

AVCORP

second quarter report 2009

ABOUT AVCORP INDUSTRIES INC. Avcorp designs and builds major airframe structures for some of the world's leading aircraft companies, including Boeing, Bombardier, and Cessna. With more than 50 years of experience, 410 skilled employees and 354,000 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, light-weight, strong, reliable structures. Avcorp is a Canadian public company traded on the Toronto Stock Exchange (TSX:AVP).

management discussion & analysis

This Management Discussion and Analysis has been prepared as of August 6, 2009, and should be read in conjunction with the Company's unaudited interim consolidated financial statements and noted thereto for the three and six month periods ended June 30, 2009 and with the audited financial statements and notes thereto for the year ended December 31, 2008.

Description of Business

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

We operate from two locations in Canada, one dedicated to composites, the other dedicated to light weight metal manufacturing.

Avcorp is in compliance with Industry Standard Quality requirements.

Financial Overview

Quarterly Results

The following table provides selected unaudited quarterly financial information for the eight most recent fiscal quarters to June 30, 2009.

QUARTERLY RESULTS

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

| For the three months ended | 2009 | | 2008 | | | | 2007 | |
|---------------------------------|--------------------------|--------------------|--------------------|----------|----------|----------|----------|----------|
| | Jun 30 | Mar 31 | Dec 31 | Sep 30 | Jun 30 | Mar 31 | Dec 31 | Sep 30 |
| Revenue | \$16,172 | \$22,087 | \$34,434 | \$30,894 | \$32,389 | \$31,151 | \$26,878 | \$26,696 |
| Income (loss) from operations | 552 | (1,989) | (1,561) | 1,004 | 859 | 183 | (1,857) | 628 |
| EBITDA ^{1,2} | 1,530 | (1,550) | 1,141 | 1,676 | 2,218 | 1,375 | (1,282) | 1,500 |
| Net income (loss) | 65 | (3,172) | (1,972) | (220) | 364 | (423) | (2,943) | 32 |
| EBITDA per share ^{1,2} | | | | | | | | |
| Basic | 0.05 | (0.05) | 0.04 | 0.05 | 0.07 | 0.04 | (0.04) | 0.05 |
| Diluted | 0.05 | (0.05) | 0.04 | 0.05 | 0.07 | 0.04 | (0.04) | 0.04 |
| Net income (loss) per share | | | | | | | | |
| Basic | 0.00 | (0.10) | (0.06) | (0.01) | 0.01 | (0.01) | (0.10) | 0.00 |
| Diluted | 0.00 | (0.10) | (0.06) | (0.01) | 0.01 | (0.01) | (0.10) | 0.00 |
| Long-term debt | 2,387³ | 2,843 ³ | 2,872 ³ | 7,192 | 7,424 | 6,306 | 6,761 | 6,419 |

1. EBITDA = earnings before interest, taxes, depreciation and amortization

2. EBITDA is not a recognized term under GAAP

3. Exclusive of \$4,193,000 (December 31, 2008: \$4,097,000) convertible debenture held by Export Development Canada classified as current portion of long-term debt due for repayment on December 31, 2009 (note 12a to the financial statements)

Three and Six Months Ended June 30, 2009 and 2008 Results Overview

During the quarter ended June 30, 2009, the Company recorded income from operations of \$552,000 on \$16,172,000 revenue, as compared to \$859,000 earnings from operations on \$32,389,000 revenue for the same quarter of the preceding year; and net income for the current quarter of \$65,000 as compared to net income of \$364,000 for the quarter ended June 30, 2008. It should be noted that earnings include a \$3,962,000 foreign exchange gain (June 30, 2008: \$116,000) which occurred as a result of holding foreign-currency-denominated receivables, payables and debt. On a year-to-date basis, the Company has recorded a \$3,107,000 net loss on \$38,259,000 revenue as compared to a \$59,000 net loss on \$63,540,000 revenue for the same period in 2008.

Second quarter 2009 continued softening of customers' order book has caused the Company to review operations and further terminate employees. This has necessitated a \$196,000 charge against income for the quarter ended June 30, 2009 (year-to-date June 30, 2009: \$521,000).

Significantly reduced customer demand, relative to the same quarter in the preceding year, has resulted in idle plant capacity. The Company has expensed \$1,500,000 of overhead costs during the current quarter which under prior periods' production levels would have been inventoried.

Additionally, the dramatic reductions in the plant labour force have resulted in a higher unit cost of labour due to the remaining senior employees earning a higher rate of wages and benefits. Reallocations of employees amongst programs in an effort to match customer delivery requirements have caused production inefficiencies as employees perform new tasks in different work centres. It is expected that these inefficiencies will continue into the second half of the year.

The Company incurred legal, consulting and professional investment service fees during the quarter in the course of negotiating, analyzing and documenting its financial restructuring (note 18 to the financial statements). During the second quarter 2009 fees in the amount of \$360,000 were expensed in this regard.

Cash flows from operating activities during the current quarter provided \$2,272,000 of cash, as compared to providing \$906,000 of cash during the quarter ended June 30, 2008. During the first two quarters of 2009 and 2008, the Company's generated cash flows from operating activities in the amounts of \$1,591,000 and \$2,318,000 respectively. The Company has a working capital deficit of \$5,633,000 as at June 30, 2009 (December 31, 2008: \$2,065,000 deficit) primarily as a result of classifying the \$4,193,000 convertible debenture held by Export Development Canada as current portion of long-term debt (note 12a to the financial statements), and an accumulated deficit of \$59,695,000 at June 30, 2009 (December 31, 2008: \$56,213,000).

During the second quarter 2009, the Company had two operating lines of credit provided by a Canadian chartered bank, which have a total maximum availability of \$17,000,000. \$2,000,000 of this total has been apportioned to Comtek Advanced Structures Ltd. (utilized \$1,621,000 as at June 30, 2009). The remaining \$15,000,000 operating line of credit (utilized \$10,618,000 as at June 30, 2009) has the following terms and conditions (note 9 to the financial statements):

- borrowing in excess of \$15,000,000 up to \$20,000,000 will be cash secured;
- interest at prime plus 0.875%, 1.00%, 1.175%, or 1.25% determined on a quarterly basis according to specific measures of the ratio of debt to tangible net worth;
- US dollar sub-limit for the operating line of credit is USD\$15,000,000; and
- foreign forward exchange facility having a notional risk for credit purposes of \$3,528,000 to purchase foreign forward exchange contracts for major currencies, with a maximum maturity of 12 months.

Subsequent to the end of the second quarter 2009, the Bank changed the terms of its agreement with the Company. On August 12, 2009, the Company entered into a Forbearance Agreement with the bank providing its operating lines of credit. The Forbearance Agreement establishes terms and conditions under which the bank will continue to provide these facilities.

The following changes were made to the terms and security of the Company's operating lines of credit:

- decrease of the operating lines of credit, before cash security, from \$17,000,000 to \$15,000,000;

- interest at Bank prime plus 3.0%;
- the Company shall pay the Bank a monthly forbearance fee of \$10,000;
- the \$2,000,000 shareholder guarantee shall be replaced in a manner and form satisfactory to the Bank no later than September 15, 2009;
- during the period between March 31, 2009, and the date which is 90 days from the date of this agreement, a minimum of \$7,500,000 shall be injected into the Company by way of equity investment or debt that will at all times be subordinated to the Bank; and
- the Forbearance Agreement ends on November 10, 2009.

A number of financing activities are being pursued as of the date of this report. It is important to note that the success of these activities cannot be assured.

The Company has taken the following actions to provide liquidity for its operations:

- Reduced its employee base by 329 staff and plant workers since December 31, 2008 (45% reduction). This employee base is sufficient for the current level of sustaining operations.
- Salary reductions for all staff and management.
- Deferred procured material receipts to levels supporting decreased production rates.
- All discretionary spending on goods and services has been eliminated.
- Postponed receipt of equipment.

The Company is currently working on the completion of the following in order to supplement its current debt financing:

- Obtain debt and/or equity to provide working capital financing (notes 11, 18a and 18b to the financial statements)
- Defer principal and interest payments on existing debt over varying periods
- Eliminate royalty payments over an extended period
- Re-finance existing non-secured equipment
- Negotiate settlement of amounts owed and re-negotiate supplier payment terms

Going Concern

As at June 30, 2009, the Company was not in compliance with its financial covenants associated with its operating line of credit. In addition, the Company is forecasting that it will be in default of one or more of its financial covenants in the next 12 months. The Company has not obtained a waiver from the debt holder for this non-compliance and for anticipated future breaches. In the absence of obtaining a waiver of such breaches, the lender is entitled to demand immediate payment (notes 9 and 18d to the financial statements).

Also, as at June 30, 2009, the Company was not in compliance with its financial covenants associated with the convertible debenture held by Export Development Canada (note 12a to the financial statements). The Company has not obtained a waiver from the debenture holder for these non-compliances and for anticipated future breaches. On March 13, 2009, Export Development Canada served notice to the Company requiring that if the non-compliances are not rectified within 60 days of the notice date, all balances shall become payable on demand. As of the date of this report, Export Development Canada has not demanded payment. In addition, the Company is forecasting that it will be in default of one or more of its financial covenants in the next 12 months. In the absence of obtaining a waiver of such breaches, the lender is entitled to demand immediate payment. The Company is currently in discussion regarding the terms of repayment with Export Development Canada. No conclusions from the Company's current discussions with Export Development Canada have been reached. To date, Export Development Canada has not taken any action in respect of the defaults noted above due to the ongoing discussions regarding the renegotiation of the terms of the debt.

In 2009, the Company will be required to seek amendments of its borrowing terms to either waive any breaches, or modify the covenants. The Company is required to maintain certain measures of working capital, debt to tangible net worth, and debt service coverage.

The Company has not paid \$375,000 of preferred share dividends which were accrued and payable as at June 30, 2009.

The Company forecasts its financing requirements for 2009 and 2010 to exceed the current availability of the operating line of credit. Accordingly, the Company has completed a private placement, and will continue its efforts to obtain additional debt financing, renegotiate debt repayments, issue additional common shares, reduce operating expenses and manage customer payments to existing terms in order to provide liquidity in excess of forecasted requirements (notes 18a and 18b to the financial statements). Management expects these financing initiatives to be sufficient to provide funds for ongoing operations. The Company expects to finance investment in the start-up of new military defence programs with milestone payments from customers. However, success of these activities cannot be assured.

During the quarter ended June 30, 2009, the Landlord for one of the Company's operations issued to the Company a demand for \$208,000 rent and related expenses which were in arrears. The Company has negotiated the payment of arrears and future rent with the Landlord, and is no longer in arrears.

These consolidated financial statements have been prepared in accordance with 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. The conditions and risks noted above cast significant doubt on the validity of that assumption.

These consolidated 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 quarter ended June 30, 2009 was \$16,172,000 as compared to \$32,389,000 for the same quarter in 2008 (year-to-date June 30, 2009: \$38,259,000; June 30, 2008: \$63,540,000). Revenues from the Company's customers are as follows.

REVENUE DISTRIBUTION

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

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|------------|----------------------------|--------------|----------|------------|--------------------------|--------------|----------|------------|
| | 2009 | | 2008 | | 2009 | | 2008 | |
| | Revenue | % of Total | Revenue | % of Total | Revenue | % of Total | Revenue | % of Total |
| Boeing | \$ 6,090 | 37.7 | \$ 5,566 | 17.2 | \$10,311 | 27.0 | \$10,818 | 17.0 |
| Bombardier | 4,067 | 25.1 | 6,790 | 21.0 | 9,744 | 25.4 | 14,363 | 22.6 |
| Cessna | 3,160 | 19.5 | 16,336 | 50.4 | 11,698 | 30.6 | 29,623 | 46.6 |
| Other | 2,855 | 17.7 | 3,697 | 11.4 | 6,506 | 17.0 | 8,736 | 13.8 |
| Total | 16,172 | 100.0 | 32,389 | 100.0 | 38,259 | 100.0 | 63,540 | 100.0 |

Shipments of large assemblies to Boeing Commercial Airplane Group (Boeing), specifically for the 737 commercial jet program remained constant during the second quarter 2009 relative to the second quarter 2008. The primary source of revenue from Boeing is from the 737 aircraft. Boeing's programs which were introduced into production over the course of 2008 have reached full rate production in 2009 and consequently produced higher revenues during the current year in comparison to the prior year. During the second quarter 2009 the Company commenced delivering components to Boeing Integrated Defense Systems for the CH47 helicopter. The Company expects to achieve full rates of production parts for this program during 2009, with the intent to deliver larger assembled structures in 2010. The Company continues

to work towards obtaining additional new contracts supporting Boeing 737, 747, 767, 777 and 787 commercial jet programs.

Deliveries to Bombardier Aerospace (Bombardier) decreased for the Challenger CL605 and CL850 business jet programs during the current quarter relative to the quarter ended June 30, 2008. The reduction in deliveries of structures for the CL605 and CL850 business jet programs caused the most significant fall in Bombardier's revenue during the current quarter when compared to the quarter ended June 30, 2008. Customer demand for these structures fell by 53% during the current quarter in comparison to the same quarter last year. The Company's primary source of revenues from Bombardier in 2009 will continue to be from components on the CL605 and CL850 business jets, and composite floor boards for the CRJ and Q400 aircraft programs.

Deliveries of major structures to Cessna decreased by 82% during the second quarter 2009, relative to the same quarter in 2008. The reduction in deliveries was precipitated by a reduction in aircraft deliveries by Cessna as well as a burn-off of inventories by this customer. 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 deliveries for components of these aircraft is expected to comprise the majority of revenues from Cessna for 2009, with Citation CJ3 component deliveries expected to further decrease while deliveries of Citation Sovereign components are expected to slightly increase in 2010. The first deliveries for the Citation CJ4 business jet components commenced during the second quarter 2009 and will increase substantially in 2010.

Deliveries of Boeing 757 commercial jets wing adapter plugs for winglet retrofit to Aviation Partners Boeing have fallen by 45% relative to the quarter-ended June 30, 2008.

Revenues for Comtek Advanced Structures Ltd. (Comtek) decreased by approximately 4% during the second quarter 2009 relative to the same quarter in 2008. The reduction in revenue was primarily attributable to the slow-down in deliveries of composite structures to a tier-one supplier for the Airbus 380.

Gross Profit

Gross profit (revenue less cost of sales) for the quarter ended June 30, 2009 was 3.5% of revenue as compared to 16.7% of revenue for the quarter ended June 30, 2008.

Gross profit has declined during the current quarter, relative to the immediately preceding quarter, as reduced revenues resulting from continued delivery slow-downs have had an adverse impact on the Company's cost structure.

Base sustaining overhead costs incurred in support of operational capabilities as well as quality and engineering systems have become increasingly significant relative to the revenues the business is generating. Costs expensed as a result of idle plant capacity amounted to \$1,500,000 during the quarter. This cost-revenue imbalance can be mitigated by new program revenue growth, which will arise with full rate production for the Citation CJ4 business jet components and delivering components to Boeing Integrated Defense Systems for the CH47 helicopter during 2010.

Labour efficiencies will commence, upon finalization of workforce reductions, as employees become fully trained in their new work centres.

As the workforce has been reduced, the remaining employees are relatively senior in pay-grade and consequently the average wage and benefit rate the Company pays has increased. This will be in part rectified as employees are re-hired to support new program growth. The cost of materials used in production has remained relatively constant.

A re-tooling of plant-floor processes as well as anticipated new program revenue growth will be the strongest factors in reducing the Company's cost structure.

Administration and General Expenses

As a percentage of revenue, administration and general expenses increased from 10.9% for the quarter ended June 30, 2008 to 18.4% for the same quarter in 2009. Administrative and general expenses were reduced by \$576,000 for the quarter ended June 30, 2009 relative to last year. Professional fees expensed for the Company's refinancing amounted to \$360,000.

Foreign Exchange Gain

The Company recorded a \$3,962,000 foreign exchange gain during the second quarter 2009 (June 30, 2008: \$116,000 gain) 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. A \$1,000 gain (June 30, 2008: \$15,000 gain) arose during the quarter ended June 30, 2009, as a result of holding sales contracts having embedded derivatives; while no gain or loss occurred during 2009 (June 30, 2008: \$Nil) as a result of derivative financial instruments associated with its procurement contracts (note 4 to the financial statements). The Company had USD \$20,000,000 of foreign-exchange-forward contracts which expired during the quarter giving rise to a \$52,000 loss recorded as at June 30, 2009 (June 30, 2008: \$Nil) (note 4 to the financial statements).

All other financial instruments have been recorded at cost or amortized cost, subject to impairment reviews.

Earnings Before Interest, Taxes, Depreciation & Amortization

Earnings before interest, taxes, depreciation and amortization (EBITDA) was \$1,530,000 for the quarter ended June 30, 2009 compared EBITDA of \$2,218,000 for the quarter ended June 30, 2008.

EBITDA

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

| | Three months ended June 30 | | Six months ended June 30 | |
|---|-------------------------------|--------------|-----------------------------|--------------|
| | 2009 | 2008 | 2009 | 2008 |
| Income (loss) for the period | \$ 65 | \$ 364 | \$ (3,107) | \$ (59) |
| Interest expense and financing charges | 436 | 510 | 965 | 1,099 |
| Income tax expense | - | - | - | - |
| Depreciation | 932 | 1,019 | 1,914 | 1,989 |
| Amortization of development costs and intangible assets | 97 | 325 | 208 | 564 |
| | 1,530 | 2,218 | (20) | 3,593 |

EBITDA is a term that does not have a standardized meaning under Canadian generally accepted accounting principles (GAAP). Current quarter EBITDA has not been adjusted for the \$3,962,000 foreign exchange gain (June 30, 2008: \$116,000 gain), which if adjusted if adjusted would result in an EBITDA loss of \$2,432,000 (June 30, 2008: \$2,102,000 gain).

Interest and Financing Charges

Total interest and financing charges on both short- and long-term debt, some to related parties, for the quarter ended June 30, 2009 was \$436,000 as compared to \$510,000 for the same quarter previous year.

Income Taxes

The Company has not incurred a tax expense during the current year (June 30, 2008: \$Nil).

Income

Income for the quarter ended June 30, 2009 was \$65,000 compared to \$364,000 for the quarter ended June 30, 2008. A \$3,962,000 foreign exchange gain was offset by the adverse impact of significantly reduced revenues and resultant gross margin deterioration.

Liquidity and Capital Resources

The Company ended the current quarter with bank operating line utilization of \$12,239,000 compared to \$14,273,000 as at December 31, 2008. Unless secured by cash, the Company's operating lines of credit provide for a total utilization of \$17,000,000.

The Company forecasts its financing requirements for 2009 and 2010 to exceed the current availability of the operating line of credit. Accordingly, the Company has completed a private placement and will continue its efforts to obtain additional debt financing, renegotiate debt repayments, issue additional common shares, reduce operating expenses and manage customer payments to existing terms in order to provide liquidity in excess of forecasted requirements (note 18a and 18b to the financial statements). The Company expects to finance investment in the start-up of new military defence programs with milestone payments from customers. However, success of these activities cannot be assured.

Cash Flows from Operating Activities

Cash provided by operating activities, before consideration of changes in non-cash items relating to operating activities, was \$2,272,000 for the quarter ended June 30, 2009 compared to cash provided of \$906,000 for the same quarter last year.

Non-cash operating assets and liabilities generated \$911,000 (note 15b to the financial statements) of cash during the current quarter, compared to \$2,172,000 for the same quarter last year. The 2009 balance arose primarily as a result of decreased inventories and to a larger extent a reduction of accounts payable and accrued liabilities. The Company continues to closely monitor accounts receivable in order to ensure cash is collected on a timely basis.

Cash Flows from Investing Activities

During the current quarter, the Company purchased capital assets totaling \$85,000 as compared to \$1,510,000 during the quarter ended June 30, 2008. The Company has significantly reduced its capital expenditures in order to conserve cash with only operation critical expenditures being made.

Additionally, the Company invested \$1,412,000 during the current quarter (June 30, 2008: \$654,000) in tooling and in improving the production efficiencies of various program lines. A significant portion of this expenditure was specifically invested in new product introduction for the Cessna Citation CJ4 business jet program, and the Boeing Integrated Defense Systems CH47 helicopter program for which the Company commenced delivering tail assemblies and components in the second quarter 2009.

Cash Flows from Financing Activities

The Company finances working capital through a combination of bank debt and other financial instruments.

During the quarter ended June 30, 2009, the Company's operating line of credit utilization decreased by \$2,920,000 (June 30, 2008: \$790,000).

For the quarter ended June 30, 2009, proceeds from the sale of tooling amounted to \$100,000.

During the current quarter, the Company repaid \$418,000 of current and long-term debt consisting of \$338,000 in equipment financing, and \$80,000 in royalty repayments.

The Company has not paid \$375,000 of preferred share dividends which were payable as at June 30, 2009.

On June 30, 2009, the ratio of the Company's current assets to current liabilities was 0.83:1 (December 31, 2008: 0.94:1), with the debt to equity ratio at 1.78:1 (December 31, 2008: 1.43:1).

As at June 30, 2009, the Company was not in compliance with its financial covenants associated with its operating line of credit provided by a Canadian chartered bank (notes 9 and 18d to the financial statements). The Company has not obtained a waiver from the debt holder for this non-compliance and for anticipated future breaches. Also, as at June 30, 2009, the Company was not in compliance with its financial covenants associated with the convertible debenture held by Export Development Canada (note 12a to the financial statements). The Company has not obtained a waiver from the debenture holder for

these non-compliances and for anticipated future breaches. On March 13, 2009, Export Development Canada served notice to the Company requiring that if the non-compliances are not rectified within 60 days of the notice date, all balances shall become payable on demand. As of the date of this report, Export Development Canada has not demanded payment. The Company is currently in discussion regarding the terms of repayment with Export Development Canada. No conclusions from the Company's current discussions with Export Development Canada have been reached. To date, Export Development Canada has not taken any action in respect of the defaults noted above due to the ongoing discussions regarding the renegotiation of the terms of the debt.

Contractual Obligations

PAYMENTS DUE BY PERIOD

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

| | Total | 2009 | 2010 – 2012 | 2013 – 2014 | Post 2014 |
|--|-----------------|----------|-------------|-------------|-----------|
| Convertible debentures | \$ 4,193 | \$ 4,193 | \$ - | \$ - | \$ - |
| Capital lease obligation | 3,402 | 547 | 2,613 | 242 | - |
| Purchase obligation ^{1,2} | 24,104 | 1,177 | 7,701 | 5,291 | 9,935 |
| Other long-term obligations ³ | 1,038 | 782 | 256 | - | - |
| Total contractual obligations | 32,737 | 6,699 | 10,570 | 5,533 | 9,935 |

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 and 2009.

³ This amount represents obligations the Company has with Technology Partnership Canada.

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

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 32,314,929 common shares issued and 293,713 reserved at June 30, 2009. The book value of common shares issued and outstanding as at June 30, 2009 was \$64,916,000.

As at August 6, 2009, there were 48,472,394 common shares, 816,800 preference shares, 1,290,000 warrants and no options issued and outstanding (note 18b to the financial statements).

Recent Accounting Pronouncements

These consolidated financial statements are prepared in accordance with accounting principles generally accepted in Canada (Canadian GAAP).

These consolidated financial statements are prepared following accounting policies consistent with the Company's audited annual consolidated financial statements and notes thereto for the year ended December 31, 2008, except for the following changes in accounting policies. Effective January 1, 2009, the Company adopted the new Canadian Institute of Chartered Accounts (CICA) standard 3064. Adoption of the standard has not had a significant effect on these financial statements.

- **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. The adoption of this standard has not affected the Company’s consolidated financial statements.
- In January 2009, the CICA approved EIC-173 Credit Risk and the Fair Value of Financial Assets and Financial Liabilities. This guidance clarified that an entity’s own credit risk and the credit risk of the counter-party should be taken into account in determining the fair value of financial assets and financial liabilities including derivative instruments. The Company has evaluated the new section and determined that adoption of these new requirements did not have a significant impact on the Company’s consolidated financial statements.
- **Convergence with International Financial Reporting Standards:**

In 2006, Canada’s Accounting Standards Board ratified a strategic plan that will result in Canadian generally accepted accounting principles (Canadian “GAAP”), as used by public companies, being evolved and converged with International Financial Reporting Standards (“IFRS”) over a transitional period which will be complete by 2011. As of the date of this report, the International Accounting Standards Board has projects underway that should result in new pronouncements; accordingly the Company is assessing the impact of the ultimate adoption of IFRS on the Company’s consolidated financial statements. Management has reviewed its business systems and determined that they are capable of processing and recording the transitional period reporting requirements. As well, key employees have been trained in the new reporting standards, and a plan for adoption of IFRS is being developed.

Operations Overview

Delivery and Quality Performance

Deliveries as at June 30, 2009 were at planned levels for Cessna, Bombardier and Boeing programs.

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.

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 June 30, 2009, was \$288 million compared to \$359 million as at March 31, 2009, \$28 million of which pertains to the remainder of 2009. The changes in order backlog are as follows:

- \$16 million decrease in order backlog resulting from revenues recorded during the quarter ended June 30, 2009;
- \$39 million net decrease in order backlog primarily due to production rate decreases of various existing programs; and
- \$16 million decrease in order backlog resulting from changes in foreign exchange rates.

Please refer to comments on currency risk.

Supply Chain

Vendor quality performance met targeted levels during the quarter, with the exception of a limited number of vendors which the Company is managing on a day-to-day basis and in some cases with on-site personnel. We have worked closely with our Supply Chain to adjust earlier forecasted deliveries downward to the lower levels of customer requirements for the remainder of 2009.

The capacity and delivery performance of a limited number of critical vendors continues to be closely monitored to mitigate risks to assembly start dates. Risk mitigation plans have been implemented during the second half of 2008. The securing of additional long-term contracts with key suppliers continues.

Working Capital Utilization

Total current assets less total current liabilities was in a deficit position of \$5,633,000 at June 30, 2009 and a deficit of \$2,065,000 at December 31, 2008. The change in position during 2009 was primarily due to the reduction of accounts receivable resulting from reduced sales during the quarter.

Financial Resources

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

Non-Financial Resources

The Company's non-financial resources relate to the Company's human resources, operating equipment, 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 June 30, 2009 was 410 (December 31, 2008: 739). 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 select number of internal projects are underway, with the aim of further increasing productivity to desired levels.

Technology upgrades in high-speed machining have occurred in 2008 and are being reviewed for 2009. These investments were made to mitigate supply chain delivery risk, provide machining capacity for new programs, and bring currently out-sourced work in-house, thereby reducing costs and capturing margin currently in supplier prices.

Information technology assets have been consistently upgraded and further deployed, increasing reliability and utility.

Risk Assessment

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

- 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 the refinancing completed and in process (note 18a and 18b to the financial statements), the acquisition of a composite manufacturer and strategic plan in place, the Company should be in a position to face and mitigate these risks. However, there can be no assurance that the Company will be successful with all initiatives.

Procured Materials and Parts

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

The Company is engaging suppliers and customers in the rescheduling efforts necessary because of the reduction in revenue. We are closely monitoring changes in forecasts in order to act as quickly as possible in adjusting procured materials and parts quantities and prevent as much as possible unwanted inventory build up.

Aircraft Production Rates

The following industry and program trends impact the Company.

- Industry research indicates that the aerostructures market for commercial aircraft and business jets is shrinking through 2010; the market for defence aircraft however is expected to continue to grow through 2010.
- Market indications like lower air travel rate and reduced airline capacity could reduce rates on the Boeing 737 in 2010, while the introduction of the Boeing 787 and the passenger version of the Boeing 747-8 are being delayed.
- Airbus continues to evaluate the rates of its programs, already reducing the ramp-up rates on the A380.
- The production rate on the Boeing 757-200 wing adapter plug for winglet retrofits is tapering off in 2009, partially offset with the introduction of the Boeing 757-300 wing adapter plug variant.
- Bombardier Challenger 850 and the Challenger 605 business jet aircraft production are forecasted to decrease in 2009 and remain flat into 2010. The rates for Bombardier's regional aircraft could soften at the end of 2009, due to generally reduced global air travel.
- Cessna Citation Sovereign and CJ3 business jet rates have decreased significantly for 2009 compared to 2008, and it is expected that these levels will be maintained into 2010. The introduction of the CJ4 is progressing as planned showing continuous growth into 2010.
- Offset opportunities created by the procurement within military aerospace programs by the Canadian government; exist to provide additional revenue from this aerospace sector.

Competitors

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

Cost Reductions

Approximately 59% of the Company's cost of sales is related to labour and overhead and 41% 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's collective agreement with its labour force expires on September 30, 2009. Management is currently preparing for the negotiation of the successor agreement.

The Company continues to focus on cost reductions for direct labour, material and overhead. These cost reductions will be achieved through continuous improvements in the internal and external parts supply chain using lean manufacturing technology, through continued negotiation of long-term agreements for the majority of key suppliers, through increased efficiency of plant capacity augmented by technological improvements, and through continued focus on cost targets at all levels of the organization. Significant reductions in the direct labour force, staff and management have been undertaken as a result of reductions in aircraft production rates for 2009. As of the date of this report, the number of employees has been reduced by 45% since December 31, 2008. Production related material and shop supply costs have been reduced proportionately with anticipated program delivery reductions. Facilities are being consolidated in order to increase utilization and reduce overhead costs. All discretionary spending is being reviewed and controlled by senior management, with expenditures focused on expediting new commercial program business growth and launching of long-term defence programs. However, fixed overhead costs are having an adverse impact on the Company cost structure as revenues decrease. In this regard, the Company is renegotiating fees and rates with its sustaining service providers.

Composite Materials

The December 31, 2007 acquisition of Comtek adds ongoing operations expertise in the design and competitive manufacture of advanced composite aerostructures which provides the opportunity for the Company to compete in a market which is trending, with each new generation of aircraft, to greater use of composite material in primary structures.

Outlook

Current economic conditions have continued to cause the Company's current order backlog to decline during the fourth quarter 2008 and into the first half of 2009. The Company continues to work towards securing additional defence programs in order to augment and diversify its backlog. The Company began making sales under its military contracts in 2009 and is currently negotiating long-term supply agreements. Assuming these long-term agreements are entered into, the Company believes that revenues from its military customers will increase to 2013 and extend past 2020. The Company expects to primarily finance investment in start-up of new military defence programs with milestone payments from customers, though this cannot be assured. Boeing will be the Company's largest customer in 2009, followed by Cessna and Bombardier.

The Company has revised its 2009 operating plans as a result of the currently forecasted 49% reduction in revenues, relative to 2008, which is as a result of the market deferral of business jet deliveries. With the exception of capital expenditures required for new programs and those which have already been contracted with suppliers, the Company's investment in new equipment will be reduced to pre-2008 levels. As of the date of this report, the Company has reduced the number of its employees by 45% since December 31, 2008. All suppliers have had their orders deferred to the extent possible in order to reduce inventory levels to that required to support the forecasted reduced level of revenues.

The Company forecasts its financing requirements for 2009 and 2010 to exceed the current availability of the operating line of credit. Accordingly, the Company has completed a private placement, and will continue its efforts to obtain additional debt financing, renegotiate debt repayments, issue additional common shares, reduce operating expenses and manage customer payments to existing terms in order to provide liquidity in excess of forecasted requirements (notes 18a and 18b to the financial statements). The Company expects to finance investment in the start-up of new military defence programs with milestone payments from customers. However, success of these activities cannot be assured.

Transactions with Related Parties

During the year ended December 31, 2005, the Company entered into an agreement under which a certain shareholder and former Chairman of the Board in consideration of mutual agreements with a Canadian chartered bank under which the shareholder and former Chairman of the Board 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 fee of 10% on the \$2,000,000 limited guarantee calculated on a daily basis. Fees paid to a certain shareholder and former Chairman of the Board during the quarter ended June 30, 2009 amounted to \$Nil (June 30, 2008: \$Nil). Fees payable to a certain shareholder and former Chairman of the Board as at June 30, 2009 are \$50,000 (June 30, 2008: \$25,000). These fees are included in the Statements of

Operations as interest expense and financing charges and amount to \$50,000 for the quarter ended June 30, 2009 (June 30, 2008: \$25,000) (note 18c to the financial statements).

On February 3, 2006, a performance guarantee was provided by certain shareholders and former directors 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 a certain shareholder and former Chairman of the Board during the quarter ended June 30, 2009 amounted to \$Nil (June 30, 2008: \$Nil). Fees payable to a certain shareholders and former directors as at June 30, 2009 are \$Nil (June 30, 2008: \$60,000). These fees are included in the Statements of Operations as cost of sales and amount to \$Nil for the quarter ended June 30, 2009 (June 30, 2008: \$60,000).

Other related-party transactions are disclosed elsewhere in these financial statements (notes 10 and 18c to the financial statements).

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

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 production to its contracted future revenues. The June 30, 2009 provision for anticipated losses was \$499,000 (December 31, 2008: \$564,000). The reduction in this provision from December 31, 2008 was primarily due to the reduction in future deliveries.
- Unamortized development and tooling costs, net of related government assistance, which reflect the Company's investment in new programs and manufacturing process development, are recorded at \$5,864,000 (December 31, 2008: \$3,299,000). 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. Current reductions in deliveries have not impacted amortizations over the expected life of these aircraft programs. 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 useful life of intangible assets. Useful life is measured as a range between one and ten years.
- During 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 affects delivered product, the Company accrued a \$1,454,000 discounted charge within cost of sales in 2007. In the opinion of the Company as at June 30, 2009, an equivalent claim against the manufacturer of a sub-component to the product can be made and is estimated to be recoverable. Accordingly, a \$1,454,000 recovery was accrued within cost of sales. During

2008, the Company revised its discounted warranty provision to \$1,521,000 and discounted warranty recovery to \$1,569,000. 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 three to four year period.

Measurement Uncertainty:

The preparation of the accompanying financial statements required management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. By their nature these estimates are subject to measurement uncertainty. The effect on the financial statements of changes in such estimates in future periods could be material and would be accounted for in the period the change occurs.

- Carrying value of long-lived assets - The Company holds property, plant and equipment, and intangible assets (note 7 and 8 to the financial statements) on the balance sheet amounting to \$19,781,000 (December 31, 2008: \$21,585,000). The recoverability of the carrying value of these assets is, in part, dependant on the estimates used in determining the expected period of future benefits over which to amortize. In addition, such recoverability is dependant on market conditions including demand for such aircraft for which the Company provides its products.
- Recoverability of deferred tooling costs - The ability to defer tooling costs is dependant on the future recoverability of the amounts from cash flows generated by the related commercial operations. If operations perform below anticipated recoverable levels, the portion of deferred tooling costs that cannot be recovered is expensed immediately when known. At June 30, 2009, \$5,864,000 (December 31, 2008: \$3,299,000) in unamortized deferred tooling costs (note 6 to the financial statements), which are expected to be recoverable from the related future cash flows of such new operations, are presented as Development Costs in the balance sheet.
- In accordance with Canadian GAAP the carrying value of long-lived assets is tested for impairment. Circumstances such as the decline in the Company's share price, the significant reduction in customer orders, and the financial condition of the Company may exist and indicate that the carrying amount of long-lived assets may not be recoverable. The aforementioned circumstances existed for the Company as at June 30, 2009 indicating that an assessment for impairment was required. An impairment assessment was made which considered the undiscounted cash flows from forecasted customer orders. The result of the impairment assessment indicated that long-lived assets were recoverable from forecasted future cash flows.

Financial Instruments and Other Instruments

Interest rate risk

The Company is exposed to interest rate risk on the utilized portion of its \$17,000,000 operating line of credit at rates of bank prime plus 0.875%, 1.00%, 1.175% or 1.25% determined on a quarterly basis according to specified measures of the ratio of debt to tangible net worth (note 9 to the financial statements). The Company lowers interest rate costs by managing utilization of the operating line of credit to the lowest amount practical.

For the quarter ended June 30, 2009, with other variables unchanged, a 1% change in the bank prime interest rate would have a \$31,000 impact on net earnings or cash.

The Company primarily finances the purchase of long-lived assets at fixed interest 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 the second quarter 2009 was \$3,962,000 as compared to a \$116,000 gain for the quarter-ended

June 30, 2008 (year-to-date June 30, 2009: \$2,918,000 gain; June 30, 2008: \$580,000 gain). The Company used derivative financial instruments to mitigate its exposure to currency risks in 2009 and 2008.

As at the balance sheet date, the Company had the following US dollar denominated balances:

| | |
|---------------------|--------------|
| Accounts receivable | \$ 3,834,000 |
| Bank indebtedness | 13,374,000 |
| Accounts payable | 3,296,000 |
| Long-term debt | 2,145,000 |

With other variables unchanged, each \$0.10 strengthening (weakening) of the US dollar against the Canadian dollar would result in a (decrease) increase of approximately \$1,498,000 in net earnings for the quarter ended June 30, 2009.

Other Items

Disclosure Controls and Procedures, and Internal Controls over Financial Reporting

In accordance with the Canadian Securities Administrators Multilateral Instrument 52-109, the Company has filed certificates signed by the Chief Executive Officer and the Head Financial Officer that, among other things, report on the design of disclosure controls and procedures and the design of internal control over financial reporting. These certificates can be found on www.sedar.com.

The Chief Executive Officer and the Vice President, Finance, have evaluated the Company's disclosure controls and procedures, and internal controls over financial reporting, as of June 30, 2009 and concluded that the Company's current disclosure controls and procedures as well as the internal controls over financial reporting are effective. There were therefore no changes to the Company's disclosure controls and procedures, or in the design of internal controls over financial reporting, during the year ended June 30, 2009, that have materially affected, or are reasonably likely to materially affect the Company's internal controls over 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 ability of the Company to renegotiate its debt agreements under which it is in default; (b) the extent to which the Company is able to achieve savings from its restructuring plans; (c) uncertainty in estimating the amount and timing of restructuring charges and related costs; (d) changes in worldwide economic and political conditions that impact interest and foreign exchange rates; (e) the occurrence of work stoppages and strikes at key facilities of the Company or the Company's customers or suppliers; (f) government funding and program approvals affecting products being developed or sold under government programs; (g) cost and delivery performance under various program and development contracts; (h) the adequacy of cost estimates for various customer care programs including servicing warranties; (i) the ability to control costs and successful implementation of various cost reduction programs; (j) the timing of certifications of new aircraft products; (k) the occurrence of further downturns in customer markets to which the Company products are sold or supplied or where the Company offers financing; (l) changes in aircraft delivery schedules or cancellation of orders; (m) the Company's ability to offset, through cost reductions, raw material price increases and pricing pressure brought by original equipment manufacturer customers; (n) the availability and cost of insurance; (o) the Company's ability to maintain portfolio credit quality; (p) the Company's access to debt financing at competitive rates; and (q) uncertainty in estimating contingent liabilities and establishing reserves tailored to address such contingencies.

report of management

The accompanying 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 (GAAP) 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, the system of internal control 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.

| | | | |
|---|--|--|--|
|  | EDWARD M. MERLO Vice President, Finance and Corporate Secretary |  | MARK VAN ROOIJ Chief Executive Officer |
|---|--|--|--|

Consolidated Balance Sheets

as at June 30, 2009 and December 31, 2008 (unaudited, in thousands of Canadian dollars)

| | June 30, 2009 | December 31, 2008 |
|---|-----------------|-------------------|
| Assets | | |
| Current assets | | |
| Accounts receivable | \$ 7,355 | \$ 12,609 |
| Inventories (note 5) | 18,240 | 19,206 |
| Prepayments | 1,292 | 1,761 |
| Other assets (note 4f) | 29 | 746 |
| | 26,916 | 34,322 |
| Development costs (note 6) | 5,864 | 3,299 |
| Property, plant and equipment (note 7) | 17,795 | 19,431 |
| Warranty claim receivable | 1,569 | 1,784 |
| Intangible assets (note 8) | 1,986 | 2,154 |
| | 54,130 | 60,990 |
| Liabilities | | |
| Current liabilities | | |
| Bank indebtedness (note 9) | 12,239 | 14,273 |
| Demand loan (note 10) | 412 | - |
| Bridge loan (note 11) | 1,558 | - |
| Accounts payable and accrued liabilities | 12,095 | 15,841 |
| Current portion of long-term debt (note 12) | 6,245 | 6,273 |
| | 32,549 | 36,387 |
| Deferred gain | 429 | 453 |
| Lease inducement | 912 | 962 |
| Deferred tooling revenues | 2,303 | 1,173 |
| Long-term debt (note 12) | 2,387 | 2,872 |
| Warranty provision | 1,521 | 1,632 |
| Future income tax liability | 1,186 | 1,186 |
| | 41,287 | 44,665 |
| Shareholders' Equity | | |
| Capital stock | 62,269 | 62,269 |
| Preferred shares | 7,622 | 7,622 |
| Contributed surplus | 2,647 | 2,647 |
| Deficit | (59,695) | (56,213) |
| | 12,843 | 16,325 |
| | 54,130 | 60,990 |

Nature of operations and going concern (note 1)

Measurement uncertainty (note 7a)

Demand loan (note 10)

Bridge loan (note 11)

Subsequent events (note 18)

Approved by the Board of Directors

David Levi
Chairman

Eric Kohn
Committee Chair,
Audit & Corporate Governance Committee

Consolidated Statements of Operations and Comprehensive Loss

For the three and six months ended June 30, 2009 and 2008

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

| | Three months ended June 30 | | Six months ended June 30 | |
|--|-------------------------------|------------------|-----------------------------|------------------|
| | 2009 | 2008 | 2009 | 2008 |
| For the quarter ended June 30 | | | | |
| Revenues | \$ 16,172 | \$ 32,389 | \$ 38,259 | \$ 63,540 |
| Cost of sales and expenses | | | | |
| Cost of sales | 15,598 | 26,966 | 34,545 | 54,355 |
| Administrative and general expenses | 2,968 | 3,544 | 5,987 | 6,500 |
| Amortization and depreciation | 1,016 | 1,136 | 2,082 | 2,223 |
| Foreign exchange (gain) (note 4) | (3,962) | (116) | (2,918) | (580) |
| | 15,620 | 31,530 | 39,696 | 62,498 |
| Income (Loss) from operations | 552 | 859 | (1,437) | 1,042 |
| Interest expense and financing charges (note 14) | (436) | (510) | (965) | (1,099) |
| Unrealized derivative gain (loss) (note 4) | (51) | 15 | (705) | (2) |
| Income (Loss) and comprehensive income (loss) for the period | 65 | 364 | (3,107) | (59) |
| Basic and diluted income (loss) per common share | 0.00 | 0.01 | (0.10) | 0.00 |
| Basic and diluted weighted average number of shares outstanding (000's) | 32,315 | 32,132 | 32,315 | 31,970 |

Consolidated Statements of Deficit

For the three and six months ended June 30, 2009 and 2008

(unaudited, in thousands of Canadian dollars)

| | Three months ended June 30 | | Six months ended June 30 | |
|--------------------------------------|-------------------------------|--------------------|-----------------------------|--------------------|
| | 2009 | 2008 | 2009 | 2008 |
| For the quarter ended June 30 | | | | |
| Deficit – Beginning of period | \$ (59,571) | \$ (53,816) | \$ (56,213) | \$ (53,204) |
| Income (Loss) for the period | 65 | 364 | (3,107) | (59) |
| Preferred share dividends | (189) | (189) | (375) | (378) |
| Deficit – End of period | (59,695) | (53,641) | (59,695) | (53,641) |

Consolidated Statements of Cash Flows

For the three and six months ended June 30, 2009 and 2008 (unaudited, in thousands of Canadian dollars)

| | Three months ended June 30 | | Six months ended June 30 | |
|--|-------------------------------|---------|-----------------------------|---------|
| | 2009 | 2008 | 2009 | 2008 |
| Cash flows from operating activities | | | | |
| Income (loss) for the period | \$ 65 | \$ 364 | \$ (3,107) | \$ (59) |
| Items not affecting cash (note 15a) | 2,207 | 542 | 4,698 | 2,377 |
| | 2,272 | 906 | 1,591 | 2,318 |
| Change in non-cash items related to operating activities (note 15b) | 911 | 2,172 | 1,958 | 1,596 |
| | 3,183 | 3,078 | 3,549 | 3,914 |
| Cash flows from investing activities | | | | |
| Purchase of property, plant and equipment | (85) | (1,510) | (278) | (2,326) |
| Payments relating to development costs and tooling | (1,412) | (654) | (2,605) | (1,204) |
| | (1,497) | (2,164) | (2,883) | (3,530) |
| Cash flows from financing activities | | | | |
| Net repayment of bank indebtedness | (2,920) | (790) | (2,034) | (165) |
| Proceeds from current and long-term debt | 1,552 | - | 1,952 | 131 |
| Proceeds from sale and leaseback of property, plant and equipment | - | 1,215 | - | 1,215 |
| Proceeds from sale of tooling | 100 | - | 249 | 372 |
| Repayment of long-term debt | (418) | (1,300) | (833) | (1,930) |
| Issue of common shares | - | 150 | - | 371 |
| Preferred share dividends | - | (189) | - | (378) |
| | (1,686) | (914) | (666) | (384) |
| Net change in cash and cash equivalents | - | - | - | - |
| Cash and cash equivalents - Beginning of period | - | - | - | - |
| Cash and cash equivalents - End of period | - | - | - | - |
| Interest paid | 204 | 303 | 644 | 726 |

Notes to Financial Statements to June 30, 2009

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

1 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 quarter ended June 30, 2009, the Company recorded net income of \$65,000 on \$16,172,000 revenue, as compared to \$364,000 net income from \$32,389,000 revenue for the quarter ended June 30, 2008. On a year-to-date basis, the Company incurred a loss of \$3,107,000 on \$38,259,000 revenue as compared to a \$59,000 loss from \$63,540,000 revenue for the same period in 2008. The Company has a working capital deficit of \$5,633,000 as at June 30, 2009 (December 31, 2008: \$2,065,000 deficit) and an accumulated deficit of \$59,695,000 at June 30, 2009 (December 31, 2008: \$56,213,000).

As at June 30, 2009, the Company was not in compliance with its financial covenants associated with its operating lines of credit. In addition, the Company is forecasting that it will be in default of one or more of its covenants in the next 12 months. The Company has not obtained a waiver from the debt holder for either the existing breaches as at June 30, 2009 or for anticipated future breaches. In the absence of obtaining a waiver of such breach, the lender is entitled to demand immediate payment (notes 9 and 18d).

Also, as at June 30, 2009, the Company was not in compliance with its financial covenants associated with the convertible debenture held by Export Development Canada (note 12a). The Company has not obtained a waiver from the debenture holder for these non-compliances and for anticipated future breaches. On March 13, 2009, Export Development Canada served notice to the Company requiring that if the non-compliances are not rectified within 60 days of the notice date, all balances shall become payable on demand. As of the date of this report, Export Development Canada has not demanded payment. In addition, the Company is forecasting that it will be in default of one or more of its covenants in the next 12 months. In the absence of obtaining a waiver of such breach, the lender is entitled to demand immediate payment. The Company is currently in discussion regarding the terms of repayment with Export Development Canada. No conclusions from the Company's current discussions with Export Development Canada have been reached. To date, Export Development Canada has not taken any action in respect of the defaults noted above due to the ongoing discussions regarding the renegotiation of the terms of the debt.

In the next 12 months, the Company will be required to seek amendments of its borrowing terms to either waive any breaches, or modify the covenants. The Company is required to maintain certain measures of working capital, debt to tangible net worth, and debt service coverage.

The Company has not paid \$375,000 of preferred share dividends which were payable as at June 30, 2009.

These consolidated financial statements have been prepared in accordance with 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. The conditions and risks noted above cast significant doubt on the validity of that assumption. The Company forecasts its financing requirements in the next 12 months to exceed the current availability of the operating line of credit. Accordingly, the Company has completed a private placement, and will continue its efforts to obtain additional debt financing, renegotiate debt repayments, issue additional common shares, reduce operating expenses and maintain existing terms regarding customer collections in order to provide liquidity in excess of forecasted requirements (notes 18a and 18b). However, the success of these activities cannot be assured.

These consolidated 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.

2 Significant Accounting Policies

These unaudited interim consolidated financial statements are prepared in accordance with accounting principles generally accepted in Canada (Canadian GAAP).

Certain information and note disclosures normally included in the annual consolidated financial statements prepared in accordance with Canadian GAAP have been condensed or excluded.

Notes to Financial Statements to June 30, 2009

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

As a result, these unaudited interim consolidated financial statements do not contain all disclosures required to be included in the annual consolidated financial statements and should be read in conjunction with the most recent audited annual consolidated financial statements and notes thereto for the year ended December 31, 2008.

These unaudited interim consolidated financial statements are prepared following accounting policies consistent with the Company's audited annual consolidated financial statements and notes thereto for the year ended December 31, 2008, except for the following changes in accounting policies. Effective January 1, 2009, the Company adopted the new Canadian Institute of Chartered Accounts (CICA) standard 3064. Adoption of the standard has not had a significant effect on these financial statements.

- 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. The adoption of this standard has not affected the Company's consolidated financial statements.
- In January 2009, the CICA approved EIC-173 Credit Risk and the Fair Value of Financial Assets and Financial Liabilities. This guidance clarified that an entity's own credit risk and the credit risk of the counter-party should be taken into account in determining the fair value of financial assets and financial liabilities including derivative instruments. The Company has evaluated the new section and determined that adoption of these new requirements did not have a significant impact on the Company's consolidated financial statements.

3 Capital Risk Management

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

The Company includes long-term debt, preferred shares and capital stock in its definition of capital, as shown in the Company's balance sheet.

The Company's primary objective in its management of capital is to ensure that it has sufficient financial resources to fund ongoing operations and new program investment. In order to secure this capital the Company may attempt to raise funds via issuance of debt and equity, or by securing strategic partners (notes 18a and 18b). The financial covenants by which the Company's debt agreements are bound are working capital, debt to tangible net worth, and debt service coverage ratios (notes 9, 12a and 18d).

4 Financial Risk Management

The Company is exposed to certain financial risks, including currency risk, credit risk, liquidity risk, interest rate risk and price risk.

a) 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 the second quarter 2009 was \$3,962,000 as compared to a \$116,000 gain for the quarter-ended June 30, 2008 (year-to-date June 30, 2009: \$2,918,000 gain; June 30, 2008: \$580,000 gain). The Company used derivative financial instruments to mitigate its exposure to currency risks in 2009 and 2008.

As at the balance sheet date, the Company had the following US dollar denominated balances:

| | |
|---------------------|--------------|
| Accounts receivable | \$ 3,834,000 |
| Bank indebtedness | 13,374,000 |
| Accounts payable | 3,296,000 |
| Long-term debt | 2,145,000 |

Notes to Financial Statements to June 30, 2009

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

With other variables unchanged, each \$0.10 strengthening (weakening) of the US dollar against the Canadian dollar would result in a (decrease) increase of approximately \$1,498,000 in net earnings for the quarter ended June 30, 2009.

b) Foreign Exchange Forward Contracts

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

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. During 2008, the Company entered into USD25,000,000 of foreign-exchange-forward contracts which were executed during 2009, with the provider of its operating lines of credit. The Company has recorded \$52,000 in derivative losses during the quarter-ended June 30, 2009 as compared to \$Nil for the quarter-ended June 30, 2008 (year-to-date June 30, 2009: \$708,000 loss; June 30, 2008: \$Nil).

c) Credit Risk

Credit risk is the risk of a financial loss to the Company if a customer or counter-party to a financial instrument fails to meet its contractual obligation. The Company manages credit risk for trade and other receivables through a financial review of the credit worthiness of the prospective customer along with credit monitoring activities. The majority of the Company's trade receivables reside with Boeing Commercial Airplane Group (Boeing), Bombardier Aerospace (Bombardier) and Cessna Aircraft Company (Cessna).

As at the balance sheet date 74% of the Company's trade accounts receivable are attributable to these three customers.

d) Liquidity Risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company seeks to manage liquidity risk through the management of its capital structure and financial leverage as outlined in note 3 to the consolidated financial statements. Other matters related to liquidity risk are set out in note 1.

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

The Company's operating line of credit is due on demand. Long-term debt repayments are as outlined in note 12.

e) Interest Rate Risk

The Company is exposed to interest rate risk on the utilized portion of its operating line of credit at rates of bank prime plus 0.875%, 1.00%, 1.175% or 1.25% determined on a quarterly basis according to specified measures of the ratio of debt to tangible net worth (note 9). The maximum operating line of credit availability is \$17,000,000; borrowing in excess of \$17,000,000 will be cash secured. The Company lowers interest rate costs by managing utilization of the operating lines of credit to the lowest amount practical. For the quarter ended June 30, 2009, with other variables unchanged, a 1% change in the bank prime interest rate would have a \$31,000 impact on net earnings or cash.

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

f) Price Risk

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

Sales Contracts

A number of the Company's sales contracts have a price adjustment clause where the final sales price is determined by certain indices in a period prior to the date of sale. As a result, the final sales price will change as these underlying indices change. This price adjustment clause is an embedded derivative that is recorded at fair value, with changes in fair value recorded in other income or expenses until the date of sale. As at June 30, 2009, the Company has \$11,218,000 (December 31, 2008: \$23,098,000)

Notes to Financial Statements to June 30, 2009

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

of firmly committed orders that include price adjustment clauses of this nature. A \$1,000 gain has been recorded in unrealized derivative gains for the quarter ended June 30, 2009 as compared to a \$15,000 gain for the quarter ended June 30, 2008 as a result of the change in the fair value of the underlying embedded derivatives (year-to-date June 30, 2009: \$3,000 gain; June 30, 2008: \$2,000 loss).

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 June 30, 2009, the Company has \$381,000 (December 31, 2008: \$764,000) of firmly committed purchases that include price adjustment clauses of this nature. No gain or loss has been recorded in unrealized derivative income for the quarter ended June 30, 2009 and for the quarter ended June 30, 2008 as a result of the change in the fair value of the underlying embedded derivatives.

Other Assets and Liabilities

Other assets are comprised of \$29,000 inflation derivatives assets arising from the Company's sales and purchase contracts having price adjustment clauses within their terms (December 31, 2008: \$38,000), and \$Nil fair value derivatives assets arising from foreign-exchange-forward contracts (December 31, 2008: \$708,000).

g) Fair values

The fair values of the Company's accounts receivable are estimated to approximate their carrying values due to the immediate or short-term maturity of these financial instruments. The fair value of the Company's bank indebtedness, accounts payable and accrued liabilities and current portion of long-term debt are significantly lower than carrying value due to the Company's current financial condition. The fair value of the long-term debt cannot be reliably estimated due to the current financial condition of the Company.

5 Inventories

| | June 30 2009 | December 31 2008 |
|-------------------|-------------------------|-----------------------------|
| Raw materials | \$ 6,358 | \$ 5,768 |
| Work in progress | 11,330 | 12,219 |
| Finished products | 552 | 1,219 |
| | 18,240 | 19,206 |

The amount of inventory expensed in cost of sales during the three month period ended June 30, 2009 amounted to \$14,127,000. The carrying value of inventory pledged as security as at June 30, 2009 is \$18,240,000.

6 Development Costs

Development costs represent hard and soft tooling, and prototype design costs incurred for various customer programs. Refer to note 7a.

| | June 30 2009 | December 31 2008 |
|-----------------|-------------------------|-----------------------------|
| Opening balance | \$ 3,299 | \$ 1,545 |
| Additions | 2,605 | 2,766 |
| Disposals | - | - |
| Amortization | (40) | (1,012) |
| | 5,864 | 3,299 |

Notes to Financial Statements to June 30, 2009

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

7 Property, Plant and Equipment

| | June 30, 2009 | | | December 31, 2008 | | |
|--------------------------------|---------------|--------------------------|---------------|-------------------|--------------------------|---------------|
| | Cost | Accumulated depreciation | Net | Cost | Accumulated depreciation | Net |
| Computer hardware and software | \$ 8,417 | \$ 5,636 | \$ 2,781 | \$ 8,396 | \$ 5,125 | \$ 3,271 |
| Machinery and equipment | 37,432 | 22,994 | 14,438 | 37,209 | 21,634 | 15,575 |
| Leasehold improvements | 990 | 414 | 576 | 956 | 371 | 585 |
| | 46,839 | 29,044 | 17,795 | 46,561 | 27,130 | 19,431 |

a) Measurement Uncertainty

The preparation of these financial statements required management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. By their nature these estimates are subject to measurement uncertainty. The effect on the financial statements of changes in such estimates in future periods could be material and would be accounted for in the period the change occurs.

- Carrying value of long-lived assets

The Company holds property, plant and equipment, and intangible assets (note 8) on the balance sheet amounting to \$19,781,000 (December 31, 2008: \$21,585,000). The recoverability of the carrying value of these assets is, in part, dependant on the estimates used in determining the expected period of future benefits over which to amortize. In addition, such recoverability is dependant on market conditions including demand for such aircraft for which the Company provides its products.

- Recoverability of deferred tooling costs

The ability to defer tooling costs is dependant on the future recoverability of the amounts from cash flows generated by the related commercial operations. If operations perform below anticipated recoverable levels, the portion of deferred tooling costs that cannot be recovered is expensed immediately when known. At June 30, 2009, \$5,864,000 (December 31, 2008: \$3,299,000) in unamortized deferred tooling costs (note 6), which are expected to be recoverable from the related future cash flows of such new operations, are presented as Development Costs in the balance sheet.

8 Intangible Assets

| | Remaining Estimated Useful Lives (years) | June 30, 2009 | | | December 31, 2008 | | |
|------------------------|--|---------------|--------------------------|--------------|-------------------|--------------------------|--------------|
| | | Cost | Accumulated Amortization | Net | Cost | Accumulated amortization | Net |
| Customer relationships | 5 | \$ 1,320 | \$ 283 | \$ 1,037 | \$ 1,320 | \$ 189 | \$ 1,131 |
| Order backlog | - | 130 | 130 | - | 130 | 130 | - |
| Trade name | 3 | 300 | 90 | 210 | 300 | 60 | 240 |
| Patents | 6 | 870 | 131 | 739 | 870 | 87 | 783 |
| | | 2,620 | 634 | 1,986 | 2,620 | 466 | 2,154 |

The Company amortizes intangible assets on a straight-line basis over their estimated useful lives, which range between one and ten years (note 7a).

Notes to Financial Statements to June 30, 2009

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

9 Bank Indebtedness

The Company has operating lines of credit with a Canadian chartered bank totalling \$17,000,000 (December 31, 2008: \$17,000,000). The facilities are due on demand. Borrowing in excess of \$17,000,000 to a maximum of \$22,000,000 will be cash secured.

Interest is at prime plus 0.875%, 1.00%, 1.175%, or 1.25% determined on a quarterly basis according to specific measures of the ratio of debt to tangible net worth. The US dollar sub-limit for the operating line of credit is USD\$15,000,000. The operating line of credit has a foreign forward exchange facility having a notional risk for credit purposes of \$3,528,000, to purchase foreign forward exchange contracts for major currencies, with a maximum maturity of 12 months.

As a condition of obtaining these operating lines of credit, security has been provided in the form of:

- 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; and
- 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 pays the shareholder a 10% fee on \$2,000,000 calculated on a daily basis (notes 16 and 18c).

As at June 30, 2009, the Company was not in compliance with its financial covenants. In addition, the Company is forecasting that it will be in default of one or more of its covenants in the next 12 months. The Company has not obtained a waiver from the debt holder for either the current breach at the balance sheet date or for anticipated future breaches. In the absence of obtaining a waiver of such breach, the lender is entitled to demand immediate payment.

In the next 12 months the Company will be required to seek an amendment of its borrowing terms to either waive any breaches, or modify the covenants (note 18d). The Company is required to maintain certain measures of working capital, debt to tangible net worth, and debt service coverage.

10 Demand Loan

During the quarter ended March 31, 2009, a certain shareholder provided a \$400,000 demand loan (June 30, 2008: \$Nil). This demand loan bears interest at 12% per annum and is repayable on demand. Interest payable as at June 30, 2009 amounted to \$12,000. The demand loan is unsecured. The demand loan and accrued interest payable was repaid from proceeds of a private placement completed on July 21, 2009 (notes 18b and 18c).

11 Bridge Loan

On June 15, 2009, the Company received \$1,552,000 from Panta Holdings B.V. in the form of a bridge loan for general working capital purposes. The bridge loan bears interest at 8% per annum. Interest payable as at June 30, 2009 amounted to \$6,000. Security has been provided in the form of a security interest in all of the Company's present and after-acquired personal property. This bridge loan and accrued interest payable was repaid from proceeds of a private placement completed on July 21, 2009 (note 18b).

Notes to Financial Statements to June 30, 2009

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

12 Long-Term Debt

| | June 30 2009 | December 31 2008 |
|---|-------------------------|---------------------|
| Convertible debenture due December 2009 (a) | \$ 4,193 | \$ 4,097 |
| Capital leases (b) | 3,401 | 4,096 |
| Accrued government royalties (c) | 1,038 | 952 |
| | 8,632 | 9,145 |
| Less: Current portion | (6,245) | (6,273) |
| | 2,387 | 2,872 |

a) Convertible Debenture Due December 2009

The principal outstanding debenture amount of \$4,097,000 is convertible at the option of the holder (Export Development Canada) into 293,713 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.

The debenture bears interest at 7.0% per annum and is unsecured.

Principal repayments are payable in 14 quarterly installments of \$100,000 commencing on December 31, 2006 with the final installment of \$3,797,000 due and payable on December 31, 2009, accordingly the debenture is classified within current portion of long-term debt on the balance sheet. No principal repayments were made for the quarters ended March 31, 2009 and June 30, 2009; and \$96,000 of unpaid interest has accrued during the year.

As at June 30, 2009, the Company was not in compliance with its financial covenants associated with the convertible debenture. The Company has not obtained a waiver from the debt holder for these non-compliances and for anticipated future breaches. On March 13, 2009, Export Development Canada served notice to the Company requiring that if the non-compliances are not rectified within 60 days of the notice date, all balances shall become payable on demand. As of the date of this report, Export Development Canada has not demanded payment. In addition, the Company is forecasting that it will be in default of one or more of its covenants in the next 12 months. In the absence of obtaining a waiver of such breach, the lender is entitled to demand immediate payment.

In the next 12 months, the Company will be required to seek an amendment of its borrowing terms to either waive any breaches, or modify the covenants. The Company is required to maintain certain measures of working capital, debt to tangible net worth, and debt service coverage. The Company is currently in discussion regarding the terms of repayment with Export Development Canada. No conclusions from the Company's current discussions with Export Development Canada have been reached. To date, Export Development Canada has not taken any action in respect of the defaults noted above due to the ongoing discussions regarding the renegotiation of the terms of the debt.

b) Capital Leases

There are various equipment leases that have a weighted average interest rate of 6.78% per annum. 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. \$2,494,000 of the leases are held in US dollars.

c) Accrued Government Royalties

Royalties of \$1,038,000 (December 31, 2008: \$952,000) are payable to Technology Partnerships Canada. The balance is repayable by June 30, 2010. The Company is currently in discussion regarding the terms of repayment with Technology Partnerships Canada. No conclusions from the Company's current discussions with Technology Partnerships Canada have been reached.

Notes to Financial Statements to June 30, 2009

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

13 Defined Contribution Plan

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

| | Three months ended June 30 | | Six months ended June 30 | |
|---------------------------|-------------------------------|---------------|-----------------------------|---------------|
| | 2009 | 2008 | 2009 | 2008 |
| Defined contribution plan | \$ 333 | \$ 373 | \$ 667 | \$ 737 |

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.

14 Interest Expense and Financing Charges

| | Three months ended June 30 | | Six months ended June 30 | |
|-----------------------------|-------------------------------|--------------|-----------------------------|---------------|
| | 2009 | 2008 | 2009 | 2008 |
| Interest on capital leases | \$ 61 | \$ 84 | \$ 129 | \$ 133 |
| Interest on long-term debt | - | 76 | - | 164 |
| Interest on short-term debt | 375 | 350 | 836 | 802 |
| Net interest expense | 436 | 510 | 965 | 1,099 |

15 Supplementary Cash Flow Information

a) Items not affecting cash:

| | Three months ended June 30 | | Six months ended June 30 | |
|--|-------------------------------|---------------|-----------------------------|----------------|
| | 2009 | 2008 | 2009 | 2008 |
| Accrued interest net of government contributions | \$ 207 | \$ 307 | \$ 461 | \$ 655 |
| Amortization and depreciation | 1,016 | 1,136 | 2,082 | 2,223 |
| Deferred tooling revenue | 993 | (670) | 881 | (1,073) |
| Development cost amortization | 13 | 208 | 40 | 330 |
| Prepaid rent amortization | - | - | 374 | - |
| Payment of fees via equity issue | - | - | - | 387 |
| Provision for loss-making contracts | (90) | (410) | (67) | (343) |
| Provision for obsolete inventory | 165 | - | 295 | - |
| Stock-based compensation | - | 19 | - | 38 |
| Unrealized derivative (gains) losses | 56 | (15) | 717 | 175 |
| Other items | (153) | (33) | (85) | (15) |
| | 2,207 | 542 | 4,698 | 2,377 |

b) Changes in non-cash items:

| | Three months ended June 30 | | Six months ended June 30 | |
|--|-------------------------------|-----------------|-----------------------------|----------------|
| | 2009 | 2008 | 2009 | 2008 |
| Accounts receivable | \$ 1,543 | \$ 1,869 | \$ 5,254 | \$ (89) |
| Inventories | 3,720 | 486 | 738 | 2,221 |
| Prepayments | 88 | 1,144 | 95 | 63 |
| Accounts payable and accrued liabilities | (4,440) | (1,327) | (4,129) | (599) |
| | 911 | 2,172 | 1,958 | 1,596 |

Notes to Financial Statements to June 30, 2009

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

c) Non-cash financing and investing activities:

| | Three months ended June 30 | | Six months ended June 30 | |
|--------------------------------------|-------------------------------|--------|-----------------------------|--------|
| | 2009 | 2008 | 2009 | 2008 |
| Assets acquired under capital leases | \$ - | \$ 231 | \$ - | \$ 256 |

16 Related Party Transactions

During the year ended December 31, 2005, the Company entered into an agreement under which a certain shareholder and former Chairman of the Board in consideration of mutual agreements with a Canadian chartered bank under which the shareholder and former Chairman of the Board 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 fee of 10% on the \$2,000,000 limited guarantee calculated on a daily basis. Fees paid to a certain shareholder and former Chairman of the Board during the quarter ended June 30, 2009 amounted to \$Nil (June 30, 2008: \$Nil). Fees payable to a certain shareholder and former Chairman of the Board as at June 30, 2009 are \$50,000 (June 30, 2008: \$25,000). These fees are included in the Statements of Operations as interest expense and financing charges and amount to \$50,000 for the quarter ended June 30, 2009 (June 30, 2008: \$25,000) (note 18c).

On February 3, 2006, a performance guarantee was provided by certain shareholders and former directors 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 a certain shareholder and former Chairman of the Board during the quarter ended June 30, 2009 amounted to \$Nil (June 30, 2008: \$Nil). Fees payable to a certain shareholders and former directors as at June 30, 2009 are \$Nil (June 30, 2008: \$60,000). These fees are included in the Statements of Operations as cost of sales and amount to \$Nil for the quarter ended June 30, 2009 (June 30, 2008: \$60,000).

Other related-party transactions are disclosed elsewhere in these financial statements (notes 10 and 18c).

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

17 Economic Dependence and Segmented Information

- a) Sales to three major customers, which comprise several programs and contracts, accounted for approximately 82.3% (June 30, 2008: 88.6%) of sales.

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|------------|----------------------------|------------|----------|------------|--------------------------|------------|----------|------------|
| | 2009 | | 2008 | | 2009 | | 2008 | |
| | Revenue | % of Total | Revenue | % of Total | Revenue | % of Total | Revenue | % of Total |
| Boeing | \$ 6,090 | 37.7 | \$ 5,566 | 17.2 | \$10,311 | 27.0 | \$10,818 | 17.0 |
| Bombardier | 4,067 | 25.1 | 6,790 | 21.0 | 9,744 | 25.4 | 14,363 | 22.6 |
| Cessna | 3,160 | 19.5 | 16,336 | 50.4 | 11,698 | 30.6 | 29,623 | 46.6 |
| Other | 2,855 | 17.7 | 3,697 | 11.4 | 6,506 | 17.0 | 8,736 | 13.8 |
| Total | 16,172 | 100.0 | 32,389 | 100.0 | 38,259 | 100.0 | 63,540 | 100.0 |

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

Notes to Financial Statements to June 30, 2009

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

18 Subsequent Events

- a) On July 13, 2009, the Company entered into an agreement for a second bridge loan to be provided by Pantia Holdings B.V. The bridge loan has been and will be advanced as follows:

- \$1,000,000 on July 13, 2009;
- \$1,500,000 on July 31, 2009;
- \$1,000,000 on or about August 14, 2009; and
- \$500,000 on or about August 31, 2009.

The bridge loan bears interest at 8% per annum. Provided no default has occurred, the Company will not be obligated to pay any interest or principal until the loan matures.

The bridge loan will mature on the earliest of:

- three months after July 13, 2009;
- the termination of the investment agreement, which incorporates the private placement and rights offering, prior to completion, and in accordance with its terms (note 18b); and
- the completion of the rights offering as defined in the investment agreement (note 18b).

Security has been provided in the form of a security interest in all of the Company's present and after-acquired personal property.

- b) An investment agreement was entered into by the Company and Pantia Holdings B.V. on July 13, 2009. The investment agreement has the following principal transaction terms:

- Equity investment: Pantia Holdings B.V. has agreed to purchase from the Company 16,157,465 common shares at \$0.15 per share for an aggregate purchase price of \$2,424,000. At the closing of this private placement the Company will repay Pantia Holdings B.V. the principal and accrued interest owed on the June 15, 2009 bridge loan (note 11). This transaction was completed on July 21, 2009.
- Rights offering: The Company has agreed to complete, as soon as practicable following the completion of the equity investment, a rights offering made pursuant to a short form prospectus to the holders of record of the common shares, of transferable rights to subscribe for two and one half common shares at a price of \$0.06 per common share. The aggregate anticipated gross proceeds from which are expected to amount to \$7,271,000.
- Stand by commitment: Pantia Holdings B.V. has agreed to purchase from the Company any rights offering common shares that are not otherwise subscribed for in the rights offering by holders of rights. In consideration of which Pantia Holdings B.V. will have the right to subscribe for up to an additional 8,078,733 common shares which are expected to provide up to \$485,000 of gross proceeds.

- c) On July 7, 2009, the Company entered into an agreement with a certain shareholder, having the following terms:

- the Company repaid the demand loan and accrued interest (note 10) on closing of a private placement (note 18b);
- the Company repaid all fees and amounts owing (note 16) on closing of a private placement (note 18b);
- the Company will reduce the limited guarantee provided by the certain shareholder on the indebtedness of the Company to the Bank (notes 9 and 16) by \$1,000,000 such that the total amount guaranteed by the certain shareholder totals \$1,000,000 upon closing of the rights offering (note 18b); and

Notes to Financial Statements to June 30, 2009

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

- the Company will use its best efforts to completely remove the shareholder's limited guarantee to the Bank as soon as reasonably practicable or no later than December 31, 2010. The Company will continue to pay the certain shareholder the aggregate guarantee fee currently paid (note 16).
- d) On August 12, 2009, the Company entered into a Forbearance Agreement with the bank providing its operating lines of credit. The Forbearance Agreement establishes terms and conditions under which the bank will continue to provide these facilities.

The following changes were made to the terms and security of the Company's operating lines of credit:

- decrease of the operating lines of credit, before cash security, from \$17,000,000 to \$15,000,000;
- interest at Bank prime plus 3.0%;
- the Company shall pay the Bank a monthly forbearance fee of \$10,000;
- the \$2,000,000 shareholder guarantee shall be replaced in a manner and form satisfactory to the Bank no later than September 15, 2009;
- during the period between March 31, 2009, and the date which is 90 days from the date of this agreement, a minimum of \$7,500,000 shall be injected into the Company by way of equity investment or debt that will at all times be subordinated to the Bank; and
- the Forbearance Agreement ends on November 10, 2009.

notes

notes

AVCORP INDUSTRIES INC.

Board of Directors and Officers

David Levi (1)(2)
CHAIRMAN OF THE BOARD
President and CEO
GrowthWorks Capital Ltd.
Vancouver, British Columbia

Kees de Koning (3)
DIRECTOR
Nootdorp, The Netherlands

Mark van Rooij (3)
DIRECTOR
Chief Executive Officer
White Rock, British Columbia

Paul Kalil
President
Vancouver, British Columbia

Eric Kohn *TD* (1*)(2*)
DIRECTOR
Managing Partner
Barons Financial Services SA
Geneva, Switzerland

Elizabeth Otis (3*)
DIRECTOR
Vashon, Washington

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

Paul Meringer
Vice President, New Ventures
Surrey, British Columbia

Amandeep Kaler
Vice President, Operations
Surrey, British Columbia

Ken McQueen
Vice President, Organization
Development
New Westminster, 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

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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

