



CALIAN

*2004 Annual Report*

# 2004

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Gatineau Satellite Station



Signal Operations (SigOps)



European Space Agency



Canadian Forces Base Kingston



MSTAR

CALIAN

stable growth, year after year.



## Message from the Chairman and CEO

The year 2004 was a spectacular year of performance for Team Calian, capping off three years of improving results. In every measurable way, 2004 has been the icing on the cake for a great three-year focus on execution and financial stability.

Our gain in net worth during 2004 was over \$7 million, which increased the per-share book value of our stock by 24% to \$4.36. Over the past three years since we commenced our restructuring project, our per-share book value has grown from \$2.84 to \$4.36, a rate of 16% compounded annually. But it's the Return On Capital Employed (ROCE) that produces results for shareholders, not book value. From the end of 2001 to date, our ROCE has improved from 4% to a solid 32%, an increase of substantial proportions.

Ray Basler, our President and COO, and also my partner in bringing Calian back to a solid ROCE position, deserves to be singled out as a key driver in our success over the past three years. His talent and outstanding capability have earned the respect of our employees and customers alike and as announced recently, Ray will be taking over the reins as CEO effective February 2, 2005. At that time I will assume the role of Chairman of Calian.

In this new role, I will work with Ray and his management team as they position Calian for continued growth in the twenty first century. I am fully confident that Calian is on very solid footing as it expands the sale of technology services into adjacent markets and continues on its pattern of steady long-term growth.

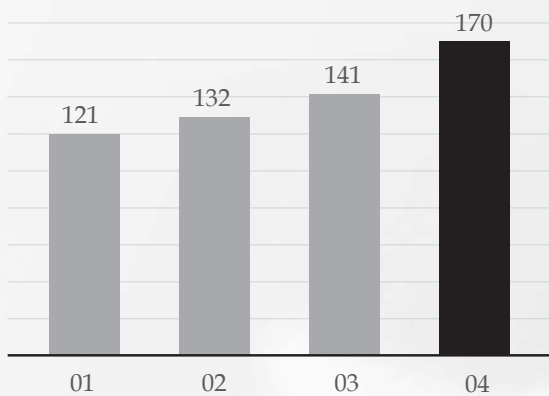
On a personal note it has been very satisfying to see the full talent of Team Calian produce results that none of us would have dreamed of three years ago after the dot COM adventures of the late 1990's. We as shareholders owe a debt of gratitude to a very special group of managers and I am looking forward to my new relationship with Calian.

I hope to see many of our shareholders at our AGM at the Brookstreet Hotel in Kanata at 3:00 p.m. on February 2, 2005.

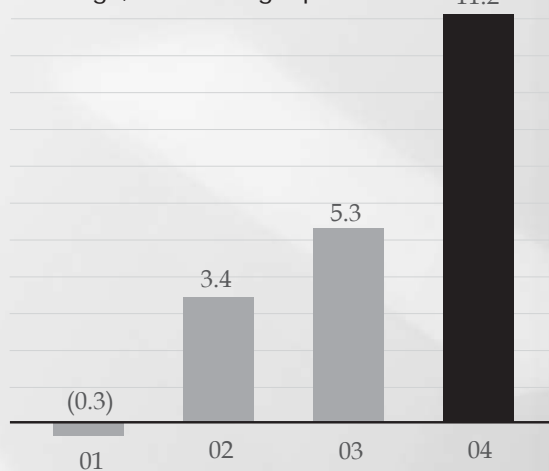
Larry O'Brien  
*Chairman and CEO*

(millions of dollars except per share data)

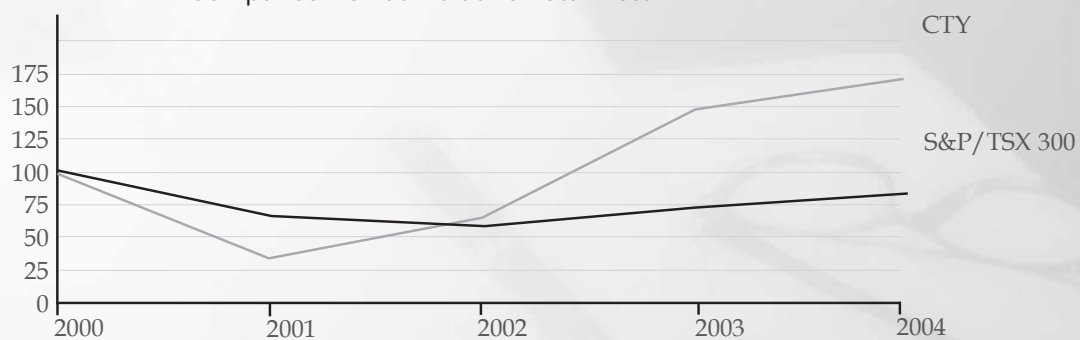
### Revenues



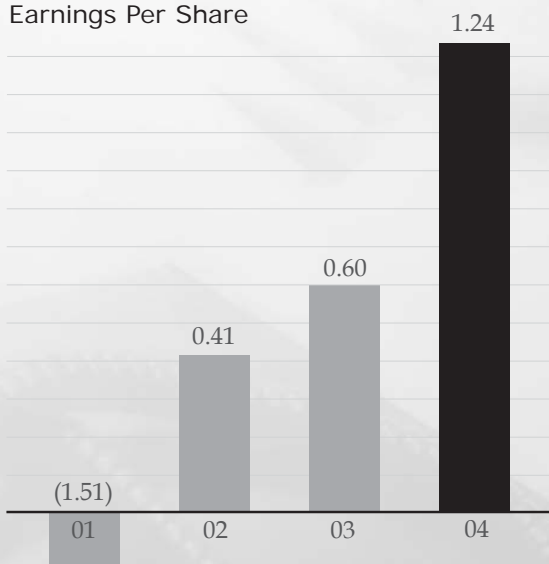
### Earnings, Continuing Operations



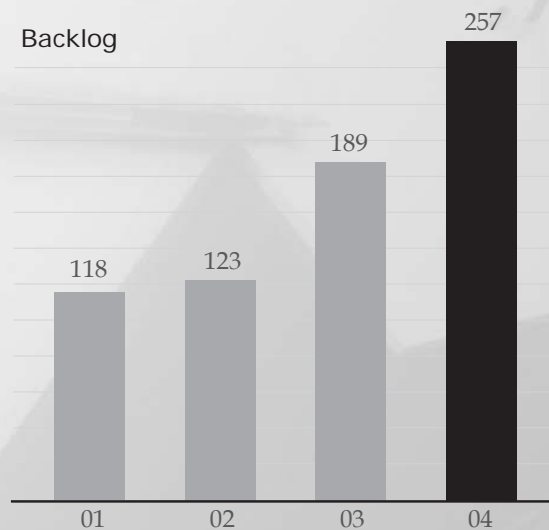
### Comparison of Cumulative Total Return



### Earnings Per Share



### Backlog





## Report on Operations

In 2004, Calian once again hit new heights. Despite prolonged slowdowns in some of our key markets, the mix of services we offer and the diversity of markets we address allowed us to achieve record revenues. Our continued focus on execution and delivery yielded satisfied customers and profitable results. With an increased workload, we were able to realize economies of scale and unprecedented utilization, measures that ultimately translated to improved margins. Our continued focus on controlling operating costs allowed these increased margins to flow directly to the bottom line. Accordingly, we achieved the highest level of operating profit in the Company's history.

Our strong and experienced management team once again delivered against its plans to meet the expectations of both our customers and our employees and to provide an excellent return to our shareholders. Our long history of performance and customer satisfaction helped us win a number of competitive renewals on long-term government contracts, thereby adding to our backlog and providing a steady base of work for years to come.

## Systems Engineering

The Systems Engineering Division (SED) had a banner year with revenues increasing by 67% to \$84 million. This is a remarkable achievement given the continuing slowdown in the satellite industry. With tight controls on operating costs and high utilization factors, we more than doubled our operating profit from last year.

The increase in revenue was primarily the result of a large contract received early in the year from Systems and Electronics Inc. (SEI) for a security and surveillance product. Although we had been manufacturing this product in limited quantities for a number of years, this particular order called for large quantities with a very aggressive schedule. We accepted the challenge and through the hard work and dedication of our employees, we were able to meet our customer's demanding requirements while achieving our own objectives for profitability.

We also performed significant levels of work for some of our key satellite customers. For example, Inmarsat continued the rollout of its next generation of satellites and we were active in developing a number of related subsystems as well as undertaking upgrades and enhancements to their existing infrastructure.

We executed well on other ground systems projects as well. For example, we made steady progress on the second deep space antenna system for the European Space Agency that is under construction in Spain. While there are still challenges ahead, we expect completion and commissioning to take place in the latter half of 2005. We also made excellent progress on satellite ground stations in Malaysia under a subcontract with Boeing for the MEASAT 3 program.

We continued to provide operations and support services to the Canadian Space Agency for Radarsat-1, Canada's remote sensing satellite. Our team has been instrumental in maintaining the integrity of this spacecraft well beyond its original design life, thus ensuring continuity of the valuable data used by a wide range of national and international customers.

Our past performance on high quality custom manufacturing contracts won us repeat business from customers such as SEI and Kidde Dual Spectrum. As well, we designed and built various test sets for customers like Agilent, Nortel and Powerwave. These projects have been important in maintaining high utilization of our manufacturing capability.

As with any project-driven business, we must continually deal with the inevitable peaks and valleys. In order to cope in this environment and to expand revenues, we will continue to seek opportunities to leverage our core capabilities into adjacent markets and to broaden our customer base. As always, we will do so in a manner that does not compromise our commitment to quality and delivery.



## Business and Technology Services

The Business and Technology Services Division experienced a difficult year with revenues declining by 5% to \$86 million. In the public sector market, political factors such as a leadership review, an election and numerous spending reviews served to log-jam procurements and delay new initiatives. In the commercial marketplace, many of our customers have yet to experience a sustained recovery, thereby reducing opportunities in the staffing area. Fortunately, due to our relatively variable cost structure, we were able to cope with this difficult business environment and still provide a respectable operating profit despite reduced revenues.

During 2004, a number of our key long-term contracts expired and were up for competition. Our excellent track record coupled with our ability to offer competitively priced solutions yielded a perfect 100% renewal success rate, thereby increasing our backlog of business to \$215 million, a 78% increase from the same period last year. We successfully renewed our Simulation Training contract with the Department of National Defence for a period of four years with options for an additional four years. This contract, the largest in the Company's history, is expected to generate over \$80M in revenue over this eight-year period. We also renewed engineering and logistics support contracts with an expected duration of five years with the Canadian and Australian governments in support of their F/A-18 programs.

Near the end of 2004, we acquired Titan Consulting Group Ltd. In addition to the revenue growth expected from this acquisition on a stand-alone basis, the acquisition also offers operational economies of scale and provides certain strategic benefits. Titan operates with a similar business model to BTS but with a pronounced bias towards private sector business. As such, this acquisition will afford BTS the opportunity to effectively diversify its revenue stream to include a vibrant and growing commercial market. We also expect that our access to this additional pool of highly skilled and specialized IT resources we will help us address more opportunities in the public sector for which the division has been pre-qualified.

During the year we maintained an operations emphasis on our continuous improvement initiative. In September, we were formally certified to the Progressive Excellence Program (PEP) Level 3 by the National Quality Institute. The efforts of the division were also acknowledged with the award of a Canada Award of Excellence at the silver level in recognition of our achievements in this area.

With most of the recent political issues behind us and having solidified many of our long-term contract renewals, we are well positioned to take advantage of upcoming opportunities. Our efficient back office can accommodate substantial growth without incurring additional costs, thus allowing us to aggressively pursue these opportunities, confident that we can enhance both revenues and operating returns.

## Summary

Overall, 2004 demonstrated our ability to take on and execute significant new business in certain sectors and proved our ability to compete in more difficult markets. Over the past few years, we have streamlined our operations and reported successive improvements in margins and operating costs. Both divisions now have excellent project execution and business delivery practices, and both have the capacity to take on significant levels of additional work with only nominal impacts on operating costs.

Our strategy for growth is to expand our customer base and service offerings and to continue to apply our core capabilities to adjacent markets. With an impressive backlog of \$257 million along with strong management, financial and operational resources, we are well positioned to take advantage of future opportunities to contribute to revenues and profitability.



Ray Basler  
*President and COO*

# Business of the Company

*Calian sells technology services to industry and government.* We operate through two autonomous divisions that complement each other and that share the vision and key tenet upon which Calian has emerged as a technology services leader—effective and prudent management with a focus on sustainable growth in carefully selected markets.

The diversity of our service offerings are at the heart of our success. By serving a number of customers in several different and geographically varied markets, we benefit from a diversity that helps us weather the downturns experienced in any one market and that allows us to take advantage of unique opportunities as they arise. This diversity is most evident when comparing the business of our two divisions.

*Systems Engineering designs and manufactures systems.* Our primary markets are the satellite communications arena and the defense and homeland security sectors. We are a relatively small niche player serving a handful of multi-national organizations working on large worldwide projects. More than 75% of our annual revenues are derived from exports.

Our approach is simple. We tailor systems to meet individual customer needs, using advanced commercial equipment from reliable suppliers. This means less development, lower risk and cost, and faster delivery. Our customers value being able to delegate the development of large and complex systems to us, confident that our technical and management skills will deliver what we promised, when we promised it, and at the agreed price. Our core competencies make us stand out from our competitors—strong project management, systems engineering know-how, and software development. Our full-service approach addresses needs from design through long-term maintenance, helping our customers roll-out new services on time and manage them profitably. We routinely enjoy repeat business due to the strong relationships we have established with industry leaders.

*Business and Technology Services provides people* to help customers manage their changing workforce requirements. We provide ready access to an exceptional team of engineers, telecommunications and technology professionals, administrative and other highly qualified business staff. The division caters mainly to the Canadian federal government, with a large presence in the Department of National Defense, but a well-established private customer base is expanding. About 7% of annual revenues are derived from the USA.

The services we offer allow our customers to focus their vital internal resources on key priorities. The value we add lies in the breadth of services we offer and our ability to source sufficient and appropriate resources on a timely basis to meet our customers' requirements. This is due to our exceptional recruiting capabilities, effective management of our employees in the field, and competitive rates.



A comparison of the business models and operating approaches of the two divisions further illustrates the diversity between them.

Contracts in Systems Engineering are technically complex and are typically on a fixed-price basis with demanding requirements to meet delivery schedules. The division operates essentially under a fixed cost structure, requiring the careful management of labour utilization. The majority of revenues are derived from international sources and contracts are often denominated in foreign currencies. While the risks are high, the margins are commensurate.

Contracts in Business and Technology Services are typically on a cost-plus or per diem basis and can range from short-term assignments to multi-year operations and maintenance contracts. The cost structure of the division is variable as direct labour costs are scalable to match contract requirements. The majority of revenues are derived from Canadian sources so there is little currency exposure. With a reduced risk profile, margins are correspondingly lower.

Systems Engineering's billings are based on achieving well-defined project milestones. These can be in advance of, or subsequent to the recognition of revenues. Milestone profiles vary depending on factors such as the customer, competition and pricing. Accordingly, cash flows and working capital requirements can vary significantly from project to project and over the life of any one project. In the Business and Technology Services Division, cash flows are very predictable as most contracts call for monthly billings for work performed.

## Management Team



Larry O'Brien  
*Chairman and CEO*



Ray Basler  
*President and COO*



Jacqueline Gauthier  
*VP, CFO and Corporate Secretary*



Tom Coates  
*VP and General Manager,  
Business and Technology Services*



Brent McConnell  
*VP and General Manager,  
Systems Engineering*

From the perspective of renewing business, Systems Engineering is awarded one project contract at a time, usually as a result of winning an open international competition. Constant marketing efforts are directed towards identifying and securing bid opportunities and a significant overhead effort is required to develop detailed proposals for new projects. The situation is similar for the short-term staffing component of the Business and Technology Services Division which requires ongoing marketing and sales efforts to maintain the backlog. However, the longer-term outsourcing component of this division enjoys the benefit of multi-year contracts that often contain provisions for extensions, offering long-term visibility of future revenues.

Overall, the diversity in markets, customers and business models provides Calian with an enviable balance in its consolidated business.

# Management's Discussion and Analysis of Financial Condition and Results of Operations

The following Management Discussion and Analysis should be read in conjunction with the audited consolidated financial statements and notes included in this annual report. The Company's accounting policies are in accordance with Canadian generally accepted accounting principles (GAAP) of the Canadian Institute of Chartered Accountants. As in the consolidated financial statements, all dollar amounts in this Management Discussion and Analysis are expressed in thousands of Canadian dollars unless otherwise noted.

## Business Overview

Calian sells technology services to industry and government. For many years, these groups have searched for and adopted new technologies in an effort to improve the efficiency of their operations. Management expects that they will continue to do so, and in recognizing this trend, the Company has built a unique combination of specialized skills and available capable resources in order to address the resulting market opportunities.

With these capable resources at the ready, Calian can quickly assemble and deploy teams of professionals with the requisite skills to promptly assist customers implement their diverse technology needs, whether it is the design and integration of a complex satellite ground system or the provision of specialized training and operations services.

The timeliness and reliability of Calian's services often cannot be duplicated by Calian's larger mainstream competitors. Furthermore, efficient and flexible operating processes allow Calian to profitably address lower margin business without compromising quality or performance, and this further distinguishes the Company from its competitors. Due to the Company's successful delivery and execution of projects, Calian experiences repeat business and a large number of contract renewals.

Calian delivers its services through its wholly owned operating subsidiaries Calian Ltd., Calian Inc., Calian Technology (US) Ltd. and Titan Consulting Group Ltd. Calian currently operates in two reportable segments, defined by their primary type of service offerings:

Systems Engineering involves planning, designing and implementing solutions that meet a customer's specific business and technical needs, primarily in the satellite communications sector. The Systems Engineering Division, also known as SED, has its principal office in Saskatchewan.

Business and Technology Services involves both short and long-term placements of personnel to augment customers' workforces as well as the long-term management of projects, facilities and customer business processes. The Business and Technology Services Division has its principal Canadian offices in the Ottawa area and its US office in Virginia.

## Long-term Strategy

Calian's long-term strategy is to continue to focus on providing its current service offerings to industry and government in specialized niche areas outside the mainstream market, avoiding competition with larger competitors. Calian will concentrate on providing services that the Company believes its competitors either do not want to provide or cannot provide efficiently.

Calian's growth plans include building upon and expanding its current technical capabilities and addressing a wider range of customers with a broader range of services without compromising its commitment to quality and delivery.

Calian plans to continue augmenting its service offerings and capitalizing on its reputation for delivery, building on its satisfied base of blue-chip customers. In addition, the Company plans to acquire specialized technology companies that have also had success in profitably addressing niche markets and whose operating philosophies align with those of Calian. With growing revenues, an efficient back office, and the realization of economies of scale, the Company's objective is to enhance the returns to its shareholders and build an enterprise that excels in its selected markets.

# Management's Discussion and Analysis of Financial Condition and Results of Operations

For existing operations, the key is controlled profitable growth. The Company expects that growth will not only extract economies of scale and provide additional returns, but will also provide an environment for its people to grow and advance within the Company. Calian's strengths in delivering specialized technology services in niche markets have so far permitted the Company to excel in a difficult business environment where many mainstream competitors have faltered. With this backdrop of continuing to do what Calian does best, there are no plans to materially alter the business of the Company.

The Company plans to expand its service offerings and customer base through strategic acquisitions. Management has established the following criteria that are designed to identify candidates that best complement Calian's existing businesses.

- The candidate company must be highly specialized, providing a unique service to a specific and loyal customer base.
- The incumbent management team must be passionate and dedicated, and be interested in continuing to run the company as an autonomous division of Calian.
- The candidate must demonstrate consistent earning power.
- The candidate must yield solid returns and employ very little capital.
- The candidate must show audited results of a minimum of \$1.5 million EBITDA over the last year.
- The owners must have a price in mind that can be expressed as a multiple of last year's EBITDA.

Careful review of candidates that meet these criteria will ensure that acquisitions are economically justified and can be expected to increase shareholder value.

## Fiscal 2004

The Company continued to focus on its core service offerings and realized record results this year. Earnings before other income, interest and income taxes increased to \$15,870 in 2004 compared with \$8,418 in 2003 and net earnings were \$10,438 for the year compared with \$4,848 in the previous year. The Company completed the year with \$30,997 of cash and equivalents compared to \$25,185 at the end of 2003.

For the **Systems Engineering Division (SED)**, work progressed on several large contracts such as the ground systems for Inmarsat's fourth generation satellites and the construction of the European Space Agency's second deep space antenna. Both of these projects will carry on into 2005.

SED also successfully completed a large order for systems and assemblies used by Systems and Electronics Inc. as part of their Manportable Surveillance and Target Acquisition Radar (MSTAR) system used in surveillance and security applications. SED has been manufacturing these components in small annual quantities as a sole source supplier to the same customer for more than ten years. The contract awarded early in fiscal 2004 required SED to manufacture the assemblies in significantly increased volumes under a very compressed schedule thereby substantially increasing the risk of not meeting the customer's expectations. However, by successfully delivering on this order, which represented over \$28 million in additional revenues for the year, SED has not only maintained, but has enhanced its preferred supplier status with this customer for future orders.

# Management's Discussion and Analysis of Financial Condition and Results of Operations

SED won several other new contracts in 2004.

Under the terms of a \$4 million contract, SED will provide London-based Inmarsat with a new satellite spectrum monitoring system. Dubbed SSMS4, the equipment will be used by Inmarsat to measure the communication carriers of its new Inmarsat I-4 satellite system. This project is scheduled to complete in fiscal 2005.

The Canadian federal government exercised a contract extension valued at over \$5 million for operations and maintenance services for the Canadian Space Agency's Satellite Operations Directorate. The work, which supports CSA's Radarsat-1 and SciSat satellites, is a continuation of activities SED has performed for the CSA since 1993.

In addition to its ongoing pursuit of opportunities in its traditional markets, the division continues to expand into complementary markets and look for new opportunities by adapting and marketing its current RF capabilities and expertise to terrestrial wireless applications. The division has had some success in this area and expects future growth opportunities to arise as that market recovers. In addition, the division is looking at adjacent markets such as the broadcast industry to utilize its expertise in data compression and transmission that was derived from its work in digital satellite radio applications.

While continuing to provide services to its current customer base, the **Business and Technology Services Division** faced the pending expiry in 2004 of many of its large long-term contracts with the federal government. The division was successful in renewing all of these contracts, securing over \$100 million of future revenues.

Among these successful renewals were the following:

A contract with the Department of National Defence to provide support to the Army Simulation Centre involves professional services to prepare, co-ordinate, support and maintain Command and Control exercises and experimentation activities using computerized combat simulation systems across Canada. The division has been providing these services since 1995 and the current contract has an estimated value of \$80 million over an eight-year period.

Two contracts for a total of \$12 million over five years with the Canadian and Australian governments provide technical staff to deliver ongoing systems engineering, logistics, configuration management, and financial and administrative support to both customers. This support is uniquely tailored to meet specific Canadian Forces and Australian requirements and includes expertise in the areas of avionics, software, airframe, engines and ancillary aircraft equipment.

A contract with Natural Resources Canada (NRCan) provides operations and maintenance services for the Gatineau Satellite Station in Cantley, Quebec. This contract has an estimated value of \$5 million over a three-year period. Calian provides management, technical, administrative and other staff to fully support the world-class remote sensing satellite data reception station owned by NRCan's Canada Centre for Remote Sensing. Calian has provided these services to NRCan since 1985; this is Calian's seventh consecutive contract.

Over the last 24 months, the federal government has undergone a leadership review, an election and numerous project spending reviews. These events have resulted in many new federal government initiatives being delayed. As a result, the Business and Technology Services Division was faced with fewer opportunities for new contracts.

At the same time, the division made good progress in developing relationships with new departments of the provincial and federal governments and obtained several new Standing Agreements, which position the division for future business with these departments.

The division also won a new contract with the Department of National Defence's Canadian Forces School of Aerospace Technology and Engineering (CFSATE) for a total value of \$17M over a five-year period. Under the contract terms,

# Management's Discussion and Analysis of Financial Condition and Results of Operations

Calian will provide technical and professional personnel to carry out Aircraft Maintenance and Repair Training Services at CFSATE on an as-and-when requested basis. This includes instructional and other services such as course design, aircraft maintenance, information technology, and administration support services. The Calian team will play an integral part to ensure the continued provision of quality aircraft maintenance training in support of CFSATE. This new contract will allow Calian to complement and build upon the experience it has gained over the years in supporting the Canadian Forces with signals operator training and performance oriented electronics training.

Despite the tough climate with the federal government, the division was still able to deliver solid earnings for 2004 due to the long-term nature of a significant portion of its revenue base.

Finally, in September 2004, the Company acquired Titan Consulting Group Ltd. (Titan). Titan, which specializes in delivering skilled SAP, PeopleSoft, Oracle and Seibel professionals to industry and government, had revenues of approximately \$10 million in the 12 months prior to acquisition. Titan uses the same economic business model as the Business and Technology Services Division with a complementary customer base and consultant database. The combined groups will be able to provide a wider range of services than ever before to its public and private sector clients. Titan has an impressive database of IT professionals that is an ideal match for the needs emerging within the Company's existing marketplace. As such, Titan will be integrated with the Business and Technology Services Division. The acquisition was based on book value plus a multiple of 4.5 times Titan's Earnings Before Interest, Taxes and Amortization (EBITDA) of up to \$1.6 million and 1 times EBITDA in excess of \$1.6 million for the period September 1, 2004 to August 31, 2005.

At September 30, 2004, the Company had a backlog of \$257 million. 36% of this backlog is expected to be earned as revenue in 2005, 17% in 2006 and 47% thereafter.

Systems Engineering begins 2005 with a backlog of \$42 million of which approximately \$37 million is expected to be earned in 2005 with the balance in 2006. This compares to a year ago when SED ended 2003 with \$37 million of its \$68 million backlog to be earned in 2004.

The renewal in 2004 of several large contracts allows Business and Technology Services to start 2005 with a backlog of \$215 million of which \$55 million is expected to be earned in 2005, \$38 million in 2006 and the balance in the following years. The Business and Technology Services Division ended 2003 with \$36 million of its \$121 million backlog to be earned in 2004.

## Results of Operations

### Revenues

Total revenues for the year ended September 30, 2004 were \$169,707, a 20% increase over 2003 revenues of \$141,040. A significant portion of this increase is related to the contract awarded to and executed during the year by the Systems Engineering Division for SEI.

The general business environment in 2004 continued to be very competitive. The Company began the year with \$73 million of its backlog to be earned in 2004. This backlog combined with Calian's strong customer relationships and its reputation for delivering high quality service resulted in a solid revenue stream for 2004.

Calian's Systems Engineering Division accounted for revenues of \$83,942 or 49% of total revenues compared to \$50,398 or 36% of revenues a year earlier, representing an increase of 67% over the prior year. The growth during 2004 was partly due to the continued success with long time customers in the satellite communication sector, but was largely a result of the division delivering on its contract with SEI worth in excess of \$28 million awarded and executed in its entirety in 2004.



# Management's Discussion and Analysis of Financial Condition and Results of Operations

The Business and Technology Services Division accounted for the balance of \$85,765 or 51% of revenues compared to \$90,642 or 64% a year earlier. This decrease of 5% over the prior year is attributed to a general slowdown with the federal government, especially as it relates to short-term services. Delays in the funding of new federal government programs and increased delays in the procurement cycle of other programs have created a difficult market environment for winning new business. The long-term nature of a significant portion of the division's business and its reputation for delivering quality services helped the division maintain a healthy level of revenues despite these market conditions.

The Company derives a significant portion of its revenues from the Government of Canada. During the year, 28% of revenues were related to contracts with various departments and agencies of the Government of Canada, compared to 38% in 2003. Both of the Company's divisions conduct business with this major customer. The Company also derived 17% of its revenues from a major customer in the call center business compared with 21% in 2003. As well, revenue from SEI accounted for 22% of the Company's total revenues in 2004 compared to 4% in 2003. Future levels of activity with this customer are ultimately dependent on the timing and magnitude of demand for their product.

Management expects the marketplace in 2005 to be similar to the one experienced in 2004. The Company begins 2005 with \$92 million of backlog to be earned over the next 12 months and with its stable source of recurring work, management expects moderate revenue growth in 2005 over the level of business experienced in 2004 after excluding the unusual level of work with SEI in 2004.

## Cost of revenues and Gross profit

The Company's cost of revenues includes all direct costs incurred in the provision of its products and services. These costs include all expenses associated with direct full-time staff, contract staff and subcontractors. They also include other direct costs including the landed cost of hardware and software sold as components of a solution, travel and living expenses necessary in the delivery of the services, and provision for warranty where applicable.

For the year ended September 30, 2004, the Company reported a gross profit of \$34,039 or 20.1% of revenues, which compares to \$25,386 or 18.0% a year earlier. Margin improved significantly over the prior year as a result of the Systems Engineering Division representing a greater portion of the overall revenues in 2004.

Gross margin was 24.9% in the Systems Engineering Division during 2004 compared to 23.3% the previous year. This was a result of a higher labour component in revenues, which generally attracts higher margins, along with exceptional labour utilization rates and economies of scale associated with the increased level of business. Excellent project control once again ensured that margins were not eroded by cost overruns.

In the Business and Technology Services Division, the gross margin was 15.3% in 2004 compared with 15.0% in 2003. Although revenues decreased in this division during 2004, the revenue mix improved slightly. In addition, the division's variable cost structure allowed it to adjust its direct costs simultaneously with its level of revenues ensuring stable gross profit percentages.

The prolonged downturn in some of the Company's markets and the uncertainty regarding federal government spending will continue to produce a very competitive marketplace for new business in the near future, which in turn will add pressure on gross margins. However, with a healthy backlog and efficient execution of projects, management believes it can maintain margins in each of its two divisions at traditional levels of 21% to 23% for the Systems Engineering Division and 14.5% to 15.5% for the Business and Technology Services Division. Because of the significant difference in gross margin between each of the two divisions, the overall gross margin of the Company is dependent on the relative level of revenue generated from each division.



# Management's Discussion and Analysis of Financial Condition and Results of Operations

## Selling, administration and other expenses

The Company separately identifies four principal expense categories in its consolidated financial statements – selling and marketing, general and administration, facilities, and amortization of capital assets. These are referred to in the Management Discussion and Analysis as selling, administration and other expenses.

Selling, administration and other expenses totaled \$18,099 or 10.7% of revenues in 2004. This compares to \$16,968 or 12.0% of revenues in 2003. As described below, the overall decrease in expenses as a percentage of sales is a result of the significant increase in the Company's revenue base during 2004 without corresponding increases in overhead requirements. Management believes that, for the foreseeable future, operating costs will remain stable with only minimal increases required to support future growth.

## Selling and marketing

Selling and marketing expenses reflect all direct selling costs including salaries, commissions, travel and living expenses, the costs of proposal development and submission, and the costs of account management activities conducted by sales personnel. The costs of the recruiting department are also classified as selling and marketing expenses as this sales support role is key in obtaining resources for customers.

Selling and marketing expenses totaled \$4,508 compared to 2003 when they were \$4,409. Selling and marketing expenses as a percentage of revenues were 2.7% in 2004 compared to 3.1% in 2003. Selling and marketing expenses are expected to increase slightly over the 2004 level as the Company concentrates on broadening its customer base and expanding its service offerings to new markets.

## General and administration

The Company's general and administration expenses include all overhead-related expenses except facilities. General and administration expenses were \$9,664 in 2004, compared with \$8,574 the previous year. The increase is mainly attributable to increased incentives, a direct result of increased profitability. As a result of the Company's continuous cost control activities, all other expenditures remained stable. General and administration expenses as a percentage of revenues decreased to 5.7% in 2004 compared to 6.1% in 2003. Management believes that the Company has the capacity for an increased level of business including the recent Titan acquisition without significantly affecting general and administration costs.

## Facilities

Facility expenses, which include costs associated with office space, have been relatively stable over the past two years. Facility costs during 2004 were \$2,691 compared to \$2,769 in 2003. Commensurate with the exit of e-business in May 2001, Calian consolidated its Ottawa-based personnel into one building while subletting another building that it had begun to lease in June 2000. As explained further in the Discontinued Operation section of this discussion, the Company's facility costs exclude lease and operating costs related to the excess space. Management believes that the existing facilities will be sufficient for the foreseeable future.

## Amortization of capital assets

Amortization of capital assets totaled \$1,236, compared with \$1,216 in the previous year. The amortization level in the future is not expected to vary significantly from current levels.

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## Amortization of intangibles

During 2004, the Company acquired the following intangibles as a result of its acquisition of Titan: customer relationships, non-competition agreements entered into with the prior owner of Titan, order backlog and consultant database. These intangibles are amortized over their expected useful life, not exceeding five years. During 2004, the Company amortized \$70, representing the amortization required for the one-month period subsequent to the acquisition date. Amortization in 2005 will represent a full year.

## Gain on sale of investment

On September 30, 2004, the Company disposed of its 18% interest in Square Peg Communications Inc. for an amount of \$825, net of costs. The Company has held this investment since 1993 and the majority shareholders wished to repurchase all the outstanding shares held by non-employees. The Company received \$250 on closing and a note receivable for \$600 as indicated in Note 3 of the Company's financial statements for the year ended September 30, 2004. After discounting the non-interest bearing note to its fair value, income of \$741 was recorded in 2004.

## Interest income, net

Interest income is earned on the Company's excess cash and cash equivalents and is shown net of the Company's interest expense associated with its long-term debt and capital leases. As a result of increased cash balances, interest income increased to \$467 during the year, compared to \$364 recorded in 2003.

## Earnings from continuing operations before income tax expense

The above factors have resulted in an increase of 94% in earnings before taxes and amortization of \$17,078 for the year, compared to \$8,782 in 2003.

## Income tax expense

Calian reports its results on a fully taxed basis. The provision for income taxes during 2004 was \$5,884 compared to \$3,454 in 2003 commensurate with the level of earnings before tax.

The total pool of federal income tax losses and research expenditures available to reduce future earnings as at September 30, 2003 amounted to \$7,857. During 2004, the Company utilized the remaining balance of these pools to reduce the current year's taxable income and after utilizing the remaining \$866 in investment tax credits, it was required to pay taxes on a large portion of its taxable earnings. Total income taxes paid in 2004 were \$2,536, compared to \$314 in 2003. For 2005 the Company's effective tax rate is expected to be approximately 35% and the Company will be required to pay taxes on all of its taxable earnings.

## Earnings from continuing operations

The Company reported earnings from continuing operations of \$11,194 or \$1.33 per share basic and \$1.31 per share diluted for 2004 compared to \$5,328 or \$0.66 per share basic and \$0.64 per share diluted for 2003.

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## Discontinued operation

As indicated in Note 17 of the Company's financial statements for the year ended September 30, 2004, Calian has a significant commitment with regards to premises leased during 2000 in anticipation of the e-business operation expansion and growth. As a result of the e-business operation being discontinued, the Company no longer requires this excess space. This lease commitment extends to April 2010. The space is currently sublet to a third party until May 2006. During 2004, the Company assessed the current market condition for leased space in the Kanata area and management determined it was prudent to increase its existing provision and recorded an additional loss on disposal of the e-business operation of \$1,200 (\$756 after tax) or \$0.09 per share. During 2003, the Company recorded a similar adjustment to the provision for \$750 (\$480 after tax) or \$0.06 per share. These adjustments bring the total provision available for future real estate and other potential costs associated with the e-business discontinued operation to approximately \$2.3 million.

## Net earnings

The Company reported net earnings of \$10,438 or \$1.24 per share basic and \$1.22 per share diluted for 2004 compared to \$4,848 or \$0.60 per share basic and \$0.58 per share diluted in 2003.

## Selected Annual Information

|   | 2004     | 2003     | 2002     |
|---|----------|----------|----------|
| Revenues                                      | \$ 169.7 | \$ 141.0 | \$ 131.9 |
| Earnings from continuing operations           | \$ 11.2  | \$ 5.3   | \$ 3.4   |
| Net earnings                                  | \$ 10.4  | \$ 4.8   | \$ 3.4   |
| Earnings per share from continuing operations | \$ 1.33  | \$ 0.66  | \$ 0.41  |
| Net earnings per share                        | \$ 1.24  | \$ 0.60  | \$ 0.41  |
| Total assets                                  | \$ 68.5  | \$ 64.1  | \$ 55.0  |
| Dividend per share                            | \$ 0.22  | \$ 0.17  | \$ -     |

## Operating Results by Quarter

The following tables provide certain financial information in summary form on a quarterly basis for the years 2004 and 2003.

The Company's operations have historically been subject to some quarterly seasonality due to the timing of vacation periods and statutory holidays. Typically the Company's first and last quarters will be negatively impacted as a result of the Christmas season and summer vacation period. During these periods, the Company can only invoice for work performed and is also required to pay employees for statutory holidays. This may result in reduced levels of revenues and a decline in gross margins. However, due to the impact of the realized sales mix of its various projects, this quarterly seasonality may not be apparent in the overall results of the Company.

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## Selected Quarterly Financial Data

(dollars in thousands except per share data)  
(unaudited)

|   | Fiscal Quarters ended |                   |                  |                  | Total<br>2004 |
|---|-----------------------|-------------------|------------------|------------------|---------------|
|   | Dec 31,<br>2003       | March 31,<br>2004 | June 30,<br>2004 | Sept 30,<br>2004 |               |
| Revenues  | 37,343                | 49,246            | 45,372           | 37,746           | 169,707       |
| Cost of revenues  | 30,588                | 39,838            | 35,361           | 29,881           | 135,668       |
| Gross profit  | 6,755                 | 9,408             | 10,011           | 7,865            | 34,039        |
| Selling, administration and other                               | 4,320                 | 4,529             | 4,653            | 4,667            | 18,169        |
| Earnings before other income, interest and income taxes expense | 2,435                 | 4,879             | 5,358            | 3,198            | 15,870        |
| Gain on sale of investment                                      | -                     | -                 | -                | 741              | 741           |
| Interest income, net  | 110                   | 123               | 99               | 135              | 467           |
| Earnings from continuing operations before income tax expense   | 2,545                 | 5,002             | 5,457            | 4,074            | 17,078        |
| Income tax expense  | 877                   | 1,784             | 2,014            | 1,209            | 5,884         |
| Earnings from continuing operations                             | 1,668                 | 3,218             | 3,443            | 2,865            | 11,194        |
| Loss on disposal of discontinued operation                      | -                     | -                 | -                | 756              | 756           |
| <b>Net Earnings</b>   | <b>1,668</b>          | <b>3,218</b>      | <b>3,443</b>     | <b>2,109</b>     | <b>10,438</b> |
| Earnings per share from continuing operations                   |                       |                   |                  |                  |               |
| Basic   | 0.20                  | 0.38              | 0.41             | 0.34             | 1.33          |
| Diluted   | 0.20                  | 0.37              | 0.40             | 0.34             | 1.31          |
| Net earnings per share  |                       |                   |                  |                  |               |
| Basic   | 0.20                  | 0.38              | 0.41             | 0.25             | 1.24          |
| Diluted   | 0.20                  | 0.37              | 0.40             | 0.25             | 1.22          |
| Weighted average number of shares                               |                       |                   |                  |                  |               |
| Basic   | 8,266,944             | 8,445,037         | 8,460,475        | 8,384,425        | 8,389,220     |
| Diluted   | 8,492,282             | 8,632,283         | 8,633,845        | 8,545,465        | 8,578,138     |

## BALANCE SHEET DATA

|                      |        |        |        |        |
|----------------------|--------|--------|--------|--------|
| Working capital      | 21,583 | 25,197 | 27,551 | 24,701 |
| Total assets         | 65,370 | 69,199 | 68,826 | 68,497 |
| Shareholders' equity | 30,712 | 33,998 | 35,766 | 36,171 |

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## Selected Quarterly Financial Data

(dollars in thousands except per share data)  
(unaudited)

|   | Fiscal Quarters ended |                   |                  |                  |               |
|---|-----------------------|-------------------|------------------|------------------|---------------|
|   | Dec 31,<br>2002       | March 31,<br>2003 | June 30,<br>2003 | Sept 30,<br>2003 | Total<br>2003 |
| Revenues  | 34,774                | 37,865            | 34,188           | 34,213           | 141,040       |
| Cost of revenues  | 28,832                | 30,903            | 27,893           | 28,026           | 115,654       |
| Gross profit  | 5,942                 | 6,962             | 6,295            | 6,187            | 25,386        |
| Selling, administration and other                             | 4,246                 | 4,372             | 4,202            | 4,148            | 16,968        |
| Earnings before interest and income tax expense               | 1,696                 | 2,590             | 2,093            | 2,039            | 8,418         |
| Interest income, net  | 48                    | 86                | 106              | 124              | 364           |
| Earnings from continuing operations before income tax expense | 1,744                 | 2,676             | 2,199            | 2,163            | 8,782         |
| Income tax expense  | 685                   | 1,057             | 913              | 799              | 3,454         |
| Earnings from continuing operations                           | 1,059                 | 1,619             | 1,286            | 1,364            | 5,328         |
| Loss on disposal of discontinued operation                    | -                     | 480               | -                | -                | 480           |
| <b>Net Earnings</b>   | <b>1,059</b>          | <b>1,139</b>      | <b>1,286</b>     | <b>1,364</b>     | <b>4,848</b>  |
| Earnings per share from continuing operations                 |                       |                   |                  |                  |               |
| Basic   | 0.13                  | 0.20              | 0.16             | 0.17             | 0.66          |
| Diluted   | 0.13                  | 0.19              | 0.16             | 0.16             | 0.64          |
| Net earnings per share  |                       |                   |                  |                  |               |
| Basic   | 0.13                  | 0.14              | 0.16             | 0.17             | 0.60          |
| Diluted   | 0.13                  | 0.13              | 0.16             | 0.16             | 0.58          |
| Weighted average number of shares                             |                       |                   |                  |                  |               |
| Basic   | 8,012,778             | 7,974,689         | 7,999,225        | 8,159,519        | 8,047,748     |
| Diluted   | 8,280,127             | 8,381,728         | 8,283,895        | 8,455,212        | 8,389,822     |

## BALANCE SHEET DATA

|                      |        |        |        |        |
|----------------------|--------|--------|--------|--------|
| Working capital      | 14,124 | 15,802 | 17,517 | 19,481 |
| Total assets         | 54,799 | 55,140 | 62,332 | 64,067 |
| Shareholders' equity | 26,130 | 26,675 | 27,662 | 28,974 |

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## Liquidity and Capital Resources

Calian's net cash position was \$30,997 at September 30, 2004, compared to \$25,185 at September 30, 2003.

## Operating Activities

Cash flows provided from operating activities in 2004 were \$15,171 as compared with \$18,678 during 2003. During the year, the Company generated cash flows from earnings from continuing operations of \$15,301 (2003, \$9,549) offset by a decrease in unearned contract revenue of \$3,951 (2003, increase of \$4,562). Accounts Receivable generated cash of \$4,077 in 2004 compared to \$4,788 in 2003 with all other working capital items remaining relatively constant.

The market for the Systems Engineering Division is characterized by long-term contracts with billings tied to milestones achieved, which often results in significant working capital requirements. Conversely, given the nature of this business, it is sometimes possible to negotiate advance payments on contracts. For example, during 2003, the Company was able to negotiate a \$10 million advance payment relating to a project with the European Space Agency. Such advance payments give rise to unearned revenue that will be realized as revenue over the course of the contract. As at September 30, 2004, the Company's total unearned revenue amounted to \$14,094. This compares to \$18,045 one year earlier. It is expected that unearned revenue will decrease over the upcoming year as the related work is performed and obtaining advance payments on new projects may become more difficult.

## Acquisition

On September 7, 2004 the Company acquired all of the outstanding shares of Titan Consulting Group Ltd. (Titan). The total value of the acquisition is expected to be in the range of \$6 to \$8 million and will be satisfied with 90% cash and the balance through the issuance of Calian common shares. On closing, the Company paid \$4,302 in cash. The balance of the amount to be paid in cash and in Calian common shares will be calculated and paid during the first 6 months of fiscal 2006. The common shares will be issued at the then-prevailing market prices.

## Capital assets

Calian acquired \$928 in capital assets during 2004, compared to \$1,044 during 2003. Assets purchased in 2004 are in line with normal requirements for asset replacement. During 2005, capital expenditures are expected to be in line with past years. At September 30, 2004 there were no significant commitments to expend capital.

## Dividend

As a result of continuing earnings and a strong cash position, the Company introduced a dividend in 2003. During 2004 the Company paid \$1,848 in dividends or \$0.22 cents per share and during 2003 paid a dividend of \$1,374 or \$0.17 cents per share. The Company intends to continue with its current dividend policy for the foreseeable future and expects to pay quarterly dividends of \$0.08 per share to shareholders.

## Shares

During 2004, the Company acquired 214,900 common shares under Normal Course Issuer Bids at an average price of \$11.50 and 290,559 shares were issued for cash as a result of options being exercised during the year at an average price of \$3.73. There are 218,125 options outstanding at an average price of \$2.99 expiring at different dates through 2007.

During 2003, the Company acquired 316,300 common shares under Normal Course Issuer Bids at an average price of \$6.03 and 489,593 shares were issued for cash at an average price of \$3.24 per share.

At September 30, 2004 there were 8,287,725 common shares outstanding and as of the date of this Management Discussion and Analysis, there were 8,290,725 common shares outstanding.



# Management's Discussion and Analysis of Financial Condition and Results of Operations

## Capital resources

At September 30, 2004 the Company had a short-term credit facility of \$10,000 with a Canadian chartered bank that bears interest at prime and is secured by assets of the Company. Management believes that Calian has sufficient cash resources to finance its working capital requirements during 2005, pay a quarterly dividend and pay the remaining balance required for the acquisition of Titan.

## Financial Instruments

The Company is exposed to foreign currency fluctuations on its cash balance, accounts receivable, accounts payable and future cash flows related to contracts denominated in a foreign currency. Future cash flows will be realized over the life of the contracts. The Company uses financial instruments, principally in the form of forward exchange contracts, in its management of foreign currency exposures. These contracts primarily require the Company to purchase or sell certain foreign currencies with or for Canadian dollars at contractual rates. At September 30, 2004, the Company had forward sell contracts valued at \$32.4 million equivalent Canadian dollars and forward buy contracts valued at \$15.1 million equivalent Canadian dollars, which represents 100% of the Company's foreign currency exposure. All foreign denominated transactions are recorded at the equivalent hedged value at the time it is earned.

## Contractual Obligations

### Payments due by period

|                               | <b>Total</b> | <b>Less than<br/>1 year</b> | <b>1-3<br/>years</b> | <b>4-5<br/>years</b> | <b>After<br/>5 years</b> |
|-------------------------------|--------------|-----------------------------|----------------------|----------------------|--------------------------|
| Capital Lease Obligations     | 53           | 53                          | -                    | -                    | -                        |
| Operating Leases              | 16,998       | 3,212                       | 6,322                | 5,557                | 1,907                    |
| Purchase Obligations          | 18,929       | 18,356                      | 573                  | -                    | -                        |
| Other Long-term Obligations   | -            | -                           | -                    | -                    | -                        |
| Total Contractual Obligations | 35,980       | 21,621                      | 6,895                | 5,557                | 1,907                    |

## Related Party Transactions

There were no transactions with related parties during 2004 and 2003.

## Significant Accounting Policies and Estimates

In 2004, the Company's most complex accounting policies and estimates were made in the area of revenue recognition on fixed-price projects, valuation of goodwill and valuation of intangibles.

## Revenue recognition

The Business and Technology Services Division's revenue is derived from cost-plus contracts where revenue is recognized when the services are provided. However, a significant portion of the Systems Engineering Division's revenue is derived from fixed-price contracts. Revenue from these fixed-price projects is recognized using the percentage of completion method using management's best estimate of the costs and related risks associated with completing the projects. The greatest risk on fixed-price contracts is the possibility of cost overruns. Management's approach to revenue recognition is tightly linked to detailed project management processes and controls. The information provided by the project management system combined with a knowledgeable assessment of technical complexities and risks are used in estimating the percentage completion.

## Goodwill

The valuation of goodwill is based on a valuation of the reporting unit to which goodwill is attributed. To the extent that the valuation exceeds the net book value of the related reporting unit, no write-down is necessary. The valuation is based on management's best estimate of future results of operations using reasonable assumptions relating to growth levels, expected costs, expected business environment and the Company's weighted average cost of capital.

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## Intangibles

The initial value of intangibles is determined based on the estimated value of the related cash flow stream associated with each intangible, discounted using the internal rate of return of the acquisition using reasonable future growth assumptions. The estimated useful life of the intangibles is determined based on the estimated turnover of the existing business relationship and consultant database and the actual life of the acquired backlog and non-competition agreements. These intangibles will be tested for recoverability whenever events or circumstances indicate that the carrying amount may not be recoverable.

## Adoption of New Accounting Policies

Effective October 1, 2003, the Company early adopted the amended recommendations of the Canadian Institute of Chartered Accountants Handbook Section 3870, Stock-based Compensation and Other Stock-based Payments. The amended standard requires that all stock based awards made to employees be measured and recognized using the fair-value based method. As a result, during 2004, the Company recorded a compensation expense of \$41 relating to its Employee Share Purchase Plan.

## Impact of Accounting Pronouncements Not Yet Implemented

As of the date of this Management Discussion and Analysis, there are no new accounting recommendations that the Company is required to adopt for the year beginning in October 2004. However, new accounting recommendations are likely to arise during the year.

## Risk Factors

The Company is subject to a number of risks and uncertainties that could significantly affect the Company's future results of operations and financial condition. The Company has a comprehensive planning process where risks are identified and plans initiated to minimize risks wherever possible. All participants in the Systems Engineering and Business and Technology Services divisions face some or all of the following risks and uncertainties:

### Competition for contracts within key markets

The markets for the Company's services are intensely competitive, rapidly evolving and subject to technological changes. The principal competitive factors in the Company's markets are quality, performance, price, timeliness, customer support and reputation. Calian has a disciplined approach to management of all aspects of its business. The Company is a proponent of quality management and its Systems Engineering Division is registered under ISO 9001-2000 standards while its Business and Technology Services Division is accredited at Level 3 of the Progressive Excellence Program by the National Quality Institute. This approach to management was developed to help the Company ensure that its employees deliver services consistently according to the Company's high standards and based on strong values underlying its client-focused culture.

### The availability of qualified professionals

Competition from other firms has a two-fold impact on the Company. Calian must not only vie for qualified employees for its own operations but must have ready access to a large pool of qualified professionals to satisfy contractual arrangements with customers. Calian mitigates these factors through a number of means. Calian's performance driven remuneration policies and its favourable working environment are conducive to attracting ambitious, qualified professionals. As a supplier of professional employees through outsourcing contracts, Calian regularly establishes relationships with a significant number of professionals in key markets.

### Performance on fixed-price contracts

A large percentage of the Systems Engineering Division's contracts are based on a fixed price for the provision of a specified service against an agreed delivery schedule. These fixed-price contracts at times involve the completion of

# Management's Discussion and Analysis of Financial Condition and Results of Operations

large-scale system engineering projects. There is a risk in all fixed-price contracts that the Company will be unable to deliver the system within the time specified and at the expected cost. The Company employs sophisticated design and testing processes and practices, which include a range of stringent factory and on-site acceptance tests with criteria and requirements jointly developed with the customer. However, non-performance could result in a customer being in a position to terminate the contract for default, or to demand repayments or penalties. Program management methodologies have been implemented to adequately manage each project and any customer changes, and to identify and mitigate potential technical risks and related cost overruns. In addition, Calian employs procedures to ensure accurate estimating of costs and performs regular detailed reviews of progress on each project.

## Non-performance of a key supplier or contractor

The Company's business is often dependent on performance by third parties and subcontractors for completion of contracts for which Calian is the prime contractor. Subcontractors for large systems are selected in concurrence with the customer's requirements, and if not directed by the customer, are selected through a competitive bid or negotiated process. Most major development subcontracts are established as fixed-price contracts. The Company believes that these subcontractors have an economic incentive to perform such subcontracts for the Company. However, no company can protect itself against all material breaches, particularly those related to financial insolvency of the subcontractors or to cost overruns by subcontractors. Risks include a significant price increase in those few subcontracts that are not fixed-price, delay in performance, a failure of any major subcontractor to perform or the inability of the Company to obtain replacement subcontractors at a reasonable price. The performance of key subcontracts is closely monitored as part of the Company's project management process to promptly identify potential issues and develop remedial actions.

## Rapidly changing technologies and customer demands

The markets in which Calian operates are characterized by changing technology and evolving industry standards. Calian keeps pace with developments in the industries it serves and actively monitors the evolution of these markets, thus ensuring that it can meet the evolving needs of its clients. The Company achieves the aforementioned through continually recruiting professionals in high demand positions and providing regular training to ensure employee skills remain current. The Company's ability to anticipate changes in technology, technical standards and service offerings will be a significant factor in the Company's ability to compete or expand into new markets.

## Government contracts

During 2004, approximately 28% of the Company's total revenues were derived from contracts with the Canadian government and its agencies. The government may change its policies, priorities or funding levels through agency or program budget reductions or impose budgetary constraints. Furthermore, contracts with governments, including the Canadian government, may be terminated or suspended by the government at any time, with or without cause. Although in the past the Company has not experienced any significant cancellations of previously awarded contracts by the Canadian government, there can be no assurance that any contract with the government will not be terminated or suspended in the future.

## Contracts with major customers

During 2004, approximately 17% of the Company's total revenues were derived from a contract with a customer in the call center business. This contract is renewed annually and can be cancelled by the customer with 4 months notice. The Company monitors the quality of its services to this customer to ensure long-term viability of the contract. As well, revenue from a customer in the security and surveillance market accounted for 22% of the Company's total revenues in 2004. Future levels of activity with this customer are ultimately dependent on the timing and magnitude of demand for their product.

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## Credit risk concentration with respect to trade receivables

As the Company grows, it monitors the concentration of its business in its various segments and with particular customers. In management's opinion, the fact that the Company operates in two segments that provide diversification of its customer base mitigates the potential impact on earnings and cash flow of problems related to an individual sector or customer. The Company does extensive in-bound call center business with a large private sector customer. Processes have been established to mitigate the Company's credit exposure with this customer.

## Insufficient or inappropriate mix of work for fixed labour resources

Virtually all employees of the Systems Engineering Division are full time staff and represent a broad spectrum of unique skill sets. Accordingly, the division strives to secure sufficient labour sales that adequately match the skill sets. The division's business development practices are designed to dynamically adjust pursuits of contracts to address the sufficiency and mix of available resources.

## Operational risk

Operational risk is managed through the establishment of effective infrastructure and controls. Key elements of the infrastructure are qualified, well-trained personnel, clear authorization levels and reliable technology. Controls established by documented policies and procedures include the regular examination of internal controls by our auditors, segregation of duties, and financial management and reporting. In addition, the Company maintains insurance coverage and contingency plans for systems failures or catastrophic events.

## Foreign currency risk

The Company operates internationally with approximately 47% of its business derived from non-Canadian sources. A substantial portion of this international business is denominated in major foreign currencies and therefore the Company's results from operations are affected by exchange rate fluctuations of these currencies relative to the Canadian dollar. The Company uses financial instruments, principally in the form of forward exchange contracts, in its management of foreign currency exposures. At September 30, 2004 the Company had various forward exchange contracts, which are explained in Note 14 to the Company's consolidated financial statements for the year ended September 30, 2004. The strengthening of the Canadian dollar relative to other foreign currencies may negatively impact the Company's competitiveness and increase pressure on margins for new work.

## Legal proceedings

The Company is involved in several lawsuits that are described in Note 10 to the Company's consolidated financial statements for the year ended September 30, 2004. These matters are at various stages of litigation and the outcomes of these matters are not determinable at this time.

## Discontinued operation

As part of its e-business strategy, the Company entered into a 10-year lease for an office building in the Ottawa area extending to April 2010. Upon exit of the e-business sector, the Company did not have any requirements for the space and accordingly sublet the excess space to a third party for a period of five years ending May 2006. In the event the sub-lessee defaults on the payments or the Company cannot sublet the premises for the remaining four years, Calian will be required to assume the lease including related operating costs for the remaining term of the lease. The total remaining commitment on this lease amounts to \$5.3 million and the Company has provided \$2.3 million for this and other potential costs associated with the e-business discontinued operation.

# Management's Discussion and Analysis of Financial Condition and Results of Operations

## Long-term Outlook

Management believes the Company is well positioned for sustained growth. The Company operates in markets that will continue to require the services that the Company delivers. To further assure itself of a stable source of revenues, the Company will focus on increasing the percentage of its revenues derived from recurring business. Its acquisition strategy focusing on adding complementary businesses to the Company's mix will also be an additional source for growth.

The Systems Engineering Division has been working within a depressed satellite sector for the last few years with no significant rebound expected in the near-term. However, management believes that new satellites adopting the latest technologies will be required in the medium term to maintain and improve service offerings. In addition, management believes the surveillance and security market will continue to be strong in the near term and that systems such as MSTAR will continue to be in demand. Although management cannot predict the timing and extent of future orders, it is confident that this market will continue to provide a good revenue stream going forward.

The services of the Business and Technology Services Division are adaptable to many different markets. Currently, its strength is with the Department of National Defence. Management believes that this department and many others within the federal government will continue to require more outsourcing services from private enterprises to supplement their current workforce. Although the delays noticed over the last few years have slowed the growth of this division, management believes that the types of service the division offers will continue to be attractive to government agencies going forward. Management also believes that there will be an increase in requirements for ERP expertise supplied on a per-diem basis. With its recent acquisition of Titan and the award to Calian of two standing agreements with the federal government for SAP and Peoplesoft resources, Calian is now well positioned to take advantage of this expected growth.

While Calian has the benefit of a healthy backlog, continued strengthening of the Canadian dollar may negatively impact the Systems Engineering Division's competitiveness when bidding against foreign competition on projects denominated in US dollars.

## Disclaimer

This annual report may contain forward-looking statements that involve a number of risks and uncertainties, including statements regarding the outlook for the Company's business and results of operations. By nature, these risks and uncertainties could cause actual results to differ materially from those indicated. Such factors include, without limitation, the various factors set forth in the Management Discussion and Analysis section of this report and as discussed in public disclosure documents filed with Canadian regulatory authorities. Calian disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

## Additional Information

Additional information about the Company such as the Company's 2004 Annual Information Form and Management Circular can be found on SEDAR at [www.SEDAR.com](http://www.SEDAR.com)

Dated: December 3, 2004

## Management's Statement of Responsibility

The accompanying consolidated financial statements of Calian Technology Ltd. and its subsidiaries and all information in the annual report are the responsibility of management and have been approved by the Board of Directors.

The financial statements include some amounts that are based on management's best estimates that have been made using careful judgment.

The financial statements have been prepared by management in accordance with accounting principles generally accepted in Canada. Financial and operating data elsewhere in the annual report are consistent with the information contained in the financial statements.

In fulfilling its responsibilities, management of Calian and its subsidiaries has developed and continues to maintain systems of internal accounting controls, including written policies and procedures and segregation of duties and responsibilities.

Although no cost-effective system of internal controls will prevent or detect all errors and irregularities, these systems are designed to provide reasonable assurance that assets are safeguarded from loss or unauthorized use, transactions are properly recorded and the financial records are reliable for preparing the financial statements.

The Board of Directors carries out its responsibility for the financial statements in this report through its Audit Committee. The Audit Committee meets periodically with management and with the external auditors to discuss the results of audit examinations with respect to the adequacy of internal controls and to review and discuss the financial statements and financial reporting matters.

The financial statements have been audited by Deloitte & Touche LLP, Chartered Accountants, who have full access to the Audit Committee with and without the presence of management.



Larry O'Brien  
*Chairman and CEO*

Kanata, Ontario  
October 28, 2004



Jacqueline Gauthier  
*Chief Financial Officer*



# Auditors' Report

To the Shareholders of Calian Technology Ltd.

We have audited the consolidated balance sheets of Calian Technology Ltd. as at September 30, 2004 and 2003 and the consolidated statements of earnings and retained earnings and of cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at September 30, 2004 and 2003 and the results of its operations and the changes in its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*Deloitte & Touche LLP*

*Chartered Accountants*

Ottawa, Ontario  
October 28, 2004

# Calian Technology Ltd.

## Consolidated Statements of Earnings and Retained Earnings

Years Ended September 30, 2004 and 2003

(dollars in thousands, except per share data)

|   | 2004       | 2003       |
|---|------------|------------|
| Revenues  | \$ 169,707 | \$ 141,040 |
| Cost of revenues  | 135,668    | 115,654    |
| Gross profit  | 34,039     | 25,386     |
| Selling and marketing   | 4,508      | 4,409      |
| General and administration  | 9,664      | 8,574      |
| Facilities  | 2,691      | 2,769      |
| Amortization of capital assets  | 1,236      | 1,216      |
| Amortization of intangibles   | 70         | -          |
| Earnings before other income, interest and income tax expense                       | 15,870     | 8,418      |
| Gain on sale of investment (Note 3)   | 741        | -          |
| Interest income, net  | 467        | 364        |
| Earnings from continuing operations before income tax expense                       | 17,078     | 8,782      |
| Income tax expense (Note 4):  |            |            |
| Current   | 3,424      | 1,279      |
| Future  | 2,460      | 2,175      |
|   | 5,884      | 3,454      |
| Earnings from continuing operations   | 11,194     | 5,328      |
| Loss on disposal of discontinued operation<br>(net of income tax expense) (Note 17) | 756        | 480        |
| <b>NET EARNINGS</b>   | 10,438     | 4,848      |
| Retained earnings, beginning of year  | 13,202     | 11,057     |
| Excess of purchase price over stated capital on<br>repurchase of shares (Note 8)    | (2,052)    | (1,329)    |
| Dividend  | (1,848)    | (1,374)    |
| Retained earnings, end of year  | \$ 19,740  | \$ 13,202  |
| Earnings per share from continuing operations<br>(Note 9)                           |            |            |
| Basic   | \$ 1.33    | \$ 0.66    |
| Diluted   | \$ 1.31    | \$ 0.64    |
| Net earnings per share (Note 9)   |            |            |
| Basic   | \$ 1.24    | \$ 0.60    |
| Diluted   | \$ 1.22    | \$ 0.58    |
| Weighted average number of shares (Note 9)  |            |            |
| Basic   | 8,389,220  | 8,047,748  |
| Diluted   | 8,578,138  | 8,389,822  |

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

# Calian Technology Ltd.

## Consolidated Balance Sheets

As at September 30, 2004 and 2003

(dollars in thousands)

|   | 2004      | 2003      |
|---|-----------|-----------|
| <b>ASSETS</b>                               |           |           |
| <b>CURRENT ASSETS</b>                       |           |           |
| Cash and cash equivalents                   | \$ 30,997 | \$ 25,185 |
| Accounts receivable                         | 18,726    | 20,519    |
| Note receivable (Note 3)                    | 158       | -         |
| Work in process                             | 3,747     | 4,759     |
| Prepaid expenses and other                  | 875       | 486       |
| Future income taxes (Note 4)                | 2,428     | 3,625     |
|   | 56,931    | 54,574    |
| INVESTMENT TAX CREDITS RECOVERABLE (Note 4) | -         | 866       |
| NOTE RECEIVABLE (Note 3)                    | 358       | -         |
| FUTURE INCOME TAXES (Note 4)                | -         | 1,271     |
| CAPITAL ASSETS (Note 5)                     | 3,873     | 4,110     |
| INTANGIBLES (Note 6)                        | 1,412     | -         |
| GOODWILL (Note 7)                           | 5,923     | 3,246     |
|   | \$ 68,497 | \$ 64,067 |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b> |           |           |
| <b>CURRENT LIABILITIES</b>                  |           |           |
| Accounts payable and accrued liabilities    | \$ 18,136 | \$ 17,048 |
| Unearned contract revenue                   | 14,094    | 18,045    |
|   | 32,230    | 35,093    |
| FUTURE INCOME TAXES (Note 4)                | 96        | -         |
|   | 32,326    | 35,093    |
| CONTINGENCIES (Note 10)                     |           |           |
| <b>SHAREHOLDERS' EQUITY</b>                 |           |           |
| Share capital (Note 8)                      | 16,431    | 15,772    |
| Retained earnings                           | 19,740    | 13,202    |
|   | 36,171    | 28,974    |
|   | \$ 68,497 | \$ 64,067 |

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

Approved by the Board:



Larry O'Brien  
Director



Richard Vickers  
Director

# Calian Technology Ltd.

## Consolidated Statements of Cash Flows

Years Ended September 30, 2004 and 2003

(dollars in thousands)

|   | 2004             | 2003             |
|---|------------------|------------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                     |                  |                  |
| Earnings from continuing operations   | \$ 11,194        | \$ 5,328         |
| Items not affecting cash  |                  |                  |
| Deferred lease inducements  | (9)              | (9)              |
| Amortization  | 1,306            | 1,216            |
| Gain on sale of investment (Note 3)   | (516)            | -                |
| Investment tax credits  | 866              | 839              |
| Future income taxes   | 2,460            | 2,175            |
|   | 15,301           | 9,549            |
| Change in non-cash working capital  |                  |                  |
| Accounts receivable   | 4,077            | 4,788            |
| Work in process   | 1,070            | (1,287)          |
| Prepaid expenses and other  | (385)            | 240              |
| Accounts payable and accrued liabilities  | (941)            | 826              |
| Unearned contract revenue   | (3,951)          | 4,562            |
|   | 15,171           | 18,678           |
| <b>CASH FLOWS USED IN FINANCING ACTIVITIES</b>                                  |                  |                  |
| Repayment of debt   | (888)            | (155)            |
| Issuance of common shares   | 1,085            | 1,510            |
| Repurchase of common shares, including cost associated with repurchase (Note 8) | (2,478)          | (1,918)          |
| Dividend  | (1,848)          | (1,374)          |
|   | (4,129)          | (1,937)          |
| <b>CASH FLOWS USED IN INVESTING ACTIVITIES</b>                                  |                  |                  |
| Acquisition of capital assets   | (928)            | (1,044)          |
| Business acquisition (Note 16)  | (4,302)          | -                |
|   | (5,230)          | (1,044)          |
| <b>NET CASH INFLOW</b>  | <b>5,812</b>     | <b>15,697</b>    |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR</b>                             | <b>25,185</b>    | <b>9,488</b>     |
| <b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>                                   | <b>\$ 30,997</b> | <b>\$ 25,185</b> |
| <b>SUPPLEMENTARY INFORMATION:</b>   |                  |                  |
| Income taxes paid   | \$ 2,536         | \$ 314           |
| Interest paid   | \$ 9             | \$ 7             |

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

# Calian Technology Ltd.

## Notes to the Consolidated Financial Statements

As at September 30, 2004 and 2003

(dollars in thousands, except per share data)

### 1. Nature of Operations

Calian Technology Ltd. ("the Company"), incorporated under the Canada Business Corporations Act, and its wholly-owned subsidiaries provide technology services to industry and government.

### 2. Accounting Policies

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles and include the following significant accounting policies:

#### Basis of consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries Calian Ltd., Calian Inc., Calian Technology (U.S.) Ltd. and Titan Consulting Group Ltd.

#### Revenue recognition

Revenue on fixed-price contracts is recognized at the net realizable value of services provided using the percentage of completion method based on management estimates. Billings and cash receipts in advance of amounts earned are reflected as unearned contract revenue. Provision is made for the entire amount of the expected losses, if any, in the period in which they are first determinable. In addition, a provision for warranty claims is established when revenue is recognized, based on warranty terms and prior claim experience. As some contracts extend over one or more years, any revision in cost and profit estimates made during the course of the work are reflected in the accounting period in which the facts indicating a need for the revision become known.

Revenue derived from cost-plus contracts is recognized in the period the services are provided.

#### Work in process

Work in process represents work performed but not invoiced and is recorded at net realizable value.

#### Capital assets

Capital assets are recorded at cost, net of related government assistance and investment tax credits. Amortization is calculated using the declining balance method at rates ranging from 20% to 30%. The Company's policy is to review all long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable, the Company will estimate the future cash flows expected to result from the use of the assets and their eventual disposition and record an impairment loss if required.

#### Intangibles

Intangibles are comprised of acquired customer relationships, non-competition agreements, order backlog and consultant database. Intangibles are amortized on a straight-line basis over their estimated useful life not exceeding five years. The intangibles are tested for recoverability whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

#### Goodwill

Goodwill represents the excess of the purchase price over the fair value of net assets of acquired businesses. Goodwill is not amortized and is tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. When the carrying amount of a reporting unit's goodwill exceeds its fair value,

# Calian Technology Ltd.

## Notes to the Consolidated Financial Statements

As at September 30, 2004 and 2003

(dollars in thousands, except per share data)

### 2. Accounting Policies (Continued)

an impairment loss is recognized in an amount equal to the excess. An impairment charge is recorded for goodwill that is considered impaired.

The Company performs its annual review of goodwill September 30th each year. Based on the impairment tests performed at September 30, 2003 and 2004, the Company concluded that no goodwill impairment charge was required.

#### Income taxes

The Company and its subsidiaries account for income taxes using the liability method. Under this method, current income taxes are recognized for the estimated income taxes payable for the current year. Future income tax assets and liabilities are recognized for temporary differences between the tax and accounting bases of assets and liabilities and for the benefit of tax losses available to be carried forward to future years if these are more likely than not to be realized.

#### Stock-based compensation

Effective October 1, 2003, the Company early adopted the amended recommendations of the Canadian Institute of Chartered Accountants Handbook Section 3870, Stock-based Compensation and Other Stock-based Payments. The amended standard requires that all stock based awards made to employees be measured and recognized using the fair-value based method.

#### Disclosure of guarantees

In 2003, the Company adopted the new recommendations of the Canadian Institute of Chartered Accountants Accounting Guideline 14, Disclosure of Guarantees. This guideline requires a guarantor to disclose in its notes to the consolidated financial statements significant information about guarantees it has provided. Under this guideline, a guarantee is defined as a contract or indemnification agreement, which requires the Company to make payments to a third party contingent on future events. The disclosures described in Note 12 are required even when the likelihood of the guarantor having to make any payment under the guarantee is remote.

#### Foreign currency translation

The accounts of a wholly owned subsidiary, which is considered to be an integrated subsidiary, and accounts in foreign currencies have been translated into Canadian dollars using the temporal method of foreign currency translation. Under this method, monetary assets and liabilities are translated at the rate of exchange in effect at year-end. Non-monetary items are translated at rates in effect on the dates of the transactions. Revenues and expenses are translated at rates in effect during the year except for amortization, which is translated at the same rate as the assets to which it relates. Gains and losses from translation are included in earnings in the period in which they occur.

#### Financial instruments and risk management

The carrying amount of the Company's current monetary assets and liabilities approximate fair value. The note receivable's carrying value represents the discounted value of the note using current market interest rates and as such approximates fair value.

Derivative financial instruments are utilized by the Company in the management of its foreign currency exposures. The Company's policy is not to utilize derivative financial instruments for trading or speculative purposes.



# Calian Technology Ltd.

## Notes to the Consolidated Financial Statements

As at September 30, 2004 and 2003

(dollars in thousands, except per share data)

### 2. Accounting Policies (Continued)

#### Financial instruments and risk management (continued)

In 2003, the Company early adopted the Canadian Institute of Chartered Accountants Accounting Guideline 13, Hedging Relationships. Accordingly, the Company formally documents all relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. This process includes linking all derivatives to specific firm contractually related commitments on projects. The Company also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

The Company hedges foreign currency exposures by entering into offsetting forward exchange contracts. Foreign exchange translation gains and losses on foreign currency denominated derivative financial instruments used to hedge foreign currency denominated contracts are deferred and recognized as an adjustment of either the hedged revenues or the hedged project costs.

Realized and unrealized gains or losses associated with derivative instruments, which have been terminated or cease to be effective prior to maturity, are deferred under other current and non-current, assets or liabilities on the balance sheet and recognized in income in the period in which the underlying hedged transaction is recognized. In the event a designated hedged item is extinguished, settled or is no longer probable of occurring prior to the termination of the related derivative instrument, any realized or unrealized gain or loss on such derivative instrument is recognized as an adjustment to revenue or cost of the related project.

#### Earnings per share

Diluted earnings per share is calculated based on the weighted average number of common shares outstanding during the period plus the effects of potentially dilutive common shares outstanding during the period. This method requires that the dilutive effect of outstanding options be calculated using the treasury stock method, as if all dilutive options had been exercised at the later of the beginning of the reporting period or date of issuance, and that the funds obtained thereby were used to purchase common shares of the Company at the average trading price of the common shares during the period. Contingently issuable shares are included in the diluted earnings per share calculation once the actual level of earnings indicate that the conditions will be met to issue shares (Note 16). The number of shares included is determined based on the earnings to date and the current market price of the shares at the end of the reporting period, if the effect is dilutive.

#### Cash and cash equivalents

Cash and cash equivalents include investments with a major Canadian chartered bank and money market instruments that have terms of three months or less at the time of acquisition. The carrying amounts of cash and cash equivalents are stated at cost, which is equal to their fair value.

### 3. Note Receivable

The Company holds a note receivable for \$600 from Square Peg Communications Inc. (Square Peg) as final settlement for the repurchase by Square Peg of its shares owned by the Company. The note is non-interest bearing and is secured by a general security agreement over the assets of Square Peg second to any bank indebtedness. The note is repayable in three equal instalments of \$200 on September 30 of each consecutive year commencing in 2005. Each instalment payment can be delayed by one year at which time interest will accrue at a rate of prime + 3%.

# Calian Technology Ltd.

## Notes to the Consolidated Financial Statements

As at September 30, 2004 and 2003

(dollars in thousands, except per share data)

### 3. Note Receivable (Continued)

The book value of the note of \$516 represents the fair value at September 30, 2004 after considering an implied interest rate of prime + 3%.

The gain on sale of the investment was determined as follows:

|                            |               |
|----------------------------|---------------|
| Cash received              | \$ 250        |
| Note receivable            | 516           |
| Legal and accounting costs | (25)          |
|                            | <u>\$ 741</u> |

### 4. Income Taxes

The balances of future income tax assets and liabilities (current and long-term) at September 30, 2004 and 2003 represent the future benefits of temporary differences between the tax and accounting bases of assets and liabilities, consisting mainly of future tax deductions.

During 2004, the Company utilized all available research and development expenditure, income tax losses and investment tax credits.

The future tax assets of the Company are comprised of the following elements:

|  | 2004  | 2003     |
|--|-------|----------|
| Donation carry-forward and income tax losses   | \$ 55 | \$ 115   |
| Research and development expenditures          | -     | 1,469    |
| Tax base of assets in excess of book base      | -     | 1,209    |
| Book base of liabilities in excess of tax base | 2,373 | 2,103    |
|  | 2,428 | 4,896    |
| Current  | 2,428 | 3,625    |
| Non-current                                    | \$ -  | \$ 1,271 |

The non-current future tax liability of the Company is comprised of the book base of assets in excess of tax base for \$96 (2003: \$NIL). None of the goodwill is expected to be deductible for tax purposes (Note 16).

The following table reconciles the difference between the income taxes that would result solely by applying statutory tax rates to pre-tax income and the income taxes actually provided in the accounts:

|  | 2004            | 2003            |
|--|-----------------|-----------------|
| Earnings from continuing operations before income taxes  | \$ 17,078       | \$ 8,782        |
| Tax provision at the combined basic Canadian federal and provincial income tax rate of 37.6% (2003: 37.8%) | 6,421           | 3,320           |
| Increase (decrease) resulting from:  |                 |                 |
| Permanent differences  | (91)            | 74              |
| Impact of rate reductions on valuation of future income tax assets   | (252)           | (9)             |
| Other  | (194)           | 69              |
|  | <u>\$ 5,884</u> | <u>\$ 3,454</u> |

# Calian Technology Ltd.

## Notes to the Consolidated Financial Statements

As at September 30, 2004 and 2003

(dollars in thousands, except per share data)

### 5. Capital Assets

|                                   | 2004      |                          | 2003           |                |
|-----------------------------------|-----------|--------------------------|----------------|----------------|
|                                   | Cost      | Accumulated Amortization | Net Book Value | Net Book Value |
| Equipment, furniture and fixtures | \$ 10,792 | \$ 6,919                 | \$ 3,873       | \$ 4,110       |

### 6. Intangibles

|                                 | 2004     |                          | 2003           |                |
|---------------------------------|----------|--------------------------|----------------|----------------|
|                                 | Cost     | Accumulated Amortization | Net Book Value | Net Book Value |
| Acquired customer relationships | 788      | 16                       | 772            | -              |
| Non-competition agreements      | \$ 480   | \$ 8                     | \$ 472         | -              |
| Order backlog                   | 126      | 44                       | 82             | -              |
| Consultant database             | 88       | 2                        | 86             | -              |
|                                 | \$ 1,482 | \$ 70                    | \$ 1,412       | \$ -           |

### 7. Goodwill

The change in the book value of goodwill is as follows:

|                                | 2004     | 2003     |
|--------------------------------|----------|----------|
| Balance, beginning of year     | \$ 3,246 | \$ 3,246 |
| Acquired during year (Note 16) | 2,677    | -        |
| Balance, end of year           | \$ 5,923 | \$ 3,246 |

### 8. Share Capital

#### Authorized

Unlimited number of common shares

Unlimited number of preferred shares issuable in series

#### Issued

Common shares as follows:

|                            | 2004      |           | 2003      |           |
|----------------------------|-----------|-----------|-----------|-----------|
|                            | Shares    | Amount    | Shares    | Amount    |
| Balance, beginning of year | 8,212,066 | \$ 15,772 | 8,038,773 | \$ 14,851 |
| Shares issued for cash     | 290,559   | 1,085     | 489,593   | 1,510     |
| Shares repurchased         | (214,900) | (426)     | (316,300) | (589)     |
| Balance, end of year       | 8,287,725 | \$ 16,431 | 8,212,066 | \$ 15,772 |

# Calian Technology Ltd.

## Notes to the Consolidated Financial Statements

As at September 30, 2004 and 2003

(dollars in thousands, except per share data)

### 8. Share Capital (Continued)

During 2004, the Company acquired 214,900 (2003: 316,300) of its outstanding common shares at an average price of \$11.50 (2003: \$6.03) per share for a total of \$2,478 (2003: \$1,918) including related expenses, through Normal Course Issuer Bids initiated in May 2003 (2003: May 2002) and May 2004 (2003: May 2003) each for a period of one year. The excess of the purchase price over the average stated capital of the shares has been charged to retained earnings.

#### Share options

The Company established a stock option plan, whereby grants were made at the sole discretion of the Company's Board of Directors. Under this plan, eligible directors and employees were granted the right to purchase shares of common stock at a price established by the Board of Directors on the date the options were granted. The plan, which expired in 2003, was not renewed and no options have since been granted.

These purchase options have been granted with vesting terms ranging from immediately to over three years and a maximum term to expiry of five years, and are contingent on the option holders maintaining their employment.

|                                | 2004      |                              | 2003      |                              |
|--------------------------------|-----------|------------------------------|-----------|------------------------------|
|                                | Options   | Weighted Avg. Exercise Price | Options   | Weighted Avg. Exercise Price |
| Outstanding, beginning of year | 467,540   | \$3.28                       | 944,280   | \$3.23                       |
| Exercised                      | (244,915) | \$3.54                       | (465,905) | \$3.11                       |
| Forfeited or expired           | (4,500)   | \$3.83                       | (10,835)  | \$6.60                       |
| Outstanding, end of year       | 218,125   | \$2.99                       | 467,540   | \$3.28                       |

As at September 30, 2004:

| Options Outstanding      |                   |  |                              | Options Exercisable |                              |
|--------------------------|-------------------|--|------------------------------|---------------------|------------------------------|
| Range of Exercise Prices | Number of Options | Weighted Avg. Remaining Contractual Life (Yrs) | Weighted Avg. Exercise Price | Number Exercisable  | Weighted Avg. Exercise Price |
| \$2.25 - \$2.65          | 141,825           | 2.19   | \$2.45                       | 11,825              | \$2.45                       |
| \$2.80 - \$3.20          | 15,500            | 2.04   | \$2.97                       | 5,500               | \$3.10                       |
| \$3.45 - \$3.80          | 35,000            | 2.84   | \$3.60                       | 15,000              | \$3.60                       |
| \$4.25 - \$4.35          | 18,000            | 0.24   | \$4.33                       | 18,000              | \$4.33                       |
| \$5.30 - \$6.90          | 7,800             | 0.97   | \$6.90                       | 7,800               | \$6.90                       |
|                          | 218,125           | 2.08   | \$2.99                       | 58,125              | \$3.99                       |

#### Employee stock purchase plan

The Company has an Employee Stock Purchase Plan (ESPP) under which most full-time employees may register once a year to participate in one of two offering periods. Eligible employees may purchase common shares by payroll deduction throughout the year at a price of 80% of the fair market value at the beginning of the initial offering period or may purchase common shares at a price of 90% of the fair market value at the beginning of the interim offering period. Such shares are issued from treasury once a year at the end of the offering periods.

# Calian Technology Ltd.

## Notes to the Consolidated Financial Statements

As at September 30, 2004 and 2003

(dollars in thousands, except per share data)

### 8. Share Capital (Continued)

A total of 500,000 common shares have been authorized for issuance under the plan. During fiscal 2004, the Company issued 43,144 (2003: 23,688) shares under the ESPP and employees subscribed to approximately 21,000 common shares which will be issued during fiscal 2005 at a price of \$9.41. Since inception and including the issuance of shares in 2004, 163,755 shares have been issued under the plan.

During the twelve-month period ending September 30, 2004, the Company recorded a compensation expense of \$41 relating to its Employee Share Purchase Plan.

### 9. Earnings Per Share

The diluted weighted average number of shares has been calculated as follows:

|   | 2004      | 2003      |
|---|-----------|-----------|
| Weighted average number of common shares - basic                      | 8,389,220 | 8,047,748 |
| Additions to reflect the dilutive effect of<br>employee stock options | 188,918   | 342,074   |
| Weighted average number of common shares - diluted                    | 8,578,138 | 8,389,822 |

Options that are anti-dilutive because the exercise price was greater than the average market price of the common shares are not included in the computation of diluted earnings per share. For 2004, no stock options were excluded from the above computation of diluted weighted average number of common shares because they were anti-dilutive (2003: 45,600).

### 10. Contingencies

The Company is party to several claims aggregating approximately \$120, which are being contested. The potential outcomes of these matters are not determinable at this time. The Company intends to defend these actions, and management believes that the resolution of these matters will not have a material adverse effect on the Company's financial condition.

In prior years the Company received assistance from the Government of Canada relating to research and development activities amounting to approximately \$2,648. This assistance may be repayable based on future sales of the projects funded. A liability will be recognized in the period in which conditions arise that cause repayment. At September 30, 2004 no provision for payment is required.

### 11. Commitments

The Company has lease agreements with terms extending to the year 2010. The aggregate minimum rental payments under these arrangements are as follows:

|                  |    |       |
|------------------|----|-------|
| 2005             | \$ | 3,119 |
| 2006             | \$ | 3,114 |
| 2007             | \$ | 3,024 |
| 2008             | \$ | 3,011 |
| 2009             | \$ | 2,453 |
| Subsequent years | \$ | 1,907 |

As part of its e-business strategy, during the year 2000, the Company entered into a 10-year lease for an office building in the Ottawa area extending to April 2010. Upon exit of the e-business sector in 2001, the Company did not have any requirements for the space and accordingly sublet the excess space to a third party for a period of five years ending May 2006. In the event the sub-lessee defaults on the payment or the Company cannot sublet the premises for the remaining four years, Calian will be required to assume the lease including related operating costs for the remaining term of the lease. The lease payments including operating costs relating to the excess space amount to approximately \$960 per year.

# Calian Technology Ltd.

## Notes to the Consolidated Financial Statements

As at September 30, 2004 and 2003

(dollars in thousands, except per share data)

### 12. Guarantees

In the normal course of business, the Company enters into agreements that may provide for indemnification and guarantees to customers in transactions such as staffing, outsourcing and engineering. These indemnification undertakings and guarantees may require the Company to compensate customers for costs and losses incurred as a result of various events, including breaches of representations and warranties, intellectual property right infringement, claims that may arise while providing services, or as a result of litigation that may be suffered by customers. The Company mitigates its responsibility by removing from its contracts clauses relating to liability for indirect or special damages such as loss of revenue or profit in all of its engineering agreements. The Company also mitigates the risk of loss by including similar indemnification clauses in the agreements entered into with its subcontractors. The term and nature of these indemnifications vary based upon the agreement, which often provides no limit. Consequently, the Company is unable to make a reasonable estimate of the maximum potential amounts that the Company could be required to pay to its customers. Historically, the Company has not been obligated to make significant payments under these indemnification clauses.

### 13. Segmented Information

Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision maker, regarding how to allocate resources and assess performance. The Company's chief operating decision maker is the Chief Executive Officer.

The Company operates in two reportable segments described below, defined by their primary type of service offering, namely Systems Engineering and Business and Technology Services.

- Systems Engineering involves planning, designing and implementing solutions that meet a customer's specific business and technical needs, primarily in the satellite communications sector.
- Business and Technology Services involves both short and long-term placements of personnel to augment customers' workforces as well as the long-term management of projects, facilities and customer business processes.

The Company evaluates performance and allocates resources based on earnings before interest and income taxes. The accounting policies of the segments are the same as those described in Note 2.

#### For the Fiscal Year ending September 30, 2004

|  | Systems<br>Engineering | Business and<br>Technology<br>Services | Corporate | Total      |
|--|------------------------|--|-----------|------------|
| Revenues   | \$ 83,942              | \$ 85,765                              | \$ -      | \$ 169,707 |
| Operating expenses   | 68,539                 | 82,328                                 | 1,664     | 152,531    |
| Amortization   | 659                    | 647                                    | -         | 1,306      |
| Earnings before other income, interest and<br>income tax expense | 14,744                 | 2,790                                  | (1,664)   | 15,870     |
| Gain on sale of investment                                       |                        |  |           | 741        |
| Interest income, net   |                        |  |           | 467        |
| Income tax expense   |                        |  |           | 5,884      |
| Earnings from continuing operations                              |                        |  |           | 11,194     |
| Discontinued operation   |                        |  |           | 756        |
| Net earnings   |                        |  |           | \$ 10,438  |
| Total assets other than cash and goodwill                        | \$ 11,014              | \$ 19,872                              | \$ 691    | \$ 31,577  |
| Goodwill   | -                      | 5,923                                  | -         | 5,923      |
| Cash   |                        |  |           | 30,997     |
| Total Assets   |                        |  |           | \$ 68,497  |
| Capital asset expenditures                                       | \$ 592                 | \$ 336                                 | \$ -      | \$ 928     |



# Calian Technology Ltd.

## Notes to the Consolidated Financial Statements

As at September 30, 2004 and 2003

(dollars in thousands, except per share data)

### 13. Segmented Information (Continued)

For the Fiscal Year ending September 30, 2003

|  | Systems<br>Engineering | Business and<br>Technology<br>Services | Corporate | Total      |
|--|------------------------|--|-----------|------------|
| Revenues   | \$ 50,398              | \$ 90,642                              | \$ -      | \$ 141,040 |
| Operating expenses                                 | 43,351                 | 86,482                                 | 1,573     | 131,406    |
| Amortization                                       | 686                    | 530                                    |           | 1,216      |
| Earnings before interest and income tax<br>expense | 6,361                  | 3,630                                  | (1,573)   | 8,418      |
| Interest income, net                               |                        |  |           | 364        |
| Income tax expense                                 |                        |  |           | 3,454      |
| Earnings from continuing operations                |                        |  |           | 5,328      |
| Discontinued operation                             |                        |  |           | 480        |
| Net earnings                                       |                        |  |           | \$ 4,848   |
| Total assets other than cash and goodwill          | \$ 15,685              | \$ 19,851                              | \$ 100    | \$ 35,636  |
| Goodwill   | -                      | 3,246                                  | -         | 3,246      |
| Cash   |                        |  |           | 25,185     |
| Total assets                                       |                        |  |           | \$ 64,067  |
| Capital asset expenditures                         | \$ 765                 | \$ 279                                 | \$ -      | \$ 1,044   |

The Company's revenues from all foreign countries represent approximately 47% in fiscal 2004 and 31% in fiscal 2003. Revenues from external customers are attributed as follows:

|               | 2004 | 2003 |
|---------------|------|------|
| Canada        | 53%  | 69%  |
| United States | 31%  | 12%  |
| Europe        | 16%  | 19%  |

Revenues are attributed to foreign countries based on the location of the customer. No significant assets are held outside of Canada.

Revenues from various departments and agencies of the Canadian federal government represented 28% (2003: 38%) of the Company's total revenues. Both operating segments conduct business with this major customer.

In 2004, revenue from a certain customer in the call-centre business accounted for 17% of the Company's total revenues (2003: 21%), all from the Business and Technology Services segment.

In 2004, revenue from a certain customer in the surveillance and security market accounted for 22% of the Company's total revenues (2003: 4%), all from the Systems Engineering segment.

# Calian Technology Ltd.

## Notes to the Consolidated Financial Statements

As at September 30, 2004 and 2003

(dollars in thousands, except per share data)

### 14. Financial Instruments and Risk Management

The Company is exposed to foreign currency fluctuations on its cash balance, accounts receivable, accounts payable and future cash flows related to contracts denominated in a foreign currency. Future cash flows will be realized over the life of the contracts.

The Company uses financial instruments, principally in the form of forward exchange contracts, in its management of foreign currency exposures. These contracts primarily require the Company to purchase or sell certain foreign currencies with or for Canadian dollars at contractual rates. At September 30, 2004, the Company had the following forward foreign exchange contracts:

| Type | Amount  | Currency | Maturity     | Equivalent<br>Cdn. Dollars |
|------|---------|----------|--------------|----------------------------|
| SELL | 13,602  | USD      | October 2004 | 17,702                     |
| BUY  | (3,819) | USD      | October 2004 | (4,970)                    |
| SELL | 9,263   | EURO     | October 2004 | 14,683                     |
| BUY  | (6,332) | EURO     | October 2004 | (10,037)                   |
| BUY  | (39)    | GBP      | October 2004 | (90)                       |

The fair value of the financial instruments at September 30, 2004 is \$431 (2003: \$163).

The Company is exposed to credit-related losses in the event of non-performance by counter-parties to derivative financial instruments but does not expect any counter-parties to fail to meet their obligations. The Company only deals with major financial institutions.

### 15. Pension Plan

The Company sponsors a defined contribution pension plan for its employees. Required contributions have been fully funded to September 30, 2004. For the year ended September 30, 2004, an amount of \$519 (2003: \$496) was expensed related to this pension.

### 16. Business Acquisition

On September 7, 2004, the Company acquired 100% of the outstanding shares of Titan Consulting Group Ltd. (Titan). Titan specializes in delivering skilled SAP, PeopleSoft, Oracle and Siebel professionals to industry and government on a cost plus model to private and public sector clients. The purchase price is based on the book value of assets and liabilities as of the date of acquisition plus a multiple of 4.5 times Titan's earnings before interest, taxes and amortization (EBITDA) of up to \$1,567 and 1 times EBITDA in excess of \$1,567 achieved during the period September 1, 2004 to August 31, 2005. The purchase price will be satisfied with 90% cash and the balance through the issuance of common shares.

On September 7, 2004, the Company paid \$691 for the book value of the assets and liabilities as of the date of acquisition and \$3,611 as an advance payment on the earnout amount. This amount is recorded based on the fact that management believes beyond a reasonable doubt that Titan can achieve the level of earning commensurate with this payout. The Company has not accrued the shares that would be issuable upon achievement of this earnings level, due to the fact that the number of shares is unknown as it is based on the market price of the shares as at September 30, 2005. Based on the earnings level the Company believes beyond a reasonable doubt will be met and the share price as at September 30, 2004, 34,822 shares would be issuable.

# Calian Technology Ltd.

## Notes to the Consolidated Financial Statements

As at September 30, 2004 and 2003

(dollars in thousands, except per share data)

### 16. Business Acquisition (Continued)

The acquisition has been accounted for using the purchase method of accounting and accordingly, the purchase price was allocated to the assets and liabilities based on their estimated fair values as of the acquisition date. The results of operations relating to the acquisition have been included in the consolidated financial statements from the effective date of acquisition.

The following table summarizes the purchase price allocation that was determined by the Company based on internal appraisals of the fair value of the tangible and intangible assets acquired.

|  |          |
|--|----------|
| Non-cash working capital                               | \$ 1,426 |
| Capital assets   | 70       |
| Intangibles (Note 6)                                   | 1,482    |
| Long-term debt   | (805)    |
| Future income tax liability                            | (548)    |
| Goodwill   | 2,677    |
| Purchase Price   | \$ 4,302 |
| <hr/>  |          |
| Consideration: Net cash, including cost of acquisition | \$ 4,302 |

Following the completion of the 12-month earnout period, the balance of the cash and shares are to be calculated and paid during the first six months of fiscal 2006. The final purchase price will be determined and accounted for as an incremental cost of the acquisition resulting in an increase to goodwill.

### 17. Discontinued Operation

During the year, the Company revised its estimate of the provision for future costs relating to the discontinued e-business operation and recorded an additional charge of \$1,200 (\$756 after tax). During 2003, the Company recorded a similar adjustment to the provision for \$750 (\$480 after tax). These charges represent non-cash transactions. These adjustments bring the total provision related to the discontinued operation to \$2,300 as at September 30, 2004 (2003: \$1,100). During 2004, the Company received lease revenues of \$955 (2003: \$923).

### 18. Comparative Figures

Certain of the comparative figures have been reclassified to conform to the financial statement presentation adopted this fiscal year.

# Notes

# Corporate Information

## Corporate & Business and Technology Services Division Office

Calian Centre  
2 Beaverbrook Road  
Kanata, Ontario, Canada K2K 1L1  
Phone: 613.599.8600  
Fax: 613.599.8650  
Web: [www.calian.com](http://www.calian.com)

## Ottawa Downtown Office

123 Slater Street  
Suite 150  
Ottawa, Ontario, Canada K1P 5H2  
Phone: 613.238.2600  
Fax: 613.238.3831

## Toronto Office

1 City Centre Drive  
7th Floor  
Mississauga, Ontario, Canada L5B 1M2  
Phone: 905.848.2818  
Fax: 905.848.4944

## Systems Engineering (SED)

P.O. Box 1464  
18 Innovation Blvd.  
Saskatoon, Saskatchewan, Canada  
S7K 3P7  
Phone: 306.931.3425  
Fax: 306.933.1486  
Web: [www.sedsystems.ca](http://www.sedsystems.ca)

## Systems Engineering - Calgary

1-2315 30th Avenue N.E.  
Calgary, Alberta, Canada T2E 7C7  
Phone: 403.717.4290  
Fax: 403.250.1011

## United States Office

7960 Donegan Drive  
Suite 223  
Manassas, Virginia, USA 20109  
Phone: 703.392.4950  
Fax: 703.392.0980

## Board of Directors

Larry O'Brien  
Chairman and CEO  
Calian Technology Ltd.

Major General (retired) C. William Hewson  
Consultant  
Lead Director

Kenneth J. Loeb  
President, Capital Box of Ottawa Limited  
Chair of the Governance Committee

David Tkachuk  
Senator  
Chair of the Compensation Committee

Richard Vickers, FCA  
Consultant  
Chair of the Audit Committee

All directors are members of the Audit Committee, the Compensation Committee and the Governance Committee with the exception of Larry O'Brien who is a member of the Governance Committee only.

## Common Share Information

The Company's common shares are listed for trading on the Toronto Stock Exchange under the symbol CTY.

## Dividend Policy

The Company intends to continue to declare a quarterly dividend in line with its overall financial performance and cash flow generation. Decisions on dividend payments are made on a quarterly basis by the Board of Directors. There can be no assurance as to the amount of such dividends in the future.

## Annual Meeting of Shareholders

The Annual General Meeting of the Shareholders of Calian will be held on February 2, 2005 at 3:00 p.m. at the Brookstreet Hotel, Kanata, Ontario, Canada. All shareholders are invited to attend. The telephone number of the Brookstreet Hotel is 613.271.1800.

