

# MANAGEMENT'S DISCUSSION AND ANALYSIS

## Third Quarter, 2008

*This Management's Discussion and Analysis ("MD&A") explains the financial condition and results of operations of Atlantis Systems Corp. ("Company" or "we" or "our" or "us" or "ASC") as at and for the three months and nine months ended September 30, 2008 with comparisons to the three months and nine months ended September 30, 2007 and the year ended December 31, 2007, where applicable. This MD&A is intended to assist shareholders and other readers to understand our business and the key factors underlying our financial results. This MD&A should be read in conjunction with our unaudited consolidated financial statements and the accompanying notes as at and for the three months and nine months ended September 30, 2008 and 2007 and the audited annual consolidated financial statements, including the notes, for the year ended December 31, 2007. We prepare our consolidated financial statements in accordance with Canadian generally accepted accounting principles ("GAAP"). This MD&A is based on information available as at November 13, 2008 except where otherwise noted.*

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## **GLOSSARY OF TECHNICAL TERMS** <sup>(1)</sup>

Certain technical terms used in this Management Discussion and Analysis are defined as follows:

“ASA” is defined as Atlantis Systems America, Inc.

“ASC” is defined as Atlantis Systems Corp.

“ASE” is defined as Atlantis Systems Eduplus, a separate division of ASC.

“ASI” is defined as Atlantis Systems International Inc.

“CF” is defined as Canadian Forces.

“CFTS” is defined as contracted flying training and support.

“CPT” is defined as cockpit procedures trainer.

“DND” is defined as Canadian Department of National Defence.

“EBITDA” is defined as consolidated net income before interest, taxes, depreciation, amortization and non-cash charges and expenses other than accruals made in the normal course of business less any dividends on capital distribution.

“Eduplus” is defined as the Eduplus division of Tecslut Inc., acquired by ASC in the third quarter of 2007

“GAAP” is defined as Canadian generally accepted accounting principles.

“HVTT” is defined as helicopter virtual task trainer.

“IMTS” is defined as integrated maintenance training system.

“PWU” is defined as Power Workers’ Union

“PWUTI” is defined as Power Workers’ Union Training Inc.

“RDAF” is defined as Royal Danish Air Force.

“SMHP” is defined as Sikorsky Maritime Helicopter Program.

**(1) The definition of the technical terms in this table are incorporated into the remainder of this document**

## 1. SUMMARY

- Revenue for the three months ended September 30, 2008 was \$3.0 million, a decrease of \$1.2 million from the \$4.2 million recognized in the second quarter of 2008, and a decrease of 55.7% from the \$6.8 million in the same quarter in the previous year.
- Revenue for the nine months ended September 30, 2008 was \$11.6 million, a 58.4% decrease from the \$27.8 million in the same period in the prior year
- The net loss in the third quarter of 2008 was \$2.5 million, compared to a net loss for the second quarter of 2008 of \$2.3 million and a net loss of \$1.6 million for the third quarter of 2007.
- The net loss for the nine months ended September 30, 2008 was \$7.2 million, compared to a net loss of \$0.7 million for the same period in 2007.
- In the second quarter of 2008 the Company's shareholders' elected four new members to its board of directors who have now in partnership with senior management changed our strategic focus to broaden the value we provide to our existing customer base.
- We have received two new orders for the Energy Sector from Bruce Power; in July 2008 for simulator training on a time and material basis and in October 2008 for \$125,000 to provide a safety system upgrade.
- The order backlog at September 30, 2008 was \$30.2 million, which includes \$17.6 million for the CFTS support services to be recognized over the next 19 years and \$7.5 million for the SMHP. This compares to \$32.1 million at June 30, 2008, which included approximately \$17.8 million for the CFTS support services and \$7.7 million for the SMHP, and \$36.4 million at December 31, 2007, which included approximately \$18.3 million for the CFTS support services and \$8.6 million for the SMHP.
- As at September 30, 2008 the Company was not in compliance with a covenant which defines the six month rolling EBITDA minimum requirement pursuant to a financing arrangement that included a secured term loan ("Term Loan") and a secured operating line of credit ("Operating Line") provided by ComVest Capital LLC ("ComVest"). In addition as at September 30, 2008 the Company had exceeded the maximum borrowing limit per the terms of this Agreement. ComVest has agreed to waive compliance for the reporting period ended September 30, 2008 for both the breach of covenant and exceeding the maximum borrowing limit.
- It has become increasingly difficult to forecast future revenues due to the complexity of the purchasing decision making process in the military sector, our status as a subcontractor and the large size of individual contracts relative to our lower revenue

base. Accordingly, the Company withdraws its revenue guidance previously provided and does not plan to provide future revenue guidance until further notice.

## 2. FORWARD-LOOKING STATEMENTS

Forward-looking statements look into the future and provide an opinion about the effect of certain events and trends on the business. Forward-looking statements may include words such as “plans”, “intends”, “anticipates”, “should”, “estimates”, “expects”, “believes”, “indicates”, “targeting”, “suggests” and similar expressions.

This MD&A, and in particular the Business Outlook for the remainder of 2008 on page 27, contains forward-looking statements. These forward-looking statements are based on current expectations and various estimates, factors and assumptions, and involve known and unknown risks, uncertainties and other factors. For information regarding risks and uncertainties that could affect our business, please see the Description of the Business – Risk Factors section in our Annual Information Form, and the section filed in our MD&A for the year ended December 31, 2007 contained in our 2007 Audited Financial Statements, both of which are available on the System for Electronic Data and Retrieval (“SEDAR”) at [www.sedar.com](http://www.sedar.com)

It is important to note that:

- Unless otherwise indicated, forward-looking statements in this MD&A describe our expectations as of November 13, 2008.
- Readers are cautioned not to place undue reliance on these statements as our actual results, performance or achievements may differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements if known or unknown risks, uncertainties or other factors affect our business, or if our estimates or assumptions prove inaccurate. Therefore, we cannot provide any assurance that the predictions of forward-looking statements will materialize.
- We assume no obligation to update or revise any forward-looking statement, whether as a result of new information, future events or for any other reason, except as required by applicable securities laws and regulations.

Additional information regarding our Company is contained in filings with securities regulatory authorities, including our Annual Information Form and Management Information Circular. These documents are available on SEDAR or on our website at [www.atlantissi.com](http://www.atlantissi.com).

***All amounts, with the exception of Section 1, Summary, are stated in thousands of Canadian dollars, except per share amounts, unless otherwise noted. All tabular amounts are expressed in thousands of Canadian dollars, except per share amounts. All non dollar values are as stated.***

***The definitions in the glossary of technical terms are incorporated into the remainder of this document.***

### 3. WHO WE ARE

Since our Company was founded 30 years ago, we have developed into a well recognized provider of simulation-based training technology primarily targeted to the military and commercial aviation industries, where we have gained a solid reputation for our technological capabilities and innovative solutions. Recently, we have expanded into the energy industry.

In June 2008, we announced a joint venture with the PWUTI to create Powertrain, which is focused on becoming a “Centre of Excellence” in training for the global energy sector. Powertrain will initially focus on addressing the growing need for enhanced training, operational efficiency and knowledge management in the nuclear industry.

In past several years, the Company has broadened its capabilities and core competencies which include: simulation, e-learning and knowledge management systems and expertise, hardware and software integration and virtual reality. We are focused on performance outcomes and on the means for ensuring optimal performance enhancement that can be measured and sustained. Subject matter expertise in both training and learning ensures that we deliver the performance results expected by our customers.

As discussed further in Section 6 of this MD&A, we have changed our strategic focus, and positioning, to leverage these recently enhanced core competencies in order to broaden the value we provide to our military and energy sector customers. We plan to now target the whole of our customers’ value-chain, not just training, by providing simulation solutions as early as product design, assisting with rapid prototyping, supporting end-user sales, and continuing through to the delivery of our traditional training systems.

We are headquartered in Brampton, Ontario and maintain offices in Orlando, Florida and Halifax, Nova Scotia. Powertrain is headquartered in Toronto and maintains an advanced nuclear training facility in Tiverton, Ontario.

#### *Our Core Values*

- Quality – we focus on our customers, their requirements and expectations.
- Innovation – we use responsible creativity to craft the best solutions.
- Integrity – we act ethically in our professional endeavours.
- Accountability – we are responsible and meet our commitments.
- Teamwork- we believe in spirited collaboration.

### 4. OUR TRADITIONAL MARKETS

#### *Military*

Our roots are in the military and we will continue to strengthen our position in this market.

There are a number of important trends in the military that favour the services we provide:

- there is a trend towards outsourcing to better manage military budgets and to encourage more innovative training solutions;
- expected high levels of attrition across armed forces creates a requirement to train more qualified technicians and trainers in less time;
- the nature of warfare is changing and the use of sophisticated computer systems in communications, weapons delivery and networking lends itself perfectly to the use of synthetic training and performance based learning systems;
- with the advent of more powerful computers, more sophisticated peripheral technology and enhanced graphics, the realism in simulation has resulted in an ever-increasing acceptance of this learning approach by the military; and
- the cost of simulation technology has been drastically reduced making it much more affordable to a wider base of applications and users.

The CF have an unprecedented number of major acquisition programs either underway or planned including new airlift airframes, modernization of the frigates, new multi-purpose ships, new trucks and tanks, a replacement fixed-wing search and rescue platform and arctic patrol boats, as well as other recently announced programs. All of these programs will require performance critical learning systems. Our capabilities position us well to capture a significant share of the training dollars for these programs.

The US military spends about US \$500 billion per year and accounts for approximately 50% of the global military spending. Our presence in this market is not only important because of the sheer size of the market but also because the US military can dictate or strongly influence who can be a supplier of goods and services for US military sales to foreign governments. To access this market directly it was essential to establish a presence in the US, gain the required security clearances and meet US government procurement policies. ASA was created for this purpose.

### *Energy*

From the early 1970s to the mid 1980s, nuclear energy in the US grew from about 2% to 19% of electrical supply and has remained relatively constant since that time due to heightened societal concerns about nuclear energy. We believe that this observation has several interesting implications for the Company:

- a significant number of these facilities have reached an age where major retrofits and upgrades are required to serve existing power demand; and
- the societal concerns around nuclear safety and the subsequent reduction in capacity at existing plants, coupled with the lack of new plants being built since the mid 1980s has resulted in both a lack of jobs and the reduction of formal training programs at many colleges and universities as fewer people were entering the nuclear industry.

The increased demand for reduced carbon emissions is prompting a renaissance of nuclear energy as the only viable source in large quantities of emission free energy. This anticipated increase in demand, as well as the demand for retrofits, major upgrades and the impending attrition or retirement of a significant portion of an aging workforce are expected to result in a significant training requirement.

The need to reduce carbon emissions is generating significant interest in emission free generation of electricity. In 2006, nuclear energy and hydro accounted for 73% and 25% respectively of the US sources of emission free generation. Other emission free sources such as solar, wind and geothermal accounted for only 2.6% of the emission free generation. While these other sources will continue to grow, it is our belief that nuclear energy is the only viable cost effective vehicle to deliver substantial emission free power for the foreseeable future.

Globally, the nuclear power industry is entering a significant growth phase, with 30 new reactors under construction and another 300 are being planned or proposed. In Ontario alone, it is estimated that \$26 billion will be spent on the building of new nuclear facilities and the rehabilitation of existing operations over the next 20 years. This expected growth has created a significant human resources challenge for the industry as a high percentage of skilled operators and other employees are nearing retirement age. In Canada, for example, 38% of the workforce is over the age of 50.

Atlantis secured its first orders for this market in 2006 and 2007 and in the second quarter of 2008 announced an important joint venture with the PWUTI to create Powertrain – a “Centre of Excellence” in training for the global energy sector. Powertrain is initially focusing on addressing the growing need for enhanced training, operational efficiency and knowledge management in the nuclear industry.

### *Civil Aviation*

We have been involved with the civil aviation industry since our inception, and continue to view this market with interest. We expect the coming years will bring an unprecedented worldwide shortage of qualified commercial pilots due to the following trends:

- a significant global growth in civil aviation that is expected to continue;
- a significant proportion of the pilot population is approaching retirement age; and
- fewer military pilots are transferring to civil aviation.

The Boeing Company estimates that 29,000 new airliners are required by 2026, for a staggering market value of US \$2.8 trillion. It estimates that these new planes will require an additional 18,000 new pilots every year for the next 20 years, for a total of 360,000 new pilots.

Our flight training devices, cockpit procedures trainers and flight simulators are installed and operating around the world, and we will continue to take a keen interest in the civil aviation industry worldwide.

Over the last several years, we have invested in developing the HVTT, our virtual-reality, full-

motion helicopter simulator, in order to provide full flight simulation training at a fraction of the cost of full flight simulators. Field tests are expected to commence in the near future.

#### *Other Potential Markets*

We believe that there are numerous other markets that would benefit from our synthetic learning systems. These include the medical industry, complex industrial facilities and the transportation industry. We do not intend to actively pursue these industries at this time unless an unexpected opportunity arises.

## 5. OUR TRADITIONAL TRAINING ORIENTED VALUE EQUATION

We believe that our integrated training systems and learning solutions allow our customers:

- to train students economically;
- to significantly reduce instructor-to-student ratio;
- to significantly reduce the cost of training by freeing up expensive assets such as fighter planes and full flight simulators through the use of simulation and virtual reality;
- to speed up the learning process and enhance the quality of learning through continuous performance assessment, feedback mechanisms and the realism of the training simulation;
- to maintain training consistency and discipline between groups that trained at different times and by different instructors;
- to pre-screen students for their suitability in the operational roles; and
- to cost effectively update their training programs.

## 6. OUR NEW STRATEGIC DIRECTION

In the past quarter, we have changed our strategic focus, and positioning, to leverage our core competencies and existing technologies in order to broaden the value we provide to our existing customer base. We are now targeting the whole of our military and energy sector customers' value-chain, not just training, which has historically been our focus. We intend to implement strategic account management practices in order to better focus our business development and R&D activities to capitalize on the many additional opportunities we have to use simulation methods to service the full life cycle of our customers' products. We plan to provide our simulation solutions commencing with product design, assisting with rapid prototyping, supporting end-user sales, and continuing through to the delivery of our traditional training systems. This strategy will allow our customers to better develop end-user capabilities and improve their asset utilization.

The Company is aggressively pursuing new business opportunities that align with its new strategic direction.

Near-term priorities for the Company include:

- Structural alignment to support new business model
- Fill gaps in resource requirements
- Restructure sales organization to develop strategic account management
- Secure key strategic partnerships
- Increased emphasis and investment in nuclear
- Secure targeted organic business

## 7. OTHER COMPANY INFORMATION

We are registered under a number of quality management programs including ISO 9001:2000, AS9100:2004, CSA-Z299.1-1985, Boeing BQMS D6-82479 and Rockwell Collins RC-9000, among others.

We operate in the US through our wholly-owned subsidiary ASA. We operate in Canada and the rest of the world through our wholly-owned subsidiary ASI, and the ASE division, a division of ASC.

At September 30, 2008, we had a total head count of 144, of which 27 were based at ASA in Orlando, Florida and 23 were with the ASE division in Halifax, Nova Scotia.

## 8. THE CFTS PROGRAM

Early in the second quarter of 2005, the Allied Wings consortium was awarded a \$1.77 billion contract for the CFTS program by the DND and the CF to provide the design, development, installation, operation and support for the CFTS ground-based training system in Southport, Manitoba over approximately a twenty-three year period. Atlantis is one of the five members of the Allied Wings consortium with Kelowna Flightcraft Ltd. (“Kelowna”) as the prime contractor.

Our portion of the contract, which started in 2005, is currently expected to generate approximately \$72.0 million in revenues for the initial phase and a further approximately \$18.2 million (including amounts recognized to date) for the twenty-year support services phase. The expected costs to complete both the initial phase and the support program are reviewed regularly by project management and as a result, the respective final contract values are subject to fluctuation. The initial phase of our contribution to the CFTS program involves the provision of an integrated training solution to the consortium. We, including ASA, are developing and manufacturing some components of this solution (“in-house” portion), while a significant portion will be provided by other companies (“subcontractor” portion).

Throughout the first three quarters of 2008 we have continued to deliver on our commitments under the CFTS program. To date, we have recognized revenues of \$16.8 million, \$26.3 million, \$22.6 million and \$4.0 million in 2005, 2006, 2007 and the first three quarters of 2008, respectively, for a total of \$69.7 million. The unrecognized remainder on the contract of

approximately \$20.5 million includes \$17.6 million for the 20-year support phase that commenced in the fourth quarter of 2007. The support revenues have been combined with the initial phase revenues for subsequent presentation in this document.

## 9. COST REDUCTION PLAN

The Company initiated a cost reduction plan in the fourth quarter of 2007. The cost reduction plan was aimed at reducing costs and overall operating expenses by approximately 15% annually. Workforce reductions and other cost cutting measures were expected to result in annualized savings of approximately \$6.4 million, with expected savings from the plan for 2008 at approximately \$4.0 million. Through September 30, 2008, the cost reductions we have achieved are consistent with the plan.

The cost reduction plan has not, nor is expected to, impact the Company's ability to execute current contracts or pursue or execute new opportunities that have been identified. Workforce reductions are primarily focused on non-revenue generating positions. While the Company has executed its plan to reduce costs at its ASA operations it expects to continue to maintain a presence in the US and retain the security clearances required to meet US government procurement policies.

## 10. POWERTRAIN

We reached an important milestone in our energy market strategy with the announcement, in June 2008, of a joint venture with the PWUTI, a wholly-owned subsidiary of the Power Workers' Union. Under this joint venture, we created a new company called Powertrain, which is focused on becoming a "Centre of Excellence" in training for the global energy sector. Powertrain is headquartered in Toronto and will maintain an advanced nuclear training facility in Tiverton, Ontario.

Powertrain will initially focus on addressing the need for enhanced training, operational efficiency and knowledge management in the nuclear industry. Powertrain is currently developing a unique, fully integrated, systematic approach to training that will employ simulations, e-learning and knowledge management applications for capturing industry-critical knowledge and know-how from experts in the field, and feeding this back to the students in physical and virtual classrooms to significantly enhance the relevancy of the training experience.

We believe that PWUTI's intimate knowledge of the industry and established relationships, coupled with our expertise in simulation, virtual reality and e-learning, will facilitate Powertrain's acceptance and its penetration in the large and growing energy market.

Powertrain is equally owned and jointly operated by Atlantis Systems Corp. and PWUTI. Atlantis will be contributing intellectual property related to maintenance training, e-learning and knowledge management. PWUTI will be contributing an investment of approximately \$1.6 million in three equal tranches within the next two years. As a result of our new strategic direction, and further discussions with respect to certain terms and conditions, the funding by PWUTI has been delayed.

Under the terms of the Shareholders Agreement, Powertrain will provide a scientifically based, technologically advanced, and an academically supported solution to the energy industry's training needs in the face of the looming decline in the available workforce. Powertrain will augment our training systems with industry experts, consulting services and subject matter expertise in the areas of training, learning and knowledge management. Powertrain is currently engaged in conducting feasibility studies for seven distinct training related projects in the energy sector.

## 11. RESULTS OF OPERATIONS

The following is a discussion of the material factors influencing the operating results and the financial condition of our Company, as at, and for the three and nine months ended September 30, 2008 with comparisons to the three months and nine months ended September 30, 2007, where applicable.

The Consolidated Statements of Operations, Comprehensive Loss and Deficit for the three and nine months ended September 30, 2008, with comparative numbers for the same periods in 2007 reflect the operations of our operating entities, ASI, ASA and ASE (a division of ASC) and corporate overheads.

### Summary Financial Information

	Three months ended		Nine months ended	
	September 30, 2008	September 30, 2007	September 30, 2008	September 30, 2007
Revenues	2,989	6,750	11,573	27,820
Gross margin	187	1,081	748	7,812
Gross margin percentage	6.3%	16.0%	6.5%	28.1%
Operating expenses <sup>(1)</sup>	1,919	2,425	5,680	8,106
Depreciation and amortization	517	286	1,569	610
Interest expense and financing costs (income), net	281	(38)	668	(207)
Net (loss) income	(2,530)	(1,594)	(7,169)	(698)
Net (loss) income per share (basic)	(0.05)	(0.03)	(0.13)	(0.01)
Total assets	21,214	30,716	21,214	30,716

<sup>(1)</sup> Includes selling and marketing, general and administrative, and stock option expense

## 12. GOING CONCERN ASSUMPTION

*These consolidated financial statements have been prepared on a going concern basis which assumes that the Company will be able to meet its commitments, realize its assets and discharge its liabilities in the normal course of business*

*For the nine months ended September 30, 2008 the Company incurred a net loss from continuing operations of \$7,169, and has a working capital deficiency of \$3,762 and deficit of \$86,132 as at September 30, 2008. This casts substantial doubt on the Company's ability to continue as a going concern. Continuation of the Company as a going concern is dependent upon achieving*

profitable operations, and the ability of the Company to obtain additional financing when necessary.

If the going concern assumption were not appropriate for these financial statements, adjustments would be necessary in the carrying values of assets and liabilities, the reported net loss and the balance sheet classifications used.

In the opinion of management, all adjustments considered necessary for fair presentation of the Company's financial position, results of operations and cash flows have been included. Operating results for the nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for any future periods.

### 13. REVENUE

#### Third Quarter

The components of revenue for the three months ended September 30, 2008 and 2007 are as follows:

	Three months ended September 30					
	2008		2007		Change	
	\$	%	\$	%	\$	%
<b>US Defense Contractor</b>	865	29%	260	4%	605	233%
<b>SMHP</b>	674	23%	-	0%	674	
<b>RDAF</b>	319	11%	1,402	21%	(1,083)	-77%
<b>CFTS</b>	312	10%	4,340	64%	(4,028)	-93%
<b>Energy Sector</b>	242	8%	91	1%	151	166%
<b>IMTS</b>	24	1%	371	5%	(347)	-94%
<b>Other</b>	553	18%	286	5%	267	93%
<b>Total</b>	2,989	100%	6,750	100%	(3,761)	-56%

We realized consolidated revenues of \$2,989 in the third quarter of 2008, a decrease of \$3,761, or 55.7% from the same period in 2007, primarily due to a decrease of \$4,028 for the CFTS program. The components of the decrease in revenue are summarized in the above table.

We began to recognize revenues from the CFTS program in the second quarter of 2005. For the CFTS program, we recognize revenue based upon the work performed in-house, materials used, and the achievement of milestones by our subcontractors on the program.

Through to the end of the third quarter of 2008, we have cumulatively recognized \$69.7 million of revenue out of a total contract value of \$90.2 million from the CFTS program. We expect ASA and ASI to continue to develop and deliver courseware for the CFTS program through the end of the fourth quarter of 2008. The CFTS program for the initial production portion of the project entered into its mature phase in the second half of 2007, and revenues from this program have correspondingly declined in subsequent quarters.

The CFTS contract value also includes approximately \$17.6 million remaining in support services that will be recognized over the next 19 years. The 20 year service program started in the fourth quarter of 2007.

In the third quarter of 2006, we were awarded a contract to provide a CPT to the RDAF for the EH-101 helicopter through prime contractor AgustaWestland. The program is expected to be completed in 2008. Revenues of \$1,475, \$5,072 and \$2,229 were recognized for this program in the first three quarters of 2008, 2007 and 2006, respectively. Revenues decreased in the three months ended September 30, 2008 compared to the same period in the prior year as a result of the expected decline in production as the project nears completion.

We acquired the SMHP contract with the completion of the Eduplus acquisition on September 27, 2007. ASE will provide the SMHP with training design, training documentation and courseware production. We recognized \$674 in revenue for the third quarter of 2008 (2007 – nil) from this project. Backlog at September 30, 2008 was \$7.5 million (2007: \$9.3 million) and we expect revenues from this project through 2011.

Revenues from customers in the energy sector increased in the third quarter of 2008 to \$242, a 166% increase from the same period in the prior year.

We began targeting the training business associated with the energy sector in 2005. We currently have five contracts for hardware and software engineering services in order to provide training services for nuclear technicians and operators, of which one was signed in July 2008 and an additional contract in October 2008.

In the first quarter of 2008, we also signed a contract with a major partner in the energy sector and have subsequently delivered an IMTS for use as a prototype for training technicians in power plants. In the second quarter of 2008, we announced our joint venture with PWUTI to create Powertrain.

The Company recognized revenues of \$865 (2007: \$260) from one contract awarded to ASA from a US defense contractor in the third quarter of 2007, as well as two additional contracts awarded by the same contractor in the first quarter of 2008.

In the third quarter of 2008, revenues from IMTS for aerospace projects decreased to 1% of total revenues, or \$24, as compared to 5%, or \$371, for the same period in 2007. This decrease is primarily due to the completion of the initial phase of a contract to provide weapons load trainers to the CF in 2008. The CF awarded us with this contract in the third quarter of 2006 (which expanded our IMTS offering) for the CF-18 aircraft fleet, along with support services through 2020.

Other revenues in the third quarter of 2008 and 2007, of \$553 and \$286, respectively were derived from a number of small, short-duration contracts.

During the third quarter of 2008 we had contracts with multiple customers, however, two customers, a US defense contractor and Sikorsky Aircraft Corp. (“Sikorsky”) represented

28.8% (2007: 3.9%) and 22.5% (2007: 0%) of revenue, respectively. In addition, during the third quarter of 2008, two additional customers represented more than 10% of revenue; the RDAF and the CF represented 10.7% (2007: 20.8%) and 10.5% (2007: 69.8%) of revenue, respectively.

The order backlog at September 30, 2008 was \$30.2 million, and consisted of \$20.5 million from the CFTS program (including approximately \$17.6 million in CFTS support services), \$7.5 million from the SMHP, \$1.0 million from programs with a US defence contractor and \$1.2 million from all other contracts. The order backlog of \$30.2 million at September 30, 2008 has decreased \$11.2 million from the comparable backlog of \$41.4 million (which included \$18.4 million in CFTS support services for the twenty-year support period) at September 30, 2007. This order backlog decrease consisted of a \$5.6 million net reduction in the CFTS program, a \$2.2 million net reduction in the RDAF program, a \$1.8 million net reduction in the SMHP program and a \$1.6 million net decrease in order backlog from other projects. The reduction in backlog is primarily due to continued revenue recognition on all significant projects, without the Company securing substantial additional contracts.

We expect approximately 10% of the order backlog as at September 30, 2008 will be realized as revenue in the fourth quarter of 2008. Without including the order backlog of approximately \$17.6 million for CFTS support services to be recognized over the next 19 years, we expect approximately 24% of the order backlog as at September 30, 2008 will be realized as revenue in the fourth quarter of 2008. While we continue to believe our pipeline of opportunities is solid, we expect lower consolidated revenues in 2008 than experienced in 2007 due to the delays experienced to-date of the award of new programs.

Order backlog is defined as that portion of a legally binding commercial agreement that provides sufficient detail on our obligations and our customers' obligations to form the basis for a contract and an order that has not yet been recognized as revenue.

### *Nine months*

The components of revenue for the nine months ended September 30, 2008 and 2007 are as follows:

	Nine months ended September 30					
	2008		2007		Change	
	\$	%	\$	%	\$	%
<b>CFTS</b>	3,989	34%	19,682	71%	(15,693)	-80%
<b>SMHP</b>	1,860	16%	-	0%	1,860	
<b>US Defense Contractor</b>	1,634	14%	428	2%	1,206	282%
<b>RDAF</b>	1,475	13%	4,088	15%	(2,613)	-64%
<b>Energy Sector</b>	741	6%	273	1%	468	171%
<b>IMTS</b>	226	2%	1,783	6%	(1,557)	-87%
<b>Other</b>	1,649	15%	1,566	5%	83	5%
<b>Total</b>	11,573	100%	27,820	100%	(16,247)	-58%

The revenue for the nine months ended September 30, 2008 as compared to the same period in the prior year decreased by \$16,247, or 58.4%, primarily due to a decrease of \$15,693 for the

CFTS program. The components of the decrease in revenue are summarized in the above table.

The decreased revenue in the CFTS, RDAF and IMTS programs are primarily due to reduced production milestones on recently completed or nearly completed projects. The SMHP was acquired pursuant to the Eduplus acquisition at the end of the third quarter of 2007. The growth in the energy sector revenue in the nine months ended September, 30, 2008 represents revenue from contract renewals of our initial contract successes as well as one new contract in 2008. We began targeting this sector in 2005. The growth in revenues from a US defense contractor reflects a full year of activity in the contract awarded in the third quarter of 2007 and the ramp up this year of the two projects awarded to ASA in 2006.

During the nine months ended September 30, 2008, while we had contracts with multiple customers, our largest customer to-date, the CF, represented 34.5% (2007: 77.0%) of revenue, and 23.3% (2007: 22.6%) of our combined accounts receivable and unbilled revenue as at September 30, 2008. Other customers that represent more than 10% of revenue for the nine months ended September 30, 2008 are Sikorsky with 16.1% (2007: 0%), a US defense contractor with 14.1% (2007: 1.5%) and the RDAF with 12.7% (2007: 14.7%). As at September 30, 2008, these same three customers represented 15.1% (2007: 0%), 25.1% (2007: 10.5%), and 24.7% (2007: 44.6%), respectively, of combined accounts receivable and unbilled revenue.

## 14. GROSS MARGIN

### *Third Quarter*

Gross margin for the third quarter of 2008 was \$187, or 6.3% of revenue, versus \$1,081, or 16.0% of revenue, for the corresponding period in 2007. The lower gross margin percentage in the third quarter of 2008 was primarily the result of a significantly lower revenue base. In addition, included in the cost of revenue, are several indirect overheads that are independent of projects and therefore do not directly vary with revenue. Furthermore, the gross margin for the third quarter of 2008 was reduced by \$397 and \$232 as a result of reconfigured cost estimates to complete the CFTS and the RDAF programs, respectively.

### *Nine months*

Gross margin for the nine months ended September 30, 2008 was \$748, or 6.5% of revenue, as compared to \$7,812, or 28.1% of revenue, for the corresponding period in 2007. The lower gross margin percentage in 2008 was primarily the result of a significantly lower revenue base and the impact of absorbing non-variable overhead on this lower revenue base. In addition, the gross margin for the nine months ended September 30, 2008 was reduced by \$909 and \$400 as a result of reconfigured cost estimates to complete the CFTS and the RDAF programs, respectively.

Gross margin for the nine months ended September 30, 2007 included additional revenue of \$1,815 as a result of updated project cost estimates for the CFTS program. In addition, the 2007 amount included higher than normal overhead costs (total ASA overhead expense of \$1,051) in order to facilitate the initial project activities of ASA.

Without giving effect to the update of the CFTS and RDAF program costs for both periods, the gross margins for the nine months ended September 30, 2008 and 2007 would have been 16.0% and 23.1%, respectively. Furthermore, gross margins fluctuated for each period depending on the mix between lower-margin CFTS revenue and non-CFTS revenue.

## 15. OPERATING EXPENSES

### *Third Quarter*

We incurred general and administrative (“G&A”) expenses of \$1,478 for the three months ended September 30, 2008, a 9.9% decrease over the same period in 2007. The G&A expense reduction reflects a \$59 decrease in costs at ASA, which is primarily the result of implementing our cost reduction plan. The remaining decrease of \$103 at the Canadian operations is primarily due to our cost reduction plan, offset, in part, by an increase of \$206 in related party professional and consulting fees and by \$83 of expense incurred by ASE.

Sales and marketing (“S&M”) expenses were \$396, a 46.8% decrease compared to the same period in 2007. The third quarter of 2008 reflects a reduction of \$85 incurred by ASA and \$264 incurred by the Canadian operations. Both reductions were primarily due to implementing our cost reduction plan. The expense in the Canadian operations was offset, in part, by \$62 of additional expenses incurred by ASE.

We recorded stock option expenses of \$45 for the three months ended September 30, 2008 as compared to \$40 for the same period in 2007.

We expect that operating costs will remain substantially unchanged in the fourth quarter of 2008 from the levels experienced in the third quarter of this year.

### *Nine months*

We incurred G&A expenses of \$4,332 for the nine months ended September 30, 2008, a 22.3% decrease over the same period in 2007. The G&A expense reduction reflects a \$307 decrease in costs incurred by ASA as compared to the same period of 2007, which is the result of implementing our cost reduction plan. The remaining decrease of \$933 at the Canadian operations is due primarily to the cost reduction plan, offset, in part, by an increase of \$168 in related party professional and consulting fees and by \$223 of expense incurred by ASE.

S&M expenses were \$1,231, a 48.5% decrease compared to the same period in 2007. The third quarter of 2008 reflects a reduction of \$314 incurred by ASA and \$847 incurred by the Canadian operations. Both reductions were primarily due to implementing our cost reduction plan. The expense in the Canadian operations was offset, in part, by \$193 of additional expenses incurred by ASE.

We recorded stock option expenses of \$117 for the nine months ended September 30, 2008 compared to \$142 for the same period in 2007.

## 16. OTHER ITEMS

### *Third Quarter*

We incurred depreciation and amortization expense of \$517 compared to \$286 in the same period of 2007. This increase of \$231 primarily reflects the amortization of the core technology acquired in the Eduplus acquisition of \$265, offset, in part, by a decrease in depreciation expense for capital assets due to decreased capital expenditures under the cost reduction plan. The amortization of the Eduplus core technology commenced in the fourth quarter of 2007. Both periods reflect amortization expense of approximately \$105 for the HVTT, which commenced amortization in the third quarter of 2007.

The Company performs periodic valuations on intangible assets including goodwill and the HVTT. A detailed review of the carrying value of these intangibles will be conducted in the fourth quarter and a write down to their fair value may be required. Without considering any such write downs, we expect that our depreciation and amortization cost will remain substantially unchanged in the fourth quarter of 2008 from the levels experienced in the third quarter of this year.

Interest and financing costs resulted in a net expense of \$281 compared to income of \$38 in the same period of 2007. The third quarter 2008 net expense of \$281 represents interest expense of \$285 and finance and bank charges, support fees and other costs of \$8, offset, in part, by interest income of \$12. The interest expense includes a non-cash component of \$124 for the increase in the accretion. This increase in the accretion is the result of using the effective interest rate method for the recognition of the original financing costs as well as the fair value of the related warrants in the ComVest financing arrangement.

The 2007 third quarter net income of \$38 includes \$47 for interest income, offset in part by, interest expense of \$1, and finance and bank charges, support fees and other costs of \$8.

We expect that interest and financing costs will remain substantially unchanged in the fourth quarter of 2008 from the levels experienced in the third quarter.

### *Nine months*

We incurred depreciation and amortization expense of \$1,569 in the nine months ended September 30, 2008 versus \$610 in the same period of 2007. This increase of \$959 primarily reflects nine months of amortization in 2008 of the HVTT as compared to three months in 2007, an increase of \$208, and the amortization of the core technology acquired in the Eduplus acquisition of \$797.

Interest and financing costs resulted in a net expense of \$668 compared to income of \$207 in the same period of 2007. The net expense of \$668 represents interest expense of \$526 and finance

and bank charges, support fees and other costs of \$187, offset, in part, by interest income of \$45.

The nine months ended September 30, 2007 net income of \$207 includes \$227 for interest income, offset in part by, interest expense of \$6, and finance and bank charges, support fees and other costs of \$14.

## 17. OTHER EXPENSES

There was no income tax (recovery) expense recorded for the three and nine month periods ended September 30, 2008, nor for the same periods in 2007. We had previously recorded a full valuation allowance for all future income tax assets (specifically cumulative operating loss carry-forwards and temporary differences) as we believed there was uncertainty in realizing the full benefit of these items. As a result, any income tax recovery, or expense, related to losses and earnings in the three-month and nine-month periods ended September 30, 2008, and in the same periods in 2007, was offset by utilizing an equal portion of the unrecognized operating loss carry-forwards from previous years. As at September 30, 2008, we continue to carry a full valuation allowance against our income tax assets due to the continued uncertainty surrounding their full usage. We will not be required to record income tax expense against earnings in Canada until either all unrecognized operating loss carry-forwards are utilized or expire. As of December 31, 2007 our Canadian loss carry-forwards were approximately \$12,311, of which \$1,767 expire in 2008, and the balance between 2009 and 2027. Furthermore, we will not be required to record income tax expense against earnings in the US until all unrecognized operating loss carry forwards are utilized or expire. As of December 31, 2007 our US loss carry-forwards were approximately \$4,183 and will expire between 2026 and 2027.

## 18. NET INCOME

### *Third Quarter*

For the three months ended September 30, 2008, we recognized a net loss of \$2,530, or \$0.05 per share, compared to a net loss of \$1,594, or \$0.03 per share, for the same period in 2007. The increased loss of \$936 was primarily due to significantly lower revenues as well as an increase in cost estimates of \$629 in the third quarter of 2008 to complete the CFTS and RDAF programs. The decreased revenues and increased cost estimates resulted in a reduction of \$894 in the gross margin in the third quarter of 2008 from the levels recorded in the same period of the prior year. In addition, the remainder of the increased loss in the third quarter of 2008 over the same period in 2007 was primarily due to an increase in amortization expense of \$266 for the Eduplus core technology and a net increase in interest expense of \$319, offset, in part, by a reduction in operating expense of \$506 primarily due to the cost reduction program.

### *Nine months*

For the nine months ended September 30, 2008, we recognized a net loss of \$7,169, or \$0.13 per share, as compared to a net loss of \$698, or \$0.01 per share, for the same period in 2007. The increased loss of \$6,471 was primarily due to significantly lower revenues in 2008. In addition to

the reduction in revenues, both an increase in cost estimates in 2008 of \$1,309 to complete the CFTS and RDAF programs and additional revenue recognized in 2007 of \$1,815 as a result of updated project cost estimates for the CFTS program, contributed to a reduction of the gross margin of \$7,064 in the first nine month period of 2008 from the levels recorded in the same period of the prior year. Furthermore, the remainder of the increased loss in the nine-month period ended September 30, 2008 over the same period in 2007 was primarily due to the net increase in amortization expense of \$1,005 for the HVTT and the Eduplus core technology and a net increase in interest expense of \$875, offset, in part, by a reduction in operating expense of \$2,426 due to the cost reduction program.

### *Net Loss per Share*

As a result of the loss recorded in both the three and nine periods of 2008 and 2007, potentially dilutive securities become anti-dilutive, and therefore the diluted net loss per share is unchanged from the basic net loss per share.

## CASH FLOW, LIQUIDITY AND CAPITAL RESOURCES

### 19. CASH FLOW SUMMARY

We had bank indebtedness, net of cash and cash equivalents, of \$1,370 at September 30, 2008 compared to cash and cash equivalents of \$5,656 at September 30, 2007. The sources and uses for the changes in cash and cash equivalents for the three months and nine months ended September 30, 2008 and 2007 are as follows:

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2008	2007	2008	2007
Cash flows provided by (used in)				
Operating activities	\$ (334)	\$ (468)	\$ (4,731)	\$ (11,079)
Investing activities	-	(228)	(36)	(582)
Financing activities	-	2,700	(432)	3,681
Foreign exchange gain on US\$ Term Loan	80	-	109	-
Increase (decrease) in cash and cash equivalents	(254)	2,004	(5,090)	(7,980)
(Bank indebtedness) cash and cash equivalents at beginning of period	(1,116)	3,652	3,720	13,636
(Bank indebtedness) cash and cash equivalents at end of period	\$ (1,370)	\$ 5,656	\$ (1,370)	\$ 5,656

### 20. OPERATING ACTIVITIES

#### *Third Quarter*

For the three months ended September 30, 2008, cash outflows from operating activities of \$334 were primarily due to a net loss of \$2,530, which after excluding non-cash charges resulted in an outflow of \$1,844. This outflow was reduced by an inflow of \$1,514 from the net change in non-cash working capital.

For the three months ended September 30, 2007, cash outflows from operating activities of \$468 were primarily due to a net loss of \$1,594, which was decreased by non-cash charges of \$328 and further reduced by \$792 for the net change in non-cash working capital.

### *Nine Months*

For the nine months ended September 30, 2008, cash outflows from operating activities of \$4,731 were primarily due to a net loss of \$7,169, which was decreased by non-cash charges of \$1,880 and further decreased by an inflow of \$559 from the net change in non-cash working capital.

For the nine months ended September 30, 2007, cash outflows from operating activities of \$11,079 was due to the net loss of \$698, decreased by non-cash charges of \$753, and the net outflow of \$10,995 from the change in non-cash working capital

## 21. INVESTING ACTIVITIES

### *Third Quarter*

For the three months ended September 30, 2008, no cash was used in investing activities as compared to \$228 of cash used for the comparable period in 2007.

For the three months ended September 30, 2007 cash used in investing activities of \$228 included a cash inflow of \$2,051, for previously restricted cash, as a result of replacing cash collateral for a letter of credit with a Canadian financial institution with a guarantee issued by Export Development Canada. Without giving effect to the change in restricted cash, cash used in investment activities was \$2,279 and consisted of investments in capital assets of \$155 and the cash consideration paid of \$2,124, including acquisition costs, for the Eduplus acquisition. The investment in capital assets was primarily for computer hardware, software and leasehold improvements for our Brampton, Ontario operating facility.

### *Nine months*

Cash used in investing activities for the nine month period in 2008 was the result of investment in capital assets of \$19 for computer hardware, software, leasehold improvements and furniture and fixtures in ASA and \$17 in computer hardware, communications equipment, software, leasehold improvements and furniture and fixtures in the Canadian facilities.

For the nine months ended September 30, 2007, without giving effect to the cash inflow of \$2,051 associated with liberating the restricted cash, cash used in investing activities was \$2,633 and includes investment in capital assets of \$510 and the cash consideration paid of \$2,124, including acquisition costs, for the Eduplus acquisition. The investment in capital assets includes \$135 investment in computer hardware, software, leasehold improvements and furniture and fixtures in ASA, and \$375 for computer hardware, software, communications equipment and leasehold improvements in our Brampton, Ontario operating facility.

## 22. FINANCING ACTIVITIES

### *Third Quarter*

Cash inflow from financing activities for the three months ended September 30, 2008 was \$nil, compared to a cash inflow of \$2,700 for the same period in 2007.

For the three months ended September 30, 2007, cash inflow from financing activities of \$2,700 represented proceeds from a bank term loan of \$2,800, which was repaid in the second quarter of 2008 with the proceeds from the Term Loan, and the final repayment of \$100 on a convertible debenture.

### *Nine months*

The Cash outflow of \$432 for the nine months ended September 30, 2008 represents the remaining principal of \$2,660 on the term debt advanced in 2007 that was repaid with the ComVest Term Loan, less the proceeds, net of financing costs, of \$2,228 from the Term Loan.

The \$3,681 inflow in the nine months ended September 30, 2007 represented the proceeds from a bank term loan of \$2,800, the exercise of common share purchase warrants of \$873, and the proceeds from the exercise of stock options of \$108, reduced, in part, by the final repayment of a convertible debenture of \$100.

## 23. LIQUIDITY

Effective April 30, 2008, we entered into financing arrangements with ComVest that provided up to US\$6.6 million of financing in the form of a secured Term Loan in the amount of US\$2.6 million at a rate of interest of 12.5% per annum payable monthly and 5% per annum of deferred interest, accrued monthly, payable at maturity. In addition, the ComVest agreement (“ComVest Agreement”) includes a secured revolving line of credit (“Operating Line”) of up to US\$4.0 million based on a borrowing base at a rate of interest of US prime plus 2% per annum with a floor of 8%. The Term Loan matures on April 30, 2011 and the Operating Line will be available until April 30, 2010, subject to a one-year extension at the option of the Company. These financing arrangements closed May 5, 2008 and the Term Loan was used to repay a bank term loan advanced in 2007. Per the Agreement the Company issued warrants, expiring April 30, 2013, to acquire an aggregate of 9,300,000 common shares at an exercise price of \$0.09 per share.

The Company’s financial statements record the ComVest transaction at amortized cost. Financing costs include the fair value of the warrants and such costs are recognized using the effective interest method. This expense is included in interest expense, with an offset to the accretion component of the Term Loan.

As at September 30, 2008, \$2,096 (US\$1,970) of the Operating Line was utilized. The Agreement provides for a maximum borrowing base based on the current month accounts receivable and unbilled revenue balance and permits us to borrow funds directly for operating

and subsidiary funding purposes. In addition the Agreement contains covenants for the minimum six month rolling EBITDA and an annual maximum capital expenditure limit. Any advances are repayable on demand. EBITDA is defined in the Agreement as consolidated net income before interest, taxes, depreciation, amortization and non-cash charges and expenses other than accruals made in the normal course of business less any dividends on capital distribution.

As at September 30, 2008 the Company was not in compliance with the covenant included in the ComVest Agreement related to the six month rolling EBITDA minimum requirement. The six month rolling EBITDA deficit was \$3,238, a deficiency of \$1,238 from the minimum covenant requirement of a deficit of \$2,000. ComVest has agreed to waive this covenant for this reporting period.

In addition the Company as at September 30, 2008 had exceeded the maximum borrowing limit per the terms of the ComVest Agreement by approximately US\$665. ComVest has agreed to waive compliance for this reporting period.

It is likely that the Company will violate covenant requirements at future compliance dates; therefore the entire balance of term debt has been classified as a current liability. The Company is currently engaged in further discussions with ComVest on future financing and covenant requirements.

## 24. CAPITAL RESOURCES

### Stock Options

During the three months ended September 30, 2008, the Company awarded 1,241,327 options, at exercise prices ranging from \$0.05 to \$0.11 per share, to purchase shares of the Company under the stock options incentive plan (the "Plan"). During the second quarter of 2008, the Company awarded 1,298,986 options, at an exercise price of \$0.11 per share.

Options awarded in 2008 expire between three and four years and have vesting periods of approximately three months to 1.5 years. The fair value of each option is calculated on the date of the grant using the Black-Scholes option pricing model.

The Company recorded a net stock option compensation expense for the combination of the vesting of existing options and the recognition of options cancelled for the three-month period and the nine-month period ended September 30, 2008 of \$45 (2007 - \$40) and \$117 (2007 - \$142), respectively.

No options have been exercised in 2008. Stock options cancelled or expired during the three-month period and the nine-month period ended September 30, 2008 were 184,666 and 474,169, respectively. As at September 30, 2008, based on the actual number of common shares outstanding, the Plan would allow for the issuance of a total of 8,399,089 options to purchase common shares of our Company. There are currently 8,324,184 options to purchase common shares outstanding, leaving 74,905 options available for issuance under the Plan. The amount of options available for issuance will change as we grant options and as the actual number of common shares outstanding changes as well.

## Warrants

On May 5, 2008, pursuant to the ComVest Agreement, the Company issued 9,300,000 common share purchase warrants, at an exercise price of \$0.09 per warrant, with a value of US\$572. During the nine months ended September 30, 2008 no common share purchase warrants were exercised and 250,000 warrants expired.

On September 16, 2008, the Company's board of directors approved, subject to TSX and other necessary approvals, the issue of 4,000,000 common share purchase warrants to acquire 2,000,000 common shares at an exercise price of \$0.10 per share and an additional 2,000,000 common shares at an exercise price of \$0.05 per share, for a period of three years. The warrants were issued pursuant to a consulting agreement with a company of which a member of the Company's board of directors is a principal shareholder.

Our contributed surplus increased by \$45 to \$9,120 as at September 30, 2008 from \$9,075 as at June 30, 2008 as a result of the stock option compensation expense recognized in the consolidated statement of operations. Our contributed surplus increased by \$179 from \$8,941 as at December 31, 2007 due to stock option compensation costs of \$117 and for the expiration and cancellation of warrants to purchase common shares whose value of \$62 was transferred from share capital.

## 25. SUMMARY OF QUARTERLY RESULTS (UNAUDITED)

Following are the quarterly results for Company's eight most recently completed quarters.

	2008			2007			2006	
	30-Sept \$	30-June \$	31-March \$	31-Dec \$	30-Sept \$	30-June \$	31-March \$	31-Dec \$
Revenue	2,989	4,245	4,339	5,359	6,750	15,241	5,829	11,152
Net (loss) income	(2,530)	(2,337)	(2,302)	(3,334)	(1,594)	2,671	(1,775)	(148)
Net (loss) income (basic)	(0.05)	(0.04)	(0.04)	(0.06)	(0.03)	0.05	(0.03)	(0.00)
Net (loss) income (diluted)	(0.05)	(0.04)	(0.04)	(0.06)	(0.03)	0.05	(0.03)	(0.00)

The Company has been and continues to be dependent on a small number of high-dollar value contracts, in particular the CTS program, and its quarterly revenues have correspondingly fluctuated. The volatility in net income and net income per share is primarily the result of the revenue fluctuations, as well as changes in cost estimates for large contracts, and in 2008, an increase in amortization expense for intangible assets and a reduction in operating expenses due to the cost reduction program.

## 26. OUTSTANDING SHARE DATA

The following table summarizes the changes in the common shares, common share purchase warrants and options to purchase common shares for the nine months ended September 30, 2008.

	<b>Common Shares</b>	<b>Warrants</b>	<b>Options</b>
<b>Outstanding at December 31, 2007</b>	55,993,929	250,000	6,258,040
<b>Issued / Exercised</b>	-	-	-
<b>Granted<sup>(1)</sup></b>	-	9,300,000	2,540,313
<b>Cancelled / Expired</b>	-	(250,000)	(474,169)
<b>Outstanding at September 30, 2008</b>	<b>55,993,929</b>	<b>9,300,000</b>	<b>8,324,184</b>

<sup>(1)</sup> Does not include 4,000,000 common share purchase warrants that have been approved by the Company's board of directors, subject to further necessary approvals.

As at September 30, 2008, there were 9,300,000 common share purchase warrants outstanding at an exercise price of \$0.09. An additional 4,000,000 common share warrants have been approved by the Company's board of directors, subject to TSX and other necessary approvals, to acquire 2,000,000 common shares at an exercise price of \$0.10 per share and an additional 2,000,000 common shares at an exercise price of \$0.05 per share, for a period of three years.

As at September 30, 2008, there were 8,324,184 stock options outstanding at exercise prices ranging from \$0.05 to \$0.68 with expiry dates from January 20, 2010 through June 28, 2012.

## 27. OFF-BALANCE-SHEET ARRANGEMENTS

In the normal course of business, we may be required to issue letters of credit or performance guarantees. As at September 30, 2008, we had one outstanding letter of credit with a Canadian financial institution in the amount of \$615 (2007 – \$1,436). This letter of credit expired on October 1, 2008 and related to a contract to provide a CPT to the RDAF via prime contractor AgustaWestland. The collateral on the letter of credit was changed in August 2007 from cash to a guarantee issued by Export Development Canada.

## 28. USE OF FINANCIAL DERIVATIVES

We may use foreign exchange forward contracts to manage exposures created when sales and purchases are made in foreign currencies. As at September 30, 2008, there were no foreign exchange forward contracts outstanding (2007 - nil).

We have not used derivative instruments to reduce our exposure to interest rate risk or to change our exposure from fixed to floating interest rates.

## 29. RELATED PARTY TRANSACTIONS

All related party transactions are in the normal course of operations, measured at their exchange amounts established and agreed to by the related parties. Amounts due to related parties are subject to normal trade terms. The Company incurred costs of \$25 (2007 - \$61) and \$303 (2007 - \$377) during the third quarter of 2008 and the nine-month period ended September 30, 2008, respectively for legal services to a firm in which a director of the Company is a partner. In addition, during the third quarter of 2008, the Company recorded

an expense of \$242 for consulting services provided by, including related costs, of organizations of which a director of the Company is a principal shareholder.

Included in the nine-month period of 2008 was an amount of \$121 for legal fees that was capitalized to financing costs for the ComVest Term Loan. All other related party expenses have been recorded to general and administrative expenses.

The amount due to related parties included in accounts payable and accrued liabilities as at September 30, 2008 was \$189 (2007 - \$49).

On September 16, 2008, the Company's board of directors approved the reimbursement of \$90 of consulting fee expenditures to a company of which a member of the Company's board of directors is a principal shareholder. This amount will be paid in six equal monthly instalments commencing in October, 2008 and has been recorded as a liability as at September 30, 2008. The reimbursement of the expenses is pursuant to a consulting agreement with the Company. In addition, the consulting agreement calls for a fee of \$25 per month and the issue of 4,000,000 share purchase warrants (see Section 24 – Capital Resources). The consulting agreement commenced in July 2008, for a term of one year. The share purchase warrants are subject to TSX and other necessary approvals, and under the terms of the consulting agreement, should these necessary approvals not be obtained, the parties have agreed to negotiate equivalent compensation.

### 30. CHANGES IN ACCOUNTING POLICIES

Effective January 1, 2008 the Company adopted the following recommendations to the Canadian Institute of Chartered Accountants (“CICA”) Handbook;

Section 3862, Financial Instruments – Disclosures: This section establishes standards for disclosing information that will enable users to evaluate the significance of financial instruments for a company's financial position and performance, the nature and extent of risks arising from financial instruments to which a company is exposed during the period and at the balance sheet date, and how the company manages those risks. The Company has included such disclosure in the notes to the interim consolidated financial statements.

Section 3863, Financial Instruments – Presentation: This section establishes standards for presentation of information that will enable users to evaluate the significance of financial instruments and non-financial derivatives., This section complements the existing Handbook Section 3861 – Financial Instruments – Disclosure and Presentation, and applies to liability instruments issued by a Company.

Section 3031, Inventories: This Section provides guidance on the measurement and disclosure requirements for inventories. The adoption of this new Section did not have an impact on the Company's financial results.

#### **Recently issued accounting standards:**

In February 2008, the CICA issued Handbook Section 3064, Goodwill and Intangible Assets, which establishes revised standards for the recognition, measurement, presentation and

disclosure of goodwill and intangible assets. CICA Handbook Section 1000, Financial Statement Concepts, was also amended to provide consistency with this new standard. The new and amended standards are effective for the Company beginning January 1, 2009. The Company is currently assessing the impact of these standards on its financial statements.

On February 13, 2008, the Canadian Accounting Standards Board (“AcSB”) confirmed the mandatory International Financial Reporting Standards (“IFRS”) changeover date for Canadian profit-oriented publicly accountable entities (“PAEs”). This means that PAEs will be required to prepare financial statements in accordance with IFRS for interim and annual financial statements for fiscal years beginning on or after January 1, 2011. The transition date of January 1, 2011 will require restatement for comparative purposes of amounts reported by the Company for annual and interim periods for the year ended December 31, 2010.

Canadian GAAP will be converged with IFRS through a combination of two methods: as current joint-convergence projects of the US Financial Accounting Standards Board and the International Accounting Standards Board are agreed upon, they will be adopted by the ACSB and may be introduced in Canada before the complete changeover to IFRS; and standards not subject to a joint-convergence project will be exposed in an omnibus manner for introduction at the time of the complete changeover to IFRS.

As the International Accounting Standards Board currently, and expectedly, has projects underway that should result in new pronouncements that continue to evolve IFRS. As of the date of these unaudited consolidated financial statements, the financial reporting impact of the transition to IFRS cannot be reasonably estimated.

### **31. CRITICAL ACCOUNTING ESTIMATES**

We are required to make estimates and assumptions when accounting for assets and liabilities and when disclosing contingent assets and liabilities at the date of the financial statements and for revenues and expenses for the period reported. We regularly review and change, when necessary, our estimates and assumptions, particularly as they relate to accounting for long-term contracts, stock-based compensation costs, income taxes, deferred development costs, intangible assets and goodwill, based on management’s judgment of current conditions and actions that we may undertake in the future. Actual results may differ from estimates previously recorded.

### **32. BUSINESS OUTLOOK**

The following contains forward-looking statements about our business outlook for 2008. Reference should be made to “Forward-Looking Statements” on page 5. For a description of material factors that could cause our actual results to differ materially from the forward-looking statements in the following, please see the Business Risk Factors section of the MD&A for the year ended December 31, 2007 as contained in our 2007 Audited Financial Statements and the Description of the Business – Risk Factors section in our Annual Information Form.

Our profitability in the short term will be determined by the uncertain timing of military contracts. We have acquired Eduplus to increase our e-learning capability and access to Canadian naval opportunities. We intend to expand our penetration of the Canadian energy industry and begin planting the seeds for a more global energy sector strategy.

We will continue to target the whole of our military and energy sector customers' value-chain in order to capitalize on the many additional opportunities we have to provide simulation solutions to service the full life cycle of our customers' products.

In terms of specific results for the fourth quarter and fiscal 2008, we expect that:

- Approximately \$3.0 million of our order backlog of \$30.2 million as at September 30, 2008 will be recognized as revenue in the fourth quarter of 2008. Our ability to replenish our backlog in the last quarter of 2008 and the first quarter of 2009 will be a key determinant of our outlook for 2009.
- Revenues from the initial contract under the CFTS program for 2008 will decrease compared to 2007, however, we are pursuing additional opportunities under the CFTS program. As at September 30, 2008, approximately \$2.9 million of revenue remained to be recognized for the initial phase of the project. We believe that the CFTS program has contributed significantly to our intellectual property and has enhanced our ability to handle large and complex learning systems. In addition, our participation in the program greatly enhances our ability to capture significant new business that will flow from the CFTS program in the form of enhancements to the existing program and new procurement programs. As a result, we believe that the CFTS program and related opportunities will continue to be a significant contributor to our Company's revenue base for the foreseeable future due to planned and projected upgrades, enhancements and improvements to the training procedures and technologies required by the CF throughout the life cycle of the program.
- Gross margins will continue to fluctuate and will depend on our future revenue base, the mix of lower margin CFTS revenue relative to higher margin projected new business and our ability to manage non-variable overhead costs.
- The Company has filed for \$1.2 million in cash tax credits, net of fees, on 10 separate projects with the Ontario Media Development Corporation for Ontario Interactive Digital Media Tax Credits. In order to access these cash tax credits the Company needed to first obtain certificates of eligibility from the Ontario Media Development Corporation. We expect to receive this cash in the first quarter of 2009.
- Our cost reduction plan will continue to meet expectations, reducing overall operating expenses by approximately 15%, and provide in 2008 cost savings of approximately \$4.0 million.
- The Company performs periodic valuations of certain balance sheet accounts including goodwill and the HVTT. A detailed review of the carrying value of these intangible assets will be conducted in the fourth quarter and a write down to their fair value may be required.
- G&A and S&M expenses will decrease in 2008 as a result of our cost reduction plan.

- Interest expense and financing costs will increase significantly over 2007 levels due to the outstanding term loan and revolving line of credit secured in April, 2008.
- Cash and cash equivalents are expected to decline as additional losses are expected for the balance of the year. Cash availability to fund future operations will depend on the Company's ability to secure new orders and its ability to secure additional capital.
- Although we have as of May 2008 repaid our bank term loan and replaced it with a three-year term loan, future unanticipated outflows and out of covenant events that may not be waived by the lender may result in our need to complete additional financings. Access to such capital at acceptable commercial terms for a company of our size and financial status will be greatly dependent on our ability to increase our backlog position, demonstrate execution of our business strategy and the general condition of the credit markets and may be significantly dilutive to existing shareholders. The Company's access to credit or capital could be further restricted by the current global financial crisis which has restricted credit worldwide. Should the Company not be able to secure additional financing it is unlikely the Company will be able to continue operations as presently constituted.
- Capital expenditures, without giving effect to assets acquired in acquisitions, will be comparable to 2007 levels.

### 33. REPORT ON DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROLS OVER FINANCIAL REPORTING

The Company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") are responsible for establishing and maintaining the Company's disclosure controls and procedures. They are assisted in this responsibility by the Company's Disclosure Committee, which consists of senior managers of the Company. The Disclosure Committee evaluates material information to determine the appropriateness and timing of its public release. The CEO and CFO have evaluated the effectiveness of the Company's disclosure controls and procedures and have concluded that they were adequate and effective as of September 30, 2008.

The Company maintains internal controls over financial reporting designed to provide reasonable assurance regarding the reliability of financial reporting and preparation of financial statements in accordance with generally accepted accounting principles. The Company's CEO and CFO do not expect that these internal controls will prevent all error and all fraud. Internal controls can only provide reasonable, not absolute, assurance that the objectives of the system are met. Because of inherent limitations, internal controls over financial reporting may not prevent or detect misstatements and fraud. Controls can be circumvented by the individual acts of some persons, by collusion of two or more people or by management override of the control. Internal controls over financial reporting are based partly on assumptions about the likelihood of future events and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

During the three months ended September 30, 2008, there have been no changes in our Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our Company's internal control over financial reporting.

November 13, 2008

*Interim Consolidated Financial Statements of*

**ATLANTIS SYSTEMS CORP.**

*September 30, 2008 and 2007*

*Interim Consolidated Financial Statements of*

**ATLANTIS SYSTEMS CORP.**

*September 30, 2008 and 2007*

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**ATLANTIS SYSTEMS CORP.****Consolidated Statements of Operations, Comprehensive Loss and Deficit****For the three and nine months ended September 30****(Expressed in thousands of Canadian dollars except per share amounts)****(unaudited)**

	<b>For the three months ended September 30</b>		<b>For the nine months ended September 30</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Revenue (note 5)	\$ <b>2,989</b>	\$ 6,750	\$ <b>11,573</b>	\$ 27,820
Cost of revenue (note 11)	<b>2,802</b>	5,669	<b>10,825</b>	20,008
Gross margin	<b>187</b>	1,081	<b>748</b>	7,812
Expenses				
General and administrative	<b>1,478</b>	1,640	<b>4,332</b>	5,572
Selling and marketing	<b>396</b>	745	<b>1,231</b>	2,392
Stock options	<b>45</b>	40	<b>117</b>	142
	<b>1,919</b>	2,425	<b>5,680</b>	8,106
Operating loss before the undernoted items	<b>(1,732)</b>	(1,344)	<b>(4,932)</b>	(294)
Depreciation and amortization	<b>517</b>	286	<b>1,569</b>	610
Interest and financing costs (income), net (note 7)	<b>281</b>	(38)	<b>668</b>	(207)
Loss on disposal of capital assets	-	2	-	1
Net loss and comprehensive loss	<b>(2,530)</b>	(1,594)	<b>(7,169)</b>	(698)
Deficit, beginning of period	<b>(83,602)</b>	(74,035)	<b>(78,963)</b>	(74,931)
Deficit, end of period	\$ <b>(86,132)</b>	\$ (75,629)	\$ <b>(86,132)</b>	\$ (75,629)
Net loss per share (note 12)				
Basic and diluted	\$ <b>(0.05)</b>	\$ (0.03)	\$ <b>(0.13)</b>	\$ (0.01)
Weighted average number of shares outstanding				
Basic and diluted (note 12)	<b>55,993,929</b>	54,741,643	<b>55,993,929</b>	54,351,362

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

**ATLANTIS SYSTEMS CORP.**  
**Consolidated Balance Sheets**

(Expressed in thousands of Canadian dollars)

	September 30 2008 (unaudited)	December 31 2007
<b>ASSETS</b>		
Current assets		
Cash (note 8)	\$ 726	\$ 3,720
Trade and other receivables (note 5)	1,339	2,766
Unbilled revenue	1,797	2,453
Inventory	463	510
Current portion of mortgage receivable	249	249
	<b>4,574</b>	<b>9,698</b>
Capital assets, net	1,259	1,671
Other long-term assets	212	235
Mortgage receivable	162	150
Deferred development costs and core technology, net (note 6)	3,272	4,382
Goodwill	11,735	11,735
	<b>16,640</b>	<b>18,173</b>
	<b>\$ 21,214</b>	<b>\$ 27,871</b>
<b>LIABILITIES</b>		
Current liabilities		
Operating line of credit (note 8)	\$ 2,096	\$ -
Accounts payable and accrued liabilities	3,255	4,601
Accrued costs on percentage completion	447	301
Deferred revenue	583	954
Term debt (note 8)	1,955	2,660
	<b>8,336</b>	<b>8,516</b>
<b>SHAREHOLDERS' EQUITY</b>		
Share capital and warrants (note 9)	89,890	89,377
Contributed surplus	9,120	8,941
Deficit	<b>(86,132)</b>	<b>(78,963)</b>
	<b>12,878</b>	<b>19,355</b>
	<b>\$ 21,214</b>	<b>\$ 27,871</b>

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

**ATLANTIS SYSTEMS CORP.**  
**Consolidated Statements of Cash Flows**  
For the three and nine months ended September 30  
(Expressed in thousands of Canadian dollars)  
(unaudited)

	For the three months ended September 30		For the nine months ended September 30	
	2008	2007	2008	2007
Cash flows provided by (used in) :				
<b>Operating activities :</b>				
Net loss	\$ (2,530)	\$ (1,594)	\$ (7,169)	\$ (698)
Items not affecting cash:				
Depreciation and amortization	517	286	1,569	610
Loss on disposal of capital assets	-	2	-	1
Stock options expense	45	40	117	142
Accretion on term debt	124	-	194	-
	(1,844)	(1,266)	(5,289)	55
Interest on mortgage receivable	(4)	(4)	(12)	(11)
Other long-term assets	-	10	11	(128)
Net change in non-cash working capital (note 16)	1,514	792	559	(10,995)
	(334)	(468)	(4,731)	(11,079)
<b>Investing activities :</b>				
Investment in capital assets	-	(155)	(36)	(510)
Proceeds from disposal of capital assets	-	-	-	1
Acquisition and acquisition costs	-	(2,124)	-	(2,124)
Restricted cash	-	2,051	-	2,051
	-	(228)	(36)	(582)
<b>Financing activities :</b>				
Term debt repayment (note 8)	-	2,800	(2,660)	2,800
Term debt proceeds (note 8)	-	-	2,228	-
Exercise of common share purchase warrants	-	-	-	873
Exercise of options to purchase common shares	-	-	-	108
Repayment of convertible debentures	-	(100)	-	(100)
	-	2,700	(432)	3,681
Net cash provided by foreign exchange gain on term debt	80	-	109	-
Net (decrease) increase in cash	(254)	2,004	(5,090)	(7,980)
Cash (bank indebtedness), beginning of period	(1,116)	3,652	3,720	13,636
(Bank indebtedness) cash, end of period	\$ (1,370)	\$ 5,656	\$ (1,370)	\$ 5,656

**SUPPLEMENTAL INFORMATION**

(Bank indebtedness) cash are comprised of:

Cash	\$ 726	\$ 5,656	\$ 726	\$ 5,656
Bank operating line of credit	(2,096)	-	(2,096)	-
	\$ (1,370)	\$ 5,656	\$ (1,370)	\$ 5,656

Interest paid	\$ 161	\$ 1	\$ 333	\$ 6
Income taxes paid	\$ -	\$ -	\$ -	\$ -

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

# **ATLANTIS SYSTEMS CORP.**

## **Notes to the (Unaudited) Interim Consolidated Financial Statements**

**September 30, 2008 and 2007**

**(Expressed in thousands of Canadian dollars except per share amounts, unless otherwise indicated)**

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### **1. BASIS OF PRESENTATION**

Atlantis Systems Corp. (“Atlantis” or the “Company”) continued under the laws of Canada and is listed on the Toronto Stock Exchange (TSX-AIQ). Atlantis Systems International Inc. (“ASI”) and Atlantis Systems America Inc. (“ASA”) are operating subsidiaries of the Company. ASI is a training integrator specializing in military, commercial aviation and energy markets worldwide. ASI combines desktop and full-flight simulation, knowledge management, learning management systems and multimedia courseware to provide integrated training systems to customers. ASA has been established to provide similar services in the United States. In addition, the Company has an 85% interest in Denbridge Digital Limited, which is an inactive holding company.

#### Going concern assumption

These consolidated financial statements have been prepared on a going concern basis which assumes that the Company will be able to meet its commitments, realize its assets and discharge its liabilities in the normal course of business

For the nine months ended September 30, 2008 the Company incurred a net loss from continuing operations of \$7,169, and has a working capital deficiency of \$3,762 and deficit of \$86,132 as at September 30, 2008. This casts substantial doubt on the Company’s ability to continue as a going concern. Continuation of the company as a going concern is dependent upon profitable operations, and the ability of the Company to obtain additional financing when necessary.

If the going concern assumption were not appropriate for these financial statements, adjustments would be necessary in the carrying values of assets and liabilities, the reported net loss and the balance sheet classifications used.

In the opinion of management, all adjustments considered necessary for fair presentation of the Company’s financial position, results of operations and cash flows have been included. Operating results for the nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for any future periods.

### **2. INTERIM FINANCIAL STATEMENT PREPARATION**

The disclosures in these unaudited interim consolidated financial statements do not meet all disclosure requirements of Canadian generally accepted accounting principles for annual financial statements. These unaudited interim consolidated financial statements should be read in conjunction with the annual financial statements of the Company and the notes thereto. Except as explained in Note 3, the unaudited interim consolidated financial statements are prepared using the same accounting principles and application thereof as the annual financial statements for the year ended December 31, 2007. Note disclosures have been presented for material updates to the information previously reported.

# ATLANTIS SYSTEMS CORP.

## Notes to the (Unaudited) Interim Consolidated Financial Statements

September 30, 2008 and 2007

(Expressed in thousands of Canadian dollars except per share amounts, unless otherwise indicated)

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### 3. CHANGE IN ACCOUNTING POLICIES

On January 1, 2008, the Company adopted the following recommendations to the Institute of Chartered Accountants (“CICA”) Handbook:

Section 3862, Financial Instruments - Disclosures: This section establishes standards for disclosing information that will enable users to evaluate the significance of financial instruments for a company’s financial position and performance, the nature and extent of risks arising from financial instruments to which a company is exposed during the period and at the balance sheet date, and how the company manages those risks. The Company has included such disclosure in the notes 5, 13 and 14 to the interim consolidated financial statements.

Section 3863, Financial Instruments – Presentation: This section establishes standards for presentation of information that will enable users to evaluate the significance of financial instruments and non-financial derivatives. This section complements the existing Handbook Section 3861 – Financial Instruments – Disclosure and Presentation, and applies to liability instruments issued by a Company. The Company has included such disclosure in the note 8 to the interim consolidated financial.

Section 3031, Inventories: This Section provides guidance on the measurement and disclosure requirements for inventories. The adoption of this section did not have an impact on the Company’s financial results.

### 4. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

#### *International Financial Reporting Standards*

On February 13, 2008, the Canadian Accounting Standards Board (“AcSB”) confirmed the mandatory International Financial Reporting Standards (“IFRS”) changeover date for Canadian profit-oriented publicly accountable entities (“PAEs”). This means that PAEs will be required to prepare financial statements in accordance with IFRS for interim and annual financial statements for fiscal years beginning on or after January 1, 2011. The transition date of January 1, 2011 will require restatement for comparative purposes of amounts reported by the Company for annual and interim periods for the year ended December 31, 2010.

Canadian GAAP will be converged with IFRS through a combination of two methods: as current joint-convergence projects of the United States Financial Accounting Standards Board and the International Accounting Standards Board are agreed upon, they will be adopted by the ACSB and may be introduced in Canada before the complete changeover to IFRS; and standards not subject to a joint-convergence project will be exposed in an omnibus manner for introduction at the time of the complete changeover to IFRS.

# ATLANTIS SYSTEMS CORP.

## Notes to the (Unaudited) Interim Consolidated Financial Statements

September 30, 2008 and 2007

(Expressed in thousands of Canadian dollars except per share amounts, unless otherwise indicated)

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#### 4. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS (continued)

##### *International Financial Reporting Standards (continued)*

The International Accounting Standards Board currently has projects underway that should result in new pronouncements that continue to evolve IFRS. As of the date of these unaudited consolidated financial statements, the financial reporting impact of the transition to IFRS cannot be reasonably estimated.

##### *Goodwill and Intangibles*

In February 2008, the CICA issued Handbook Section 3064, Goodwill and Intangible Assets, which establishes revised standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. CICA Handbook Section 1000, Financial Statement Concepts, was also amended to provide consistency with this new standard. The new and amended standards are effective for the Company beginning January 1, 2009. The Company is currently assessing the impact of these standards on its financial statements.

#### 5. CONCENTRATION OF CREDIT RISK

The Company has contracts with many customers; however, as at September 30, 2008 two customers each represented 25% of the accounts receivable and unbilled revenue (December 31, 2007 – 0% and 45%, respectively). The first customer represented 29% while a different customer represented 23% of revenue for the three months ended September 30, 2008 (2007 – 4% and 0%, respectively) and 14% and 16% of revenues for the nine months ended September 30, 2008 (2007 – 2% and 0%, respectively).

The following table summarizes the value of assets included in trade and other receivables:

	<u>September 30, 2008</u>	<u>December 31, 2007</u>
Trade receivables	\$ 1,052	\$ 2,298
Other receivables	287	468
	<u>\$ 1,339</u>	<u>\$ 2,766</u>

# ATLANTIS SYSTEMS CORP.

## Notes to the (Unaudited) Interim Consolidated Financial Statements

September 30, 2008 and 2007

(Expressed in thousands of Canadian dollars except per share amounts, unless otherwise indicated)

### 6. DEFERRED DEVELOPMENT COSTS AND CORE TECHNOLOGY

The following table summarizes the value of assets included in deferred development costs:

	2008		
	Cost	Accumulated Amortization	Net Book Value
HVTT deferred development costs	\$ 1,669	\$ 522	\$ 1,147
Eduplus core technology	3,188	1,063	2,125
	<b>\$ 4,857</b>	<b>\$ 1,585</b>	<b>\$ 3,272</b>

  

	2007		
	Cost	Accumulated Amortization	Net Book Value
HVTT deferred development costs	\$ 1,669	\$ 209	\$ 1,460
Eduplus core technology	3,188	266	2,922
	<b>\$ 4,857</b>	<b>\$ 475</b>	<b>\$ 4,382</b>

No development costs for the Helicopter Virtual Task Trainer (HVTT) project were capitalized in 2007 or during the nine months ended September 30, 2008. Amortization for the HVTT commenced in the third quarter of 2007.

The Eduplus core technology is software that was acquired as part of the purchase of the Eduplus division of Tecsuit Inc. on September 27, 2007 and is being amortized over three years.

### 7. INTEREST AND FINANCING COSTS (INCOME)

	For the three months ended September 30		For the nine months ended September 30	
	2008	2007	2008	2007
Interest expense	\$ 285	\$ 1	\$ 526	\$ 6
Finance and bank charges	8	8	187	14
Interest income	(12)	(47)	(45)	(227)
	<b>\$ 281</b>	<b>\$ (38)</b>	<b>\$ 668</b>	<b>\$ (207)</b>

### 8. OPERATING LINE OF CREDIT AND RESTRICTED CASH

On April 30, 2008, the Company entered into financing arrangements with ComVest Capital LLC ("ComVest") that provided up to US\$6,600 of financing in the form of a secured term loan (the "New Term Loan") in the amount of US\$2,600 at a rate of interest of 12.5% per annum payable monthly and a deferred interest fee of 5% per annum payable at maturity as well as a secured revolving line of credit (the "Line of Credit") of up to US\$4,000 based on a borrowing base at a rate

# ATLANTIS SYSTEMS CORP.

## Notes to the (Unaudited) Interim Consolidated Financial Statements

September 30, 2008 and 2007

(Expressed in thousands of Canadian dollars except per share amounts, unless otherwise indicated)

### 8. OPERATING LINE OF CREDIT AND RESTRICTED CASH (continued)

of interest of US prime plus 2% per annum with a floor of 8% and is collateralized by a general security agreement over all present and future personal property. The New Term Loan matures on April 30, 2011 and the Line of Credit will be available until April 30, 2010, subject to a one-year extension at the option of the Company. These financing arrangements closed on May 5, 2008 and the New Term Loan was used to repay the term loan secured from the Company's creditors in the third quarter of 2007. The arrangement also involved the Company issuing warrants to acquire an aggregate of 9,300,000 common shares at an exercise price of \$0.09 per share for a period of five years.

The Company has utilized \$2,096 (US\$1,970) of the line of credit as of September 30, 2008 (2007 – nil).

In July 2006, as a condition of a new contract to provide a cockpit procedures trainer, the Company entered into a letter of credit with a Canadian financial institution in the amount of \$2,051. The collateral on the letter of credit was changed in August 2007 from cash to a guarantee issued by Export Development Canada. The value of this letter of credit will decline as the contract milestones are achieved through to the October 1, 2008 expiry date. As at September 30, 2008 the value of the letter of credit was \$615.

The Company's New Term Loan requires monthly principal repayments of US\$87 commencing December 1, 2008 and continuing until maturity.

The term debt liability includes the following:

	<u>September 30, 2008</u>	
Loan proceeds from Comvest	US\$	2,600
Financing costs		(380)
Common share warrants expense		(572)
Accretion		189
Term debt liability in US currency	US\$	1,837
Canadian exchange on loan proceeds		118
Term debt liability in Canadian currency	\$	1,955

The Company was in breach of the same New Term Loan covenant at June 30, 2008 and September 30, 2008; however, ComVest has provided waivers for both breaches. In addition, as at September 30, 2008, the Company had exceeded its maximum borrowing limit for the revolving line of credit by US\$665.

The Company anticipates it will violate covenant requirements at future compliance dates; therefore the entire balance of the term debt has been classified as a current liability.

# ATLANTIS SYSTEMS CORP.

## Notes to the (Unaudited) Interim Consolidated Financial Statements

September 30, 2008 and 2007

(Expressed in thousands of Canadian dollars except per share amounts, unless otherwise indicated)

### 9. SHARE CAPITAL AND WARRANTS

In the three months ended September 30, 2008, the Company awarded 1,241,327 options to purchase shares of the Company under the stock options incentive plan.

In the three months and nine months ended September 30, 2008, the Company expensed \$45 and \$117, respectively (2007 - \$40 and \$142), relating to the fair value of options granted in fiscal 2008, 2007, 2006 and 2005.

In the three months ended September 30, 2008, no common share stock options were exercised, while there were 184,666 common share stock options that either expired or were cancelled.

In the three months ended September 30, 2008, the Company issued no common share warrants, no common share warrants were exercised, and no common share warrants expired.

In the nine months ended September 30, 2008, no common share stock options were exercised, while there were 474,169 common share stock options that either expired or were cancelled. As at September 30, 2008, the Company had 8,324,184 common share options outstanding.

The estimated fair value of the options is amortized to income over the vesting period, on a straight-line basis, and was determined using the Black-Scholes option pricing model with the following weighted average assumptions:

	2008	2007
Risk-free rate	2.7%	3.9%
Dividend yield	0%	0%
Volatility factor of expected market price of the Company's shares	96% and 119%	66%
Expected option life (in years)	3 and 4	3
Weighted-average grant date fair values of options granted	\$ 0.06	\$ 0.23

In the nine months ended September 30, 2008, the Company issued 9,300,000 common share warrants with a value of \$576 (US\$572) which is included in share capital, no common share warrants were exercised, while there were 250,000 previously issued common share warrants with a value of \$63 that expired. As at September 30, 2008, the Company had 9,300,000 common share warrants outstanding.

On September 16, 2008, the Company's board of directors approved, subject to TSX approval, the issue of 4,000,000 common share warrants to acquire 2,000,000 common shares at an exercise price of \$0.10 per share and an additional 2,000,000 common shares at an exercise price of \$0.05 per share, for a period of three years. The warrants were issued pursuant to a consulting agreement with a company of which a member of the Company's board of directors is a principal shareholder.

The estimated fair value of the warrants issued in 2008 was determined using the Black-Scholes pricing model with the following assumptions:

# ATLANTIS SYSTEMS CORP.

## Notes to the (Unaudited) Interim Consolidated Financial Statements

September 30, 2008 and 2007

(Expressed in thousands of Canadian dollars except per share amounts, unless otherwise indicated)

### 9. SHARE CAPITAL AND WARRANTS (continued)

Risk-free rate	2.4%
Dividend yield	0%
Volatility factor of expected market price of the Company's shares	87%
Expected warrant life (in years)	5
Fair value of warrants issued	\$ 0.06

### 10. MANAGING CAPITAL

The Company's objectives when managing capital are to safeguard the Company's ability to continue as a going concern in order that it can provide future returns for shareholders and benefits for other stakeholders. Management intends to accomplish this objective with the least dilution to our shareholders and while remaining in compliance with existing or future debt covenants. The Company's current situation requires an approach to managing capital that will not generally focus on optimizing the cost of such capital and will most likely in the short-term favor debt financing.

Management believes that the use of debt to equity ratios or similar capital management tools would be inappropriate for the Company's current objectives for managing capital. Throughout 2007 and 2008 the Company did not use capital measurement tools other than those required to monitor and report on its compliance with certain debt covenants. Management is of the opinion that because these capital measurement tools are specific to certain debt instruments, and are not used on a long-term basis by Management to manage capital, disclosure of the details of their definitions and methods of calculation is inappropriate.

For the New Term Loan and Line of Credit secured from its bankers in the second quarter of 2008 the Company monitors on a monthly basis its rolling EBITDA coverage and its annualized capital expenditures. EBITDA is defined as consolidated net income before interest, taxes, depreciation, amortization and non-cash charges and expenses other than accruals made in the normal course of business less any dividends on capital distribution.

The Company was in breach of the same New Term Loan covenant at June 30, 2008 and September 30, 2008, however, ComVest has provided waivers for both breaches. The covenant in breach was the minimum EBITDA. In addition, as at September 30, 2008, the Company had exceeded its maximum borrowing limit for the revolving line of credit. (see note 8).

The Company includes shareholders' equity and all interest bearing debt in the definition of capital. The components of capital for the nine months ended September 30, 2008 and the year ended December 31, 2007 are as follows:

	<u>2008</u>	<u>2007</u>
Interest bearing debt	\$ 4,051	\$ 2,660
Shareholders' equity	12,878	19,355
<b>Total Capital</b>	<b>\$ 16,929</b>	<b>\$ 22,015</b>

# ATLANTIS SYSTEMS CORP.

## Notes to the (Unaudited) Interim Consolidated Financial Statements

September 30, 2008 and 2007

(Expressed in thousands of Canadian dollars except per share amounts, unless otherwise indicated)

### 11. RESEARCH AND DEVELOPMENT

Research and development expenditures included in cost of revenue for the three months and nine months ended September 30, 2008 were \$20 and \$56 respectively (2007 - \$25 and \$95).

### 12. NET LOSS PER SHARE

Basic earnings per share figures are calculated using the weighted average number of common shares outstanding during the year. Diluted earnings per share reflects the dilution that would occur if outstanding stock options and share purchase warrants were exercised or converted into common shares using the treasury stock method.

The treasury stock method of calculating the diluted earnings per share requires that only those of the Company's stock options and share purchase warrants whose exercise prices are lower than the average share prices for the relevant periods are used in the calculation of dilution.

The weighted average number of shares outstanding used in the calculation of the diluted earnings per share using the treasury stock method for the three months and nine months ended September 30, 2008 were as follows:

	For three months ended September 30		For nine months ended September 30	
	2008	2007	2008	2007
Weighted average common shares outstanding	55,993,929	54,741,643	55,993,929	54,351,362
Weighted average potential common shares	-	-	-	-
Share purchase warrants	-	-	-	-
Stock options	-	-	-	-
	<b>55,993,929</b>	54,741,643	<b>55,993,929</b>	54,351,362

For the three months and nine months ended September 30, 2008 the inclusions of the Company's stock options and share purchase warrants in the computation of diluted loss per share had an anti-dilutive effect on earnings per share and, therefore, were excluded from the computation.

### 13. FINANCIAL ASSETS AND FINANCIAL LIABILITIES

#### *Financial assets held-for-trading*

Cash and cash equivalents and restricted cash are classified as held-for-trading assets and are recorded at fair value. The fair values of cash and cash equivalents and restricted cash are adjusted to their respective fair market values at the end of each reporting period.

# ATLANTIS SYSTEMS CORP.

## Notes to the (Unaudited) Interim Consolidated Financial Statements

September 30, 2008 and 2007

(Expressed in thousands of Canadian dollars except per share amounts, unless otherwise indicated)

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### 13. FINANCIAL ASSETS AND FINANCIAL LIABILITIES (continued)

#### Financial assets recorded at amortized cost

Trade and other receivables, unbilled revenue, and the mortgage receivable are classified as loans and receivables and are recorded at amortized cost. The Company has determined that the carrying value represents fair value as at September 30, 2008.

#### Financial liabilities recorded at amortized cost

All accounts payable and accrued liabilities, accrued costs on percentage completion, deferred revenue and the term debt are recorded at their amortized cost. The Company has determined that the carrying value represents fair value as at September 30, 2008.

### 14. FINANCIAL RISK MANAGEMENT

#### Overview

The Company has exposure to the following risks from its use of financial instruments.

- a) Credit risk
- b) Liquidity Risk
- c) Market risk

The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to limits.

Risk management policies and systems are reviewed regularly to reflect changes in market conditions and the Company's activities.

#### (a) Credit Risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its obligations. The carrying amount of the Company's financial assets represents its maximum credit exposure.

#### Cash and Cash Equivalents

The Company's cash balance is on deposit in an operating account with a major Canadian bank. As at September 30, 2008, the Company had no short term cash investments. However, in accordance with its investment policy, the Company will only invest in money market deposits with major

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### 14. FINANCIAL RISK MANAGEMENT (continued)

Canadian Banks and with a maturity of less than 90 days. Accordingly, the Company believes it has minimal credit risk with respect to its cash and cash equivalents.

#### *Trade Receivable*

In the last two years the Company's end customers have primarily been the Canadian, US, Australian and Danish military. When the Company does not act as the prime contractor with government agencies, the prime contractor has always been a large, well capitalized aerospace company. The Company also contracts directly with such aerospace companies. Management expects that such customers, as well as public and private organizations within the power generation sector, will provide a substantial portion of the Company's revenue in 2009. In addition to the intrinsic credit worthiness of this customer base, the Company has contracted with Export Development Canada, when risks warrant, for line of credit guarantees on certain non-domestic projects.

Historically, the Company has not experienced any significant credit losses. The Company does not have any material accounts receivable balances greater than 90 days outstanding and has never recorded a material expense associated with a credit risk exposure. As a result, the Company believes that its trade accounts receivable represents a low credit risk. However, due to the nature of the contracts and the complexity of the deliverables to its customers, the Company is exposed to a significantly greater degree of related performance risk.

#### (b) Liquidity Risk

Liquidity risk arises through an excess of financial obligations over financial assets at any point in time. The Company's objective in managing liquidity risk is to maintain sufficient readily available cash to meet its financial obligations as they fall due. In order to meet its financial liabilities, the Company has recently relied on collecting its accounts receivable and utilizing its operating line of credit. The Company as of September 30, 2008 exceeded its maximum borrowing limit on the operating line of credit under its financing arrangement with ComVest and is in breach of its EBITDA covenant. As a result, the Company's ability to manage its liquidity risk going forward will require some or all of the following: the ability to modify its financing arrangement with ComVest; the ability to secure capital on reasonable terms in the current marketplace; and the ability to significantly increase its backlog through new contracts being awarded to the Company. (see note 1, Basis of Presentation – going concern assumption and note 8, Operating Line of Credit).

The following are the contractual maturities of financial liabilities, including interest payments, as at September 30, 2008:

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### 14. FINANCIAL RISK MANAGEMENT (continued)

	Carrying amount	Contractual cash flows	3 months or less	3-12 months	1 - 2 years	2 - 3 years
Accounts payable and accrued liabilities	\$ 3,255	\$ (3,255)	\$ (3,255)			
Operating line of credit <sup>(1)(2)</sup>	2,096	(2,530)	(42)	\$ (126)	\$ (168)	\$ (2,194)
Term debt <sup>(1)</sup>	1,955	(3,634)	(322)	(1,038)	(1,262)	(1,012)
	\$ 7,306	\$ (9,419)	\$ (3,619)	\$ (1,164)	\$ (1,430)	\$ (3,206)

<sup>(1)</sup> Assumes there is not an early repayment requirement with respect to the loan covenant or other conditions currently in breach, and, if applicable, in breach at any time throughout the remainder of the term of Comvest agreement.

<sup>(2)</sup> Assumes that the operating line balance will not change from the September 30, 2008 levels, the interest rate is 8%, and that the Company will exercise its option to extend the facility for one year.

#### (c) Market Risk

Market risk is the risk that changes in the market prices, such as fluctuations in foreign exchange rates and interest rates, will affect the Company's net earnings or the value of its financial instruments.

#### Currency Risk

The Company operates internationally giving rise to exposure to changes in foreign exchange rates. The currency risk is derived from revenues denominated in currencies other than the Canadian dollar, its functional currency, primarily the US dollar, and expenses associated with its US operations, as well as the respective receivable and payable balances. The Company believes that it is to a degree naturally hedged with offsetting US dollar expenses related to its US dollar revenue. The Company is also exposed to currency risk on cash and cash equivalents and other current assets denominated in foreign currencies.

#### Interest Rate Risk

The Company is exposed to interest rate risk principally on its operating line of credit. Under this agreement, interest is payable throughout the term of the facility at US prime plus 2%, with a floor of 8%. The US prime interest rate at September 30, 2008 was 5.00%, and subsequently the US Federal Reserve Board has lowered its prime lending rate to 4.00% in response to the current global financial situation. As a result the Company believes it is unlikely during the next 12 months that the interest rate on this facility will exceed the floor rate of 8% and therefore expects the interest expense on the operating line to be \$80 per \$1,000 of operating line debt. Furthermore, the Company's cash balances are deposited in highly-accessible and low-interest bank accounts and are

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### 14. FINANCIAL RISK MANAGEMENT (continued)

used for short-term working capital requirements. The term debt has a fixed interest rate throughout its term. Accordingly, the Company does not feel an interest rate sensitivity calculation is material.

#### Quantification of Foreign Currency Risk

At September 30, 2008, the Company's gross balance sheet exposure to foreign currency risk was substantially as follows:

<i>In Canadian \$ equivalents (000's)</i>	Canadian	US	Other	Total
Cash and cash equivalents	\$ 361	\$ 365	\$ -	\$ 726
Trade and other receivables	474	865	-	1,339
Operating line of credit	-	(2,096)	-	(2,096)
Accounts payable and accrued liabilities	(3,019)	(226)	(10)	(3,255)
Term debt	-	(1,955)	-	(1,955)
Net balance sheet exposure	\$ (2,184)	\$ (3,047)	\$ (10)	\$ (5,241)

The Company's revenue and expense exposure for revenue and expense denominated in foreign currencies were substantially as follows:

<i>In Canadian \$ equivalents (000's)</i>	Three months ended September 30, 2008			Nine months ended September 30, 2008		
	Canadian	US	Total	Canadian	US	Total
Revenue	\$ 1,450	\$ 1,539	\$ 2,989	\$ 8,079	\$ 3,494	\$ 11,573
Cost of goods sold and operating expenses	\$ 3,602	\$ 1,119	\$ 4,721	\$ 13,525	\$ 2,980	\$ 16,505
<i>In Canadian \$ equivalents (000's)</i>	Three months ended September 30, 2007			Nine months ended September 30, 2007		
	Canadian	US	Total	Canadian	US	Total
Revenue	\$ 6,520	\$ 230	\$ 6,750	\$ 27,422	\$ 398	\$ 27,820
Cost of goods sold and operating expenses	\$ 5,201	\$ 2,893	\$ 8,094	\$ 16,716	\$ 11,398	\$ 28,114

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### 14. FINANCIAL RISK MANAGEMENT (continued)

#### Fair Value Sensitivity Analysis

*Gross Balance Sheet Exposure:* A 10% strengthening of the Canadian dollar against the US dollar at September 30, 2008 would have increased net earnings by approximately \$305. This analysis assumes that all other variables, in particular interest rates, remain constant and represents the Company's gross balance sheet exposure at September 30, 2008. A 10% weakening of the Canadian dollar against the same would have had an equal but opposite effect.

*Net Revenue Exposure:* A 10% strengthening on average of the Canadian dollar against the US dollar for the three-month period and the nine-month period ended September 30, 2008 would have decreased net revenue by approximately \$155 and \$350, respectively. This analysis assumes that all other variables, in particular interest rates, remained constant during the quarter, and represents the exposure of the Company's revenues denominated in foreign currencies, to the relative strength of its functional currency. A 10% weakening of the Canadian dollar against the same would have had an equal but opposite effect.

*Expense Exposure:* A 10% strengthening on average of the Canadian dollar against the currencies in the above table for the three-month period and the nine-month period ended September 30, 2008 would have increased net earnings by approximately \$110 and \$300, respectively. This analysis assumes that all other variables, in particular interest rates, remained constant during the quarter, and represents the exposure of the Company's revenues denominated in foreign currencies, to the relative strength of its functional currency. A 10% weakening of the Canadian dollar against the same would have had an equal but opposite effect.

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## Notes to the (Unaudited) Interim Consolidated Financial Statements September 30, 2008 and 2007

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### 15. SEGMENTED INFORMATION

	Three months ended September 30, 2008			Three months ended September 30, 2007		
	Canada	USA	Total	Canada	USA	Total
Revenue from external customers	\$ 2,124	\$ 865	\$ 2,989	\$ 6,520	\$ 230	\$ 6,750
Inter-segment revenues	\$ -	\$ 117	\$ 117	\$ -	\$ 1,301	\$ 1,301
Interest revenue	\$ 12	\$ -	\$ 12	\$ 47	\$ -	\$ 47
Interest expense	\$ 285	\$ -	\$ 285	\$ 1	\$ -	\$ 1
Amortization of capital assets	\$ 105	\$ 38	\$ 143	\$ 129	\$ 48	\$ 177
Amortization of deferred costs	\$ 374	\$ -	\$ 374	\$ 109	\$ -	\$ 109
Segment loss	\$ (2,238)	\$ (292)	\$ (2,530)	\$ (1,527)	\$ (67)	\$ (1,594)
Segment assets	\$ 20,057	\$ 1,157	\$ 21,214	\$ 29,593	\$ 1,123	\$ 30,716
Expenditures for segment capital assets	\$ -	\$ -	\$ -	\$ 141	\$ 14	\$ 155

	Nine months ended September 30, 2008			Nine months ended September 30, 2007		
	Canada	USA	Total	Canada	USA	Total
Revenue from external customers	\$ 9,939	\$ 1,634	\$ 11,573	\$ 27,422	\$ 398	\$ 27,820
Inter-segment revenues	\$ -	\$ 1,397	\$ 1,397	\$ -	\$ 3,551	\$ 3,551
Interest revenue	\$ 45	\$ -	\$ 45	\$ 227	\$ -	\$ 227
Interest expense	\$ 526	\$ -	\$ 526	\$ 6	\$ -	\$ 6
Amortization of capital assets	\$ 318	\$ 129	\$ 447	\$ 364	\$ 137	\$ 501
Amortization of deferred costs	\$ 1,122	\$ -	\$ 1,122	\$ 109	\$ -	\$ 109
Segment loss	\$ (5,694)	\$ (1,475)	\$ (7,169)	\$ 82	\$ (780)	\$ (698)
Segment assets	\$ 20,057	\$ 1,157	\$ 21,214	\$ 29,593	\$ 1,123	\$ 30,716
Expenditures for segment capital assets	\$ 19	\$ 17	\$ 36	\$ 375	\$ 135	\$ 510

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### 15. SEGMENTED INFORMATION (continued)

#### Geographic Information

	Revenue				Capital Assets and Goodwill	
	For three months ended September 30		For nine months ended September 30		September 30	
	2008	2007	2008	2007	2008	2007
Canada	\$ 714	\$ 4,989	\$ 5,399	\$ 22,880	\$ 12,797	\$ 13,153
International	2,275	1,761	6,174	4,940	197	357
	<b>\$ 2,989</b>	<b>\$ 6,750</b>	<b>\$ 11,573</b>	<b>\$ 27,820</b>	<b>\$ 12,994</b>	<b>\$ 13,510</b>

The allocation of revenues to the geographic segments is based upon the location of the customer.

### 16. NET CHANGE IN NON-CASH WORKING CAPITAL

Net change in non-cash working capital items:

	For three months ended September 30		For nine months ended September 30	
	2008	2007	2008	2007
	Trade and other receivables	\$ 849	\$ 1,732	\$ 1,427
Unbilled revenue	973	(738)	656	(2,883)
Inventory	53	(36)	47	(136)
Accounts payable and accrued liabilities	26	605	(1,346)	(3,766)
Accrued costs on percentage completion	3	15	146	(312)
Deferred revenue	(390)	(786)	(371)	(8,186)
	<b>\$ 1,514</b>	<b>\$ 792</b>	<b>\$ 559</b>	<b>\$ (10,995)</b>

### 17. RELATED PARTY TRANSACTIONS

All related party transactions are in the normal course of operations, measured at their exchange amounts established and agreed to by the related parties. Amounts due to related parties are subject to normal trade terms. In the three months and nine months ended September 30, 2008, the Company incurred the following amounts with firms in which a director of the Company is an owner, partner or principal: \$267 and \$545 respectively (2007 - \$61 and \$377) for legal services, consulting services and meeting facilities. The cost of these services was charged to the ComVest term loan account as well as to general and administrative expenses. The amount due to related parties,

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### **17. RELATED PARTY TRANSACTIONS (continued)**

included in accounts payable and accrued liabilities, as at September 30, 2008 was \$189 (2007 - \$49).

On September 16, 2008, the Company's board of directors approved the reimbursement of \$90 of consulting fee expenditures to a company of which a member of the Company's board of directors is a principal shareholder. This amount will be paid in six equal monthly installments commencing in October, 2008 and is pursuant to a consulting agreement with this company. In addition, the consulting agreement calls for a fee of \$25 per month and the issue of 4,000,000 share purchase warrants (see note 9). The consulting agreement commenced in July 2008, for a term of one year. The share purchase warrants are subject to TSX and other necessary approvals, and under the terms of the consulting agreement, should such approvals not be obtained, equivalent compensation would be negotiated.