



# Second Quarter Report

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Three and six months ended March 31, 2006

To Our Shareholders:

For the fiscal second quarter ended March 31, 2006, Xenos reported revenues of \$3,128,000 compared to revenues of \$3,206,000 for the same quarter last year. The Company reported negative EBITDA of \$1,316,000, compared to negative EBITDA of \$643,000, for the same period last year and a second quarter net loss of \$1,734,000, or (\$0.18) per share, compared with a net loss of \$997,000, or (\$0.10) per share for the second quarter of fiscal 2005.

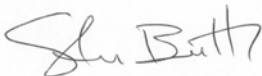
For the first six months of fiscal 2006, Xenos reported revenues of \$6,747,000 and a net loss of \$2,661,000, or (\$0.27) per share. This compares to revenues of \$6,731,000 and a net loss of \$1,505,000, or (\$0.15) per share, for the same period last year.

Our second quarter results were below our targets as a result of a few factors: Professional and consulting services revenues were softer during the quarter. This has been corrected and our services group, expanded by several new hires is now expected to be fully-booked through the current quarter.

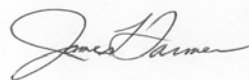
The Company spent 33% more on marketing, sales and promotion during the quarter than during the corresponding quarter last year. This significant increase in activity has not yet been converted to new license revenue as the impact of these lead generating and prospect qualifying programs is not immediate. The Company took action during the quarter to accelerate conversion to sales through intensive work within market segments that it considers most promising for growth. Additionally, Xenos is investing in a high level campaign to enhance Xenos brand equity. Investors can watch for Xenos in the pages of Information Week and Computerworld, among other mass circulation IT publications. We are pleased to report that new lead generation is currently encouraging. Overall, our investment in market-related activities is beginning to bear fruit in terms of increased profile within our markets leading to both new direct sales and a number of significant new partnership opportunities.

In addition, the continuing depreciation of the US dollar decreases our Canadian dollar revenues and makes year over year comparisons seem weaker than they are in terms of actual ongoing business activity. While we continue our policy of hedging our US currency exposure we continue to be impacted by the effects of the extended trend that we have experienced over the past three years.

Xenos maintains a strong balance sheet, with a cash position of \$10.5 million, or \$1.06 per common share and no long-term debt.



Stuart Butts  
Chairman of the Board  
And Chief Executive Officer



Jim Farmer  
President and  
Chief Operating Officer

## Notice to reader of the interim financial statements

The Company's external auditors, Grant Thornton LLP, have not performed a review of these interim consolidated financial statements. These statements have been prepared by management and include the selection of appropriate accounting principles, judgments and estimates necessary to prepare these financial statements in accordance with Canadian generally accepted accounting principles.

## Management's Discussion and Analysis of Financial Condition and Results of Operations for the Three and Six Months ended March 31, 2006

*The following discussion and analysis should be read together with the Company's unaudited quarterly financial statements for the periods ended March 31, 2006 and 2005 and related notes, as well as the audited consolidated financial statements and Management's Discussion and Analysis for the year ended September 30, 2005. 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 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 March 31, 2006, there were 9,936,944 shares issued and outstanding. Stock options for a total of 1,162,638 shares were outstanding at exercise prices ranging from \$1.36 to \$4.36 with various expiry dates, the latest of which is March, 2011.

#### *Fiscal 2006 Business Highlights*

During the second quarter, the Company embarked upon a significant media and lead generation program including extensive print advertising in selected high profile and high circulation publications such as Computerworld and Information Week. The Company concurrently launched a corporate awareness and positioning plan featuring online banner advertisements, online whitepaper placements, new web-based outreach campaigns and third party facilitated webcasts. Early results from the aggressive marketing campaign are encouraging, but will take time to bring to fruition. Management had anticipated that the new marketing campaign, in support of the very promising technology it has built and acquired over the past three years, would have been launched prior to the beginning of the current fiscal year. This slippage was costly to the company's overall strategic plan, and during the quarter, the Company made several personnel and program changes to address this issue.

Version 2.2 of Xenos d2e Vision™, containing significant new features and enhancements, was released for general availability.

### **RESULTS OF OPERATIONS FOR THE THREE AND SIX MONTHS ENDED MARCH 31, 2006**

For the three months ended March 31, 2006, sales decreased marginally to \$3.1 million as compared to \$3.2 million in the previous year. Although second quarter sales activities are typically seasonally low, the volume of new license sales in particular was well below expectations. This was largely the result of ineffectual and delayed marketing programs, circumstances that management believes it has corrected, as detailed above. On a year-to-date basis, sales were consistent with the prior year at \$6.7 million.

Geographically, 68% of sales in the quarter were in North America while 31% were in Europe compared to 62% and 36% respectively in fiscal 2005. License sales comprised approximately 23% of total revenues in fiscal 2006 compared to 18% in the prior year.

Gross profits for the quarter were 81% of sales compared to 80% in the prior year.

Sales and marketing expenses were \$2.4 million for the quarter compared with \$1.8 million in the prior year. This increase was primarily due to new marketing team hires, some severance costs for changes made and increased marketing expenditures on media advertising and online bulk placements as part of the new initiatives. As a percentage of revenues, sales and marketing expenses were at 76% as compared to 56% last year. Year-to-date, sales and marketing costs were \$4.7 million as compared to \$3.6 million last year.

Total expenditures on product development for the quarter, gross of amounts deferred, were relatively unchanged at \$921,000 as compared to \$969,000 last year. On a year-to-date basis, the expenditures were \$1.9 million and \$2.0 million respectively.

Administrative expenses were relatively consistent at \$609,000 for the quarter as compared to \$624,000 last year. Year-to-date, administrative expenses were \$1.3 million for both the current and prior year.

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 for the quarter of \$290,000 were virtually unchanged from the prior year. Year-to-date, amortization was \$553,000 versus \$550,000 last year.

Stock based compensation expense was \$34,000 for the quarter as compared to \$20,000 last year as a result of grants made in the first and second quarter. Year-to-date, stock based compensation expense was \$51,000 compared to \$38,000 last year.

The foreign exchange loss for the quarter of \$85 compares to a loss last year of \$71,000 as a result of relatively stable exchange rates in the quarter. Year-to-date, the foreign exchange gain was \$119,000 versus a loss of \$107,000 last year.

The tax expense of \$195,000 (Fiscal 2005 – expense of \$48,000) relates to lower utilization of tax loss carry-forwards in the Canadian parent, some of which could expire if not used in F2007. Year-to-date, the tax expense was \$217,000 as compared to \$81,000 last year.

Interest income was \$80,000 for the quarter as compared to \$61,000 in the previous year. Year-to-date, interest income was \$158,000 versus \$135,000 last year.

The net loss for the quarter was \$1.7 million or (\$0.18) per share as compared to a net loss of \$997,000 or (\$0.10) per share in the previous year. Year-to-date, the net loss was \$2.7 million versus a loss of \$1.5 million last 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.

#### 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 typically used to test for impairment every three years. As a result of the weaker than anticipated results for the first and second quarter, as well as the change in product marketing leadership and related strategy, the Company has scheduled an external valuation in the current fiscal year to be based on revised projections in order to ensure appropriate reporting of this asset on an ongoing basis. This is an involved process that includes running revised long-term projections based on the current outlook which are then factored through the existing valuation model. The process is expected to be completed in the fourth quarter of the 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.

#### 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.

#### **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 March 31, 2006, have concluded that, as at March 31, 2006, the Company's disclosure controls and procedures were effective.

#### **LIQUIDITY AND CAPITAL RESOURCES**

As at March 31, 2006, cash and short-term investments stood at \$10.5 million (March 31, 2005 - \$11.8 million) or \$1.06 per common share (i). Cash from operations was a use of \$366,000 as compared to a use of \$342,000 in the previous year. Several significant

payments on annual contracts were received during the quarter, reducing the use of cash amount reported.

The Company currently has an operating line of credit of \$1.0 million of which \$500,000 (March 31, 2005 - \$ 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.

Capital expenditures for the quarter ended March 31, 2006 were \$111,000 versus \$73,000 in the prior year. The increase was primarily related to network infrastructure changes, replacement computer equipment and some leasehold improvements.

Development costs capitalized were \$86,000 versus \$195,000 last year and represent the internal development costs relating to specific products as required by Canadian GAAP.

Shareholders equity stood at \$17.9 million or \$1.80 per share (ii) compared to \$20.7 million or \$2.09 per share (ii) as at March 31, 2005.

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 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 and marketing initiatives.

*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 and provided only minimal increases in fiscal 2006 except in the case of promotions and special situations. The Company also relies on intangible benefits such as providing a desirable, team oriented workplace environment in order to retain staff. Management monitors attrition rates carefully in order to assess trends and establish competitive benchmark compensation plans. However, driving revenue growth and profitability in line with targets and keeping salaries current with respect to

appropriate benchmarks will be critical to retaining key staff in an increasingly competitive labour marketplace.

#### *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 generating revenue growth and building an infrastructure that is efficient and scalable.

#### *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.

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 March 31		Six Months Ended March 31	
	2006	2005	2006	2005
Sales	\$ 3,127,937	\$ 3,206,137	\$ 6,746,791	\$ 6,731,061
Cost of sales	589,093	640,756	1,209,185	1,160,149
Gross profit	2,538,844	2,565,381	5,537,606	5,570,912
Expenses				
Sales and marketing	2,376,549	1,790,083	4,657,187	3,549,978
Research and development	834,696	774,138	1,708,040	1,587,841
Administration and general	609,185	624,488	1,265,031	1,277,420
Amortization	290,382	286,775	553,274	549,781
Stock based compensation	33,931	19,537	50,688	37,845
Interest and bank charges	13,430	10,199	25,648	20,143
	4,158,173	3,505,220	8,259,868	7,023,008
Loss from operations	(1,619,329)	(939,839)	(2,722,262)	(1,452,096)
Other income				
Interest and other	80,269	61,383	158,427	134,610
Foreign exchange (loss) gain	(85)	(70,768)	119,393	(106,739)
Loss before income taxes	(1,539,145)	(949,224)	(2,444,442)	(1,424,225)
Provision for income taxes	194,668	47,732	216,519	80,777
Net loss	\$ (1,733,813)	\$ (996,956)	\$ (2,660,961)	\$ (1,505,002)
Net loss per common share				
- Basic	\$ (0.18)	\$ (0.10)	\$ (0.27)	\$ (0.15)
- Fully diluted	\$ (0.18)	\$ (0.10)	\$ (0.27)	\$ (0.15)
Weighted average number of shares				
- Basic			9,935,440	9,912,566
- Fully diluted			9,935,440	9,912,566
Deficit, beginning of year as previously stated			\$ (24,603,941)	\$ (22,775,608)
Impact of retroactive adoption of CICA recommendations for stock based compensation			-	(65,141)
Deficit, beginning of year as restated			(24,603,941)	(22,840,749)
Net loss			(2,660,961)	(1,505,002)
Deficit, end of period			\$ (27,264,902)	\$ (24,345,751)

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

	As at March 31	
	2006	2005
<b>ASSETS</b>		
<b>CURRENT</b>		
Cash & S.T. investments	\$ 10,491,618	\$ 11,803,326
Trade receivables	1,335,280	2,336,405
Other receivables	7,073	9,662
Prepays	957,489	712,191
Future income taxes	198,554	48,137
	<u>12,990,014</u>	<u>14,909,721</u>
<b>LONG TERM</b>		
Future income taxes	1,483,564	1,941,742
Capital assets	1,319,473	1,258,189
Intangibles and other assets	2,800,593	3,021,529
Goodwill	6,369,870	6,259,400
	<u>11,973,500</u>	<u>12,480,860</u>
<b>TOTAL ASSETS</b>	<u>\$ 24,963,514</u>	<u>\$ 27,390,581</u>
<b>LIABILITIES</b>		
<b>CURRENT</b>		
Bank indebtedness	\$ 500,000	\$ 500,000
Payables & accruals	1,987,550	1,613,875
Income taxes payable	55,386	22,425
Deferred revenue	4,176,059	4,287,394
Current portion - capital lease	40,900	32,896
	<u>6,759,895</u>	<u>6,456,590</u>
<b>LONG TERM</b>		
Capital lease obligations	92,644	106,248
Deferred revenue	20,571	6,937
Deferred rent	186,945	105,491
	<u>300,160</u>	<u>218,676</u>
<b>TOTAL LIABILITIES</b>	7,060,055	6,675,266
<b>SHAREHOLDERS' EQUITY</b>		
Capital stock	44,969,035	44,953,086
Contributed surplus	199,326	107,980
Deficit	(27,264,902)	(24,345,751)
<b>TOTAL SHAREHOLDERS' EQUITY</b>	<u>17,903,459</u>	<u>20,715,315</u>
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<u>\$ 24,963,514</u>	<u>\$ 27,390,581</u>

**Xenos Group Inc.**

**Consolidated Statements of Cash Flows**

(Unaudited)

	Three Months Ended March 31		Six Months Ended March 31	
	2006	2005	2006	2005
Operating activities				
Net loss	\$ (1,733,813)	\$ (996,956)	\$ (2,660,961)	\$ (1,505,002)
Amortization	290,382	286,775	553,274	549,781
Future income taxes	166,132	56,734	173,745	60,931
Stock based compensation	33,931	19,537	50,688	37,845
Change in non-cash working capital	877,564	292,091	900,460	698,585
	(365,804)	(341,819)	(982,794)	(157,860)
Financing Activities				
Capital lease payments	(9,737)	(11,104)	(19,289)	(21,970)
Proceeds on issue of shares	4,950	5,363	4,950	54,313
	(4,787)	(5,741)	(14,339)	32,343
Investing activities				
Cash paid on acquisition of business assets	-	-	-	(228,625)
Additional consideration paid on acquisitions	(64,326)	(6,505)	(67,688)	(15,784)
Purchase of capital assets	(110,843)	(72,890)	(254,186)	(108,969)
Development costs incurred	(85,891)	(194,677)	(223,116)	(361,843)
	(261,060)	(274,072)	(544,990)	(715,221)
Net decrease in cash and short term investments	(631,651)	(621,632)	(1,542,123)	(840,738)
Cash and short term investments				
Beginning of period	11,123,269	12,424,958	12,033,741	12,644,064
End of period	\$ 10,491,618	\$ 11,803,326	\$ 10,491,618	\$ 11,803,326

Xenos Group Inc.

## Notes to the Condensed Consolidated Financial Statements

March 31, 2006 and 2005

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

Xenos, for over 20 years, has provided high-performance software solutions that automate the processing and delivery of data and documents. 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.

The Xenos integrated software portfolio enables organizations to create powerful new Information Supply Chains that are both flexible and scalable, enabling organizations to quickly and easily adapt business processes to evolving market dynamics and regulatory requirements, scalable to 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

#### 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.

### 3. Intangibles and other assets

	As at March 31	
	2006	2005
Cost		
Deferred development costs	\$ 6,579,225	\$ 6,078,225
Acquired intangible assets	1,104,000	1,104,000
	<u>\$ 7,683,225</u>	<u>\$ 7,182,225</u>
Accumulated amortization		
Deferred development costs	\$ 4,612,932	\$ 4,001,396
Acquired intangible assets	269,700	159,300
	<u>\$ 4,882,632</u>	<u>\$ 4,160,696</u>
Net book value		
Deferred development costs	\$ 1,966,293	\$ 2,076,829
Acquired intangible assets	834,300	944,700
	<u>\$ 2,800,593</u>	<u>\$ 3,021,529</u>

Included in amortization expense in the income statement is \$ 312,506 (2005 - \$ 306,174) related to amortization of deferred development costs and \$ 55,200 (2005 - \$ 55,200) related to amortization of acquired intangibles.

### 4. Goodwill

	As at March 31	
	2006	2005
Net book value, beginning of period	\$ 6,302,182	\$ 6,243,616
Additional consideration paid on acquisitions	67,688	15,784
Net book value, end of period	<u>\$ 6,369,870</u>	<u>\$ 6,259,400</u>

During the six month period ended March 31, 2006, the Company paid additional consideration of \$ 67,688 (six month period ended March 31, 2005 - \$ 15,784) to the former owners of Rush Creek Software Corporation.

### 5. Capital stock

	March 31, 2006		March 31, 2005	
	Number	Amount	Number	Amount
Balance, beginning of year	9,933,944	\$ 44,964,085	9,894,361	\$ 45,127,398
Issued pursuant to exercise of vested stock options	3,000	4,950	32,917	54,313
Reduction due to cash paid subsequently pursuant to the share price guarantee	-	-	-	(228,625)
Balance, end of period	<u>9,936,944</u>	<u>\$ 44,969,035</u>	<u>9,927,278</u>	<u>\$ 44,953,086</u>

## 6. Contributed surplus

	As at March 31	
	2006	2005
Balance, beginning of year	\$ 148,638	\$ 4,994
Retroactive adoption of the fair value method	-	65,141
Stock based compensation	50,688	37,845
Balance, end of period	<u>\$ 199,326</u>	<u>\$ 107,980</u>

## 7. Stock based compensation 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 March 31, 2006 and 2005 and any changes during each year-to-date period is presented below:

	Shares		Weighted Average Exercise Price	
	2006	2005	2006	2005
Outstanding, beginning of year	958,138	1,112,388	\$ 2.14	\$ 4.00
Granted	294,000	47,000	1.97	2.34
Exercised	(3,000)	(32,917)	1.65	1.65
Forfeited	<u>(86,500)</u>	<u>(120,417)</u>	2.67	17.98
Outstanding, end of quarter	<u>1,162,638</u>	<u>1,006,054</u>	\$ 2.06	\$ 2.33
Options exercisable at quarter end	<u>421,138</u>	<u>851,054</u>		

## 7. Stock based compensation plan (continued)

The following information applies to options outstanding at March 31, 2006:

Exercise Price	Number outstanding and exercisable	Number outstanding but not exercisable	Weighted average remaining life in months	Weighted average exercise price	Expiry
\$ 1.36	2,000	-	11	\$ 1.36	February, 2007
1.50	2,000	-	10	1.50	January, 2007
1.65	207,638	-	9	1.65	December, 2006
1.65	20,000	-	17	1.65	August, 2007
1.65	25,000	-	14	1.65	May, 2007
1.65	-	400,000	57	1.65	December, 2010
1.90	15,000	-	58	1.90	January, 2011
1.93	-	100,000	57	1.93	December, 2010
1.99	-	179,000	60	1.99	March, 2011
2.20	8,000	-	24	2.20	March, 2008
2.29	5,000	-	47	2.29	February, 2010
2.35	17,000	-	47	2.35	February, 2010
2.40	2,500	7,500	47	2.40	February, 2010
3.45	52,500	2,500	32	3.45	November, 2008
3.60	10,000	10,000	32	3.60	November, 2008
3.80	42,500	42,500	31	3.80	October, 2008
4.36	12,000	-	36	4.36	March, 2009

## 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. 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 currencies 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 March 31, 2006, the Company had foreign exchange forward contracts outstanding to fix the rate at which estimated US dollar revenues are to be recorded in fiscal 2006. The Company has committed to sell \$4.0 million US dollars during the balance of fiscal 2006 at an average rate of exchange of CAD 1.1887. The fair market value of those contracts at March 31, 2006 was approximately \$4.071 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.

	<u>Sales</u>		<u>Capital Assets and Goodwill</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Canada	\$ 433,006	\$ 295,089	\$ 5,032,418	\$ 4,918,614
European Union	339,078	625,721	-	-
United Kingdom	1,296,696	1,584,773	270,546	294,647
United States	4,071,562	3,804,330	2,386,379	2,304,328
Other	<u>606,449</u>	<u>421,148</u>	<u>-</u>	<u>-</u>
	<u>\$ 6,746,791</u>	<u>\$ 6,731,061</u>	<u>\$ 7,689,343</u>	<u>\$ 7,517,589</u>

## 10. Comparative figures

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

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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.*

## Shareholder Information

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### Trading

Xenos Group Inc. trades on  
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