



# First Quarter Report

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Three months ended December 31, 2004

To Our Shareholders:

For the fiscal first quarter ended December 31, 2004, Xenos reported revenues of \$3,525,000 compared to revenues of \$4,464,000 for the same quarter last year. The Company reported negative EBITDA of \$239,000, compared to positive EBITDA of \$857,000 for the same period last year and a first quarter net loss of \$508,000, or (\$0.05) per share, compared with net earnings of \$493,000, or \$0.05 per share for the first quarter of fiscal 2004.

While the first quarter results were not what we had hoped for, we anticipate that over the full year Xenos will deliver growth and profitability. We are working on many sales opportunities in markets including healthcare, government and financial services. We expect our second quarter revenues to be substantially higher than Q1.

Xenos maintains a strong balance sheet, with a cash position of \$12.4 million, or \$1.25 per common share and no long-term debt.

Xenos has been enhancing its capabilities in marketing and sales with the addition of new sales people and marketing resources. New hires include Lee Garrison, recently appointed Vice President of Marketing. Mr Garrison joined Xenos on February 1.

Management believes that increased industry awareness will result in increased sales. Xenos has built its technological competencies by following a horizontal vision of moving information throughout the enterprise and beyond. We are marketing our technology in market verticals by identifying and propagating industry specific messaging as to what the technology means to a particular vertical. Generally this means documenting Xenos' successful implementations and identifying the business drivers and the reasons for the perceived success.

With global marketing and product management, the Company is focused on offering established solutions that fit the specific requirements of identified market segments or niches. Xenos also partners with customers wishing to develop a specific new solution incorporating one or more of Xenos' core technology competencies. Through these initiatives Xenos intends to increase the volume of high value sales thereby driving top line growth and profitability.

The Company's new e-government initiative gained momentum during the quarter with the success of its infoWEB electronic report distribution product. infoWEB takes enormous amounts of information that is typically printed from a diversity of information systems and distributes the information electronically to the various government and public recipients, thereby eliminating printing and distribution costs and making the information more readily available. The Company has significantly enhanced the product recently by incorporating work flow components that add significant value to the selling proposition, particularly for the "approvals rich" public sector.

The Company's new healthcare initiative progressed during the quarter. We are responding to a lot of requests for proposals from healthcare systems in different jurisdictions, including individual hospitals and networks of hospitals.

Xenos has invested for over 10 years in building a technology that puts a wrapper around the history of the current technology install base and allows it all to work together in harmony. Xenos products are applicable to nearly any market sector, reducing costs and increasing efficiencies. In single applications, Xenos has typically saved customers hundreds of thousands of dollars annually, and in some cases millions of dollars.

For example, a spokesman for Fireman's Fund Insurance Co. was recently quoted in Insurance and Risk Management magazine, "Since implementing d2e in April 2003 Fireman's Fund has saved more than \$640,000 in printing and associated costs, with the potential to cut as much as \$2.3 million."

In an era of integration, rationalization and "return on investment" driven technology purchases, Xenos is very well positioned. We intend to take advantage of that positioning.



Stuart Butts  
Chairman of the Board  
And Chief Executive Officer



Jim Farmer  
President and  
Chief Operating Officer

## Management's Discussion and Analysis of Financial Condition and Results of Operations for the Three Months ended December 31, 2004

*The following discussion and analysis should be read together with the Company's unaudited quarterly financial statements for the periods ended December 31, 2004 and 2003 and related notes, as well as the audited consolidated financial statements and management's discussion and analysis for the year ended September 30, 2004. 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 quarterly 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.*

### Overview

Xenos provides its customers with access to, enhancement, storage and delivery of mission critical information through its non-invasive middleware products and services. Xenos d2e Vision™ and d2e Platform™ software transforms and repurposes documents, statements and reports into e-content, supporting both e-business and print strategies for electronic statement presentment, enterprise content management, archiving and print automation. Xenos infoWEB™ software securely and rapidly distributes business documents and reports within departments, throughout the enterprise and beyond, to any standard web browser. Xenos GoXML™ Integration suite enables the integration of business processes, enterprise systems, structured data, databases and web services or service oriented architectures. 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.

Xenos 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.

The Company has historically had success in a wide range of industry verticals and in particular banking, brokerage and insurance. The introduction of the GoXML™ products has enabled recent initiatives in other verticals, the healthcare sector in particular, which appear to be very promising.

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

The authorized share capital of the Company consists of an unlimited number of Common Shares. As at December 31, 2004, there were 9,924,028 shares issued and outstanding.

Stock options for a total of 1,025,721 shares were outstanding at exercise prices ranging from \$1.36 to \$42.00 with various expiry dates, the latest of which is March, 2009.

#### *Fiscal 2005 Business Highlights*

During the first quarter, the Company continued its move into new vertical markets with its broadened technology and service offerings through focused marketing and sales efforts. In particular, the healthcare market is looking very promising and activity levels in this segment are up significantly.

The product suite was further enhanced through the release of GoXML Transform 6.0 during the quarter.

#### **RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED DECEMBER 31, 2004**

For the three months ended December 31, 2004, sales were \$3.5 million as compared to \$4.5 million in the previous year. The decrease was primarily the result of lower new license sales and the continued decline in the US dollar exchange rate. It's noteworthy that the first quarter of last year included a large license sale to a U.S. financial institution for close to \$700,000.

Geographically, 60% of sales in the quarter were in North America while 35% were in Europe compared to 68% and 28% respectively in fiscal 2004. License sales comprised approximately 28% of total revenues in fiscal 2005 compared to 38% in the prior year.

Gross profits for the quarter were 85% of sales compared to 83% in the prior year.

Sales and marketing expenses were \$1.8 million for the quarter compared with \$1.5 million in the prior year. This increase was primarily due to the impact of several new sales hires near the end of the previous year. As a percentage of revenues, sales and marketing expenses were at 50% as compared to 33% last year.

Total expenditures on product development, gross of amounts deferred, were \$1.0 million during the year as compared to \$880,000 in fiscal 2004. The overall increase reflects an increase in staffing offset by the reduction in the cost of our US based development team members due to the depreciation of the US dollar.

Administrative expenses increased to \$660,000 from \$578,000 in the prior year primarily due to the early timing of our year end filings in response to the new continuous disclosure requirements and recruiting costs in the UK office.

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 \$263,000 compare to \$340,000 in fiscal 2004. The decrease reflects the fact that certain deferred items became fully amortized at the end of the prior quarter.

Foreign exchange losses were \$36,000 as compared to losses of \$83,000 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 expense of \$33,000 (Fiscal 2004 – expense of \$4,000) is primarily related to lower utilization of tax loss carry-forwards in the Canadian parent.

Interest income was relatively consistent at \$73,000 as compared to \$69,000 in the previous year.

The net loss for the quarter was \$508,000 or a loss of (\$0.05) per share as compared to net income of \$493,000 or \$0.05 per share in the previous year.

#### 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. The Company is scheduled to commission an external valuation for impairment test purposes in this current fiscal year as part of its normal practice.

#### Revenue

In accordance with GAAP, 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 next scheduled external valuation is in this fiscal year. The valuation methodology used includes the performance of a discounted cash flow calculation against projected cash flows for the Company as a whole and also for each of its reporting units, being the North American and EMEA operations.

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. 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.

## LIQUIDITY AND CAPITAL RESOURCES

As at December 31, 2004, cash and short-term investments stood at \$12.4 million (December 31, 2003 - \$11.6 million) or \$1.25 per common share (i). Cash from operations was \$173,000 as compared to a use of \$486,000 in the previous year. The previous year cash used for operations 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 (December 31, 2003 - \$ 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 a capital lease.

Cash on final settlement of the price guarantee mechanism of the XML Global transaction of \$228,625 was paid in the quarter.

Capital expenditures for the quarter ended December 31, 2004 were \$36,000, versus \$75,000 in the prior year. However, during the quarter, the Company entered into a capital lease for a new data and voice infrastructure for equipment valued at \$145,000.

Development costs capitalized were \$167,000 versus \$91,000 last year and represent the internal development costs relating to specific products as required by Canadian GAAP. The increase relates largely to new enhancements to the GoXML product line.

Shareholders equity stood at \$21.7 million or \$2.19 per share (ii) compared to \$22.4 million or \$2.26 per share (ii) as at December 31, 2003.

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.

### *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 that will be the basis of future revenue growth, particularly in certain vertical markets. 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, over 95% on average, 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 unsustainable double digit rates. Also, non-promotion based salaries were frozen for the current fiscal year and no bonuses were payable in respect of fiscal 2004. Travel related costs are the second highest expense category and the Company maintains a 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 are 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 has not increased employee base salaries in this fiscal year except in the case of promotions. In addition, given uncertainty in the market regarding appropriate forms of long-term incentives, the Company has deferred the issuance of any stock options to employees, including Executive Management, until current trends become more apparent. 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 per employee, employee costs as a percent of sales, 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. For the current fiscal year, non-commissioned employees operate under a bonus plan which requires the achievement of certain revenue and operating profit levels in order for there to be a payout. Further, any bonus 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 while remaining profitable and efficient. Realizing the opportunity for rapid and sustainable growth through a vertical market approach will be the focus of the Company's efforts in the coming year.

Additional information regarding the Company is available on SEDAR at [www.sedar.com](http://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.

Xenos Group Inc.

**Consolidated Statements of Operations**

(Unaudited)

	Three Months Ended December 31	
	2004	2003
Sales	\$ 3,524,924	\$ 4,463,585
Cost of sales	<u>519,393</u>	<u>750,253</u>
Gross Profit	<u>3,005,531</u>	<u>3,713,332</u>
Expenses		
Sales and marketing	1,768,869	1,490,012
Research and development	816,386	788,814
Administration and general	659,583	577,526
Amortization	263,006	339,838
Interest and bank charges	<u>9,944</u>	<u>6,983</u>
	<u>3,517,788</u>	<u>3,203,173</u>
(Loss) income from operations	(512,257)	510,159
Other income		
Interest and other	73,227	69,130
Foreign exchange loss	<u>(35,971)</u>	<u>(83,169)</u>
(Loss) income before income taxes	(475,001)	496,120
Provision for income taxes	<u>33,045</u>	<u>3,556</u>
Net (loss) income	<u>\$ (508,046)</u>	<u>\$ 492,564</u>
Net (loss) income per common share		
- Basic	\$ (0.05)	\$ 0.05
- Fully diluted	\$ (0.05)	\$ 0.05
Weighted average number of shares		
- Basic	9,899,515	9,372,639
- Fully diluted	10,135,399	9,770,262
<hr/>		
Deficit, beginning of year as previously stated	\$ (22,775,608)	\$ (23,254,319)
Impact of retroactive adoption of CICA recommendations for stock-based compensation	<u>(65,141)</u>	<u>-</u>
Deficit, beginning of year as restated	(22,840,749)	(23,254,319)
Net (loss) income	<u>(508,046)</u>	<u>492,564</u>
Deficit, end of period	<u>\$ (23,348,795)</u>	<u>\$ (22,761,755)</u>

**Xenos Group Inc.**  
**Consolidated Balance Sheets**  
(Unaudited)

	As at December 31	
	2004	2003
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash & S.T. investments	\$ 12,424,958	\$ 11,646,258
Trade receivables	1,953,816	3,719,201
Other receivables	2,466	2,995
Prepays	813,979	719,502
Future income taxes	215,601	400,601
	<u>15,410,820</u>	<u>16,488,557</u>
<b>LONG TERM</b>		
Future income taxes	1,831,012	1,615,352
Capital assets	1,286,216	1,313,139
Intangibles and other assets	3,012,710	3,232,416
Goodwill	6,252,895	6,185,067
	<u>12,382,833</u>	<u>12,345,974</u>
<b>TOTAL ASSETS</b>	<u>\$ 27,793,653</u>	<u>\$ 28,834,531</u>
<b>LIABILITIES</b>		
<b>CURRENT</b>		
Bank indebtedness	\$ 500,000	\$ 500,000
Payables & accruals	1,660,542	2,203,429
Income taxes payable	32,868	86,560
Deferred revenue	3,675,960	3,593,135
Current portion - capital lease	37,271	17,798
	<u>5,906,641</u>	<u>6,400,922</u>
<b>LONG TERM</b>		
Capital lease obligations	112,977	11,395
Deferred revenue	14,181	42,992
Deferred rent	72,483	27,303
	<u>199,641</u>	<u>81,690</u>
<b>TOTAL LIABILITIES</b>	<u>6,106,282</u>	<u>6,482,612</u>
<b>SHAREHOLDERS' EQUITY</b>		
Capital stock	45,036,166	45,113,674
Retained earnings/(deficit)	(23,348,795)	(22,761,755)
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<u>21,687,371</u>	<u>22,351,919</u>
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<u>\$ 27,793,653</u>	<u>\$ 28,834,531</u>

Xenos Group Inc.

**Consolidated Statements of Cash Flows**

(Unaudited)

	Three Months Ended December 31	
	2004	2003
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Operating activities		
Net (loss) income	\$ (508,046)	\$ 492,564
Amortization	263,006	339,838
Loss on sale of capital assets	-	(225)
Future income taxes	4,197	(41,067)
Stock based compensation	18,308	681
Change in non-cash working capital	395,628	(1,277,383)
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	173,093	(485,592)
Financing Activities		
Share issuance costs	-	(3,500)
Proceeds on issue of shares	48,950	-
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	48,950	(3,500)
Investing activities		
Cash paid on acquisition of business assets	(228,625)	(1,669,928)
Additional consideration paid on acquisitions	(9,279)	(1,563)
Purchase of capital assets	(36,079)	(74,938)
Proceeds on disposal of fixed assets	-	225
Development costs incurred	(167,166)	(90,719)
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	(441,149)	(1,836,923)
Net decrease in cash and short term investments	(219,106)	(2,326,015)
Cash and short term investments		
Beginning of period	12,644,064	13,972,273
End of period	\$ 12,424,958	\$ 11,646,258
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Xenos Group Inc.

## Notes to the Condensed Consolidated Financial Statements

December 31, 2004 and 2003

### 1. Nature of operations and Basis of presentation

Xenos provides its customers with access to, enhancement, storage and delivery of mission critical information through its non-invasive middleware products and services. Xenos d2e Vision™ and d2e Platform™ software transforms and repurposes documents, statements and reports into e-content, supporting both e-business and print strategies for electronic statement presentment, enterprise content management, archiving and print automation. Xenos infoWEB™ software securely and rapidly distributes business documents and reports within departments, throughout the enterprise and beyond, to any standard web browser. Xenos GoXML™ Integration suite enables the integration of business processes, enterprise systems, structured data, databases and web services or service oriented architectures. 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 is headquartered in Toronto with offices in Dallas, London and Vancouver.

### 2. Summary of significant accounting policies

#### 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. Actual results could differ from those estimates.

#### Stock-based compensation

On October 1, 2002, the Company changed its accounting policy with respect to the recognition, measurement, and disclosure of stock-based compensation made in exchange for goods and services provided by employees and non-employees, to be consistent with new rules issued by the Canadian Institute of Chartered Accountants, in December 2001. The new standard requires that a fair value based method of accounting be applied to all stock-based payments to non-employees and to employee awards that are direct awards of stock, that call for settlement in cash or other assets or are stock appreciation rights that call for settlement by the issuance of equity instruments.

The Company has reflected these changes in its financial statements with retroactive application effective October 1, 2004. Compensation expense is being recorded related to employee stock options previously disclosed on a proforma basis. An adjustment to opening retained earnings has been made to reflect the related compensation expense for the period October 1, 2002 to September 31, 2004 on all options granted subsequent to October 1, 2002.

### 3. 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	<u>4,123,080</u>
	<u>\$ 5,169,928</u>
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 on acquisition	<u>3,271,375</u>
	<u>\$ 5,169,928</u>
Net cash paid:	
Cash, per above	<u>\$ 1,898,553</u>

During the quarter, as per the terms of the Company's acquisition of substantially all of the business assets of XML-Global Technologies, Inc. ("XML Global") on November 17, 2003, 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.

#### 4. Other Assets

	As at December 31	
	2004	2003
Cost		
Deferred development costs	\$ 5,883,547	\$ 5,188,257
Acquired intangible assets	1,104,000	1,104,000
	<u>\$ 6,987,547</u>	<u>\$ 6,292,257</u>
Accumulated amortization		
Deferred development costs	\$ 3,843,137	\$ 3,038,541
Acquired intangible assets	131,700	21,300
	<u>\$ 3,974,837</u>	<u>\$ 3,059,841</u>
Net book value		
Deferred development costs	\$ 2,040,410	\$ 2,149,716
Acquired intangible assets	972,300	1,082,700
	<u>\$ 3,012,710</u>	<u>\$ 3,232,416</u>

Included in amortization expense in the income statement is \$ 147,916 (2004 - \$ 214,855) related to amortization of deferred development costs and \$ 27,600 (2004 - \$ 14,425) related to amortization of acquired intangibles.

#### 5. Goodwill

	As at December 31	
	2004	2003
Net book value, beginning of period	\$ 6,243,616	\$ 2,066,578
Additions related to acquisition of business assets	-	4,123,080
Additional consideration paid on acquisitions	9,279	1,563
Realized tax asset benefit	-	(6,154)
Net book value, end of period	<u>\$ 6,252,895</u>	<u>\$ 6,185,067</u>

During the three month period ended December 31, 2004, the Company paid additional consideration of \$9,279 (three month period ended December 31, 2003 – \$ 1,563) 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 purchased substantially all of the business assets of XML Global, (see Note 3) and recorded goodwill in the amount of \$4,123,080 pertaining to the acquisition.

## 6. Capital stock

	December 31, 2004		December 31, 2003	
	Number	Amount	Number	Amount
Balance, beginning of year	9,894,361	\$ 45,132,392	8,883,750	\$ 41,616,493
Issued pursuant to exercise of vested stock options	29,667	48,950	-	-
Stock based compensation (Note 2)	-	83,449	-	681
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 3)	-	(228,625)	-	-
Balance, end of period	<u>9,924,028</u>	<u>\$ 45,036,166</u>	<u>9,883,750</u>	<u>\$ 45,113,674</u>

## 7. Stock-based compensation plan

A summary of the status of the Company's stock option plan as of December 31, 2004 and 2003 and any changes during each year-to-date period is presented below:

	Shares		Weighted Average Exercise Price	
	2004	2003	2004	2003
Outstanding, beginning of year	1,112,388	936,833	\$ 4.00	\$ 4.02
Granted	-	192,000	-	3.62
Exercised	(29,667)	-	1.65	-
Forfeited	<u>(57,000)</u>	<u>-</u>	9.76	-
Outstanding, end of quarter	<u>1,025,721</u>	<u>1,128,833</u>	\$ 3.75	\$ 3.95
Options exercisable at quarter end	<u>901,304</u>	<u>668,139</u>		

The following information applies to options outstanding at December 31, 2004:

<u>Option Price</u>	<u>Number</u>	<u>Expiry</u>
\$ 1.36	2,000	February, 2007
1.40	1,667	November, 2006
1.50	2,000	January, 2007
1.65	638,054	December, 2006
1.65	20,000	August, 2007
1.65	25,000	May, 2007
2.20	10,000	March, 2008
3.20	20,000	January, 2006
3.25	11,000	December, 2005
3.45	70,000	November, 2008
3.60	20,000	November, 2008
3.80	85,000	October, 2008
4.05	5,000	January, 2006
4.36	15,000	March, 2009
6.00	65,000	July, 2005
40.00	16,000	February, 2005
42.00	20,000	January, 2005

Pro forma disclosure of net income and earnings per share as if the Corporation had elected to adopt the fair value based accounting method for all awards granted on or after October 1, 2002:

	Three Months Ended	
	December 31	
	2004	2003
Net (loss) income for the period		
As reported	\$ (508,046)	\$ 492,564
Pro forma	\$ (508,046)	\$ 477,781
Net (loss) income per share - basic		
As reported	\$ (0.05)	\$ 0.05
Pro forma	\$ (0.05)	\$ 0.05
Net (loss) income per share – fully diluted		
As reported	\$ (0.05)	\$ 0.05
Pro forma	\$ (0.05)	\$ 0.05

For options issued, the fair value of each stock option grant is estimated as at the date of grant using the Black-Scholes option pricing model.

## 8. 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. 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 currencies and the Canadian dollar.

As at December 31, 2004, the Company had foreign exchange forward contracts outstanding to fix the rate at which estimated US dollar revenues are to be recorded in fiscal 2005 and 2006. The Company has committed to sell \$5.5 million US dollars during the balance of fiscal 2005 and \$1.0 million US dollars during the first quarter of fiscal 2006 at an average rate of exchange of CAD 1.2845. The fair market value of those contracts at December 31, 2004 was approximately \$6.946 million in US dollars.

## 9. Segmented information

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

Geographic information

The following table provides information about geographic segment sales, capital assets and goodwill.

	Sales		Capital Assets and Goodwill	
	2004	2003	2004	2003
Canada	\$ 115,552	\$ 247,451	\$ 4,920,019	\$ 4,833,260
European Union	362,645	251,722	-	-
United Kingdom	845,529	963,717	310,305	362,675
United States	1,982,663	2,805,983	2,308,787	2,302,271
Other	218,535	194,712	-	-
	<u>\$ 3,524,924</u>	<u>\$ 4,463,585</u>	<u>\$ 7,539,111</u>	<u>\$ 7,498,206</u>

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*This report 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.*

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