



Xenos

# **Second Quarter Report**

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Three and six months ended March 31, 2002

To Our Shareholders:

For the second quarter of fiscal 2002, Xenos posted year-over-year revenue growth, positive cash flow, EBITDA profitability and a significantly improved bottom line. It was an enormous improvement over the second quarter of 2001 as we reversed a substantial cash burn to positive cash flow. We are on target for a full year of revenue growth and are targeting increasing quarterly EBITDA and operating cash flow for the balance of the year. Our customer space is increasing the capital investments in software and information technology again.

For the three month period ended March 31, 2002, Xenos reported revenues of \$2,887,000, a 10% increase over revenues of \$2,626,000 for the same period last year. This marks a return to year-over-year quarterly growth following the revenue decline experienced in fiscal 2001. The Company reported positive EBITDA of \$50,000 in the second quarter for the first time since the quarter ended December 31, 1999. This is a significant turnaround versus negative EBITDA of \$1,583,000 last year and negative \$96,000 in the most recent quarter.

Xenos also reported significantly improved bottom line results with a net loss of \$206,000, or (\$0.03) per share, compared with a net loss of \$2,553,000, or (\$0.30) per share, for the second quarter of fiscal 2001.

For the second quarter Xenos reported positive cash flow of \$108,000, compared to negative cash flow of \$158,000 for the second quarter of fiscal 2001. At March 31, 2002, Xenos reported a cash position of \$12,762,000, or \$1.52 per common share.

During our second quarter, significant sales were made to American Bank Note Company, AdminiSource, Allstate, First National Bank of Omaha, Guaranty National Insurance, Johnson & Quin, MBNA Technology, Moore Handley, NiSource Corporate Services and Venture Encoding.

Subsequent to the close of the second quarter, Xenos completed an acquisition of Dallas-based Rush Creek Software Corporation, effective May 17th. Rush Creek develops corporate reporting software solutions called infoWEB™, based on advanced Internet technology that enables organizations to extract, publish and rapidly disseminate critical business information throughout the Enterprise.

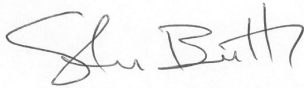
All of the current Rush Creek employees will be joining Xenos and will work out of the Xenos Dallas offices. The consolidation will expedite the integration process and provide cost savings in operational overhead.

In its most recently completed fiscal year, Rush Creek was profitable on sales of approximately \$1.4 million. In consideration for all of the issued shares of Rush Creek, Xenos will issue 200,000 Xenos Common Shares, make cash payments totalling \$1.5 million and a future consideration to be determined on a performance based arrangement.


We also continued to progress with our alliance program strategy, and subsequent to the close of the quarter, we announced an expansion of our relationship with IBM. The Software Remarketing Agreement (SRA) that was announced in December, 2001 has been extended with the Xenos d2e Platform HTML and XML generation features. The addition of Xenos XML and HTML generators allow the IBM Content Manager portfolio to integrate with the increasing number of applications that require HTML and XML. Several organizations have already licensed and implemented the Xenos d2e HTML/XML generation capabilities now available through the IBM SRA.

Xenos announced the signing of a non-exclusive agreement in the second quarter to form a marketing alliance with INSCI (OTCBB: INSS). Under the terms of the agreement, INSCI and Xenos will co-operate in the marketing and distribution of Xenos d2e Platform™ to INSCI customers. The relationship provides Xenos access and distribution to INSCI's worldwide client base. The integration of INSCI and Xenos technology offers customers a superior platform for supporting document enabled e-commerce solutions.

We are optimistic about further improvement in our financial performance as our market niche continues to grow. We are also pursuing new opportunities that have the potential to further enhance shareholder value in the years ahead through the acquisition of new technologies and markets.



Stuart Butts  
Chairman of the Board  
and Chief Executive Officer



Jim Farmer  
President and  
Chief Operating Officer

## Management's Discussion and Analysis of Financial Results for the Three and Six Months ended March 31, 2002.

### Selected Consolidated Financial Information

(in dollar thousands)	Three Months		Six Months		Year Ended	
	Mar 31 2002	Mar 31 2001	Mar 31 2002	Mar 31 2001	Sept 30 2001	Sept 30 2000
Sales	\$2,887	\$2,626	\$6,066	\$6,736	\$12,414	\$15,428
Gross Margin	\$2,267	\$1,672	\$4,810	\$5,064	\$9,199	\$11,859
EBITDA <sup>(1)</sup>	\$50	\$(1,583)	\$(46)	\$(2,517)	\$(4,506)	\$(4,319)
Net income (loss)	\$(206)	\$(2,553)	\$(489)	\$(4,277)	\$(8,875)	\$(9,530)

<sup>(1)</sup> EBITDA is not a recognized measure under Canadian generally accepted accounting principles (GAAP). Management believes that in addition to net income (loss), EBITDA is a useful supplemental measure as it provides investors with an indication of operating profitability. Investors should be cautioned, however, that EBITDA should not be construed as an alternative to net income (loss). Xenos' method of calculating EBITDA may differ from other companies and accordingly may not be comparable to measures used by other companies.

*The following discussion should be read in conjunction with the Company's unaudited second quarter financial statements for the periods ending March 31, 2002 and 2001 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 second quarter of fiscal 2002 were \$2.9 million as compared with \$2.6 million in the same quarter last year. This result represented a 10% increase. For the six months ended March 31, 2002, sales were \$6.1 million as compared to \$6.7 million in the previous year.

Gross margins in the quarter as a percentage of sales were 79% as compared to 64% last year and 80% in the previous quarter. For the six months ended March 31, 2002, gross margin as a percentage of sales was 79% as compared to 75% in the previous year. Results reflect the continued emphasis on driving efficiencies through the organization.

Research and development expenses in the three month periods ended March 31, 2002 and 2001 were \$733,000 and \$836,000 respectively. During the quarter, the Company deferred approximately \$398,000 in development costs as compared to \$414,000 in the comparable period last year. On a year-to-date basis, the expenses were \$1.6 million this year and \$1.8 million in the comparable period last year.

Sales and Marketing expenses were \$941,000, down from \$1.7 million last year and \$1.1 million in the previous quarter. Administrative and general expenses were \$543,000, down from \$739,000 in the same period last year. These reductions follow on from last year's staff reductions and as well the redesign of the compensation system to link employee costs more directly with company-wide revenues and operating profits.

As previously disclosed, 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 \$283,000 were significantly lower than \$1.1 million in the same period last year. On a year-to-date basis, amortization expense was \$553,000 this year vs \$2.2 million last year. Total amortization of goodwill in the same quarter last year was \$735,000 and on a year-to-date basis was \$1.5 million.

Tax expense for the three and six month periods was \$31,000 and \$104,000 respectively as compared to \$114,000 and \$165,000 in the previous year. These amounts relate primarily to the UK entity.

The net loss for the quarter was \$206,000 or (\$0.03) per share as compared to the net loss of \$2.6 million or (\$0.30) per share last year. For the six month period ended March 31, 2002, the net loss was \$489,000 or (\$0.06) per share as compared to the net loss of \$4.3 million or (\$0.51) per share last year. As noted above, the current fiscal year includes the non-amortization of goodwill.

Subsequent to quarter end, the Company acquired all the issued and outstanding shares of Rush Creek Software Corporation in exchange for 200,000 Xenos Common Shares, cash payments totaling \$1.5 million and a future consideration to be determined on a performance based arrangement. Rush Creek's product is an enterprise distribution system for digitized documents which is early in its growth cycle and which integrates well with the Xenos d2e suite.

*Financial Condition and Liquidity:*

As at March 31, 2002 and 2001, cash and short-term investments stood at \$12.8 million and \$17.2 million respectively and \$12.7 million at the end of the previous quarter. The cash increase in the second quarter of \$108,000 is the first quarter of positive cash flow, excluding financing, since the quarter ended December 31, 1999.

Capital expenditures in the second quarter of the current year of \$72,000 were reduced compared to the \$203,000 incurred in the prior year. For the year-to-date period, capital expenditures were \$110,000 this year as compared to \$348,000 last year.

Based on having achieved cash flow breakeven in the quarter and current forecasts of revenues, Management believes that its current cash reserves will be more than sufficient to fund operations during the next 12 month period. Furthermore, we expect to utilize some of our cash resources to fund investments in future growth.

*Outlook:*

Management continues to believe that the Company is well positioned to drive year-over-year sales growth, enhanced gross margins and improved operating cash flows.

*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 March 31		Six Months Ended March 31	
	2002	2001	2002	2001
Sales	\$2,886,793	\$2,625,522	\$6,066,089	\$6,735,889
Service integration costs	620,075	953,074	1,256,320	1,672,038
Gross profit	<u>2,266,718</u>	<u>1,672,448</u>	<u>4,809,769</u>	<u>5,063,851</u>
Expenses				
Sales and marketing	941,067	1,679,778	2,008,513	4,235,574
Research and development	732,868	836,069	1,592,431	1,767,480
Administration and general	542,666	739,103	1,254,943	1,577,520
Amortization	282,713	1,093,923	552,971	2,175,095
Interest expense	11,698	7,863	19,892	17,943
	<u>2,511,012</u>	<u>4,356,736</u>	<u>5,428,750</u>	<u>9,773,612</u>
Earnings (Loss) from operations	(244,294)	(2,684,288)	(618,981)	(4,709,761)
Other income				
Dividends, interest and other	<u>69,481</u>	<u>244,928</u>	<u>233,357</u>	<u>597,646</u>
Earnings (loss) before income taxes	(174,813)	(2,439,360)	(385,624)	(4,112,115)
Provision for income taxes	<u>31,266</u>	<u>114,099</u>	<u>103,623</u>	<u>165,211</u>
Net earnings (loss)	<u>\$(206,079)</u>	<u>\$(2,553,459)</u>	<u>\$(489,247)</u>	<u>\$(4,277,326)</u>
Net earnings (loss) per share				
- Basic & fully-diluted	\$ (0.03)	\$ (0.30)	\$ (0.06)	\$ (0.51)
Weighted average number of shares			8,408,250	8,380,465

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

	As at March 31	
	2002	2001
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash & S.T. investments	\$12,761,580	\$17,180,215
Trade receivables	2,460,605	2,244,091
Other receivables	16,906	75,328
Prepays	328,056	269,818
Income taxes recoverable	46,620	187,973
Deferred income taxes	121,775	-
	<u>15,735,542</u>	<u>19,957,425</u>
<b>LONG TERM</b>		
Deferred income taxes	1,746,122	1,942,939
Capital assets	1,857,412	2,343,520
Other assets	2,094,247	1,261,643
Goodwill	6,073,863	6,976,143
	<u>11,771,644</u>	<u>12,524,245</u>
<b>TOTAL ASSETS</b>	<u>\$27,507,186</u>	<u>\$32,481,670</u>
<b>LIABILITIES</b>		
<b>CURRENT</b>		
Bank indebtedness	\$500,000	\$470,000
Payables & accruals	1,797,287	2,265,584
Income taxes payable	246,231	327,829
Deferred revenue	2,830,578	2,133,225
	<u>5,374,096</u>	<u>5,196,638</u>
<b>LONG TERM LIABILITIES</b>		
Deferred revenue	64,797	143,865
	<u>64,797</u>	<u>143,865</u>
<b>TOTAL LIABILITIES</b>	<u>5,438,893</u>	<u>5,340,503</u>
<b>SHAREHOLDERS' EQUITY</b>		
Capital stock	41,062,473	41,048,098
Retained earnings/(deficit)	(18,994,180)	(13,906,931)
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<u>22,068,293</u>	<u>27,141,167</u>
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<u>\$27,507,186</u>	<u>\$32,481,670</u>

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

(Unaudited)

	Three Months Ended March 31		Six Months Ended March 31	
	2002	2001	2002	2001
Operating activities				
Net earnings (loss)	\$(206,079)	\$(2,553,459)	\$(489,247)	\$(4,277,326)
Amortization	282,713	1,093,923	552,971	2,175,095
Loss (gain) on sale of capital assets	(11,121)	-	(9,863)	-
Deferred income taxes	(4,860)	(16,943)	(27,975)	(17,029)
Change in non-cash working capital	504,889	1,969,634	(671,468)	2,513,018
	<u>565,542</u>	<u>493,155</u>	<u>(645,582)</u>	<u>393,758</u>
Financing activities				
Bank financing	-	(50,000)	(20,000)	154,615
Proceeds on issue of shares	-	16,100	-	38,813
	<u>-</u>	<u>(33,900)</u>	<u>(20,000)</u>	<u>193,428</u>
Investing activities				
Cash paid on acquisition of subsidiaries	-	-	-	(766,985)
Purchase of capital assets	(71,842)	(203,322)	(110,134)	(348,041)
Proceeds on disposal of fixed assets	11,802	-	23,198	-
Development costs incurred	(397,751)	(414,210)	(689,843)	(762,035)
	<u>(457,791)</u>	<u>(617,532)</u>	<u>(776,779)</u>	<u>(1,877,061)</u>
Net (decrease) increase in cash and cash equivalents	107,751	(158,277)	(1,442,361)	(1,289,875)
Cash and cash equivalents				
Beginning of period	12,653,829	17,338,492	14,203,941	18,470,090
End of period	<u>\$12,761,580</u>	<u>\$17,180,215</u>	<u>\$12,761,580</u>	<u>\$17,180,215</u>

## **Xenos Group Inc.**

### **Notes to the Condensed Consolidated Financial Statements**

March 31, 2002 and 2001

#### **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 adopted 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 March 31, 2002 and 2001.

### 3. Goodwill

	As at March 31			
	2002		2001	
Cost	\$ 12,443,822		\$ 12,443,822	
Accumulated amortization	<u>6,369,959</u>		<u>5,467,679</u>	
Net book value	<u>\$ 6,073,863</u>		<u>\$ 6,976,143</u>	
	Three Months Ended March 31		Six Months Ended March 31	
	2002	2001	2002	2001
Reported net income (loss)	\$ (206,079)	\$(2,553,459)	\$ (489,247)	\$(4,277,326)
Add back: Goodwill amortization	<u>-</u>	<u>735,083</u>	<u>-</u>	<u>1,470,166</u>
Adjusted net income (loss)	<u>\$ (206,079)</u>	<u>\$(1,818,376)</u>	<u>\$ (489,247)</u>	<u>\$(2,807,160)</u>
Basic & Fully-diluted earnings (loss) per share:				
Reported net income (loss)	\$ (0.03)	\$ (0.30)	\$ (0.06)	\$ (0.51)
Add back: Goodwill amortization	<u>-</u>	<u>0.09</u>	<u>-</u>	<u>0.18</u>
Adjusted net income (loss)	<u>\$ (0.03)</u>	<u>\$ (0.21)</u>	<u>\$ (0.06)</u>	<u>\$ (0.33)</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 grant.

A summary of the status of the Company's stock option plan as of March 31, 2002 and 2001 and any changes during each year-to-date period is presented below:

	Shares		Weighted Average Exercise Price	
	2002	2001	2002	2001
Outstanding, beginning of year	1,052,083	1,212,375	\$6.36	\$4.90
Granted	846,583	188,000	1.65	3.26
Exercised	-	(33,750)	-	1.15
Forfeited	<u>(560,333)</u>	<u>(30,166)</u>	<u>6.32</u>	<u>17.02</u>
Outstanding, end of period	<u>1,338,333</u>	<u>1,336,459</u>	<u>\$3.40</u>	<u>\$6.21</u>
Options exercisable at period end	<u>394,583</u>	<u>461,709</u>		

The following information applies to options outstanding at March 31, 2002:

<u>Option Price</u>	<u>Number</u>	<u>Expiry</u>
\$ 0.44	45,000	July, 2003
1.15	224,250	July, 2003
1.36	2,000	February, 2007
1.40	5,000	November, 2006
1.50	2,000	January, 2007
1.65	831,083	December, 2006
3.20	20,000	January, 2006
3.25	11,000	December, 2005
4.05	5,000	January, 2006
6.00	65,000	July, 2005
8.50	42,000	August, 2004
10.70	50,000	October, 2004
40.00	16,000	February, 2005
42.00	20,000	January, 2005

During the first quarter ended December 31, 2001, 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. In addition, an aggregate of 670,625 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.

## **6. Subsequent event**

Effective May 17, 2002 the Company acquired all of the issued and outstanding shares of Rush Creek Software Corporation in exchange for 200,000 Xenos Common Shares, cash payments totalling \$1.5 million and a future consideration to be determined on a performance based arrangement.

## Corporate Addresses

### Corporate Headquarters

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## [www.xenos.com](http://www.xenos.com)

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## Shareholder Information

### Legal Counsel

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### Transfer Agent/Registrar

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### Auditors

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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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