



Xenos

First Quarter Report

Three months ended December 31, 2001

To Our Shareholders:

In the first quarter of fiscal 2002 Xenos completed the corporate restructuring initiated last year, released a significant new version of its flagship product, signed an important remarketing agreement with IBM and showed improved financial performance by many yardsticks.

For the three month period ended December 31, 2001, Xenos recorded revenues of \$3,179,000, compared with \$4,110,000 for the same period in the previous year. This represents a second consecutive quarter of growth following the revenue decline experienced in early fiscal 2001. Xenos achieved significantly improved bottom line results with a net loss of \$283,000, or (\$0.03) per share, compared with a net loss of \$1,724,000, or (\$0.21) per share, for the first quarter of fiscal 2001. The results also compare favourably on a consecutive quarterly basis to a net loss of \$2,166,000 or (\$0.26) per share for the quarter ended September 30, 2001. (It should be noted that the first quarter results reflect the non-amortization of goodwill - see note.)

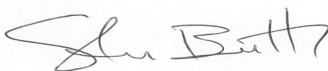
During the quarter our market segment strengthened, our sales strategy has been improved and adapted to changing conditions, and managing expense levels has resulted in an encouraging trend towards positive cash flow. We have reduced our headcount and made important cost saving measures to align our expenses with revenue expectations for the balance of the fiscal year.

The first quarter saw the release of Version 5.0 of the Xenos d2e Platform™ - software that enables organizations to rapidly transform their legacy data and documents into web-ready content for e-business. During the period, several sales were made to significant customers. In North America these include American General Insurance, Foremost Insurance, Security Service Federated Credit Union, Prudential, Unum Provident and US Bank. Internationally, these include BBS and IF Insurance in Norway and American Bank Note Company in Brazil.

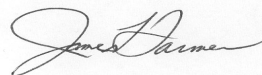
Xenos progressed its alliance program strategy, and on November 22, 2001, announced a global software remarketing agreement with IBM for the sale and distribution of Xenos' d2e software as part of IBM's enterprise content management solution, Content Manager OnDemand. The agreement follows the successful integration of the Xenos d2e (data to e-content) Platform™ software with IBM's Content Manager OnDemand V7.1. IBM customers in industries including banking, brokerage, insurance, telecommunications, and utilities can now purchase from IBM a single integrated solution that enables and drives content-based e-business initiatives, such as electronic statement presentment, online billing and online invoicing.

While we remain optimistic about significantly improving our financial performance from Xenos' existing market niche, we have embarked on a search for other opportunities that have the potential to further enhance shareholder value in the years ahead.

While there can be no assurance that we will identify an appropriate opportunity in a timely manner, management believes that this strategy is worth pursuing in conjunction with the continued in-house development of Xenos d2e suite of technologies.



Chairman of the Board
and Chief Executive Officer



President and
Chief Operating Officer

Management's Discussion and Analysis of Financial Results for the Three Months ended December 31, 2001

The following discussion should be read in conjunction with the Company's unaudited quarterly financial statements for the periods ending December 31, 2001 and 2000 contained herein and the notes thereto, as well as the management's discussion of the financial results and financial position for the year ended September 30, 2001.

Results of Operations:

Sales in the first quarter of fiscal 2002 were \$3.2 million as compared with \$4.1 million in the same quarter last year and \$3.1 million in the most recent quarter. This result represents a second consecutive quarter of growth following the revenue decline experienced in early fiscal 2001.

Gross margins in the quarter as a percentage of sales were 80% as compared to 83% last year, but showed a modest improvement from the 79% in the most recent quarter.

Research and development expenses in the three month periods ended December 31, 2001 and 2000 were \$860,000 and \$931,000 respectively. During the quarter, the Company deferred approximately \$292,000 in R&D costs as compared to \$348,000 in the comparable period last year.

Sales and marketing expenses were \$1.1 million, down from \$2.6 million last year and \$1.6 million in the previous quarter. Administrative and general expenses were \$712,000, down from \$838,000 in the same period last year. These reductions follow on from last year's staff reductions, the elimination of all unnecessary processes and outside services, and the distribution of all remaining functions to members of the current team.

The Company has elected to adopt the new CICA accounting rules with respect to goodwill beginning in Fiscal 2002, which among other things requires the non-amortization of goodwill. As a result, amortization charges in the quarter of \$270,000 were significantly lower than \$1.1 million in the same period last year. Total amortization of goodwill in the same period last year was \$735,000.

Tax expense was \$72,000 as compared to \$51,000 last year. Both amounts relate primarily to the UK entity.

The net loss for the quarter was \$283,000 or \$0.03 per share as compared to the net loss of \$1.7 million or \$0.21 per share last year. As noted above, the current quarter includes non-amortization of goodwill.

Financial Condition and Liquidity:

As at December 31, 2001 and 2000, cash and short-term investments stood at \$12.7 million and \$17.3 million respectively and \$14.2 million at the end of the previous quarter. The cash used in the first quarter of \$1.5 million was related to \$827,000 in previously accrued restructuring costs and the remainder to cyclical working capital changes and operations.

Capital expenditures in the first quarter of the current year of \$38,000 were reduced compared to the \$145,000 incurred in the prior year.

Based on its current cost structure and forecasts of revenues, in particular with respect to the new IBM remarketing agreement, Management believes that its current cash reserves will be more than sufficient to fund operations during the next twelve month period. Furthermore, we expect to reach the point of cash flow breakeven by the end of the fiscal year.

Outlook:

Management continues to believe that the Company is well positioned to drive quarterly growth, enhanced gross margins and achieve cash flow breakeven by the end of the current fiscal year.

This management's discussion and analysis contains forward-looking statements based on current expectations. These forward-looking statements entail various risks and uncertainties that could cause actual results to differ materially from those reflected in these forward-looking statements. Risks and uncertainties about the Company's business are more fully discussed in the Management Discussion and Analysis published in the Company's annual report.

Xenos Group Inc.
Consolidated Statements of Operations
(Unaudited)

	Three Months Ended December 31	
	2001	2000
Sales	\$3,179,296	\$4,110,367
Service integration costs	<u>636,245</u>	<u>718,964</u>
Gross profit	2,543,051	3,391,403
Expenses		
Sales and marketing	1,067,446	2,555,796
Research and development	859,563	931,411
Administration and general	712,277	838,417
Amortization	270,258	1,081,172
Interest expense	<u>8,194</u>	<u>10,080</u>
	<u>2,917,738</u>	<u>5,416,876</u>
Earnings (loss) from operations	(374,687)	(2,025,473)
Other income		
Dividends, interest and other	<u>163,876</u>	<u>352,718</u>
Earnings (loss) before income taxes	(210,811)	(1,672,755)
Provision for income taxes	<u>72,357</u>	<u>51,112</u>
Net earnings (loss)	<u>\$(283,168)</u>	<u>\$(1,723,867)</u>
Net earnings (loss) per share		
- Basic & fully-diluted	\$(0.03)	\$(0.21)
Weighted average number of shares	8,408,250	8,373,957

Xenos Group Inc.
Consolidated Balance Sheets
(Unaudited)

	As at December 31	
	2001	2000
ASSETS		
CURRENT		
Cash & S.T. investments	\$12,653,829	\$17,338,492
Trade receivables	3,424,349	5,388,569
Other receivables	63,218	115,873
Prepays	337,004	301,618
Income taxes recoverable	53,720	203,122
Deferred income taxes	298,745	-
	<u>16,830,865</u>	<u>23,347,674</u>
LONG TERM		
Deferred income taxes	1,740,190	1,925,996
Capital assets	1,965,226	2,332,898
Other assets	1,800,234	1,013,573
Goodwill	6,073,863	7,711,226
	<u>11,579,513</u>	<u>12,983,693</u>
TOTAL ASSETS	<u>\$28,410,378</u>	<u>\$36,331,367</u>
LIABILITIES		
CURRENT		
Bank indebtedness	\$500,000	\$520,000
Payables & accruals	2,047,423	3,310,387
Income taxes payable	401,346	232,848
Deferred revenue	3,102,960	2,425,686
	<u>6,051,729</u>	<u>6,488,921</u>
LONG TERM LIABILITIES		
Deferred revenue	84,277	163,920
	<u>84,277</u>	<u>163,920</u>
TOTAL LIABILITIES	6,136,006	6,652,841
SHAREHOLDERS' EQUITY		
Capital stock	41,062,473	41,031,998
Retained earnings/(deficit)	(18,788,101)	(11,353,472)
TOTAL SHAREHOLDERS' EQUITY	<u>22,274,372</u>	<u>29,678,526</u>
TOTAL LIABILITIES & EQUITY	<u>\$28,410,378</u>	<u>\$36,331,367</u>

Xenos Group Inc.**Consolidated Statements of Cash Flows**

(Unaudited)

	Three Months Ended December 31	
	2001	2000
Operating activities		
Net earnings (loss)	\$(283,168)	\$(1,723,867)
Amortization	270,258	1,081,172
Loss on sale of capital assets	1,258	-
Deferred income taxes	(23,115)	(86)
Change in non-cash working capital	<u>(1,176,357)</u>	<u>543,384</u>
	(1,211,124)	(99,397)
Financing activities		
Bank financing	(20,000)	204,615
Proceeds on issue of shares	-	22,713
	<u>(20,000)</u>	<u>227,328</u>
Investing activities		
Cash paid on acquisition of subsidiaries	-	(766,985)
Purchase of capital assets	(38,292)	(144,719)
Proceeds on disposal of fixed assets	11,396	-
Development costs incurred	<u>(292,092)</u>	<u>(347,825)</u>
	(318,988)	(1,259,529)
Net (decrease) increase in cash and cash equivalents	(1,550,112)	(1,131,598)
Cash and cash equivalents		
Beginning of period	14,203,941	18,470,090
End of period	<u>\$12,653,829</u>	<u>\$17,338,492</u>

Xenos Group Inc.

Notes to the Condensed Consolidated Interim Financial Statements

December 31, 2001 and 2000

1. Nature of operations and Basis of presentation

Xenos develops software solutions that transform transactional data and documents into e-content to enable e-business applications. Xenos solutions are deployed by large “bricks and mortar” organizations in key industry segments, including banking and financial services, insurance, telecommunications and utilities. The Company has corporate headquarters in Toronto, Canada supported by global sales, marketing, product development and customer support. Xenos’ leading-edge software is used by alliance partners to provide total e-business solutions.

The unaudited interim financial statements of Xenos Group Inc. and related notes have been condensed and do not contain certain information that will be included in the Company’s annual consolidated financial statements and related notes thereto. For further information, refer to the Company’s annual consolidated financial statements and related notes for the year ended September 30, 2001.

2. Summary of significant accounting policies

Goodwill

In Fiscal 2002, the Company elected to change its accounting policy and early adopt the new rules on accounting for goodwill issued by the Canadian Institute of Chartered Accountants. Under the new rules, goodwill will no longer be amortized but will be subject to annual impairment tests in accordance with the section.

The Company has applied the new rules in the first quarter of fiscal 2002. During fiscal 2002, the Company will perform the first of the required impairment tests of goodwill as of October 1, 2001 and has not yet determined what the effect of these tests will be on the financial position of the Company.

Any impairment loss identified by the impairment test will be accounted for as a change in accounting policy through a charge to opening retained earnings without restatement of prior periods.

Earnings per share

In Fiscal 2002, the Company changed its accounting policy with respect to the computation of earnings per share to that issued by the Canadian Institute of Chartered Accountants in December 2000. The main effect of the change to the Company’s financial statements is in the calculation of fully-diluted earnings per share, which is now calculated using the treasury stock method instead of the imputed interest method. This change has been applied on a retroactive basis but there was no effect for the periods ended December 31, 2001 and 2000.

3. Goodwill

	As at December 31	
	2001	2000
Cost	\$ 12,443,822	\$ 12,443,822
Accumulated amortization	<u>6,369,959</u>	<u>4,732,596</u>
Net book value	\$ <u>6,073,863</u>	\$ <u>7,711,226</u>
	Three Months Ended December 31	
	2001	2000
Reported net income (loss)	\$ (283,168)	\$ (1,723,867)
Add back: Goodwill amortization	<u>-</u>	<u>735,083</u>
Adjusted net income (loss)	\$ <u>(283,168)</u>	\$ <u>(988,784)</u>
Basic & Fully-diluted earnings (loss) per share:		
Reported net income (loss)	\$ 0.03)	\$ (0.21)
Add back: Goodwill amortization	<u>-</u>	\$ <u>0.09</u>
Adjusted net income	\$ <u>(0.03)</u>	\$ <u>(0.12)</u>

4. Stock-based compensation plan

The Company has a stock option plan which allows the granting of stock options to service providers to acquire up to an aggregate of 1.6 million common shares. Under current Company practice the options, which have a five (5) year term, vest immediately for directors and over three (3) years for all others at a rate of 1/3 for each year 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 the grant.

A summary of the status of the Company's stock option plan as of December 31, 2001 and 2000 and any changes during each year-to-date period is presented below:

	Shares		Weighted Average Exercise Price	
	2001	2000	2001	2000
Outstanding, beginning of fiscal year	1,052,083	1,212,375	\$ 6.36	\$ 4.90
Granted	676,875	41,000	1.65	3.37
Exercised	-	(19,750)	-	1.15
Forfeited	<u>(230,749)</u>	<u>(18,750)</u>	<u>5.66</u>	<u>16.63</u>
Outstanding, end of period	<u>1,498,209</u>	<u>1,214,875</u>	\$ <u>4.34</u>	\$ <u>6.62</u>
Options exercisable at period end	<u>587,504</u>	<u>473,146</u>		

The following information applies to options outstanding at December 31, 2001:

<u>Option Price</u>	<u>Number</u>	<u>Expiry</u>
\$ 0.44	45,000	July, 2003
1.15	225,250	July, 2003
1.40	5,000	November 2006
1.65	671,875	December 2006
3.00	25,000	October, 2004
3.20	3,333	January, 2002
3.20	3,333	February, 2002
3.20	42,000	January, 2006
3.25	11,000	December, 2005
4.05	5,000	January, 2006
5.00	75,000	September, 2005
5.00	50,000	October, 2005
6.00	115,000	July, 2005
7.50	19,000	October, 2004
8.50	42,000	August, 2004
10.70	6,667	February, 2002
10.70	95,001	October, 2004
13.25	17,750	June, 2005
40.00	16,000	February, 2005
40.50	5,000	February, 2005
42.00	20,000	January, 2005

During the quarter, the Company executed a stock option exchange program for non-insiders to deal with certain out-of-the-money options. At completion, 257,250 options (with exercise prices ranging from \$3.00 to \$42.00) were cancelled and 160,458 new options with three year vesting terms and an exercise price of \$1.65 were issued. At December 31, 2001, 9,500 options had been cancelled and 4,750 options had been reissued under the program with the balance taking place early in the second quarter. In addition, an aggregate of 672,125 new options were granted under the plan at an exercise price of \$1.65.

5. Segmented information

Management has determined that the Company operates primarily within one dominant business segment, being electronic commerce.

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Shareholder Information

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Trading

Xenos Group Inc. trades on the Toronto Stock Exchange and is listed under the symbol XNS.

Investor Relations

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