

**CONSOLIDATED FINANCIAL
INFORMATION**

Xenos Group Inc.

September 30, 2005.

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To Our Shareholders:

In the fall of 2001 Xenos began the task of rebuilding itself.

In the aftermath of the tech bubble and burst we found ourselves as the vendor of the best d2e middleware in the world, but with no executable long term strategic vision and limited ability to expand beyond the d2e beachhead in our very impressive customer base, largely composed of financial services, banking and brokerage components of the Fortune 1000.

We set out on a long term mission. Our specific objective: to identify, define and capture a defensible market niche where Xenos would be a dominant player and thereby gain our place in the sun. To accomplish this, we needed to achieve a number of ancillary goals including: broaden Xenos' technology base; continue to push the frontiers of our own and newly acquired technologies through an aggressive development agenda; standardize and integrate the components of our technology into a seamless whole; maintain, nourish, support and harvest our existing customer base; attract hire, train and motivate future "all star" employees; and, finally, we needed to build stakeholder and investor confidence while we completed our mission.

So, where do we stand at the end of fiscal 2005? Reporting to shareholders this year, we have taken the symbolically important step of liberating our new corporate positioning and mission statement from the confines of our Annual Financial Report, Report to Shareholders and Management Discussion and Analysis. In our corporate brochure "Vitalizing the Information Supply Chain" we have identified an important and newly emerging market we intend to dominate.

We have substantially accomplished all of the ancillary objectives set out above with the visible exception of one, "building investor confidence". We have not only failed to put good numbers on the board, but we have so far failed to communicate to the market the growing value of our Intellectual property and the franchise that we have been defining.

Fiscal 2005 was Xenos' first unprofitable year since we set out on our rebuilding mission in 2001. We had an operational plan to make money in fiscal 2005 but we were unable to successfully execute on our plan for a number of reasons. With the realization of our strategic vision within sight we ramped up spending, particularly in marketing and sales. Due to the lead times involved in training, acclimatization and engagement of our new recruits little additional revenue was generated by this activity in 2005. Second, we have been making significant investments in three promising new vertical markets (healthcare, logistics/ports and harbors, and county/municipal governments) where we have had early encouragement (though little revenue) but where we expect to excel over time. Our 2005 plan called for a significant number of "enterprise" sales of our d2e technologies to tide us over until our broadened product offering was suitable to be introduced to our traditional high value markets in financial services/insurance. Unfortunately, as a defense against "shelf ware" enterprise buying patterns have changed such that an enterprise scale transaction requires specific project identification and buy-in from all of the relevant decision makers. While we successfully negotiated a number of enterprise deals during the year, we are only able to recognize revenues as additional applications using our d2e technology are brought on line by our customers. Finally, the continued depreciation of the U.S. dollar has had a significant negative top and bottom line impact on our results.

For the 2005 fiscal year, Xenos reported revenues of \$14,470,000 and a net loss of \$1,763,000 or (\$.18) per share. This compares to revenues of \$16,204,000 and net earnings of \$479,000 or \$0.05 per share for fiscal 2004.

The disappointing financial results of 2005 should not be allowed to cloud the very substantial progress we have made in the last four years and the very substantial assets we have been building.

Our recurring revenue from product maintenance and multi-year contracts now represents about \$7.5 million per annum. Our focused and purposeful expenditures on technology acquisition and ongoing research and development has exceeded \$22 million over the past four years. We intend to see a return on that investment. We have invested heavily in people, and have assembled a motivated team of dedicated professionals in product development, customer support, professional services, sales and marketing, and the administrative personnel that bind it all together. We well understand the need to boost investor confidence by executing on Xenos' mission and returning the company to top line growth and profitability.

Xenos maintains a strong balance sheet, with a cash position of \$12 million or \$1.21 per common share⁽ⁱ⁾

Read "Vitalizing the Information Supply Chain". We think you will be very impressed with the progress and encouraged by the opportunity ahead. We are confident that our financial results will soon reflect the value of the investments that we have been making.



Stuart Butts
Chairman of the Board
And Chief Executive Officer



Jim Farmer
President and
Chief Operating Officer

Footnotes:

(i) Cash per share is a non-GAAP measure and is calculated by dividing the cash and short term investments by the number of common shares outstanding.

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

The following discussion and analysis should be read together with the Company's audited financial statements and related notes. The objective of the MD&A is to communicate the Company's vision and core business strategy as executed through key performance drivers. These drivers are enabled by the Company's capability to execute on the strategy through its resources and systems and are manifested in both the historical and prospective results.

Certain statements made in the Management's Discussion and Analysis, elsewhere in the annual report, in various filings with Canadian regulators, in reports to shareholders and in other communications, are forward-looking within the meaning of certain securities laws. Such forward-looking statements are based on a number of assumptions and involve known and unknown risks, uncertainties and other factors that may cause the actual results, performance or achievements of the Company or developments in the Company's business or its industry to differ materially from the anticipated results, performance, achievements or developments expressed or implied by such forward-looking statements. We urge you not to place undue reliance on these forward-looking statements as they are based on Management's current plans, estimates, opinions and projections. The Company assumes no obligation to update forward-looking statements if assumptions or these plans, estimates, opinions or projections should change.

Corporate History

Xenos Group Inc. ("Xenos") was formed under articles of amalgamation dated October 1, 1989. The Company acquired GenText, Inc. ("Gentext"), a private software development company located in Dallas, on January 1, 1998. Gentext had developed printstream transformation software that formed the basis of Xenos' current d2e Platform™ and d2e Vision™ products. On October 1, 1999, Xenos acquired Geneva Digital Limited ("Geneva"), a private value-added software reseller based in London, which sold and maintained third party document solutions in the U.K. Today, Geneva (now Xenos Europe Limited) is our sales office in Europe selling a combination of Xenos products, services and third party based document solutions. Xenos acquired Rush Creek Software Corporation ("Rush Creek"), a private software developer based in Dallas, on May 17, 2002. Rush Creek brought the infoWEB™ report distribution product to Xenos' suite of products in addition to its important customer base. Finally, on November 17, 2003, Xenos acquired the business assets of XML-Global Technologies, Inc. ("XML Global") which included the GoXML™ data integration suite of products, that now form the basis of Xenos' current terminalONE™ product suite, as well as certain key employees and its customer base.

Overview

Xenos provides software and services solutions that automate the processing and delivery of data and documents. Its solutions enable organizations to create powerful new information supply chains (ISCs), a seamlessly integrated assembly of dynamic applications and automated process engines that streamline and simplify the conversion of data and content into actionable business information. The company's products are embraced worldwide across a wide variety of industries by organizations concerned with improving the efficiency of information and data management while preserving investments in existing IT infrastructure, systems, applications and procedures.

Xenos solutions are scalable and meet the needs of high-volume data processing where performance is critical. Its solutions are hardware and platform agnostic, are supported

on all popular operating systems, and conform to open standards. Xenos product technologies include Xenos infoWEB™, a report and document distribution solution that consolidates information from incompatible systems to make them available for Web viewing; Xenos d2e™, a document enhancement solution that enables the transformation, repurposing, archival, retrieval, printing and Web viewing of documents across the enterprise; Xenos terminalONE™, an end-to-end, transaction gateway solution that expedites business transactions over the Internet and across disparate platforms; and GoXML Transform Designer™, a desktop utility that makes it easy for developers to map and transform a wide variety of industry standard data formats.

The Company has historically had success in a wide range of industry verticals, in particular banking, brokerage and insurance. It now provides its solutions to customers worldwide in key markets including financial services, insurance, telecommunications, healthcare, manufacturing, government, service bureaus, supply chain and retail.

Xenos partners with industry-leading software companies to provide end-to-end solutions for its customers. Key technology partnerships include Oracle, FileNet, IBM, and EMC/Documentum. The Company sells primarily through its direct sales force but also uses value-added resellers in specific markets such as in Latin America, Asia and certain parts of continental Europe. To a much lesser extent, the Company continues to sell through a small number of OEM and Service Bureau partners on an application specific basis.

Xenos Document Solutions (marketed principally in the UK) use in-house expertise, owned and third party software to enable organizations to automate, personalize and manage their business communications through document creation, content automation and content management.

Xenos has offices in Toronto, Dallas, London (U.K.), Paris (France) and Vancouver.

The authorized share capital of the Company consists of an unlimited number of Common Shares. As at September 30, 2005, there were 9,933,944 (2004 - 9,894,361) shares issued and outstanding. Stock options for a total of 958,138 (2004 - 1,112,388) shares were outstanding at exercise prices ranging from \$1.36 to \$4.36 (2004 - \$1.36 to \$42.00) with various expiry dates, the latest of which is July, 2010.

Fiscal 2005 Business Highlights

For Xenos, fiscal 2005 was a year of contrasts. The financial results were disappointing, in particular, the decline in top line revenue on a year over year basis. However, it was also a year of key strategic initiatives which included substantial completion and implementation of significant new product marketing approaches and related product development, increased market awareness and the establishment of an inside sales team.

Following the acquisition of important new technologies in fiscal 2002 and fiscal 2004, the challenge has been to integrate the operations and to position the breadth of offerings appropriately in the marketplace.

In fiscal 2005, product management completed a market assessment for the integrated offering and launched major new market-driven initiatives including the core technology framework to support high value, scalable applications across all components. This architecture delivers integrated Xenos solutions and the ability to create effective information supply chains. In addition to product marketing and brand positioning, targeted campaigns, white papers, press and industry analyst awareness, new approaches included the creation of a well-received free trial download site for the developer market to promote the XML-based technologies on a widespread basis.

After three consecutive years of profitability, the Company incurred a loss in fiscal 2005. The business plan had called for both a significant increase in marketing activities generally and an increased focus on enterprise-scale sales of the d2e technologies while the core technology framework initiative was being brought to fruition. Building, training, and integrating the marketing team and rolling out the new strategies took longer than originally anticipated. The increased focus on one time big ticket enterprise sales was largely unsuccessful due to changed corporate buying practices where enterprises are requiring buy-in for all instances of a product's intended implementation, rather than permitting a bulk "enterprise" purchase and subsequent roll-out. In summary, top line revenues did not receive any meaningful benefit from the marketing expenditures in the year due to the lead times required. Other factors impacting new license and service revenues included continued weakening of the US dollar, fewer and lower value component-based license sales and the learning curve of introducing new and evolving products into the distribution channel. These experiences only serve to reinforce the Company's view that the strategic adjustment that we have been undertaking these last three years is not only correct but necessary.

RESULTS OF OPERATIONS FOR THE YEAR ENDED SEPTEMBER 30, 2005

For the year ended September 30, 2005, sales were \$14.5 million as compared to \$16.2 million in the previous year. The decrease was largely driven by lower new license sales and the decline in the US dollar exchange rate partially offset by higher services revenue. Revenue by quarter during fiscal 2005 was \$3.5, \$3.2, \$4.5 and \$3.3 million respectively. In the previous year, revenue by quarter was \$4.5, \$3.8, \$3.8 and \$4.1 million respectively.

Geographically, 65% of sales in fiscal 2005 were in North America while 32% were in Europe compared to 62% and 34% respectively in fiscal 2004. License sales comprised approximately 28% of total revenues in fiscal 2005 compared to 29% in the prior year.

Gross profits for the year were 84% of sales compared to 82% in the prior year. The stability in the gross margin rate was primarily the result of a consistent mix of sales from year to year.

Sales and marketing expenses were \$7.4 million for the year compared with \$6.3 million in the prior year. This increase was primarily due to the planned increase in marketing activities. As a percentage of revenues, sales and marketing expenses were at 51% as compared to 39% last year.

Total expenditures on product development, including amounts deferred, were \$3.7 million during the year as compared to \$3.6 million in fiscal 2004. Financial expenditures in this area have been held relatively steady on a year over year basis notwithstanding our focus and commitment to the product reorientation described above.

Administrative expenses remained the same at \$2.2 million.

The Company allocates common costs to each department based on relative headcount or other relevant measures. These costs include rent and other facility-related costs, communication and infrastructure expenditures.

Amortization charges of \$1.1 million compare to \$1.4 million in fiscal 2004. The decrease was primarily in the amortization of deferred development where certain items became fully depreciated at the end of fiscal 2004.

Foreign exchange losses were \$124,000 as compared to losses of \$19,000 in the prior year. The change is largely due to a significant decrease in the US dollar exchange rate in the fourth quarter impacting US dollar denominated monetary assets.

The tax expense of \$219,000 (Fiscal 2004 – recovery of \$12,000) is primarily related to lower than anticipated utilization of tax loss carry-forwards in the Canadian parent which impacted the valuation allowance.

Interest income was \$240,000 as compared to \$204,000 in the previous year. The increase is primarily due to higher interest rates paid on the balances on account.

The net loss for the year ended September 30, 2005 was \$1.8 million or (\$0.18) per share as compared to net income of \$0.5 million or \$0.05 per share in the previous year.

RESULTS OF OPERATIONS FOR THE YEAR ENDED SEPTEMBER 30, 2004

For the year ended September 30, 2004, sales were \$16.2 million as compared to \$16.9 million in the previous year. The marginal decrease was largely driven by lower new license sales and the decline in the US dollar exchange rate partially offset by higher services revenue. Revenue by quarter during fiscal 2004 was \$4.5, \$3.8, \$3.8 and \$4.1 million respectively. In the previous year, revenue by quarter was \$4.4, \$4.1, \$3.9 and \$4.5 million respectively.

Geographically, 62% of sales in fiscal 2004 were in North America while 34% were in Europe compared to 62% and 35% respectively in fiscal 2003. License sales comprised approximately 29% of total revenues in fiscal 2004 compared to 33% in the prior year.

Gross profits for the year were 82% of sales compared to 80% in the prior year. The stability in the gross margin rate was primarily the result of a consistent mix of sales from year to year.

Sales and marketing expenses were \$6.3 million for the year compared with \$5.1 million in the prior year. This increase was primarily due to the planned increase in marketing activities following the XML Global acquisition and several new sales hires during the year. As a percentage of revenues, sales and marketing expenses were at 39% as compared to 30% last year.

Total expenditures on product development, including amounts deferred, were \$3.6 million during the year as compared to \$3.5 million in fiscal 2003. The overall increase in spending reflects an increase in staffing offset by lower bonus expenses and the reduction in the cost of our US based development team members due to the depreciation of the US dollar.

Administrative expenses decreased to \$2.2 million from \$2.5 million in the prior year primarily due to a decrease in bonus expenses.

The Company allocates common costs to each department based on relative headcount or other relevant measures. These costs include rent and other facility-related costs, communication and infrastructure expenditures.

Amortization charges of \$1.4 million compare to \$1.3 million in fiscal 2003. The increase reflects the amortization of certain new version releases during the year.

Foreign exchange losses were \$19,000 as compared to losses of \$557,000 in the prior year. The change is primarily due to a planned reduction in the amount of foreign denominated cash on hand during the year.

The tax recovery of \$12,000 (Fiscal 2003 – recovery of \$164,000) is primarily related to lower than anticipated utilization of tax loss carry-forwards in the Canadian parent and higher tax expenses in the US subsidiary.

Interest income was \$204,000 as compared to \$280,000 in the previous year. The decrease was due to a combination of lower interest rates and less cash on hand as a result of the XML Global transaction which closed in November 2003.

The net income for the year ended September 30, 2004 was \$0.5 million or \$0.05 per share as compared to \$1.6 million or \$0.19 per share in the previous year.

Quarterly Results

The following sets out on a quarterly basis, the sales and net (loss) income of the Company for Fiscal 2005 and 2004:

(\$000's except per share amounts)

	Fiscal 2005				Fiscal 2004			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Sales	\$3,231	\$4,508	\$3,206	\$3,525	\$4,110	\$3,825	\$3,805	\$4,464
Net (Loss) Income (i)	(341)	83	(997)	(508)	70	250	(334)	493
Net (Loss) Income per Share (i)								
Basic	(\$0.04)	\$0.01	(\$0.10)	(\$0.05)	\$0.01	\$0.02	(\$0.03)	\$0.05
Diluted	(\$0.04)	\$0.01	(\$0.10)	(\$0.05)	\$0.01	\$0.02	(\$0.03)	\$0.05

(i) – Net (Loss) Income is equivalent to (Loss) Income from Continuing Operations for the periods disclosed as there were no Discontinued Operations or Extraordinary Items.

Critical Accounting Policies and Estimates

The preparation of the Consolidated Financial Statements and the related notes require by necessity, that the Company make estimates and judgments. The Company reviews its estimates, including those related to revenues, bad debts, goodwill, acquired intangibles, deferred development, income taxes, contingencies and litigation. These estimates are based on historical experience and other assumptions believed to be reasonable under the circumstances. Under different assumptions, the reported results will differ, potentially materially, from those previously estimated. Many of the conditions impacting these assumptions and estimates are outside the Company's control.

The Company believes the following critical accounting policies reflect its more significant judgments and estimates.

Acquisition of XML Global

On November 17, 2003, Xenos acquired the business assets of XML Global for a combination of cash and stock which came with a price guarantee on the one year anniversary of the transaction. The purchase price equation and allocation between acquired intangible assets and goodwill was determined internally based on a methodology consistent with valuation calculations that had been done for the Company in the past by independent valuers. Although this calculation was reviewed by our external auditors, it was not performed by an independent valuation firm.

Revenue

In accordance with GAAP, license revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed and determinable, and collectibility is probable. The terms of each contract can vary but the Company

endeavours to apply consistent and appropriate treatment to them based on the available literature, professional judgment and consultation with its external auditors where deemed necessary.

Allowance for Doubtful Accounts

The Company provides for an allowance for doubtful accounts to reasonably provide for losses resulting from the inability of its customers to make required payments.

Valuation of Intangible Assets

The carrying value of goodwill and acquired intangibles are compared to their fair value at least annually to determine if a permanent impairment exists, at which time the impairment would be recorded as a charge to earnings. Valuations are inherently subjective and necessarily involve judgments and estimates regarding future cash flows and other operational variables.

The Company's practice is to review goodwill for impairment on an annual basis or when an event or a change in facts and circumstances indicates the fair value of a reporting unit may be below its carrying amount. Independent valuation firms are used to test for impairment whenever there are indications of impairment or under other circumstances every three years. The Company commissioned an external valuation for impairment test purposes in fiscal 2005 as part of its normal practice and no impairment was found to exist. The next scheduled external valuation is in fiscal 2008. The valuation methodology used includes the performance of a discounted cash flow calculation against projected cash flows for the Company as a whole.

Based on currently available information, management does not anticipate that an impairment of its goodwill or acquired intangibles will occur in the foreseeable future, although there can be no assurance of this.

Deferred Development

Development costs are deferred only as they relate directly to new products or functionality and where technological feasibility has been established. These deferred amounts are amortized following general release of the products over their estimated useful lives. The assets are also periodically reviewed for impairment by comparison to the expected future undiscounted cash flows that they are expected to generate.

Income, Sales & Other Taxes

Accounting for income taxes, in particular the future benefit of available loss carryforwards, is subjective by nature and requires the exercise of judgment. Tax assets are determined using a consistent model which incorporates estimated future earnings, expiry of loss carryforwards and the estimated probability of realization.

Income taxes are framed within a transfer pricing model in which the Canadian parent owns all intellectual property of the software products, the US subsidiary is a service provider and the UK subsidiary is a value-added reseller. The model is supported by contemporaneous documentation and advice from independent transfer pricing consultants.

Sales tax practices vary widely in the various jurisdictions into which we sell our products and services. This area requires the exercise of judgment in respect of applicability and determination of rates. The Company has a review process that is applied to every customer billing and also performs regular analytical reviews to assess its compliance from an overall perspective.

Stock-based Compensation

In accordance with new GAAP requirements, stock options are required to be expensed and incorporated into the financial statements as per certain transitional timelines (See Notes to Consolidated Financial Statements). The Company uses the Black-Scholes model to establish the fair value of the options granted. The calculation requires the estimation of certain inputs including expected volatility, risk-free interest rates and expected lives of the specific grants.

Litigation

With respect to legal proceedings, the Company assesses the likelihood that a loss will result, as well as the amount of such loss. The financial statements provide for the Company's best estimate of such losses as applicable.

Recent Accounting Pronouncements

In 2005, the CICA issued section 1530, "Comprehensive Income," section 3855, "Financial Instruments - Recognition and Measurement," and section 3865, "Hedges." The Company is currently evaluating the impact of these standards on its consolidated financial position and results of operations for future periods.

Controls and Procedures

As required by Multilateral Instrument 52-109 issued by the Canadian Securities Administrators, the CEO and CFO will be making certifications related to the information in the annual filings. As part of these certifications, the CEO and CFO must certify that they are responsible for establishing and maintaining disclosure controls and procedures and have designed such disclosure controls and procedures to ensure that material information of Xenos is made known to them and that they have evaluated the effectiveness of the disclosure controls and procedures as of the end of the period covered by these annual filings. The Company has documented and implemented such controls and procedures.

Evaluation of Disclosure Controls and Procedures

The Company's CEO and CFO, after evaluating the effectiveness of the disclosure controls and procedures as at September 30, 2005, have concluded that, as at September 30, 2005, the Company's disclosure controls and procedures were effective.

LIQUIDITY AND CAPITAL RESOURCES

As at September 30, 2005, cash and short-term investments stood at \$12.0 million (September 30, 2004 - \$12.6 million) or \$1.21 per common share (i). Cash from operations was \$0.5 million as compared to \$1.4 million in the previous year. Cash from operations in fiscal 2004 includes changes in non-cash working capital relating to the acquisition of the business assets of XML Global.

The Company currently has an operating line of credit of \$1.0 million of which \$500,000 (September 30, 2004 - \$ 500,000) was unused, bearing interest at bank prime. The Company continues to have no long-term debt other than a small obligation relating to capital leases.

Cash paid as additional consideration under the price guarantee mechanism for the acquisition of the business assets of XML Global was \$228,625 as compared to the initial payment of \$1.7 million during the previous year.

Capital expenditures for the year ended September 30, 2005 were \$251,000, versus \$323,000 in the prior year. The expenditure levels continue to be moderate given our emphasis on cost control and targeted spending. In addition, certain telecommunications equipment was acquired through capital leases in the current year and have been reflected in the balance sheet.

Development costs capitalized were \$640,000 versus \$619,000 last year and represent the internal development costs relating to specific products as required by Canadian GAAP. The most relevant factor in determining the appropriate treatment is the establishment of technological feasibility, which was the case for the majority of products developed this past year.

During the year, the Company entered into a new short-term lease in Vancouver and committed to additional leased space in its head office location subsequent to year end.

Shareholders equity stood at \$20.5 million or \$2.06 per share (ii) compared to \$22.4 million or \$2.26 per share (ii) as at September 30, 2004.

The Company anticipates that its current cash reserves and available credit facilities will be sufficient to fund its anticipated cash requirements for working capital and capital expenditures for at least the next 12 months. If the Company is required to raise additional funds for rapid expansion of its businesses or technologies, it could potentially issue equity or convertible debt which would cause current shareholders to experience dilution.

Commitments and Contractual Obligations

As of September 30, 2005, the Company had future commitments and contractual obligations as summarized in the following table.

Contractual Obligations	Total	Less than 1 year	1-3 Years	4-5 years	After 5 years
Capital Lease Obligations	\$ 161,494	\$ 45,516	\$ 84,568	\$ 31,410	\$ -
Operating Leases	3,089,664	405,386	784,065	644,493	1,255,720
Purchase Obligations	240,301	111,114	129,047	140	-
Total Contractual Obligations	3,491,459	\$ 562,016	\$997,680	\$ 676,043	\$1,255,720

Payments Due by Period

Risk Factors

You should carefully consider each of the following factors as well as the other information in this report in evaluating our business and our prospects. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently consider immaterial may also impair our business.

If the Canadian dollar continues to rise relative to the US dollar, future operating results will be negatively affected

The Company is a net exporter that currently derives about 60% of its revenue in US dollars whereas its cost base is largely in Canadian dollars with smaller proportions in

US dollars, UK pounds and Euros. Over the past few years, we have relocated most technical and administrative positions to our Toronto head office where we have a significant employee cost advantage, lower healthcare costs, the synergies of having departments located in the same facility and excellent availability of highly qualified individuals.

The decline of the US dollar therefore has a major impact on the Company's profitability as it negatively impacts revenues and reduces the cost advantage of staffing in Canada. For the past few years, we have entered into forward contracts in order to partially hedge the exposure of our US dollar receipts. Although the Company has been quite successful in reducing the impact of changes in the exchange rate through forward contracts, these measures obviously do not alter the fundamental challenge that the decline of the US dollar represents.

Our products and services may not gain market acceptance or competitors may introduce offerings that surpass those of the Company

The Company has assembled what it believes to be a unique suite of products along with an aggressive product marketing strategy that will be the basis of driving future revenue growth. There are numerous competitors in our market spaces, some of whom have significantly more resources than the Company. In addition, the market for the Company's products is subject to rapid technological change. There can be no assurance that the Company will be successful in driving significant revenue growth through its current strategy.

International operations expose the Company to increased business risks

The Company does over one-third of its business outside of North America. Operations in Europe, through our UK based subsidiary, are subject to certain risks and costs including the challenge of administering business abroad, compliance with foreign laws, language issues and limitations regarding the repatriation of funds. Sales into Latin America and Asia are through value-added resellers whose performance and sales effort is largely outside of the control of the Company.

The renewal of maintenance revenue on our older software sales may decline

The Company has historically enjoyed a very high retention rate across its various product lines. In addition, recurring revenue has been running at about 50% of overall revenues. As the products age, these retention rates may not be sustained unless the Company is successful in providing our customers with more advanced functionality and the levels of support that they require.

The loss of licenses to use or sell third party software or the lack of support or enhancement of such software could adversely affect the Company's business significantly

The Company, specifically its UK based subsidiary, depends on the sale and support of third party software for a significant component of its business. There can be no assurance that these third party products will be available on commercially reasonable terms or they may not be appropriately supported, maintained or enhanced by the licensors. Such occurrences would have significant adverse impacts on the Company although all efforts would be made to mitigate such impacts.

We derive significant recurring annual revenues from one customer and have reliance on individual contracts

Although not greater than 10% of revenues, the Company currently derives significant recurring annual revenue relating to multiple subsidiaries of one large multi-

national organization. Also, in any given quarter, license sales from individual transactions can be material and in some cases the related sales cycles can be long. Therefore, the Company's revenue and earnings can fluctuate materially between quarters due to the timing of significant license agreements. There is no guarantee or assurance that such timing will remain consistent making year over year comparisons less meaningful than in some other industries.

Other companies may claim that Xenos infringes on their intellectual property

The Company does not believe that its products infringe on the rights of third parties but there can be no assurance that such assertions will not be made resulting in costly litigation or the requirement to source alternate solutions on reasonable terms. By practice, the Company does not patent its intellectual property but rather relies upon a combination of trademark and trade secret laws, confidentiality procedures, contractual provisions and other measures to protect its proprietary information.

The impact of income, sales and other taxes may be higher than the Company believes

The Company is subject to taxes in a variety of jurisdictions and our tax structure is reviewed by domestic and foreign tax authorities. As a matter of practice, we allocate significant external and internal resources towards tax compliance efforts made by the Company. Although we believe our practices and estimates to be reasonable, adverse tax outcomes may differ from our reported results and could impact our financial results.

The Company's products may contain defects that would expose it to liability

The Company's business may subject it to the risk of product liability claims. From time to time, our software may contain design defects or software errors. These risks are mitigated through limitations in our customer contracts as well as the maintenance of Errors & Omissions insurance coverage where available on commercially reasonable terms. There can be no assurance that uninsured product claims will not have an adverse effect on the Company's business.

Financial Instruments can introduce risks to the organization

The Company does not employ the use of financial instruments other than the foreign exchange forward contracts for hedging purposes.

The Company's ability to manage cost containment could have a materially adverse impact on future profitability

The Company is endeavouring to construct a cost structure that will allow profits, if not reinvested, to scale at a much higher rate than revenue growth. Employee costs are by far the single largest expenditure of the organization. The Company recently reduced its level of employee subsidization for US benefits which had been growing at an unsustainable rate. Also, base salaries were frozen in fiscal 2005 with only moderate increases granted for fiscal 2006. Travel related costs are the second highest expense category and the Company maintains a centralized system of controls and procedures to ensure that only fiscally appropriate travel is undertaken. If the Company should lose control over its cost containment the result could threaten its business model.

Evolving financial reporting standards, regulation of corporate governance and public disclosure may result in additional expenses and continuing uncertainty

Changing financial reporting standards and corporate governance related laws, and regulations, including National Instrument 52-109, are creating challenges for a relatively small company such as ourselves. The application of these new securities laws will evolve over time which in the meantime will result in a period of uncertainty regarding compliance matters, liability of directors and officers, and higher costs. We are committed to maintaining a high standard of corporate governance and public disclosure and continue to be well into our scoped project to meet the required timelines for full certification.

The Company's ability to hire and retain key employees is significant

The Company's business is almost entirely dependent on the performance of its employees and its success on the ability of its managers to continually recruit, train and motivate. Due to financial constraints, the Company did not increase employee base salaries in fiscal 2005 except in the case of promotions. In addition, given uncertainty in the market regarding appropriate forms of long-term incentives, the Company has substantially deferred the issuance of stock options to employees, including Executive Management. In addition, a relatively large block of stock options expire in December 2006 which could aggravate the situation. Management monitors attrition rates carefully in order to assess trends and establish competitive benchmark compensation plans.

Corporate Governance

The Company's Board of Directors includes a majority of independent Directors and its Committees include Audit, Compensation, Nominating/Corporate Governance and Disclosure.

The members of the Audit Committee are all independent Board members and are financially literate. The Committee meets regularly to approve the release of financial information including the MD&A and also to oversee relations with auditors and stewardship issues including compliance with new regulatory requirements.

Key Performance Drivers

In addition to traditional GAAP financial statements, Management monitors numerous key performance indicators (KPI's) to assist in running the business. Some of these include sales pipeline, lead generation, software downloads, response from internet based marketing initiatives, maintenance renewal rates, average deal sizes, revenue by channel and component, professional services utilization rates, costs by department and attrition rates. These factors revolve around building an infrastructure that is scalable and which drives profitability at a rate that exceeds top line revenue growth.

Workplace environment and Compensation Structures

The Company has designed compensation structures aligned to shareholder interests. Bonus allocations are largely driven by company financial performance, depending on job function, and amounts earned under the plan are placed into departmental pools and allocated to individuals based entirely on merit. The workplace culture of the organization is one in which outstanding performance is rewarded and management time is heavily focused on empowering the success of "A" players rather than incrementally improving the performance of "C" players.

Outlook

The Company's strategy for creating value for shareholders is to drive sustainable and significant top line growth for each of its product lines, and increasingly for its overall "framework" and Information Supply Chain market offering, aligning the structure of the distribution channel accordingly, protecting the recurring revenue base and ultimately driving scalable long-term profitability.

Additional information regarding the Company is available on SEDAR at www.sedar.com.

Footnotes:

- (i) Cash per share is a non-GAAP measure and is calculated by dividing the cash and short term investments by the number of common shares outstanding.
- (ii) Shareholders' equity is a non-GAAP measure and is calculated by dividing the shareholders' equity by the number of common shares outstanding.

Management's Responsibility for Financial Reporting

The accompanying financial statements of Xenos Group Inc. (Xenos) are the responsibility of management and have been approved by the Board of Directors on recommendation by the Audit Committee.

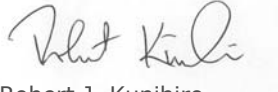
The financial statements have been prepared by management in accordance with generally accepted accounting principles. When alternative accounting methods exist, management has chosen those it deems most appropriate in the circumstances. Financial statements are not precise since they include certain amounts based on estimates and judgments. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly, in all material respects. Management has prepared financial information presented elsewhere in the annual report and has ensured that it is consistent with that in the financial statements.

Xenos maintains systems of internal accounting and administrative controls of high quality, consistent with reasonable cost. Such systems are designed to provide reasonable assurance that the financial information is relevant, reliable and accurate and that the company's assets are appropriately accounted for and safeguarded.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and is ultimately responsible for reviewing and approving the financial statements. The Board carries out this responsibility through its Audit Committee.

The Audit Committee is appointed by the Board. The Committee meets periodically with management and the external auditors to discuss internal controls over the financial reporting processes, auditing matters and financial reporting issues to satisfy itself that each party is properly discharging its responsibilities, and to review the financial statements and the external auditors' report. The Committee reports its findings to the Board for consideration when approving the financial statements for issuance to the shareholders. The Committee also considers, for review by the Board and approval by the shareholders, the engagement or re-appointment of the external auditors.

Financial statements have been audited by Grant Thornton LLP, the external auditors, in accordance with generally accepted auditing standards on behalf of the shareholders. Grant Thornton LLP has full and free access to the Audit Committee.



Robert J. Kunihiro
Executive Vice President and Chief Financial Officer
November 11, 2005

Auditors' Report

To the Shareholders of Xenos Group Inc.

We have audited the consolidated balance sheets of Xenos Group Inc. as at September 30, 2005 and 2004 and the consolidated statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at September 30, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.



Chartered Accountants

Markham, Canada
November 11, 2005

Xenos Group Inc.

Consolidated Statements of Operations

Year Ended September 30	2005	2004
Sales	\$ 14,469,798	\$ 16,203,559
Cost of sales	<u>2,309,136</u>	<u>2,885,234</u>
Gross profit	<u>12,160,662</u>	<u>13,318,325</u>
Expenses		
Sales and marketing	7,396,590	6,347,112
Research and development	3,046,205	3,021,086
Administration and general	2,242,994	2,196,500
Amortization	1,092,191	1,439,458
Interest and bank charges	<u>42,666</u>	<u>32,784</u>
	<u>13,820,646</u>	<u>13,036,940</u>
	(1,659,984)	281,385
Other income		
Interest and other	240,059	204,188
Foreign exchange loss	<u>(123,826)</u>	<u>(19,183)</u>
(Loss) income before income taxes	(1,543,751)	466,390
Provision (recovery) of income taxes (Note 12)	<u>219,441</u>	<u>(12,321)</u>
Net (loss) income	\$ <u>(1,763,192)</u>	\$ <u>478,711</u>
Net (loss) income per common share (Note 21)		
Basic	\$ <u>(0.18)</u>	\$ <u>0.05</u>
Diluted	\$ <u>(0.18)</u>	\$ <u>0.05</u>
Weighted average number of shares outstanding		
Basic	<u>9,921,011</u>	<u>9,759,154</u>
Diluted	<u>9,921,011</u>	<u>10,146,246</u>
Deficit, beginning of year as previously stated	\$ (22,775,608)	\$ (23,254,319)
Change in accounting policy (Note 3)	<u>(65,141)</u>	-
Deficit, beginning of year as restated	(22,840,749)	(23,254,319)
Net (loss) income	<u>(1,763,192)</u>	<u>478,711</u>
Deficit, end of year	\$ <u>(24,603,941)</u>	\$ <u>(22,775,608)</u>

See accompanying notes to the consolidated financial statements.

Xenos Group Inc.

Consolidated Balance Sheets

September 30

2005

2004

Assets

Current

Cash and short term investments (Notes 13 and 18)	\$ 12,033,741	\$ 12,644,064
Trade receivables	1,118,206	2,258,593
Other receivables	3,502	550
Prepays	890,837	833,860
Future income taxes (Note 12)	<u>63,007</u>	<u>204,350</u>
	14,109,293	15,941,417

Long term

Future income taxes (Note 12)	1,792,856	1,846,460
Capital assets (Note 5)	1,250,855	1,192,556
Intangibles and other assets (Note 6)	2,945,183	3,021,060
Goodwill (Note 7)	<u>6,302,182</u>	<u>6,243,616</u>
	\$ 26,400,369	\$ 28,245,109

Liabilities

Current

Bank indebtedness (Note 9)	\$ 500,000	\$ 500,000
Payables and accruals	1,686,844	1,595,100
Income taxes payable	56,754	55,736
Deferred revenue	3,331,294	3,656,403
Current portion – capital lease (Note 8)	<u>39,341</u>	<u>16,043</u>
	5,614,233	5,823,282

Long term

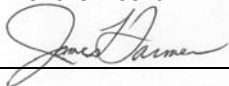
Capital lease obligations (Note 8)	113,492	-
Deferred revenue	-	21,424
Deferred rent (Note 19)	<u>163,862</u>	<u>43,619</u>
	5,891,587	5,888,325

Shareholders' Equity

Capital stock (Note 10)	44,964,085	45,127,398
Contributed surplus (Note 11)	148,638	4,994
Deficit	<u>(24,603,941)</u>	<u>(22,775,608)</u>
	20,508,782	22,356,784
	\$ 26,400,369	\$ 28,245,109

Commitments and contingencies (Notes 14 and 15)

On behalf of the Board

 Director

 Director

See accompanying notes to the consolidated financial statements.

Xenos Group Inc.

Consolidated Statements of Cash Flows

Year Ended September 30

2005

2004

Cash derived from (applied to)

Operating		
Net (loss) income	\$ (1,763,192)	\$ 478,711
Amortization	1,092,191	1,439,458
Loss on sale of capital assets	-	6,969
Future income taxes	194,947	(69,365)
Stock based compensation (Note 17)	78,503	2,724
Change in non-cash working capital (Note 13)	<u>946,930</u>	<u>(505,695)</u>
	<u>549,379</u>	<u>1,352,802</u>
Financing		
Share Issuance Costs	-	(3,500)
Capital lease payments	(47,137)	(17,280)
Proceeds on issue of shares	<u>65,312</u>	<u>16,675</u>
	<u>18,175</u>	<u>(4,105)</u>
Investing		
Cash paid on acquisition of business assets (Note 4)	(228,625)	(1,669,928)
Additional consideration paid on acquisitions (Note 7)	(58,566)	(66,671)
Purchase of capital assets	(250,959)	(322,735)
Proceeds on disposal of capital assets	-	1,272
Development costs incurred	<u>(639,727)</u>	<u>(618,844)</u>
	<u>(1,177,877)</u>	<u>(2,676,906)</u>
Net decrease in cash	(610,323)	(1,328,209)
Cash and cash equivalents, beginning of year	<u>12,644,064</u>	<u>13,972,273</u>
Cash and cash equivalents, end of year	\$ <u>12,033,741</u>	\$ <u>12,644,064</u>

See accompanying notes to the consolidated financial statements.

Xenos Group Inc.

Notes to the Consolidated Financial Statements

September 30, 2005

1. Nature of operations

Xenos has provided data and document management solutions for over 20 years. Its products are used worldwide across a wide variety of industries by organizations concerned with improving the efficiency of information and data management while preserving investments in existing IT infrastructures, systems, applications and procedures.

Xenos' products accept many types of input in the form of data, documents or a combination of both and its scalable solutions meet the needs of high-volume data processing where performance is critical. Its solutions are hardware and platform agnostic and are supported on many popular operating systems. Xenos solutions conform to open standards and readily adapt to in-house applications without changes or custom programming. Xenos Document Solutions use in-house expertise, owned and third party software to enable organizations to automate, personalize and manage their business communications through document creation, content automation and content management.

The Company has offices in Canada, the United States, the United Kingdom and France.

2. Summary of significant accounting policies

The consolidated financial statements of the Company were prepared by management in accordance with Canadian generally accepted accounting principles.

Accounting estimates

In preparing the Company's financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported amounts of revenues and expenses. Significant areas requiring the use of management estimates include the useful lives of capital assets, the amount of investment tax credits to be received, the evaluation of impairment for long term assets, the value of assets acquired and liabilities assumed in business combinations, and the provision for income taxes. Long-lived assets, including capital assets and acquired intangibles are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amounts may not be recoverable from estimated future cash flows. Actual results could differ from those estimates.

Principles of consolidation

The consolidated financial statements include the accounts of all companies in which the Company has a controlling interest, after the elimination of inter-company transactions and balances.

Investment tax credits

Investment tax credits relating to scientific research and experimental development expenditures are recorded as a reduction of the expenditure whether current or capital in nature. Investment tax credits are recorded when there is reasonable assurance they will be realized.

Xenos Group Inc.

Notes to the Consolidated Financial Statements

September 30, 2005

2. Summary of significant accounting policies (continued)

Amortization

Amortization of capital assets is recorded from the date of acquisition over their estimated service lives, on the following bases:

Computer equipment	30% declining balance
Software	33% straight-line
Office furniture and equipment	20% declining balance
Vehicles	25% declining balance
Leasehold improvements	Straight-line over the term of the lease plus the first option period

Deferred development costs are amortized on a straight-line basis over their estimated useful lives, currently ranging from 3 to 5 years.

Goodwill

Goodwill arises on acquisitions and comprises the excess of amounts paid over the fair value of the net assets acquired. Goodwill is not amortized. The carrying value of goodwill is compared to its fair value annually to determine if a permanent impairment in value exists, at which time the impairment is recorded as a charge to earnings. Independent valuation firms are used to test for impairment whenever there are indications of impairment or under other circumstances every three years. An external valuation was conducted for the current fiscal year which indicated no impairment.

Acquired intangibles

Acquired intangibles represent the purchase price allocated to intellectual property rights acquired in a business acquisition. Acquired intangibles are being amortized on a straight-line basis over ten years, being the estimated useful life of the asset.

Revenue recognition

The Company recognizes revenue on software licenses when persuasive evidence of an arrangement exists, the related products are shipped, the fees are fixed and determinable and collection is considered probable. Customization and implementation revenues are recognized as the services are performed on a percentage of completion basis. Revenue from annual maintenance and support is recognized ratably over the period of substantial performance of the contracted deliverables, after ratification thereof.

Research and development

Research costs are expensed as incurred. Development costs are expensed as incurred unless a project meets the criteria under generally accepted accounting principals for deferral and amortization. The Company has deferred development costs in the current year.

Xenos Group Inc.

Notes to the Consolidated Financial Statements

September 30, 2005

2. Summary of significant accounting policies (continued)

Derivative financial instruments

The Company's use of derivative instruments is intended to manage the risk of foreign currency fluctuations on revenue. The Company does not hold or issue derivative instruments for trading purposes. Accordingly, the Company accounts for exchange gains and losses on forward exchange contracts at the time of occurrence of the hedged transaction.

Gains and losses on forward exchange contracts cancelled prior to maturity are deferred and recognized at the time the originally hedged transactions occur.

Translation of foreign currencies

Canadian legal entities and integrated foreign subsidiaries translate monetary assets and liabilities at the year end rate of exchange. Non-monetary items are translated at the exchange rate in effect on the date on which the transaction occurred. Revenue and expenses are translated at average rates of exchange, except for depreciation, which is translated at the rates prevailing when the related assets were acquired. Translation gains and losses are included in earnings.

Stock-based compensation plan

The Company has a stock-based compensation plan, which is described in Note 17. Effective October 1, 2004, compensation expense is recognized with respect to these plans with a corresponding credit to contributed surplus. Any consideration paid upon exercise of options and issues of shares is credited to share capital as is any related amount in contributed surplus. Previously, the Company provided proforma disclosure of net earnings and per share information as if the Company had accounted for employee stock options under the fair value method from the date of implementation of the new standard on October 1, 2002.

Income taxes

The Company provides for income taxes using the liability method of tax allocation. Under this method, future income tax assets and liabilities are determined based on deductible or taxable temporary differences between financial statement values and tax values of assets and liabilities, using enacted income tax rates expected to be in effect for the year in which the differences are expected to reverse.

The Company establishes a valuation allowance against future income tax assets if, based on available information, it is more likely than not that one or all of the future tax assets will not be realized.

Xenos Group Inc.

Notes to the Consolidated Financial Statements

September 30, 2005

3. Change in accounting policies

Stock-based compensation

Effective October 1, 2004, the Company retroactively adopted, without restatement, the amended recommendations of the Canadian Institute of Chartered Accountants (CICA) handbook section 3870 regarding accounting for stock-based compensation. In accordance with these standards, the Company recognizes, at the grant date, the compensation costs of the stock options granted to employees and directors, measured at fair value and expensed over the period in which the related services are rendered, with a corresponding increase to contributed surplus. Previously, under the intrinsic method, the Company disclosed the pro-forma effects to net earnings (loss) and earnings (loss) per share as if the fair value method had been used on stock-based awards to employees and directors and no compensation expense was recognized.

The Company has a stock option plan for directors, officers, employees and consultants described in Note 17. Under the fair value based method, compensation expense for stock options is measured at fair value at the date of the grant using the Black-Scholes option pricing model and is recognized over the period in which the related services are rendered. The Company has not restated prior years' reported amounts, and accordingly the October 1, 2004 deficit and contributed surplus were increased by \$65,141 to account for stock-based compensation that would have been charged to operations with respect to stock options granted during the period October 1, 2002 to September 30, 2004.

4. Acquisition of assets from XML-Global Technologies Inc.

Effective November 17, 2003, the Company acquired substantially all of the business assets of XML-Global Technologies, Inc. ("XML Global"), a software developer and vendor of XML middleware products. The Company acquired XML Global's intellectual property, customer relationships, and operating assets and retained all employees, for a total purchase price of \$5,169,928. The net assets acquired are as follows:

Accounts receivable (net)	\$	21,482
Office furniture and fixtures		52,400
Intangible assets		<u>1,054,000</u>
Total identifiable assets		1,127,882
Total liabilities		<u>81,034</u>
Net assets	\$	<u>1,046,848</u>
Acquisition price	\$	<u>5,169,928</u>
Allocation:		
Net assets	\$	1,046,848
Goodwill (Note 7)		<u>4,123,080</u>
	\$	<u>5,169,928</u>

Xenos Group Inc.

Notes to the Consolidated Financial Statements

September 30, 2005

4. Acquisition of assets from XML-Global Technologies Inc. (continued)

Consideration:

Cash paid on acquisition	\$ 1,669,928
Cash paid subsequently in accordance with the share price guarantee	228,625
	<u>1,898,553</u>

Shares issued	<u>3,271,375</u>
	<u>\$ 5,169,928</u>

During the year, as per the terms of the Company's acquisition of substantially all of the business assets of XML Global, the remaining 250,000 common shares were released from escrow and a one-time cash payment of \$228,625 was made to the holders. This payment was reflected as a reduction in Capital Stock.

5. Capital assets

	<u>2005</u>	<u>2004</u>
Cost		
Computer equipment	\$ 2,687,290	\$ 2,566,385
Software	875,475	831,136
Leasehold improvements	529,320	502,064
Office furniture and equipment	981,128	919,783
Asset under capital lease	<u>234,994</u>	<u>51,067</u>
	<u>5,308,207</u>	<u>4,870,435</u>
Accumulated amortization		
Computer equipment	2,181,200	2,010,407
Software	756,573	669,765
Leasehold improvements	340,052	315,713
Office furniture and equipment	713,286	655,324
Asset under capital lease	<u>66,241</u>	<u>26,670</u>
	<u>4,057,352</u>	<u>3,677,879</u>
Net book value		
Computer equipment	506,090	555,978
Software	118,902	161,371
Leasehold improvements	189,268	186,351
Office furniture and equipment	267,842	264,459
Asset under capital lease	<u>168,753</u>	<u>24,397</u>
	<u>\$ 1,250,855</u>	<u>\$ 1,192,556</u>

Additions of assets under capital lease were \$183,927 (2004 - \$Nil). Included in amortization expense in the income statement is \$376,587 (2004 - \$470,697) related to amortization and depreciation of capital assets.

Xenos Group Inc.

Notes to the Consolidated Financial Statements

September 30, 2005

6. Intangibles and other assets	<u>2005</u>	<u>2004</u>
Cost		
Deferred development costs	\$ 6,356,109	\$ 5,716,382
Acquired intangible assets	<u>1,104,000</u>	<u>1,104,000</u>
	<u>7,460,109</u>	<u>6,820,382</u>
Accumulated amortization		
Deferred development costs	4,300,426	3,695,222
Acquired intangible assets	<u>214,500</u>	<u>104,100</u>
	<u>4,514,926</u>	<u>3,799,322</u>
Net book value		
Deferred development costs	2,055,683	2,021,160
Acquired intangible assets	<u>889,500</u>	<u>999,900</u>
	<u>\$ 2,945,183</u>	<u>\$ 3,021,060</u>

Included in amortization expense in the income statement is \$605,204 (2004 - \$871,536) related to amortization of deferred development costs and \$110,400 (2004 - \$97,225) related to amortization of acquired intangibles.

7. Goodwill	<u>2005</u>	<u>2004</u>
Net book value, beginning of period	\$ 6,243,616	\$ 2,066,578
Additions related to acquisition of business assets (Note 4)	-	4,123,080
Additional consideration paid on acquisitions	58,566	66,671
Realized tax asset benefit	<u>-</u>	<u>(12,713)</u>
Net book value, end of period	<u>\$ 6,302,182</u>	<u>\$ 6,243,616</u>

During the year ended September 30, 2002, the Company purchased the share capital of Rush Creek Software Corporation and as part of the purchase price the Company agreed to pay the former principals of Rush Creek Software Corporation additional consideration. These amounts will be equal to 5% of the net receipts on sales of the infoWEB™ product completed prior to May 14, 2007.

During the year, the Company paid additional consideration of \$58,566 (2004 - \$66,671) to the former owners of Rush Creek Software Corporation. At the date of acquisition, a future income tax asset existed but was not recorded in accordance with Management's determination. Generally accepted accounting principles require that when the benefit of this asset is realized it is recorded as a reduction of goodwill previously recognized. During the year ended September 30, 2004, the Company realized the remainder of this benefit (\$12,713) and reduced goodwill accordingly.

An external valuation was conducted for the current fiscal year which indicated no impairment.

Xenos Group Inc.

Notes to the Consolidated Financial Statements

September 30, 2005

8. Capital lease obligation	<u>2005</u>	<u>2004</u>
Capital lease obligation payable in monthly principal and interest instalments of \$4,100.	\$ 152,833	\$ 16,043
Less: current portion	<u>39,341</u>	<u>16,043</u>
	<u>\$ 113,492</u>	<u>\$ -</u>

Future minimum payments under capital lease are as follows:

2006	\$ 49,194
2007	49,194
2008	41,559
2009	<u>33,924</u>
Total minimum payments	173,871
Less: amount representing interest	<u>21,038</u>
	<u>\$ 152,833</u>

Included in interest and bank charges in the income statement is \$11,353 (2004 - \$3,034) related to capital lease obligations.

9. Bank indebtedness

The Company has a revolving operating line of credit available for \$1,000,000 (2004 - \$1,000,000), of which \$500,000 was unused at September 30, 2005 (2004 - \$500,000). This demand loan bears interest at the Royal Bank Prime Rate which was 4.5 % at September 30, 2005.

Security provided by the Company for the line of credit includes a general security agreement covering all the assets of the Company.

10. Capital stock	<u>2005</u>		<u>2004</u>	
	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>
Balance, beginning of year	9,894,361	\$ 45,127,398	8,883,750	\$ 41,614,223
Issued pursuant to exercise of vested stock options (Note 17)	39,583	65,312	10,611	16,675
Share issuance costs	-	-	-	(3,500)
Issued pursuant to acquisition of XML Global business assets	-	-	1,000,000	3,500,000
Reduction due to cash paid subsequently pursuant to the share price guarantee (Note 4)	<u>-</u>	<u>(228,625)</u>	<u>-</u>	<u>-</u>
Balance, end of year	<u>9,933,944</u>	<u>\$ 44,964,085</u>	<u>9,894,361</u>	<u>\$ 45,127,398</u>

Xenos Group Inc.

Notes to the Consolidated Financial Statements

September 30, 2005

10. Capital stock (continued)

The authorized share capital of the Company consists of an unlimited number of Common Shares, no par value, issued 9,933,944 (2004 - 9,894,361) and an unlimited number of special shares issuable in series, none issued.

During 2005, as per the terms of the Company's acquisition of substantially all of the business assets of XML Global the remaining 250,000 common shares were released from escrow and a one-time cash payment of \$228,625 was made to the holders. This payment was reflected as a reduction in Capital Stock (see Note 4).

11. Contributed surplus	<u>2005</u>	<u>2004</u>
Balance, beginning of year	\$ 4,994	\$ 2,270
Retroactive adoption of the fair value method (Note 3)	65,141	-
Stock based compensation	<u>78,503</u>	<u>2,724</u>
Balance, end of year	\$ <u>148,638</u>	\$ <u>4,994</u>

12. Income taxes

The reconciliation of the statutory federal and provincial rates to the Company's effective income tax rate is as follows:

	<u>2005</u>	<u>2004</u>
Combined basic income tax	\$ (557,458)	\$ 181,260
Effect of differing tax rates of foreign jurisdictions	32,552	20,118
Non-deductible expense	26,204	(76,761)
Other	(11,889)	384,620
Increase (decrease) in valuation allowance	<u>730,032</u>	<u>(521,558)</u>
	\$ <u>219,441</u>	\$ <u>(12,321)</u>
Income tax expense		
Current	\$ 24,494	\$ 69,758
Future	<u>194,947</u>	<u>(82,079)</u>
	\$ <u>219,441</u>	\$ <u>(12,321)</u>

Xenos Group Inc.

Notes to the Consolidated Financial Statements

September 30, 2005

12. Income taxes (continued)

Future income taxes represent the future benefits of temporary differences between the tax and accounting bases of assets and liabilities consisting of:

	<u>2005</u>	<u>2004</u>
Future tax assets		
Net operating loss carryforwards	\$ 5,329,016	\$ 4,983,348
Investment tax credits	761,327	703,073
Foreign tax credits	81,459	118,918
Differences between accounting and tax carrying values	610,045	441,423
Valuation allowance	<u>(4,925,984)</u>	<u>(4,195,952)</u>
Net future tax asset	1,855,863	2,050,810
Less current	<u>(63,007)</u>	<u>(204,350)</u>
Long term	\$ <u>1,792,856</u>	\$ <u>1,846,460</u>

The loss carryforward amounts for income tax purposes if unused will expire as follows:

	<u>Non-capital losses</u>		<u>Tax credits</u>	
	<u>Federal</u>	<u>Provincial/State</u>	<u>Federal</u>	<u>Provincial/State</u>
2006	\$ -	\$ -	\$ 1,395	\$ -
2007	5,442,277	5,957,773	-	-
2008	7,207,265	7,214,074	2,781	-
2009	460,866	444,999	99,849	-
2010-2021	<u>1,631,541</u>	<u>580,408</u>	<u>738,761</u>	<u>-</u>
	\$ <u>14,741,949</u>	\$ <u>14,197,254</u>	\$ <u>842,786</u>	\$ <u>-</u>

The above noted losses include those that have been recorded as future tax assets net of an appropriate valuation allowance.

13. Supplemental cash flow information

	<u>2005</u>	<u>2004</u>
(a) Change in non-cash operating working capital:		
Receivables	\$ 1,137,435	\$ 284,093
Prepays	(56,977)	160,402
Income taxes recoverable	-	1,215
Payables and accruals	91,744	(967,438)
Income taxes payable	1,018	(27,417)
Deferred Rent	120,243	13,582
Deferred revenue	<u>(346,533)</u>	<u>29,868</u>
	\$ <u>946,930</u>	\$ <u>(505,695)</u>

Xenos Group Inc.

Notes to the Consolidated Financial Statements

September 30, 2005

13. Supplemental cash flow information (continued)	<u>2005</u>	<u>2004</u>
(b) Cash and short term investments consist of cash on hand, balances with banks, cash equivalents and short term investments. (See Note 18)		
(c) Interest paid	\$ <u>42,666</u>	\$ <u>32,784</u>
(d) Income taxes paid (net of recoveries)	\$ <u>12,267</u>	\$ <u>27,416</u>
(e) Reorganization costs paid (Note 16)	\$ <u>37,532</u>	\$ <u>58,760</u>

14. Commitments

The Company has entered into future commitments and contractual obligations for operating leases, capital leases and certain purchase obligations. Minimum payments in aggregate and for each of the next five years are as follows:

2006	\$ 562,016
2007	549,834
2008	447,846
2009	350,412
2010	325,631
Thereafter	<u>1,255,720</u>
	\$ <u>3,491,459</u>

15. Contingencies

The Company is a party to a legal proceeding brought by a shareholder of a predecessor company alleging entitlement to 135,900 Class A shares of the predecessor company. An estimate of the potential loss cannot be determined, if any.

The Company denies entitlement and intends to vigorously defend this action.

16. Reorganization costs

During the fourth quarter of fiscal 2001, the Company incurred a reorganization charge of \$1.2 million, which included a 25% reduction in headcount and the relocation of all UK based head office management, marketing and administrative functions to Toronto. During the year ended September 30, 2005, the remaining commitment on a remote office lease expired and the outstanding liability which had been included in accrued liabilities as at September 2004 of \$37,500 was depleted.

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Notes to the Consolidated Financial Statements

September 30, 2005

17. Stock-based compensation plan

(a) Stock option plan

The Company has a stock option plan which allows the granting of stock options to employees and service providers up to an aggregate of 1.6 million common shares. Under current company practice the options, which have a five-year term, vest immediately for directors and generally over 3 - 4 years for all others, commencing on the grant date. The exercise price of each option equals the closing market price of the Company's common shares on the last trading day preceding the date of grant.

A summary of the status of the Company's stock option plan as of the fiscal year ends 2005 and 2004 and changes during each fiscal year is presented below.

	Shares		Weighted Average Exercise Price	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Outstanding, beginning of year	1,112,388	936,833	4.00	4.02
Granted	57,000	207,000	2.27	3.68
Exercised	(39,583)	(10,611)	1.65	1.57
Forfeited	(171,667)	(20,834)	14.39	2.69
Outstanding, end of year	<u>958,138</u>	<u>1,112,388</u>	<u>2.14</u>	<u>4.00</u>
Options exercisable at year end	<u>813,138</u>	<u>714,453</u>		

The following information applies to options outstanding and exercisable at September 30, 2005:

<u>Exercise Price</u>	<u>Number outstanding and exercisable</u>	<u>Number outstanding but not exercisable</u>	<u>Weighted average remaining life in months</u>	<u>Weighted average exercise price</u>	<u>Expiry</u>
\$ 1.36	2,000	-	17	\$ 1.36	February, 2007
1.50	2,000	-	16	1.50	January, 2007
1.65	628,138	-	15	1.65	December, 2006
1.65	20,000	-	23	1.65	August, 2007
1.65	25,000	-	20	1.65	May, 2007
1.95	-	10,000	59	1.95	July, 2010
2.20	8,000	-	30	2.20	March, 2008
2.29	-	20,000	53	2.29	February, 2010
2.35	17,000	-	53	2.35	February, 2010
2.40	-	10,000	53	2.40	February, 2010
3.20	20,000	-	4	3.20	January, 2006
3.25	9,000	-	3	3.25	December, 2005
3.45	38,750	26,250	38	3.45	November, 2008
3.60	5,000	15,000	38	3.60	November, 2008
3.80	21,250	63,750	37	3.80	October, 2008
4.05	5,000	-	4	4.05	January, 2006
4.36	12,000	-	42	4.36	March, 2009

Xenos Group Inc.

Notes to the Consolidated Financial Statements

September 30, 2005

17. Stock-based compensation plan (continued)

(b) Pro forma disclosure

Pro forma disclosure of net income and earnings per share for fiscal 2004 as if the Corporation had elected to adopt the fair value based accounting method retroactively with restatement for all employee awards granted on or after October 1, 2002 (Note 2):

Net income for the period		
As reported	\$	478,711
Pro forma	\$	417,110
Net income per share - basic		
As reported	\$	0.05
Pro forma	\$	0.04
Net income per share –diluted		
As reported	\$	0.05
Pro forma	\$	0.04

(c) Fair value determination

The fair value of each stock option grant on the date of grant was estimated using the Black-Scholes option-pricing model with the following assumptions: dividend yield 0%, expected volatility 35% (2004 – 35%), risk-free interest rates of 3.32 - 3.43% (2004 – 3.28 - 3.85%) and expected lives of 2 - 4 years (2004 – 2 - 4 years) as applicable to the specific grants.

18. Financial instruments

Current financial assets and liabilities

Due to the short period to maturity of the instruments, the carrying values as presented in the consolidated balance sheets are reasonable estimates of fair value. As at September 30, 2005 cash and short term investments include \$9,797,518 of interest bearing notes (2004 - \$9,964,909).

Capital leases

The fair value of the Company's capital leases, based on current rates for leases with similar terms, is not materially different from their carrying value.

Foreign currency risk

The following factors create significant exposure with regard to fluctuations in exchange rates:

- the majority of the Company's sales are denominated in U.S. dollars and British pounds
- Xenos Inc., a subsidiary of the Company, operates in the United States
- Xenos Europe Limited, a subsidiary of the Company, operates in the United Kingdom

Xenos Group Inc.

Notes to the Consolidated Financial Statements

September 30, 2005

18. Financial instruments (continued)

The Company attempts, as much as possible, to match cash outlays with cash inflows in the same currency. The Company's revenues denominated in U.S. dollars generate sufficient U.S. dollars to cover its annual U.S. dollar expenses and act as a hedge against exchange rate fluctuations. The Company's revenues denominated in British pounds generate sufficient British pounds to cover its annual British pound expenses and act as a hedge against exchange rate fluctuations.

Foreign exchange contracts

From time to time, the Company uses foreign exchange forward contracts to hedge portions of its forecasted revenues denominated in foreign currencies. These forward contracts are designated and documented as revenue hedges. As a matter of policy, the Company does not enter into speculative futures contracts or use other derivative financial instruments. These activities serve to minimize, but not eliminate, the risk from fluctuations in the exchange rate between the foreign currency and the Canadian dollar.

The Company formally documents all relationships between hedging instruments and hedging items, as well as the risk management objective and strategy for undertaking various hedge transactions. This process includes linking all hedging instruments to specific firm commitments or anticipated transactions. The company also formally assesses, both at the hedge's inception and on an ongoing basis, whether the hedging instruments that are used in hedging transactions are effective in offsetting hedged risks. If not designated as hedges, forward exchange contracts are accounted for at fair value, with gains and losses recorded in the consolidated financial statements as changes in value occur.

As at September 30, 2005 the Company has entered into the following outstanding foreign exchange forward contracts to fix the rate at which US dollar revenues are to be reported during 2006. The Company has committed to sell \$8.0 million US dollars during fiscal 2006 at an average rate of exchange of CAD 1.1956. The fair market value of those contracts at September 30, 2005 was approximately \$8.226 million US dollars.

Credit risk

Credit risk related to the Company's trade receivables is minimized due to its customer base of large and financially sound companies.

The Company is also exposed to credit risk from the potential default by any of its counterparties on its foreign exchange forward contracts. The Company mitigates this credit risk by dealing with counterparties who are major financial institutions and which are included on an authorized list of counterparties maintained by the Company.

19. Deferred rent

During the year, the Company entered into a new lease agreement for its office located in Vancouver whereby a lease inducement benefit was received. During 2004 the Company entered into a new lease agreement for its head office location in Toronto and also received a lease inducement benefit. Deferred rent represents the benefit of operating lease inducements, which are being amortized on a straight-line basis over the term of the relevant leases.

Xenos Group Inc.

Notes to the Consolidated Financial Statements

September 30, 2005

20. Segmented information

The Company has determined that it serves one industry segment, information technology.

Geographic information

	Sales to External Customers		Capital Assets and Goodwill	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Canada	\$ 982,442	\$ 948,720	\$ 4,937,312	\$ 4,795,601
European Union	1,177,908	1,228,746	-	-
United Kingdom	3,159,163	3,920,194	283,439	327,560
United States	8,479,122	9,169,220	2,332,286	2,313,011
Other	<u>671,163</u>	<u>936,679</u>	<u>-</u>	<u>-</u>
	<u>\$ 14,469,798</u>	<u>\$ 16,203,559</u>	<u>\$ 7,553,037</u>	<u>\$ 7,436,172</u>

21. (Loss) earnings per share

	<u>2005</u>	<u>2004</u>
(Loss) earnings from continuing operations – basic and diluted \$	<u>(1,763,192)</u>	<u>\$ 478,711</u>
Weighted average number of common shares outstanding during the year	<u>9,921,011</u>	<u>9,759,154</u>
Dilutive impact of the following:		
Fiscal 2004 – 2,000 stock options with an exercise price of \$1.36	-	1,221
Fiscal 2004 – 1,667 stock options with an exercise price of \$1.40	-	998
Fiscal 2004 – 2,000 stock options with an exercise price of \$1.50	-	1,140
Fiscal 2004 – 714,721 stock options with an exercise price of \$1.65	-	376,817
Fiscal 2004 – 10,000 stock options with an exercise price of \$2.20	-	3,696
Fiscal 2004 – 20,000 stock options with an exercise price of \$3.20	-	1,662
Fiscal 2004 – 11,000 stock options with an exercise price of \$3.25	-	756
Fiscal 2004 – 70,000 stock options with an exercise price of \$3.45	<u>-</u>	<u>802</u>
Denominator used for diluted earnings per share from continuing operations	<u>9,921,011</u>	<u>10,146,246</u>

Xenos Group Inc.**Notes to the Consolidated Financial Statements**

September 30, 2005

21. (Loss) earnings per share (continued)

The stock options other than the items adjusted above were not included in the computation of diluted earnings per share as they are anti-dilutive. In addition, for fiscal 2005 the otherwise dilutive options do not factor into the calculation due to the loss position for the year.

22. Comparative figures

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

Directors & Officers	Shareholder Information	Corporate Addresses
<p><i>Stuart Butts 3,4</i> Director, Chairman of the Board and Chief Executive Officer</p> <p><i>James Farmer 4</i> Director, President and Chief Operating Officer</p> <p><i>Calvin Galatiuk</i> Director and Product Manager</p> <p><i>Forest Lee Garrison</i> Vice President of Marketing</p> <p><i>Robert Hines 1,2</i> Director Managing Partner, Heidrick & Struggles Canada Inc</p> <p><i>Robert Kunihiro 4</i> Executive Vice President and Chief Financial Officer</p> <p><i>William Kurtz</i> Vice President of Sales</p> <p><i>Chungsen Leung 1</i> Director Business Executive</p> <p><i>Edmund F. Merringer 3,4</i> Director and Secretary Partner, Borden Ladner Gervais LLP</p> <p><i>Kent Petzold 1,2</i> Director Principal, Arris Ventures, LLC</p> <p><i>Peter Williams 2,3</i> Director Chairman of RPC Group Plc</p>	<p><i>Legal Counsel</i> Borden Ladner Gervais LLP Scotia Plaza 40 King Street West Toronto, Ontario M5H 3Y4</p> <p><i>Auditors</i> Grant Thornton LLP Chartered Accountants 15 Allstate Parkway Suite 200 Markham, Ontario L3R 5B4</p> <p><i>Investor Relations</i> Corbet Pala Phone: +1-416-657-2400 e-mail: cpala@xenos.com</p> <p><i>Transfer Agent/Registrar</i> CIBC Mellon Trust Company P.O. Box 7010 Adelaide Postal Station Toronto, Ontario M5C 2W9 Phone: +1-416-643-5500 Toll Free: +1-800-387-0825 e-mail: inquiries@cibcmellon.com</p> <p><i>Trading</i> Xenos Group Inc. trades on the Toronto Stock Exchange and is listed under the symbol TSX:XNS.</p>	<p><i>United States Headquarters</i> 1909 Woodall Rogers Freeway Suite 575 Dallas, Texas 75201 USA Phone: +1-972-857-0776 Toll Free: +1-888-436-8398 Fax: +1-972-857-0979</p> <p><i>European Headquarters</i> 130-132 Terrace Road Walton-on-Thames Surrey KT12 2EA United Kingdom Phone +44 1932 252 299 Fax: +44 1932 252 288</p> <p><i>Corporate Headquarters</i> 95 Mural Street, Suite 201 Richmond Hill, Ontario L4B3G2 Phone: +1 905-709-1020 Toll Free: +1-888-242-0692 Fax: +1-905-709-1023</p> <hr/> <p>"Xenos is a trademark of Xenos Group Inc. All other product names mentioned are acknowledged to be the marks of their producing companies."</p> <p><i>Annual General Meeting</i> Xenos will hold its Annual General Meeting at 3:00 pm on Monday, Jan 23rd, 2006 in the Gallery Room of The Toronto Stock Exchange Broadcast and Conference Centre, The Exchange Tower 2 First Canadian Place 130 King Street West Toronto, Ontario</p>
<p>Notes:</p> <p>1 Member of the Audit Committee</p> <p>2 Member of the Compensation Committee</p> <p>3 Member of the Nominating/Corporate Governance Committee</p> <p>4 Member of the Disclosure Policy Committee</p>		<p>This annual report can be downloaded from the Xenos Group Inc. website at www.xenos.com</p>