated at arm's length.

The acquisition was accounted for as a business combination with the purchase price consideration allocated to the fair values of assets and liabilities acquired as follows:

DECEMBER 31	**2007**
Asset aquired and liabilities assumed:	
Current assets	**$ 3,343**
Property, plant and equipment	**2,052**
Customer relationships	**1,320**
Order backlog	**130**
Trade name	**300**
Patents	**870**
Goodwill	**571**
	8,586
Bank indebtedness assumed	**(925)**
Current liabilities assumed	**(3,315)**
Liabilities assumed	**(783)**
Future income tax liability	**(1,186)**
Net assets assumed	**2,377**
Purchase consideration:	
Cash	**2,073**
Acquisition costs	**102**
Company shares	**129**
Company warrants	**73**
	2,377

RISK ASSESSMENT

The principal risks that the Company faces are summarized as follows:

- significant increases in material costs, primarily aluminum plate, titanium 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;
- actions and globalization by competitors;
- potential failure to achieve cost-reduction objectives relative to revenue growth; and
- the trend to greater use of composite material in primary structures in each new generation of aircraft.

The Company's view is that, with its financial structure, acquisition of a composite manufacturer and strategic plan in place, the Company is in a position to face and mitigate these risks.

Procured Materials and Parts

The Company is continuing its efforts to utilize its customer relationships to reduce or minimize the increase in cost of bought-in materials and parts as well as ensure delivery commitments. Delivery delays on raw materials, in particular aluminum plate and machined components have been partially mitigated by dual sourcing.

Aircraft Production Rates

The following industry and program trends impact the Company.

- Industry research indicates that the aerostructures market for commercial aircraft, business jets, as well as defence aircraft, will continue to grow through 2010.
- Boeing is increasing the rates on the 737 and 777 programs, while giving the 747 program renewed life with the introduction of the 747-8.
- The production rate on the Boeing 757-200 wing adapter plug for winglet retrofits increased through 2006, almost tripled in 2007 and will continue at slightly lower levels through 2008.
- Bombardier Challenger 850 and the Challenger 605 business jet aircraft production rates are forecasted to increase in 2008; while the CRJ700/900 program will end during the first half of 2008.
- Cessna Citation Sovereign and CJ3 business jet rates have increased significantly through 2007, with continued solid demand and increased order backlogs into 2008 to 2012.

Competitors

The long-term trend is to more intense competition from larger entities in Asia and Europe, while original equipment manufacturers continue to increase the size and amount of outsourced components. The strengthening of the Canadian dollar relative to the US dollar has caused the Company's Canadian operations' cost structure to increase on the global market.

Accordingly, 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 36% of the Company's cost of sales is related to labour and overhead and 64% related to procurement of raw materials and finished parts. The Company's wage rates are generally lower than its Western European and US competitors and higher than those in Asia, Eastern Europe and Mexico. The Company has achieved an element of labour cost certainty via a four-year collective agreement with its labour force expiring in September 2009.

The Company continues to focus on cost reductions for direct labour, material and overhead. These reductions will be achieved through headcount and overtime limitations as negotiated in the collective labour agreement, continued negotiation of long term agreements for 50% of the key suppliers, increased plant capacity augmented by technological improvements, and continued focus on cost targets at all levels of the organization.

Outlook

The Company's backlog increased by $86 million in 2007 primarily as a result of increased sales of products to existing OEM customers, new orders with Honda Aircraft Company Inc. for HondaJet components and Boeing Integrated Defense Systems for Chinook CH-47 Multi-Mission Heavy-Lift Transport helicopter components, and the acquisition of Comtek Advanced Structures Ltd. Cessna continues to be the Company's largest customer. Overall, revenue in 2008 is expected to remain constant in comparison to 2007 for existing operations, while the most significant growth of revenue in 2008 will be derived from the Company's December 31, 2007 acquisition of Comtek Advanced Structures Ltd.

Transactions with Related Parties

During the year ended December 31, 2005, the Company entered into an agreement with a certain shareholder in consideration of mutual agreements with a Canadian chartered bank under which the shareholder guarantees the indebtedness of the Company to the Bank limited to $2,000,000. In connection with providing the limited guarantee on the operating line of credit, the Company will pay a 5% annual fee on the $2,000,000 limited guarantee calculated on a daily basis. Fees paid to a certain shareholder during the year ended December 31, 2007 amounted to $58,000 (December 31, 2006: $75,000). Fees payable to a certain shareholder as at December 31, 2007 are $75,000 (December 31, 2006: $33,000). These fees are included in the Statements of Operations as interest expense and financing charges and amount to $100,000 for the year ended December 31, 2007 (December 31, 2006: $100,000).

On February 3, 2006, a performance guarantee was provided by certain shareholders on production contracts with a certain customer. Fees totalling $20,000 per month were provided as consideration for the performance guarantee. Fees paid to certain shareholders during the year ended December 31, 2007 amounted to $60,000 (December 31, 2006: $179,000). Fees payable to certain shareholders as at December 31, 2007 are $180,000 (December 31, 2006: $80,000). These fees are included in the Statements of Operations as cost of sales and amount to $240,000 for the year ended December 31, 2007 (December 31, 2006: $259,000).

The Company had no demand loans outstanding as at December 31, 2007 (December 31, 2006: $Nil). During the second quarter of 2007, a certain shareholder advanced the Company $800,000 at 12% interest per annum, for the purpose of the Company extending a loan to Comtek Advanced Structures Ltd. The principal portion of the demand loan was repaid during the second quarter of 2007.

Total interest and fees charged on demand loans for the year ended December 31, 2007 were $2,000 (December 31, 2006: $153,000). Interest and fees payable on the demand loans as at December 31, 2007 are $2,000 (December 31, 2006: $Nil). Interest and fees paid on the demand loans for the year are $Nil (December 31, 2006: $692,000).

On January 4, 2007, the Company entered into a 12-month USD$12,000,000 foreign-exchange-forward contract with its provider of the operating line of credit. Under the terms of this agreement, the Canadian chartered bank required a CAD$3,024,000 deposit be made on the Company's behalf by a significant shareholder, for a three-month period. The Company paid this significant shareholder a $15,000 fee for this transaction.

Other related-party transactions are disclosed elsewhere in the financial statements (notes 15 and 27 to financial statements).

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

Fourth Quarter

The following summarizes financial results for the fourth quarter.

Operating losses for the fourth quarter of 2007 were $1,857,000 from $26,878,000 in revenues, as compared to operating income of $740,000 from $25,944,000 in revenues for the quarter ended December 31, 2006. Major contributing causes, to an operating loss for the fourth quarter of 2007, were a provision for loss-making contracts amounting to $781,000, inventory write-offs totalling $276,000 (1.6% inventory value), Bombardier CRJ700 program termination costs of $96,000, and restructuring expenses of $153,000. Consequently, EBITDA fell from $1,642,000 in the fourth quarter of 2006 to negative EBITDA of $1,282,000 for the same quarter this year.

On December 31, 2007, the Company completed its acquisition of Comtek Advanced Structures Ltd., a composite aerostructures manufacturing business.

Proposed Transactions

As at the date of this report, no agreements to merge with or acquire another entity have been entered into, other than as disclosed elsewhere in the accompanying financial statements.

Critical Accounting Estimates

The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the reported revenues and expenses.

The critical accounting estimates the Company has made relate to the following.

- 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 productions to its contracted future revenues.
- Unamortized development costs, net of related government assistance, which reflect the Company's investment in new programs and manufacturing process development, are recorded at $1,545,000 (December 31, 2006: $1,186,000). These costs are to be amortized over the number of units which management believes is a conservative estimate of deliveries for the programs to the customer. Development costs will be written off proportionately to any anticipated reduction in expected unit deliveries to the customer. No such reduction in deliveries exists at this time. Furthermore, the Company will write off any amounts of development costs, which it estimates will not be recoverable from the recurring programs to which they relate. At this time, management estimates that all development costs are recoverable.
- An estimation is made of the useful life of equipment. Useful life is measured in terms of years or on a units of production basis.

Computer hardware and software	2 – 10 years
Machinery and equipment	5 – 15 years
Leasehold improvements	end of lease, 2018

- An estimation is made of the cost of the Company's stock-based compensation and other stock-based payments made in exchange for goods and services. The Company has adopted the Black-Scholes model for its fair value base method of accounting for stock options (note 17 to the financial statements). Option-pricing models require the input of highly subjective assumptions regarding the expected volatility. Changes in assumptions can materially affect the fair value estimate, and therefore the existing models do not necessarily provide a reliable measure of the fair value of the Company's stock options at the date of grant.

- In 2004, the value of the Company's investment in Series D Preferred stock of Eclipse Aviation Corporation was written down by $768,000 to its estimated recoverable value of $759,000. This estimation is based on management's review of Eclipse's financial results and forecasts. Should these forecasts significantly deteriorate; the Company will write down the investment further when management determines that there has been any further impairment in the value of the investment that is other than temporary.
- During the fourth quarter 2007, the Company became aware of a requirement to rework previously delivered product. As at the date of this report, it is uncertain as to when the rectification will take place. In consideration of the nature of rework required, and the possible extent to which the defect effects delivered product, the Company has accrued a $1,454,000 charge within cost of sales. In the opinion of the Company, an equivalent claim against the manufacturer of a sub-component to the product can be made. Accordingly, a $1,454,000 recovery has been accrued within cost of sales. The amounts recorded are based on management's best estimate of the amount of product affected and the timing of the rework, which is expected to occur over a four to five year period.

Financial Instruments and Other Instruments

INTEREST RATE RISK

Since August 18, 2005, the Company has been exposed to interest rate risk by its operating line of credit at an interest rate of bank prime plus 0.875% on the portion of $10,000,000 utilized. Commencing October 1, 2006, the Company is exposed to interest rate risk by its operating line of credit at a rate of bank prime plus 0.75%. As at December 31, 2007, the Company is exposed to interest rate risk on the utilized portion of its $15,000,000 operating line of credit at rates of bank prime plus 0.375%, 0.50%, 0.675% or 0.75% determined on a quarter basis according to specified measures of the ratio of debt to tangible net worth. The Company lowers interest rate costs by managing utilization of the operating line of credit to the lowest amount practical.

All of the Company's other financial instruments are at fixed rates.

CURRENCY RISK

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 in US dollars at prices that are usually established at the order date. All of the Company's operations are based in Canada. 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 2007 was $1,321,000 (December 31, 2006: $3,000 loss). The Company used derivative financial instruments to mitigate its exposure to currency risks in 2007 and into the first quarter 2008 (note 4 to the financial statements). The component of the 2007 foreign exchange gain which was attributable to its foreign-exchange-forward contracts amounted to $1,178,000.

Other Items

DISCLOSURE CONTROLS AND PROCEDURES, AND INTERNAL CONTROLS OVER FINANCIAL REPORTING

On a quarterly basis during 2007, an evaluation was carried out under the supervision of and with the participation of the Company's management, including the Chief Executive Officer, President and Vice President, Finance, of the effectiveness of the Company's disclosure controls and procedures. Based on that evaluation, the Chief Executive Officer and the Vice President, Finance, concluded that the design and operation of these disclosure controls and procedures were effective as at December 31, 2007 to provide reasonable assurance that material information relating to the Company would be made known to them by others within the entity.

Under the supervision of and with the participation of the Company's management, including the Chief Executive Officer and Vice President, Finance, internal controls and procedures have been designed to provide reasonable assurance which ensures the reliability of financial reporting. For the year ended December 31, 2007, no material changes to internal controls over financial reporting occurred which would adversely effect the Company's financial reporting.

Forward Looking Statements

This management discussion and analysis should be read in conjunction with the Company's audited 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 extent to which the Company is able to achieve savings from its restructuring plans; (b) uncertainty in estimating the amount and timing of restructuring charges and related costs; (c) changes in worldwide economic and political conditions that impact interest and foreign exchange rates; (d) the occurrence of work stoppages and strikes at key facilities of the Company or the Company's customers or suppliers; (e) government funding and program approvals affecting products being developed or sold under government programs; (f) cost and delivery performance under various program and development contracts; (g) the adequacy of cost estimates for various customer care programs including servicing warranties; (h) the ability to control costs and successful implementation of various cost reduction programs; (i) the timing of certifications of new aircraft products; (j) the occurrence of further downturns in customer markets to which the Company products are sold or supplied or where the Company offers financing; (k) changes in aircraft delivery schedules or cancellation of orders; (l) the Company's ability to offset, through cost reductions, raw material price increases and pricing pressure brought by original equipment manufacturer customers; (m) the availability and cost of insurance; (n) the Company's ability to maintain portfolio credit quality; (o) the Company's access to debt financing at competitive rates; and (p) uncertainty in estimating contingent liabilities and establishing reserves tailored to address such contingencies.

Report of Management

The accompanying financial statements of Avcorp Industries Inc. and all other information contained in the Management Discussion and Analysis are the responsibility of management. The financial statements were prepared in conformity with Canadian generally accepted accounting principles 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 Report and Analysis is consistent with that in the financial statements.

Management is responsible for maintaining a system of internal accounting controls and procedures to provide reasonable assurance. As of the end of the period covered by this report, management provides reasonable assurance regarding the reliability of financial reporting and preparation of financial statements for external purposes in accordance with GAAP. 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.

Ed Merlo

Ed Merlo
VICE PRESIDENT, FINANCE
AND CORPORATE SECRETARY

Mark Van Rooij
CHIEF EXECUTIVE OFFICER

Report of Auditors

To the Shareholders of Avcorp Industries Inc.

We have audited the consolidated balance sheets of Avcorp Industries Inc. as at December 31, 2007 and 2006 and the consolidated statements of operations and comprehensive income (loss), deficit and cash flows for each of the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2007 and 2006 and the results of its operations and its cash flows for each of the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
CHARTERED ACCOUNTANTS
VANCOUVER, BRITISH COLUMBIA
MARCH 31, 2008

Consolidated Balance Sheets

as at December 31, 2007 and 2006
(in thousands of Canadian dollars)

DECEMBER 31	2007	2006
Assets		
CURRENT ASSETS		
Accounts receivable	**12,224**	8,394
Inventories (note 5)	**17,801**	19,421
Prepayments (note 12)	**2,401**	1,611
Other assets (note 4)	**138**	—
	32,564	29,426
Prepaid rent (note 12)	**481**	1,500
Development costs (note 6)	**1,545**	1,186
Property, plant and equipment (note 7)	**20,310**	15,746
Investment (note 8)	**759**	759
Warranty claim receivable (note 21)	**1,454**	—
Intangible assets (note 9)	**2,620**	—
Goodwill (note 26)	**571**	—
	60,304	48,617
Liabilities		
CURRENT LIABILITIES		
Bank indebtedness (note 10)	**11,279**	5,564
Accounts payable and accrued liabilities	**14,812**	13,525
Current portion of long-term debt (note 13)	**2,056**	737
	28,147	19,826
Deferred gain (note 12)	**501**	548
Lease inducement (note 12)	**1,060**	1,159
Deferred tooling revenues (note 11)	**2,676**	3,434
Long-term debt (note 13)	**6,761**	4,957
Warranty provision (note 21)	**1,454**	—
Future income tax liability (note 26)	**1,186**	—
	41,785	29,924
Shareholders' Equity		
Capital stock (note 15)	**61,194**	55,600
Preferred shares (note 16)	**7,672**	11,454
Contributed surplus (note 15)	**2,857**	2,244
Deficit	**(53,204)**	(50,605)
	18,519	18,693
	60,304	48,617

Nature of operations and going concern (note 1)
Commitments (note 14)
Contingencies (note 21)
Subsequent events (note 27)

Approved by the Board of Directors

Michael C. Scholz
CHAIRMAN

The Hon. John D. Reynolds, PC
COMMITTEE CHAIR,
AUDIT & CORPORATE GOVERNANCE COMMITTEE

Consolidated Statements of Operations and Comprehensive Income (Loss)

For the years ended December 31, 2007 and 2006
(in thousands of Canadian dollars, except number of shares and per share amounts)

	2007	2006
Revenues (note 2)	**$ 110,283**	$ 103,850
Cost of sales and expenses		
Cost of sales (note 2)	**98,442**	89,561
Administrative and general expenses	**9,562**	7,665
Depreciation	**3,395**	3,138
Foreign exchange (gain) loss	**(1,321)**	3
	110,078	100,367
Income from operations	**205**	3,483
Interest expense and financing charges (note 19)	**(2,094)**	(2,033)
Unrealized derivative gain (note 4)	**170**	—
Income (loss) before income taxes	**(1,719)**	1,450
Income taxes (note 22)	**—**	—
Income (loss) and comprehensive income (loss) for the year	**(1,719)**	1,450
Basic earnings (loss) per common share	**(0.06)**	0.06
Basic weighted average number of shares outstanding (000's)	**29,674**	24,964
Diluted earnings (loss) per common share	**(0.06)**	0.06
Diluted weighted average number of shares outstanding (000's)	**29,674**	25,872

Consolidated Statements of Deficit

For the years ended December 31, 2007 and 2006
(in thousands of Canadian dollars)

	2007	2006
Deficit – Beginning of year as previously reported	**$ (50,605)**	$ (51,529)
Adoption of financial instruments standards (note 3)	**40**	—
Deficit – Beginning of year as restated	**(50,565)**	(51,529)
Income (loss) for the year	**(1,719)**	1,450
Preferred share dividends (note 16)	**(920)**	(526)
Deficit – End of year	**(53,204)**	(50,605)

Consolidated Statements of Cash Flows

For the years ended December 31, 2007 and 2006
(in thousands of Canadian dollars)

	2007	2006
Cash flows from operating activities		
Income (loss) for the year	$ (1,719)	$ 1,450
Items not affecting cash (note 20a)	4,790	3,556
	3,071	5,006
Change in non-cash items related to operating activities (note 20b)	(1,323)	(4,238)
	1,748	768
Cash flows from investing activities		
Purchase of property, plant and equipment	(5,020)	(2,111)
Payments relating to development costs	(744)	(873)
Proceeds from sale of property, plant and equipment	15	21
Acquisition of Comtek Advanced Structures Ltd. (note 26)	(2,073)	—
	(7,822)	(2,963)
Cash flows from financing activities		
Net proceeds from bank indebtedness	4,790	(2,282)
Proceeds from current and long-term debt	858	490
Proceeds from sale and leaseback of property, plant and equipment	1,903	—
Repayment of current and long-term debt	(2,581)	(7,263)
Issue of common shares (note 15b)	1,680	4,720
Issue of warrants (note 15b)	411	—
Issue of preferred shares (note 16)	—	7,635
Preferred share dividends (note 16)	(920)	(526)
Share issue expense (note 15)	(67)	(579)
	6,074	2,195
NET CHANGE IN CASH AND CASH EQUIVALENTS	—	—
CASH AND CASH EQUIVALENTS – BEGINNING OF YEAR	—	—
CASH AND CASH EQUIVALENTS – END OF YEAR	—	—
INTEREST PAID	1,244	1,377

01 Nature of Operations and Going Concern

The Company 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.

For the year ended December 31, 2007, the Company recorded a net loss for the year of $1,719,000 (December 31, 2006: $1,450,000, net income). The Company has a working capital surplus of $4,417,000 as at December 31, 2007 (December 31, 2006: $9,600,000) and an accumulated deficit of $53,204,000 at December 31, 2007 (December 31, 2006: $50,605,000).

As at December 31, 2007, the Company was not in compliance with its debt servicing covenant associated with the convertible debenture held by Export Development Canada (note 13a). The Company has obtained a waiver from the debenture holder for this non-compliance. Also at December 31, 2007, the Company was not in compliance with its financial covenants associated with the term loan held by the Business Development Bank of Canada (note 13c). The Company has obtained a waiver from the debt holder for these non-compliances. In addition, the Company has a potential exposure to fund rework for a defective product in an amount of $1,454,000 which is expected to occur over a four to five year period (note 21c).

Management believes that the financing activities undertaken to date, and the ongoing efforts to reduce costs and improve productivity and working capital usage, make the use of the going concern basis appropriate; however, there can be no assurance that the Company will be successful with all initiatives.

While these financial statements have been prepared using Canadian generally accepted accounting principles (GAAP) applicable to a going concern, which contemplates the realization of assets and liquidation of liabilities during the normal course of operations, in the event that the Company is unable to obtain additional financing if required, and without the continued support of significant shareholders (note 24), there is significant doubt about the Company's ability to continue as a going concern as a consequence of the adverse conditions and events described above.

These financial statements do not reflect adjustments to the carrying value of assets and liabilities, the reported revenues and expenses, and balance sheet classifications used that would be necessary if the going concern assumption were not appropriate; such adjustments could be material.

02 Significant Accounting Policies

Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the reported revenues and expenses during the reporting period. The most significant estimates are related to economic lives of depreciable long-lived assets, asset impairment, inventory valuation, development costs and investments. Actual results could differ from those estimates.

Principles of consolidation

The consolidated financial statements of the Company include the accounts of the Company and its subsidiaries. All significant intercompany transactions and balances have been eliminated.

Revenue recognition

Revenue is accounted for under two methods.

A) Revenues from recurring production contracts utilize the completed contract method whereby revenue is recognized when the production of a unit is completed, delivery to the customer occurs, ownership is transferred to the customer and there is reasonable assurance of collection.

B) Revenues from long-term, non-recurring contracts are recognized using the percentage-of-completion method. The percentage complete is calculated based upon contract costs incurred to date compared with total estimated contract costs. The percentage complete is then applied to total anticipated contract revenue to determine the period's revenue. A provision for the estimated loss is made when contract costs are expected to exceed estimated contract revenue. At December 31, 2007 and 2006, the Company did not have any contracts accounted for under this method.

Cost of sales

A) Cost of sales for all recurring production contracts that are not segmented into production lots represents actual costs incurred and includes materials, direct labour and manufacturing overhead costs.

B) Cost of sales for long-term, non-recurring contracts represents total contract costs, including material, direct labour and manufacturing overhead costs. The effect of changes to total estimated profit for each contract is recognized in the period in which the determination is made and losses, if any, are fully recognized when anticipated. At December 31, 2007 and 2006, the Company did not have any contracts accounted for under this method.

Stock-based compensation

The fair value method of accounting is used for stock-based awards. Under this method, the compensation cost of options and other stock-based compensation arrangements are estimated at fair value at the grant date and charged to earnings over the vesting period.

Income taxes

The Company follows the liability method of accounting for income taxes. Under this method, future income taxes are measured using the rates that are expected to apply to taxable income in the periods in which the future income tax liability or asset is expected to be settled or realized. Future income tax assets and liabilities are recognized based on the difference between the tax and accounting value of assets and liabilities and are calculated using the tax rates for the periods in which the differences are expected to reverse.

Future income tax assets are evaluated and if realization is not considered “more likely than not” a valuation allowance is provided. Future income tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of substantive enactment.

Income or loss per common share

Income or loss per common share is calculated based on the weighted average number of shares outstanding during the year. The Company follows the treasury stock method in the calculation of diluted loss per share. Under this method, dilution is calculated based upon the net number of common shares issued, should “in the money” options and warrants be exercised, convertible debt converted, with the proceeds used to repurchase common shares at the average market price in the period.

Translation of foreign currencies and financial instruments

Monetary assets and liabilities denominated in US dollars are converted into Canadian dollars at the rate of exchange prevailing at the period end. Non-monetary assets and liabilities, revenues and expenses in US dollars are converted into Canadian dollars at rates of exchange prevailing on transaction dates, except for amortization which is converted at historical rates.

Inventories

Raw materials are valued at the lower of cost or net realizable value. The cost of raw materials is determined on a weighted average basis. Work in progress and finished goods are valued at the lower of standard cost (which is calculated to approximate actual costs, and includes raw materials, labour and applicable overheads) or net realizable value.

Research and development costs

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

Government assistance

Government assistance towards research and development expenditures is received from Technology Partnerships Canada. Assistance is repayable by way of royalties only if revenues are generated from specified product sales.

The Company credits government assistance directly to the costs and expenses of the related programs for which the assistance was provided.

Property, plant and equipment

Machinery and equipment are recorded at cost less related government grants and investment tax credits. Depreciation is calculated using the straight-line method over the following estimated useful lives of the assets or on a units-of-production basis.

Computer hardware and software	2 – 10 years
Machinery and equipment	5 – 15 years
Leasehold improvements	end of lease, 2018

Impairment of long-lived assets

Management reviews property, plant and equipment for impairment whenever events or changes in circumstances indicate that an impairment may have occurred. Recoverability is assessed by management comparing the carrying amount to the estimated future net cash flows the assets are expected to generate. Where the carrying value exceeds estimated net cash flows, the assets are written down to their estimated fair value.

Investments

Investments in which the Company does not exercise significant influence and are held for the long term are carried at cost. If management determines there is an other than temporary decline in value, these investments will be written down to net realizable value.

Intangible Assets

Intangible assets are comprised of the fair value of customer relationships, order backlog, trade name and patents. The income approach is used to value intangible assets. The fair value of intangible assets acquired in a business combination is assigned a portion of the total cost of the purchase based on their fair values at the date of acquisition. The Company amortizes intangible assets on a straight-line basis over their estimated useful lives, which range between one and ten years.

Management also reviews intangible assets for impairment on an annual basis or whenever events or changes in circumstances indicate that the Company may not recover the carrying amount. Absent of any triggering factors during the year, management conducts its intangible asset assessment in the fourth quarter of the year to correspond with the Company's planning cycle. Management recognizes an impairment loss when the carrying amount exceeds the projected undiscounted future net cash flows expected from its use and disposal. Management measures the loss as the amount by which the carrying amount exceeds its fair value, which is determined using discounted cash flows when quoted market prices are not available. The process of determining fair values is subjective and requires management to exercise judgement in making assumptions about future results, including revenue and cash flow projections and discount rates.

Goodwill from Business Combination

The Company is required to evaluate goodwill annually or whenever events or changes in circumstances indicate that the carrying amount of goodwill may not be recovered. Absent any triggering factors during the year, the Company conducts its goodwill assessment in the fourth quarter of the year to correspond with its planning cycle. Impairment is tested at the reporting unit level by comparing the reporting unit's carrying amount to its fair value. The Company estimates the fair value of the reporting unit using a combination of market approach and income approach. To the extent a reporting unit's carrying amount exceeds its fair value, there is an impairment of goodwill. The Company measures impairment by comparing the fair value of goodwill, determined in a manner similar to a purchase price allocation, to its carrying amount. The process of determining fair values is subjective and requires management to exercise judgement in making assumptions about future results, including revenue and cash flow projections at the reporting unit level and discount rates.

Convertible loans and debentures

Upon issuance, convertible debentures and loans are classified into their equity and liability components based on their relative fair values. The liability components on convertible debentures and loans are accreted up to their principal value by way of a charge to earnings over the term of the debt, using the effective interest rate method.

Deferred gain

Deferred gain represents the unamortized portion of the gain arising on the sale of property, which is amortized over the life of the related property lease.

Asset Retirement Obligations

Future obligations to retire an asset including dismantling, remediation and ongoing treatment and monitoring of the site are initially recognized and recorded as a liability at fair value, based on the Company's current credit-adjusted, risk-free discount rate and an estimated inflation factor. The liability is adjusted for changes in the expected amounts and timing of cash flows required to discharge the liability and accreted to full value over time through periodic charges to earnings. The amount of the asset retirement liability initially recognized is capitalized as part of the asset's carrying value and amortized over the asset's estimated useful life. Future asset retirement obligations are only recorded when the timing or amount of remediation costs can be reasonably estimated.

Leases

Leases are classified as capital or operating leases. A lease that transfers substantially all the benefits and risks incident to the ownership of property is classified as a capital lease. All other leases are accounted for as operating leases whereby lease payments are expensed. Assets recorded under capital leases are depreciated on the same basis as similar assets owned by the Company.

03 Recent Accounting Pronouncements

These financial statements for the year ended December 31, 2007 have been prepared using accounting policies consistent with the audited financial statements for the year ended December 31, 2006 except for the following.

A) Effective January 1, 2007, the Company adopted the Canadian Accounting Standards Board accounting standards dealing with the recognition, measurements and disclosure of financial instruments, hedges and comprehensive income. These new standards are as follows.

Financial instruments – Recognition and measurement

This standard prescribes when a financial asset, financial liability, or non-financial derivative is to be recognized on the balance sheet and whether fair value or cost-based measures are used. It also specifies how financial instrument gains and losses are to be presented (note 4).

Hedges

This standard establishes when and how hedge accounting may be applied. Specifically, hedge accounting may be applied only when gains, losses, revenues and expenses on a hedging item would otherwise be recognized in net income in a different period than gains, losses, revenues and expenses are recognized on the hedged item. The Company has also determined that its derivative instruments do not meet the requirements to qualify them as hedges. Accordingly, they are being marked-to-market with changes in their fair value recognized as unrealized gains and losses in the statement of operations, in the period in which they occur.

Comprehensive Income

This standard provides guidance for the reporting and presentation of other comprehensive income. Comprehensive income represents the change in equity of an enterprise during a period from transactions and other events arising from non-owner sources. Examples of some items that would be included in other comprehensive income are changes in the fair value of available for sale assets and the effective portion of the change in fair value cash flow hedging instruments. Adoption of this new standard did not result in any amounts being recorded in comprehensive income.

B) The effect of these financial instruments, upon adoption of this new standard effective January 1, 2007, was a $40,000 reduction in deficit and a corresponding $40,000 increase in other assets. All derivative and embedded derivative instruments are recorded on the balance sheet at fair value. Mark-to-market adjustments on these instruments are included in net income in accordance with the standard's transitional provisions. The Company recognize as separate assets and liabilities only embedded derivative acquired or substantially modified on or after January 1, 2003. All other financial instruments are initially recorded at fair value and are subsequently measured at amortized cost.

C) Effective January 1, 2007, the Company adopted the revised "Accounting Changes" generally accepted accounting policy, which requires that:

- a voluntary change in accounting principles can be made if, and only if, the changes result in more reliable and relevant information;
- changes in accounting policies are accompanied with disclosures of prior period amounts and justification for the change; and
- for changes in estimates, the nature and amount of the change should be disclosed.

The Company has not made any voluntary change in accounting principles since the adoption of the revised standard.

D) New accounting pronouncements not yet adopted. Effective January 1, 2008, the Company will adopt new Canadian Institute of Chartered Accountants (CICA) standards 1535, 3031 and 3862 and, effective January 1, 2009, standard 3064. The Company is considering the effect these standards may have on its financial statements.

- Section 1535 – Capital Disclosures: This section requires the Company to disclose its objectives, policies and processes for managing capital.
- Section 3031 – Inventories: This section prescribes the accounting treatment for inventories and provides guidance on the determination of cost and subsequent recognition as an expense, including any write-down to net realizable value.
- Section 3862 – Financial Instruments: This section enhances the disclosure requirements on the nature and extent of risks arising from financial instruments and how the Company manages those risks.
- Section 3064 – Goodwill and Intangible Assets: This section replaces CICA 3062, "Goodwill and Intangible Assets", and establishes revised standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. The new standard also provides guidance for the treatment of pre-production and start-up costs and requires that these costs be expensed as incurred.

04 Financial Instruments

The Company uses derivative financial instruments to reduce its exposure to foreign currency and price risk associated with its revenues and costs of certain procured items.

A) 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 in other income or expenses until the date of sale. As at December 31, 2007, the Company has $66,026,000 (December 31, 2006: $30,535,000) of firmly committed orders that include price adjustment clauses of this nature. A loss of $3,000 has been recorded in unrealized derivative gains for the year ended December 31, 2007 (December 31, 2006: $Nil) as a result of the change in the fair value of the underlying embedded derivatives.

B) PURCHASE CONTRACTS

A number of the Company's purchase contracts have a price adjustment clause where the final purchase price is determined by certain indices in a period prior to the date of purchase. As a result, the final purchase 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 in other income or expenses until the date of purchase. As at December 31, 2007, the Company has $3,000 (December 31, 2006: $1,856,000) of firmly committed purchases that include price adjustment clauses of this nature. A gain of $2,000 has been recorded in unrealized derivative gains for the year ended December 31, 2007 (December 31, 2006: $Nil) as a result of the change in the fair value of the underlying embedded derivatives.

C) FOREIGN EXCHANGE FORWARD CONTRACTS

Foreign exchange exposure to US dollar sales, purchases, and related receivables and payables is in part managed by the use of foreign-exchange-forward contracts. On January 4, 2007, the Company entered into a 12-month USD$12,000,000 foreign-exchange-forward contract with the provider of its operating line of credit of which a one-month USD$1,000,000 foreign-exchange-forward contract remains as at December 31, 2007. The Company has marked to market its unrealized foreign-exchange-forward contracts as at December 31, 2007 and recorded a gain of $171,000 in unrealized derivative gains during the year ended December 31, 2007 (December 31, 2006: $Nil).

All other financial instruments have been recorded at cost or amortized cost, subject to impairment reviews, such as the investment in Eclipse Aviation Corporation.

D) OTHER ASSETS

Other assets are comprised of $33,000 inflation derivatives liabilities arising from the Company's sales and purchase contracts having price adjustment clauses within their terms, and $171,000 fair value derivatives assets arising from its foreign-exchange-forward contracts.

05 Inventories

YEAR ENDED DECEMBER 31	2007	2006
Raw materials	$ 6,454	$ 5,403
Work in progress (note 2)	10,546	13,320
Finished products	801	698
	17,801	19,421

06 Development Costs

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

YEAR ENDED DECEMBER 31	2007	2006
Opening balance	$ 1,186	$ 615
Additions	744	953
Disposals	—	—
Amortization	(385)	(382)
	1,545	1,186

07 Property, Plant and Equipment

	2007			2006		
YEAR ENDED DECEMBER 31	COST	ACCUMULATED DEPRECIATION	NET	COST	ACCUMULATED DEPRECIATION	NET
Computer hardware and software	$ 7,431	$ 3,923	$ 3,508	$ 5,054	$ 2,714	$ 2,340
Machinery and equipment	39,154	22,928	16,226	32,726	19,563	13,163
Leasehold improvements	864	288	576	257	14	243
	47,449	27,139	20,310	38,037	22,291	15,746

Included in machinery and equipment are assets held under capital leases at a cost of $3,112,000 (2006: $923,000) having accumulated depreciation of $149,000 (2006: $68,000).

Also included in machinery and equipment is aircraft tooling which will be amortized to income, straight-line on a unit-of-production basis over the expected life of the program (note 11).

08 Investment

On June 17, 2002, the Company acquired 5,264 Series D Preferred Stock of Eclipse Aviation Corporation for $1,527,000.

On December 31, 2004, the Company wrote down its investment by $768,000 to its estimated fair value of $759,000.

09 Intangible Assets

The fair value of intangible assets arising from the December 31, 2007 acquisition of Comtek Advanced Structures Ltd. amounted to $2,620,000.

YEAR ENDED DECEMBER 31	2007	2006
Customer relationships	$ 1,320	$ —
Order backlog	130	—
Trade name	300	—
Patents	870	—
	2,620	—

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

10 Bank Indebtedness

The Company has an operating line of credit with a Canadian chartered bank having interest at prime plus 0.75% per annum. The facility is due on demand. As a condition of obtaining this operating line of credit, the following security has been provided:

- general security agreement creating a first priority security interest in all present and after-acquired personal property of the Company and a floating charge over all of the Company's present and after-acquired real property;
- assignment/endorsements by the Company to the Bank of all risk insurance on all of the Company's real and personal property with the Bank as first loss payee;
- general assignment of book debts creating a first priority assignment of all the Company's debts and accounts;
- Section 427 Bank Act security creating a first priority charge on the Company's assets;
- guarantee of the indebtedness of the Company to the Bank executed by a Canadian financial institution limited to $2,500,000; as consideration for the guarantee, the Company will pay a 3% fee on $2,500,000 calculated on a daily basis;
- assignment and postponement by the shareholders of the Company of all present and future amounts outstanding to them by the Company;
- letter of undertaking from a shareholder of the Company, to raise sufficient equity in 2006 to finance the Company's ongoing tooling deferred costs, to ensure that the Company remains in compliance with the conditions of credit;
- guarantee of the indebtedness of the Company to the Bank, executed by a shareholder limited to $2,000,000; as consideration for the guarantee, the Company will pay the shareholder a 5% fee on $2,000,000 calculated on a daily basis (note 24); and
- priority and standstill agreements with all debenture holders or secured parties having an interest in the Company's property, granting the Bank priority over and postponing any security held by such parties so as to ensure the Bank has a first security interest in all of the Company's property, other than purchase money security interests restricted to the property financed thereby.

During 2007, the following changes were made to the terms and security of the Company's operating line of credit:

- increase of the operating line of credit from $10,000,000 to $15,000,000;
- interest at prime plus 0.375%, 0.50%, 0.675%, or 0.75% determined on a quarterly basis according to specific measures of the ratio of debt to tangible net worth;
- foreign-exchange-forward facility having a notional risk for credit purposes of $3,528,000 to purchase foreign-exchange-forward contracts for major currencies up to an aggregate $3,528,000, with a maximum maturity of 12 months;
- release of the guarantee of the indebtedness of the Company by a Canadian financial institution; and
- increase in margining capacity.

In the course of acquiring Comtek Advanced Structures Ltd. the Company established an additional $2,000,000 operating line of credit with the Canadian chartered bank having interest at prime plus 0.75% per annum. As a condition of obtaining this operating line of credit, the following security has been provided:

- general security agreement creating a first priority security interest in all present and after acquired personal property of the Company and a floating charge over all of the Company's present and after acquired real property;
- Section 427 Bank Act security creating a first priority charge on the Company's assets;
- unlimited guarantee of the indebtedness of the Company to the Bank, executed by Avcorp Industries Inc. (Guarantor);
- general security agreement creating a first priority security interest in all present and after acquired personal property of the Guarantor and a floating charge over all of the Guarantor's present and after acquired real property;
- debt service agreement in favour of the Bank executed by the Guarantor;
- assignment and postponement by the Guarantor of all present and future amounts outstanding to them by the Borrower;
- assignment/endorsements by the Company and the Guarantor to the Bank of all risk insurance on all of the Company's and Guarantor's real and personal property showing the Bank as first loss payee; and
- consent and waiver in favour of the Bank from the landlord of each of the leasehold premises of the Company if required.

11 Deferred Tooling Revenues

YEAR ENDED DECEMBER 31	2007	2006
Opening balance	$ 3,434	$ 4,220
Additions	465	68
Amortization	(1,223)	(854)
	2,676	3,434

The Company sold tooling on certain aircraft programs to customers. The customers are allowing the Company to use the tooling for production of aircraft components for the life of those programs. Accordingly, as the Company will receive the full benefit of the use of the tooling, the sale amount is deferred and will be amortized to income, straight-line on a units-of-production basis over the expected life of the program. The cost of the tooling has been re-classified from development costs to property, plant and equipment and will also be amortized to income, straight-line on a units-of-production basis.

12 Lease Inducement and Deferred Gain

On July 17, 2003, the Company sold its land and building 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. The $712,000 gain arising on disposal of the property 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 $501,000 as at December 31, 2007.

The lease inducement credit of $1,500,000 is being amortized against rental expense over the term of the lease. It has an unamortized balance of $1,060,000 as at December 31, 2007. The related prepaid rent amount recorded of $1,500,000 will be charged to rental expense over the term of the rent-free period which arises in 2008 and 2009. Consequently, $1,019,000 of the rental prepayment will be amortized during 2008 and has been reclassified as a current asset within Prepayments. The remaining $481,000 is classified as Prepaid rent on the balance sheet.

13 Long-Term Debt

YEAR ENDED DECEMBER 31	2007	2006
Convertible debenture due December 2009 **(A)**	$ 4,497	$ 4,897
Convertible debentures due March 2008 **(B)**	—	12
Bank term loan **(C)**	331	—
Capital leases **(D)**	2,806	597
Accrued government royalties **(E)**	1,183	188
	8,817	5,694
Less: Current portion	2,056	737
	6,761	4,957

A) CONVERTIBLE DEBENTURE DUE DECEMBER 2009

During 1998, the Company issued an $8,000,000 convertible debenture; $3,000,000 of the convertible debenture was repaid prior to 2005. The remaining debenture is convertible at the option of the holder (Export Development Canada) into 322,387 shares at a conversion price of $13.95. The Company can require conversion of the full amount of the debenture in the event that the weighted average trading price of the Company's shares on the Toronto Stock Exchange is greater than 125% of the conversion price for 20 consecutive days.

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

The debenture was amended on June 27, 2006 to give effect to the following:

- the debenture bears interest at 7.0% commencing January 3, 2006;
- the amount of the debenture is increased from $5,000,000 to $5,197,000 to include outstanding interest due thereon; and
- principal repayments are payable in 14 quarterly installments of $100,000 commencing on June 30, 2006 with the final installment of $3,797,000 due and payable on December 31, 2009.

As at December 31, 2007, the Company was not in compliance with its debt servicing covenant associated with the convertible debenture. The Company has obtained a waiver from the debenture holder for this non-compliance.

B) CONVERTIBLE DEBENTURES DUE MARCH 2008

During 2004, the Company issued $7,000,000 of a series of secured subordinated debentures.

In previous years, the Company repaid $6,459,000 of principal outstanding on its series of secured subordinated debentures. The remaining $500,000 principal of the debentures was converted on December 22, 2006 at the $1.50 per common share conversion price. $12,000 accrued interest remained outstanding as at December 31, 2006, and was paid during the quarter ended March 31, 2007.

C) BANK TERM LOAN

A Canadian chartered bank holds a term loan with Comtek Advanced Structures Ltd. in the amount of $331,000 as at December 31, 2007.

The terms and security of the term loan are as follows.

- Interest at a rate of 12% per annum.
- Commencing August 23, 2007, the principal will be repaid by 49 consecutive monthly installments of $7,500 each, followed with the final payment of $1,000 on September 23, 2011.
- All security shall be in form and substance satisfactory to the Lender and its counsel and shall be in form sufficient for registration or filing under all applicable laws. It includes a general security agreement over the assets of Comtek Advanced Structures Ltd.

As at December 31, 2007, the Company was not in compliance with its financial covenants associated with the term loan held by this Canadian chartered bank. The Company has obtained a waiver from the debt holder for these non-compliances.

D) CAPITAL LEASES

There are various equipment leases that have a weighted average interest rate of 7.13%. 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. $1,464,000 of the leases are held in US dollars.

E) ACCRUED GOVERNMENT ROYALTIES

Royalties of $1,183,000 (December 31, 2006: $188,000) are payable to Technology Partnerships Canada.

14 Obligations and Commitments Under Capital 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:

	2007		2006	
YEAR ENDED DECEMBER 31	**OPERATING**	**CAPITAL**	OPERATING	CAPITAL
2007	**$ —**	**$ —**	$ 2,038	$ 178
2008	**1,674**	**911**	1,018	170
2009	**2,311**	**882**	1,686	170
2010	**2,620**	**617**	2,167	116
2011	**2,465**	**492**	2,167	63
2012	**2,167**	**346**	2,167	—
Thereafter	**12,673**	**—**	12,673	—
Total future minimum lease payments	**23,910**	**3,248**	23,916	697
Less: Imputed interest	**n/a**	**(442)**	n/a	(100)
Balance of obligation under capital leases included in long-term debt (note 13)	**n/a**	**2,806**	n/a	597

For the year ended December 31, 2007, an amount of $1,981,000 representing payments under operating leases was expensed (2006: $2,134,000).

15 Capital Stock

Authorized

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 are determined by the directors at the time of creation of each series.

Common shares issued or reserved:

	NUMBER OF SHARES	AMOUNT
December 31, 2005	22,418,510	$ 49,626
Share issue **(C)**		
Cash	4,957,327	4,720
Non-cash	460,790	971
Issuance costs	—	(33)
	5,418,117	5,658
Transfer from contributed surplus on exercise of options and warrants	—	316
December 31, 2006	27,836,627	55,600
Share issue **(B)**		
Cash	1,069,398	1,680
Conversion from preferred shares	2,439,241	3,782
Acquisition of Comtek Advanced Structures Ltd.	99,458	129
Issuance costs	—	(67)
	3,608,097	5,524
Transfer from contributed surplus on exercise of options and warrants	—	70
December 31, 2007	31,444,724	61,194

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

A) The Company has reserved a total of 322,387 common shares, the maximum number that may be exercised under the terms of the convertible debenture due December 2009 (note 13a).

B) During 2007, 3,608,097 common shares were issued from the following transactions.

I) EXERCISE OF WARRANTS

Holders of warrants exercised 50,000 share purchase warrants (issued on February 3, 2006 for a performance guarantee on certain production contracts) resulting in the issuance of 50,000 common shares at $0.90 per share for gross proceeds of $45,000.

II) EXERCISE OF OPTIONS

Holders of options exercised a total of 179,398 share purchase options resulting in the issuance of 167,398 shares at $1.08 per share and 12,000 shares at $1.40 per share for total gross proceeds of $198,000.

III) COMMON SHARE ISSUE

During the year ended to December 31, 2007, the Company entered into a placement of 840,000 units at $2.20 per unit; 287,500 units were subscribed for by insiders of the Company. Each unit consists of one share and one warrant, where one warrant entitles the holder the right to purchase one additional share at $2.40 per share for a 24-month period from the closing date. Proceeds of the unit offering were split between capital stock and warrants ($411,000, note 15f).

IV) PREFERRED SHARE CONVERSION

Holders of preferred shares converted 378,200 preferred shares resulting in the issuance of 2,439,241 common shares at $1.55 per share.

V) COMMON SHARE ISSUE ON ACQUISITION OF COMTEK ADVANCED STRUCTURES LTD.

On December 31, 2007, the Company issued 99,458 common shares to shareholders of the acquired Company at a value of $1.30 per share.

The costs of issuing the capital stock during 2007 amounted to $67,000 and were deducted from total proceeds of $1,680,000 to record $1,613,000 as capital stock.

C) During 2006, 5,418,117 common shares were issued from the following transactions.

I) EXERCISE OF WARRANTS

Holders of warrants exercised a total of 5,180,516 share purchase warrants (issued on April 4, 2005 through a private placement, on February 3, 2006 for a performance guarantee on certain production contracts, and on October 27, 2005 through a private placement) resulting in the issuance of a total of 4,663,849 common shares at prices of $0.90, $1.00 and $1.05 for gross proceeds of $4,688,000.

II) EXERCISE OF OPTIONS

Holders of options exercised a total of 220,935 share purchase options resulting in the issuance of a total of 220,935 common shares at prices of $0.90, $1.08 and $1.40 per share for total gross proceeds of $236,000.

III) PRIVATE PLACEMENT

Insiders of the Company purchased a total of 200,000 units at $1.35 per unit for gross proceeds of $270,000, resulting in the issuance of a total of 200,000 common shares and 200,000 share purchase warrants (where one warrant entitles the holder the right to purchase one additional share at $1.50 per share for a 24-month period ending November 3, 2008).

IV) DEBENTURE CONVERSION

The holder of a convertible debenture due March 2008 (note 13b) converted a $500,000 debenture at $1.50 per common share resulting in the issuance of 333,333 common shares for gross proceeds of $Nil.

The costs of issuing the capital stock during 2006 amounted to $33,000 and were deducted from total proceeds of $5,691,000 to record $5,658,000 as capital stock. $804,000 of the proceeds from the equity financings have been used for repayment of debt and interest, $167,000 for payment of fees, and the remainder for general working capital purposes.

D) Basic and Diluted Weighted Average Number of Common Shares.

YEAR ENDED DECEMBER 31	**2007**	2006
Weighted average shares outstanding		
Effect of dilutive securities	**29,673,847**	24,964,118
Incremental shares from share options and warrants	**—**	907,645
Shares issuable on conversion of preferred shares	**—**	—
Weighted average diluted shares outstanding	**29,673,847**	25,871,763

E) The Company's incentive stock option plan is administered by the Board of Directors. The maximum number of common shares that may be optioned is 3,166,667. The period during which an option is exercisable shall not exceed 10 years. Existing stock options vest over periods ranging from immediately to two years.

A summary of the Company's stock option plan as of December 31, 2007 and December 31, 2006, and changes during the periods ending on those dates, is presented below.

	2007		2006	
YEAR ENDED DECEMBER 31	**SHARES (000'S)**	**WEIGHTED AVERAGE EXERCISE PRICE**	SHARES (000'S)	WEIGHTED AVERAGE EXERCISE PRICE
Outstanding – Beginning of year	**1,059**	**$ 1.22**	880	$ 1.17
Granted	**60**	**1.85**	810	1.31
Forfeited	**—**	**—**	(410)	1.36
Exercised	**(179)**	**1.10**	(221)	1.07
Outstanding – End of year	**940**	**1.28**	1,059	1.22

The following table summarizes stock options outstanding and exercisable:

OPTIONS OUTSTANDING AND EXERCISABLE AT DECEMBER 31, 2007	NUMBER (000'S)	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE (YEARS)	WEIGHTED AVERAGE EXERCISE PRICE
$0.00 – $1.50	880	0.57	$ 0.79
$1.50 – $3.00	60	1.08	1.85
	940	0.73	1.28

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

YEAR ENDED DECEMBER 31	**DEC 31, 2007**	DEC 31, 2006
Beginning of year	**$ 2,244**	$ 2,042
Stock-based compensation expense	**199**	252
Fair value of warrants	**73**	266
Transfer to capital stock on exercise of options and warrants	**(70)**	(316)
Allocation of units offering proceeds to warrants (note 15biii)	**411**	—
End of year	**2,857**	2,244

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

16 Preferred Shares

On July 10, 2006, the Company issued 1,200,000 preferred shares at an issue price of $10.00 per preferred share. Gross proceeds from the 2006 issuance of preferred shares amounted to $12,000,000; $4,365,000 of the gross proceeds receivable was used to retire debt (note 13b); the remaining $7,635,000 was received in cash. The costs of issuing the preferred shares during 2006 amounted to $546,000 and were deducted from total proceeds.

The preferred shares provide for a 9.25% per annum dividend, payable quarterly in cash on the last day of September, December, March and June with the first dividend payable on December 31, 2006. Dividends paid during the year ended December 31, 2007 amounted to $920,000 (December 31, 2006: $526,000).

Each preferred share will be convertible at any time, without the payment of additional consideration, at the option of the holder, on the following basis:

- Year 1: into 6.45 common shares, at a conversion price of $1.55 per common share;
- Year 2: into 5.71 common shares, at a conversion price of $1.75 per common share;
- Year 3: into 5.00 common shares, at a conversion price of $2.00 per common share;
- Year 4: into 4.26 common shares, at a conversion price of $2.35 per common share; and
- Thereafter: into 3.64 common shares, at a conversion price of $2.75 per common share.

The conversion price will be subject to adjustment in certain circumstances pursuant to customary anti-dilution provisions.

From July 1, 2008 to June 30, 2011, the preferred shares will be redeemable at the option of the Company at issue price plus accrued and unpaid dividends, provided that the volume weighted average trading price of the common shares on the Toronto Stock Exchange, for at least 20 trading days in any consecutive 30-day period ending on the fifth trading day prior to the date on which the notice of redemption is given, exceeds 125% of the conversion price. From July 1, 2011, the preferred shares will be redeemable at issue price plus accrued and unpaid dividends.

The preferred shares will not be redeemable by the company at any time prior to July 1, 2008.

At any time after June 30, 2011, the preferred shares will be redeemable in whole or in part at the option of the holder at the issue price plus all accrued and unpaid dividends thereon calculated to the date of redemption if:

- at any time after that date the current market price on the fifth day prior to such date is less than $2.75; or
- there is a change in control of the Company involving the acquisition of voting control or direction over 66-2/3% or more of the common shares.

During the year ended December 31, 2007, holders of preferred shares converted 378,200 preferred shares resulting in 821,800 preferred shares remaining having a $7,672,000 book value (note 15b).

17 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 60,000 options granted during the year ended December 31, 2007 was $46,000. These options are exercisable at $1.85 each, with 30,000 options vesting on July 23, 2007 and 30,000 options vesting on January 23, 2008. All 60,000 options expire on January 23, 2009.

	2007	2006
Risk-free interest rate (%)	**4.19**	4.21
Dividend yield (%)	**0**	0
Expected lives (years)	**1.75**	1.70
Volatility (%)	**54.41**	64.87

The fair value of options expense, for options granted in current and prior periods, amortized to earnings during the year ended December 31, 2007 was $199,000 (December 31, 2006: $252,000).

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

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.

18 Defined Contribution Plan

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

YEAR ENDED DECEMBER 31	2007	2006
Defined contribution plan	$ 1,283	$ 1,147

The Company's contribution to the plan is calculated on a percentage of employee wages. The range of percentages is 1.5% to 8.5%. The plan is available to all employees.

19 Interest Expense and Financing Charges

YEAR ENDED DECEMBER 31	2007	2006
Interest on capital leases	$ 134	$ 34
Interest on other long-term debt	332	356
Interest on short-term debt	1,628	1,643
Net interest expense	2,094	2,033

20 Supplementary Cash Flow Information

A) Items not affecting cash:

YEAR ENDED DECEMBER 31	2007	2006
Accrued interest net of government contributions	$ 1,046	$ 1,004
Deferred tooling revenue amortization	(913)	(718)
Depreciation	3,395	3,138
Development cost amortization	385	382
Fair value of warrants	—	266
Payment of fees via equity issue	—	167
Provision for loss-making contracts	1,039	(724)
Unrealized derivative gains	(98)	—
Stock-based compensation	199	252
Other items	(263)	(211)
	4,790	3,556

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

B) Changes in non-cash items:

YEAR ENDED DECEMBER 31	2007	2006
Accounts receivable	$ (2,565)	$ 20
Inventories	2,396	(5,232)
Prepayments	389	(150)
Accounts payable and accrued liabilities	(1,543)	1,124
	(1,323)	(4,238)

C) Non-cash financing and investing activities:

YEAR ENDED DECEMBER 31	2007	2006
Assets acquired under capital leases	$ 903	$ 245
Conversion of preferred shares	3,782	—
Shares and warrants issued for investment in Comtek Advanced Structures Ltd.	202	—

21 Contingencies and Commitments

A) The Company has agreements with Technology Partnerships Canada (TPC), under which TPC will make cash contributions to the Company's various projects, up to a cumulative maximum of $8,912,000. In return, a royalty will be paid to TPC by the Company based on the selling price and units sold. During the year ended December 31, 2007, the Company received $226,000 (2006: $247,000) from TPC. This amount was credited to development costs, as it related directly to certain long-term programs, and as a recovery of expenses.

B) The Company's subsidiary, Comtek Advanced Structures Ltd. has an agreement with TPC, under which TPC has made cash contributions to Comtek Advanced Structures Ltd.'s various projects, in the amount of $3,325,000. In return, a $350,000 royalty will be paid to TPC by Comtek Advanced Structures Ltd. on each of June 30, 2008 and June 30, 2009, after which payment, no further amount will be due.

C) During the fourth quarter 2007, the Company became aware of a requirement to rework previously delivered product. As at the date of this report, it is uncertain as to when the rectification will take place. In consideration of the nature of rework required, and the possible extent to which the defect effects delivered product, the Company has accrued a $1,454,000 charge within cost of sales. In the opinion of the Company, an equivalent claim against the manufacturer of a sub-component to the product can be made. Accordingly, a $1,454,000 recovery has been accrued within cost of sales. The amounts recorded are based on management's best estimate of the amount of product affected and the timing of the rework, which is expected to occur over a four to five year period.

22 Income Taxes

A) A reconciliation of income taxes at statutory rates to actual income taxes is as follows:

YEAR ENDED DECEMBER 31	2007	2006
Combined basic income tax rate	34.1%	34.1%
Income tax (recovery) at the basic income tax rate	$ (586)	$ 494
Other	186	541
Impact of change in statutory income tax rate	1,746	1,037
Change in valuation allowance	(2,516)	(2,072)
Expiry of ITC	1,170	—
	0	0

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

B) The tax effect of temporary differences that give rise to significant portions of future tax assets and future tax liabilities as at December 31 are as follows:

YEAR ENDED DECEMBER 31	2007	2006
Future income tax assets (liability)		
Non-capital losses	**$ 6,049**	$ 6,234
Scientific research expenditures	**2,407**	2,779
Investment	**104**	119
Capital losses	**673**	424
Property, plant and equipment	**5,550**	5,677
Gain deferred for accounting purposes	**621**	968
Expenses not deductible in current period	**582**	148
Financing costs	**388**	606
Investment tax credits	**773**	1,844
Intangible asset	**(761)**	—
	16,386	18,799
Net future income tax asset	**16,386**	18,799
Less: Valuation allowance	**(17,572)**	(18,799)
Net future income tax asset (liability)	**(1,186)**	—

C) The Company has available non-capital loss carry-forwards totalling approximately $21,578,000. These losses expire as follows:

EXPIRY DATE	LOSS CARRY-FORWARDS
2010	$ 4,451
2014	5,451
2015	8,416
2027	3,260

D) The Company has approximately $8,915,000 of unclaimed research and development costs that may be claimed against future taxable income.

E) The Company has accumulated net capital losses for tax purposes of approximately $2,491,000 which may be carried forward and used to reduce taxable capital gains in future years.

F) The Company has investment tax credits (ITC's) from Scientific Research and Experimental Development expenditures, which can be applied to reduce income taxes payable in future years. The ITC's expire as follows:

EXPIRY DATE	ITC
2008	$ 705
2011	364

No net future tax benefit has been recognized in these financial statements with respect to these losses.

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

23 Financial Instruments

Interest rate risk

The Company is subject to interest rate risk to the extent that interest rates on bank indebtedness, demand loans and long-term debt fluctuate. At December 31, 2007, all long-term debt bears fixed rates of interest as detailed in these financial statements.

Currency risk

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 in US dollars at prices that are usually established at the order date. All of the Company's operations are based in Canada. As a result of this, the Company is exposed to currency risk to the extent that fluctuations in exchange rates are experienced. The Company uses derivative financial instruments to mitigate its exposure to currency risks.

Credit risk

The Company is exposed to credit risk in the event of non-performance by customers, but does not anticipate such non-performance. The Company monitors the credit risk and credit rating of customers on a regular basis. The maximum credit risk is the fair value of the accounts receivable.

Fair values

The fair values of the Company's accounts receivable, bank indebtedness, term loan and accounts payable and accrued liabilities are estimated to approximate their carrying values due to the immediate or short-term maturity of these financial instruments. Management has assessed that it is not practical to determine the fair value of the long-term investment which represents 5,264 Series D Preferred Stock of Eclipse Aviation Corporation as these shares are not traded in an organized financial market. The fair value of the long-term debt is estimated using present value techniques and assumptions concerning the amount and timing of expected future cash flows and discount rates which reflect current market rates on similar financial instruments.

	2007		2006	
YEAR ENDED DECEMBER 31	**CARRYING VALUE**	**FAIR VALUE**	CARRYING VALUE	FAIR VALUE
Long-term debt	**$ 8,817**	**$ 8,358**	$ 5,694	$ 4,700

24 Related-Party Transactions

During the year ended December 31, 2005, the Company entered into an agreement with a certain shareholder in consideration of mutual agreements with a Canadian chartered bank under which the shareholder guarantees the indebtedness of the Company to the Bank limited to $2,000,000. In connection with providing the limited guarantee on the operating line of credit, the Company will pay a 5% fee on the $2,000,000 limited guarantee calculated on a daily basis. Fees paid to a certain shareholder during the year ended December 31, 2007 amounted to $58,000 (December 31, 2006: $75,000). Fees payable to a certain shareholder as at December 31, 2007 are $75,000 (December 31, 2006: $33,000). These fees are included in the Statements of Operations as interest expense and financing charges and amount to $100,000 for the year ended December 31, 2007 (December 31, 2006: $100,000).

On February 3, 2006, a performance guarantee was provided by certain shareholders on production contracts with a certain customer. Fees ranging to $20,000 per month were provided as consideration for the performance guarantee. Fees paid to certain shareholders during the year ended December 31, 2007 amounted to $60,000 (December 31, 2006: $179,000). Fees payable to certain shareholders as at December 31, 2007 are $180,000 (December 31, 2006: $80,000). These fees are included in the Statements of Operations as cost of sales and amount to $240,000 for the year ended December 31, 2007 (December 31, 2006: $259,000).

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

The Company had no demand loans outstanding as at December 31, 2007 (December 31, 2006: $Nil). During the second quarter of 2007, a certain shareholder advanced the Company $800,000 at 12% interest per annum, for the purpose of the Company extending a loan (note 26) to Comtek Advanced Structures Ltd. with which it was finalizing its acquisition. The principal portion of the demand loan was repaid during the second quarter of 2007.

Total interest and fees charged on demand loans for the year ended December 31, 2007 were $2,000 (December 31, 2006: $153,000). Interest and fees payable on the demand loans as at December 31, 2007 are $2,000 (December 31, 2006: $Nil). Interest and fees paid on the demand loans for the year are $Nil (December 31, 2006: $692,000).

On January 4, 2007, the Company entered into a 12-month USD$12,000,000 foreign-exchange-forward contract with its provider of the operating line of credit. Under the terms of this agreement, the Canadian chartered bank required a CAD$3,024,000 deposit be made on the Company's behalf by a significant shareholder, for a three-month period. The Company paid this significant shareholder a $15,000 fee for this transaction.

Other related-party transactions are disclosed elsewhere in these financial statements (notes 15 and 27).

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

25 Economic Dependence and Segmented Information

A) Sales to three major customers, which comprise several programs and contracts, accounted for approximately 91.6% (December 31, 2006: 95.6%) of sales.

	2007		2006	
YEAR ENDED DECEMBER 31	**REVENUE**	**% OF TOTAL**	REVENUE	% OF TOTAL
Boeing	**$ 19,327**	**17.5**	$ 21,084	20.3
Bombardier	**24,025**	**21.8**	22,698	21.9
Cessna	**57,666**	**52.3**	55,447	53.4
Other	**9,265**	**8.4**	4,621	4.4
Total	**110,283**	**100.0**	103,850	100.0

B) The Company operates in one industry that involves the manufacture and sale of aerospace products. As a result, the Company has only one operating segment. All of the Company's operations and assets are in Canada.

26 Business Acquisitions

On April 2, 2007, the Company entered into a preliminary agreement to acquire all of the shares of a composite aerostructures manufacturing business. The acquisition closed on December 31, 2007.

Prior to the closing date of December 31, 2007, the Company advanced Comtek Advanced Structures Ltd. $1,850,000 under the terms of a convertible loan agreement, which was subsequently applied as cash consideration in the purchase price.

In addition to the $1,850,000 invested into Comtek Advanced Structures Ltd., the Company assumed and repaid $150,000 of shareholder loans on behalf of Comtek Advanced Structures Ltd., and made payments totalling $73,000 to a group of its shareholders.

A majority of the principals of Comtek Advanced Structures Ltd. will remain and have agreed to assign their shares to the Company for 450,000 Company warrants, exercisable over a three-year period from closing, at an exercise price of $2.60 in year 1, $3.00 in year 2, and $3.50 in year 3. Comtek Advanced Structures Ltd. minority shareholders received 37,880 Company warrants, exercisable over an 18-month period from closing, at an exercise price of $2.50. The fair value of the 487,880 warrants issued to Comtek Advanced Structures Ltd. shareholders is $73,000. The Black-Scholes warrant-pricing model used by the Company to calculate warrant values utilizes subjective input assumptions whose change can materially affect the fair value estimate, and therefore, the existing models do not necessarily provide a reliable, simple measure of the fair value of warrants issued by the Company.

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

The Company also issued 99,458 common shares to the shareholders of Comtek Advanced Structures Ltd. The $129,000 fair value of these common shares was estimated at the Company's December 31, 2007 market closing price of $1.30 per common share.

In addition, the Company has agreed to pay to the principal shareholders of Comtek Advanced Structures Ltd. one-third of the composite business' EBITDA for the year ending December 31, 2010, which is payable two-thirds in cash and one-third in the Company shares at the then current market price.

The costs of completing this acquisition amounted to $102,000.

The transaction was completed on December 31, 2007 and has been negotiated at arm's length.

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

YEAR ENDED DECEMBER 31	2007
Current assets	$ 3,343
Property, plant and equipment	2,052
Customer relationships	1,320
Order backlog	130
Trade name	300
Patents	870
Goodwill	571
	8,586
Bank indebtedness assumed	(925)
Current liabilities assumed	(3,315)
Liabilities assumed	(783)
Future income tax liability	(1,186)
Net assets assumed	2,377
Purchase consideration:	
Cash	2,073
Acquisition costs (included in accounts payable and accrued liabilities)	102
Company shares	129
Company warrants	73
	2,377

27 Subsequent Events

Subsequent to December 31, 2007, holders of warrants exercised a total of 675,000 share purchase warrants (issued on February 3, 2006 for a performance guarantee on certain production contracts) resulting in the issuance of 675,000 common shares at $0.90 per share.

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

Board of Directors and Officers

Michael C. Scholz[2,3]
CHAIRMAN OF THE BOARD
West Vancouver, British Columbia

Earnest Beaudin[1]
DIRECTOR
Chief Executive Officer
& General Counsel
Decker Management Ltd.
Calgary, Alberta

Eric Kohn TD[2*]
DIRECTOR
Managing Partner
Barons Financial Services SA
Geneva, Switzerland

Kees de Koning[3]
DIRECTOR
Nootdorp, The Netherlands

Elizabeth Otis[3*]
DIRECTOR
Vashon, Washington

David Levi[1,2]
DIRECTOR
President and CEO
GrowthWorks Capital Ltd.
Vancouver, British Columbia

The Hon. John Reynolds, PC[1*]
DIRECTOR
Senior Strategic Advisor
Lang Michener LLP
Gibsons, British Columbia

Mark van Rooij[3]
DIRECTOR
Chief Executive Officer
White Rock, British Columbia

Paul Kalil
President
Vancouver, British Columbia

Edward Merlo
CORPORATE SECRETARY
Vice President, Finance
Richmond, British Columbia

Paul Meringer
Vice President, Procurement
Richmond, British Columbia

Amandeep Kaler
Vice President, Assembly
Surrey, British Columbia

[1] Member of the Audit and Corporate Governance Committee
[2] Member of the Compensation and Nominating Committee
[3] Member of the Executive Committee
* Designates the Committee Chair

Directory

BANK
HSBC Bank Canada
Vancouver, British Columbia

LEGAL COUNSEL
Lang Michener LLP
Barristers & Solicitors
Vancouver, British Columbia

REGISTRAR AND TRANSFER AGENT
CIBC Mellon Trust Company
Vancouver, British Columbia

AUDITORS
PricewaterhouseCoopers LLP
Chartered Accountants
Vancouver, British Columbia

SHARES LISTED
Toronto Stock Exchange
Symbol AVP

ANNUAL GENERAL MEETING
Thursday, May 22, 2008 at 2:00pm
at Avcorp Industries Inc.
10025 River Way
Delta, British Columbia

AVCORP INDUSTRIES INC.
10025 River Way
Delta, British Columbia
Canada V4G 1M7
Telephone: 604.582.1137
Facsimile: 604.582.2620
Email: info@avcorp.com
Website: www.avcorp.com

Design: SamataMason Printing: Blanchette Press

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