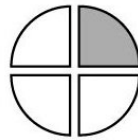




*Accelerate your Vision.*

# **Intrinsic Software Inc.**

**Quarterly Report 2003**



Second Quarter

## **Executive Officers**

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Derek W. Spratt, P.Eng.  
President & CEO

Chuck Leighton, B.Comm., CA  
Chief Financial Officer

David W. Monroe, BA  
VP, Worldwide Sales

David B. Manuel, P.Eng.  
VP, Engineering

André Viljoen, B.Eng.  
VP, Research & Development

Alan Scott, B.Sc., M.Sc., MBA  
VP, Intrinsic Europe

## **Board of Directors**

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Ronald P. Erickson, BA, MA, JD  
Seattle, WA, USA

Robert J. Gayton, Ph.D., FCA  
West Vancouver, BC, Canada

Vincent Luciano  
Port Jefferson Station, NY, USA

Moiz Beguwala, B.Eng., MS, Ph.D, MBA  
Anaheim Hills, CA, USA

Vincent Schiralli, BA  
Waterloo, ON, Canada

George A. Duguay, CGA  
Thornhill, ON, Canada

Derek W. Spratt, P.Eng.  
Vancouver, BC, Canada

Neil McDonnell, B.Comm., MBA  
North Vancouver, BC, Canada

## **Corporate Office**

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**Market Information Symbol:** ICS:TSX

**Web Site:** [www.intrinsyc.com](http://www.intrinsyc.com)

## Report To Shareholders

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April 2003

### Dear Shareholder:

During the second quarter, fiscal 2003, Intrinsyc posted revenues of \$2.7 million and net losses of \$2.5 million. Our year-to-date revenues have increased 10% to \$7.2 million compared to the same period in 2002. Second quarter revenues were down 21% from first quarter revenues of \$3.4 million. We ended the quarter with cash and cash equivalents of \$7.1 million, no long term bank debt, and working capital of \$8.8 million. This is *net* of any contingent payments to the NMI principals as a result of this acquisition in 2002.

The milestones we achieved this quarter include:

- » **Announced IBM Partnership** – Intrinsyc is developing and distributing products and services for the PowerPC community, including Intrinsyc's new CerfCube 405EP, based on IBM's 405EP microprocessor.
- » **Microsoft purchased new  $\mu$ PDA (MicroPDA)** – This cutting-edge wireless handheld development platform was launched in December, with Microsoft ordering the first commercial units.
- » **Selected as finalist for Technology Award** – The  $\mu$ PDA was short-listed by industry technology experts for the prestigious EDN Magazine Innovation of the Year Award in the Embedded Development category.
- » **Signed contracts in key verticals** – Intrinsyc's engineering services, systems integration expertise and hardware and software products continued to be deployed in several key vertical markets.

As Intrinsyc's new President and CEO, my immediate goal is to address our corporate profitability issues in a prudent and efficient manner while preserving our intellectual property, working capital, customers and strategic partnerships.

The technology sector slowdown, commoditization pressures and the global recessionary business climate have combined to make the intelligent device market highly competitive. Intrinsyc, and other embedded solutions providers, need to adapt to these changes.

Over the next 90 days I intend to review our impressive portfolio of intellectual property and technology, and marry our competencies and advantages with my vision of the market and our partners' strategies. During this period, we have some significant customer deliverables and ongoing business that will continue to generate core revenues as we determine and embark on the necessary course of changes.

Moving forward our focus will be on booking and delivering against profitable customer engagements and not top line revenues alone. We will refocus our product development and customer engagement mix back towards licensable software. We will de-emphasize, but not eliminate, lower margin hardware-based development platforms as a source of revenue. These hardware products form an excellent market access strategy providing us with opportunities to up sell our solutions, deepen customer engagements, develop long-term working relationships, and emphasize Intrinsyc's capabilities as an end-to-end solutions provider. This product refocus is aimed at steadily improving our blended gross margins back towards historical levels.

I intend to support this initiative through new strategic investments in software-based technologies. This will ensure a strong recurring licensing stream and provide opportunities to engage customers with systems integration and engineering services.

Our company has always had a reputation of being a pioneer and a powerful innovation leader in our space. We have some of the best and brightest technology professionals in the business that have won numerous international awards and generated almost \$40 million in revenues for Intrinsyc. As a result, we have earned the respect and trust of some of the world's largest and most successful companies. We have an enviable list of customers such as Siemens, Ford, General Electric, JP Morgan and strategic partners such as Microsoft, Intel, Philips, and now IBM. This is a testament to the value of Intrinsyc's products and expertise.

Intrinsyc has what it takes to win profitable business today, while positioning itself to capitalize on solid growth opportunities when the inevitable market recovery occurs. I passionately believe our long-term prospects remain strong in the dynamic and fast-paced specialized, intelligent device market.

On behalf of Management and the Board of Directors, I would like to thank all of Intrinsyc's shareholders, stakeholders and employees for their continued support as we move forward together under this new plan.



Derek Spratt, President & CEO, Intrinsyc Software, Inc.



## Management's Discussion & Analysis

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*This discussion and analysis covers our interim consolidated financial statements for the three and six month periods ended February 28, 2003. It also provides an update to the discussion and analysis contained in our 2002 Annual Report. This discussion and analysis should be read in conjunction with the "Management Discussion and Analysis" section and the annual consolidated financial statements contained in our 2002 Annual Report.*

### Results of Operations

Our loss for the quarter ended February 28, 2003 was \$2,495,638 (\$0.07 per share) compared to \$592,897 (\$0.02 per share) for the quarter ended February 28, 2002. The current quarter operating loss was \$1,330,376 greater than the operating loss of \$1,165,262 (\$0.03 per share) for the previous quarter ended November 30, 2002.

**Revenue** for the three months ended February 28, 2003 was \$2.72 million compared with \$3.43 million during the same period in fiscal 2002, a decrease of 21 percent, and a decrease of \$1,758,503 or 39 percent from the previous quarter revenue of \$4.48 million. During the quarter there were no customers that accounted for more than 10 percent of recognized revenue. Year to date revenue of \$7.20 million for the six months ended February 28, 2003 increased by \$619,477 or 9 percent from the same period ended February 28, 2002 as the Company's products and services continue to gain acceptance in a cautious market.

**Licensing revenue** comprised 27 percent of the revenue in the period, up from 18 percent in the previous quarter, with services revenue amounting to 53 percent of revenue, slightly down from 54 percent in the first quarter, and sales of products generating 20 percent of revenue, down from 28 percent in the first quarter. The gross margin on sales for the quarter was 19 percent, down from 43 percent in the first quarter of 2003 and down from 58 percent in the second quarter of fiscal 2002. The decline in gross margin over the quarter last year is primarily attributable to lower service revenue on a fixed cost base associated with the operations infrastructure.

**General administration expenses** for the quarter ended February 28, 2003 were \$606,879, an increase of 66 percent or \$240,345, over the same period last year. Administration expenses decreased by \$47,821 or 7 percent compared to the first quarter of 2003. The increase over the same period last year is predominantly attributable to the growth in infrastructure costs through the addition of Intrinsyc Europe Ltd. ("IEL") formerly known as NMI Electronics Ltd. The reduction as compared to the first quarter of 2003 is a result of continuing cost reduction programs and reductions in staffing levels.

**Marketing and sales expenses** for the quarter ended February 28, 2003 were \$1,121,117, an increase of 5 percent or \$51,593, compared to the same period last year. Expenses decreased by 17 percent or \$230,089

compared to the first quarter of 2003 as a result of cost reduction initiatives and streamlining the sales operations. The increase over the same period last year is predominantly attributable to the growth in infrastructure costs through the addition of IEL. The decrease relative to the first quarter of 2003 is due to a reduction in the direct sales force and a move to foster indirect sales channels.

**Research and development expenses** for the quarter ended February 28, 2003 were \$944,728, a decrease of 1 percent or \$6,618, compared to the same period last year and a decrease of 28 percent or \$364,147 from the first quarter of 2003. This decrease in costs for research and development is predominantly attributable to the majority of the development expenses of the first generation prototypes of the  $\mu$ PDA incurring in the first quarter of 2003. In addition, the Technology Partnerships Canada investment funding has aided in the growth of our research and development activities through cash payments of \$1.4 million to date.

**Interest income** earned on cash and short-term balances was \$140,158 for the quarter, up by 83% or \$63,658 from \$76,500 in the same period last year and up by 185% or \$90,982 from \$49,176 in the first quarter of 2003. The increase in the quarter is primarily attributable to higher interest rates and interest payments received from the funds that were held in trust.

**Foreign exchange losses** for the quarter ended February 28, 2003 were \$560,402, an increase of 519 percent or \$694,290, compared to the same period last year and an increase of 726 percent or \$649,986 from the first quarter of 2003. The majority of the Company's trade receivables, restricted funds and deferred revenue balances are denominated in US dollars or UK pounds. During the quarter, the Canadian dollar strengthened significantly relative to these two currencies producing a translation loss on these assets which was partially offset by payables denominated in US dollars.

### Liquidity and Capital Resources

**Cash and cash equivalents** decreased to \$7.1 million as of February 28, 2003, compared to \$8.9 million as at November 30, 2002 and working capital decreased to \$8.9 million as of February 28, 2003 from \$11.4 million as of November 30, 2002.

Revenues allocated to future support activities, the delivery of future services, or future product deliveries are deferred until such time as the customer obligation is met. As of the quarter ended February 28, 2003, \$398,403 has been deferred compared to \$502,651 as of November 30, 2002.

The Company continues to have no long-term liabilities or bank debt.

The Company's operating activities resulted in cash outflows of \$2,397,338 for the three months ended February 28, 2003 compared to cash outflows of \$3,135,760 during the same period in 2002. Cash of \$632,500 was provided in the quarter from investments,

net of cash used in capital assets acquisition, compared to cash used of \$6,021 during the same period last year. Capital assets purchased in the quarter were primarily computer software. Restricted cash was reduced by \$185,243 during the quarter as a foreign exchange loss adjustment due to the UK pound weakening relative to the Canadian dollar. There was no financing activity affecting cash in the quarter compared to cash inflow of \$12,244,676 during the same period last year from common shares issued on exercise of stock options and warrants. In addition, \$1,714,624 was accrued for the contingent consideration payable for the NMI acquisition as certain revenue targets were achieved by NMI.

## **Consolidated Financial Statements of Intrinsyc Software, Inc.**

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Three months ended February 28, 2003 and 2002  
Six months ended February 28, 2003 and 2002

(Expressed in Canadian dollars)

(Unaudited)

## Consolidated Balance Sheets

(Expressed in Canadian dollars)

|   | February 28,<br>2003 | August 31,<br>2002   |
|---|----------------------|----------------------|
|   | (Unaudited)          | (Audited)            |
| <b>Assets</b>                               |                      |                      |
| Current assets:                             |                      |                      |
| Cash and cash equivalents                   | \$ 7,090,749         | \$ 9,226,932         |
| Funds held in trust                         | 494,172              | 517,700              |
| Accounts receivable                         | 3,104,453            | 5,159,369            |
| Other receivable                            | 766,147              | 1,256,418            |
| Inventory                                   | 1,064,849            | 753,155              |
| Prepaid expenses                            | 183,709              | 263,609              |
|   | <u>12,704,079</u>    | <u>17,177,183</u>    |
| Funds held in trust                         | -                    | 520,461              |
| Restricted cash (note 4)                    | 5,021,729            | 5,132,238            |
| Capital assets                              | 1,418,755            | 1,472,962            |
| Goodwill (note 7(a))                        | 9,683,745            | 6,784,821            |
| Other assets (note 7(b))                    | 2,026,452            | 2,384,122            |
|   | <u>\$ 30,854,760</u> | <u>\$ 33,471,787</u> |
| <b>Liabilities and Shareholders' Equity</b> |                      |                      |
| Current liabilities:                        |                      |                      |
| Accounts payable and accrued liabilities    | \$ 3,309,929         | \$ 3,428,276         |
| Deferred revenue                            | 398,403              | 439,050              |
| Future income taxes                         | 179,600              | 179,600              |
|   | <u>3,887,932</u>     | <u>4,046,926</u>     |
| Future income taxes                         | 428,333              | 535,633              |
| Shareholders' equity:                       |                      |                      |
| Share capital (note 6(b))                   | 48,303,710           | 48,697,555           |
| Shares to be issued (note 4)                | 1,735,606            | -                    |
| Share purchase warrants                     | 140,000              | 140,000              |
| Cumulative translation adjustment           | (2,684)              | 28,910               |
| Deficit                                     | (23,638,137)         | (19,977,237)         |
|   | <u>26,538,495</u>    | <u>28,889,228</u>    |
|   | <u>\$ 30,854,760</u> | <u>\$ 33,471,787</u> |

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board:



Ronald P. Erickson, Chairman



Robert Gayton, Director

## Consolidated Statements of Operations and Deficit

(Unaudited)  
(Expressed in Canadian dollars)

|  | Three months ended<br>February 28, |               | Six months ended<br>February 28, |               |
|--|------------------------------------|---------------|----------------------------------|---------------|
|  | 2003                               | 2002          | 2003                             | 2002          |
| Revenues   | \$ 2,718,107                       | \$ 3,427,571  | \$ 7,194,717                     | \$ 6,575,240  |
| Cost of sales                                    | 2,195,539                          | 1,455,946     | 4,823,951                        | 2,582,440     |
|  | 522,568                            | 1,971,625     | 2,370,766                        | 3,992,800     |
| Expenses:  |                                    |               |                                  |               |
| Administration                                   | 606,879                            | 366,534       | 1,261,579                        | 785,023       |
| Marketing and sales                              | 1,121,117                          | 1,069,524     | 2,472,323                        | 1,914,386     |
| Research and development                         | 944,728                            | 951,346       | 2,253,603                        | 1,859,507     |
| Amortization                                     | 319,145                            | 369,288       | 647,493                          | 681,854       |
| Less: Government assistance<br>(note 8)          | (290,675)                          | -             | (800,675)                        | -             |
|  | 2,701,194                          | 2,756,692     | 5,834,323                        | 5,240,770     |
| Loss before other income (expense)               | 2,178,626                          | 785,067       | 3,463,557                        | 1,247,970     |
| Other income (expense)                           |                                    |               |                                  |               |
| Interest income                                  | 140,158                            | 76,500        | 189,334                          | 175,847       |
| Foreign exchange gain (loss)                     | (560,402)                          | 133,888       | (470,818)                        | 141,541       |
|  | (420,244)                          | 210,388       | (281,484)                        | 317,388       |
| Loss before income taxes                         | 2,598,870                          | 574,679       | 3,745,041                        | 930,582       |
| Income tax expense (recovery)                    |                                    |               |                                  |               |
| Current  | (49,582)                           | 48,218        | 23,159                           | 48,218        |
| Future   | (53,650)                           | (30,000)      | (107,300)                        | (60,000)      |
|  | (103,232)                          | 18,218        | (84,141)                         | (11,782)      |
| Loss for the period                              | 2,495,638                          | 592,897       | 3,660,900                        | 918,800       |
| Deficit, beginning of period                     | 21,142,499                         | 16,528,186    | 19,977,237                       | 16,202,283    |
| Deficit, end of period                           | \$ 23,638,137                      | \$ 17,121,083 | \$ 23,638,137                    | \$ 17,121,083 |
| Loss per share                                   | \$ 0.07                            | \$ 0.02       | \$ 0.10                          | \$ 0.03       |
| Weighted average number of<br>shares outstanding | 38,283,965                         | 33,519,710    | 38,283,965                       | 33,076,404    |

See accompanying notes to consolidated financial statements.

## Consolidated Statements of Cash Flows

(Unaudited)  
(Expressed in Canadian dollars)

|   | Three months ended<br>February 28, |               | Six months ended<br>February 28, |               |
|---|------------------------------------|---------------|----------------------------------|---------------|
|   | 2003                               | 2002          | 2003                             | 2002          |
| Cash provided by (used in):                       |                                    |               |                                  |               |
| Operations:                                       |                                    |               |                                  |               |
| Loss for the period                               | \$ (2,495,638)                     | \$ (592,897)  | \$ (3,660,900)                   | \$ (918,800)  |
| Items not involving cash:                         |                                    |               |                                  |               |
| Amortization                                      | 319,145                            | 369,288       | 647,493                          | 681,854       |
| Foreign exchange                                  | (43,868)                           | -             | (31,595)                         | -             |
| Future income taxes                               | (53,650)                           | (30,000)      | (107,300)                        | (60,000)      |
| Changes in non-cash operating<br>working capital: |                                    |               |                                  |               |
| Funds held in trust (current)                     | 25,587                             | (37,612)      | 23,528                           | (44,178)      |
| Accounts receivable                               | 1,485,329                          | (1,857,720)   | 2,054,916                        | (2,102,822)   |
| Other receivable                                  | (27,494)                           | -             | 490,271                          | -             |
| Prepaid expenses                                  | 55,810                             | (27,866)      | 79,900                           | 9,654         |
| Inventory   | (49,943)                           | 83,213        | (311,694)                        | (28,582)      |
| Accounts payable and accrued<br>liabilities       | (1,508,368)                        | (910,882)     | (1,727,101)                      | (1,500,683)   |
| Deferred revenue                                  | (104,248)                          | (131,284)     | (40,647)                         | (664,399)     |
|   | (2,397,338)                        | (3,135,760)   | (2,583,129)                      | (4,627,956)   |
| Investments:                                      |                                    |               |                                  |               |
| Purchase of capital assets                        | (75,274)                           | (95,847)      | (235,614)                        | (194,638)     |
| Restricted cash                                   | 185,243                            | -             | 110,509                          | -             |
| Funds held in trust (long-term)                   | 522,531                            | 89,826        | 520,461                          | 13,593        |
|   | 632,500                            | (6,021)       | 395,356                          | (181,045)     |
| Financing:  |                                    |               |                                  |               |
| Issuance of common shares for cash:               |                                    |               |                                  |               |
| Options   | -                                  | 117,510       | 51,590                           | 310,735       |
| Warrants  | -                                  | 2,906,250     | -                                | 3,596,250     |
| Special warrants                                  | -                                  | 9,234,692     | -                                | 9,234,692     |
| Repayment of obligation under<br>capital lease    | -                                  | (13,776)      | -                                | (27,555)      |
|   | -                                  | 12,244,676    | 51,590                           | 13,114,122    |
| Increase (decrease) in cash and cash equivalents  | (1,764,838)                        | 9,102,895     | (2,136,183)                      | 8,305,121     |
| Cash and cash equivalents,<br>beginning of period | 8,855,587                          | 14,267,325    | 9,226,932                        | 15,065,099    |
| Cash and cash equivalents, end of period          | \$ 7,090,749                       | \$ 23,370,220 | \$ 7,090,749                     | \$ 23,370,220 |
| Supplementary information:                        |                                    |               |                                  |               |
| Interest paid                                     | \$ 727                             | \$ 830        | \$ 1,389                         | \$ 1,660      |
| Income taxes paid                                 | 30,000                             | -             | 30,000                           | -             |
| Non-cash investing activities:                    |                                    |               |                                  |               |
| Contingent consideration<br>payable (note 4)      | 1,714,624                          | -             | 2,765,168                        | -             |
| Share price guarantee<br>(note 6(b))              | 445,345                            | -             | 445,345                          | -             |

See accompanying notes to consolidated financial statements.

## Notes to Consolidated Financial Statements

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(Unaudited)

(Expressed in Canadian dollars)

Six months ended February 28, 2003 and 2002

Three months ended February 28, 2003 and 2002

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### 1. Basis of presentation:

The accompanying unaudited consolidated financial statements do not include all information and footnote disclosures required for an annual set of financial statements under Canadian generally accepted accounting principles. In the opinion of management, all adjustments (consisting solely of normal recurring accruals) considered necessary for a fair presentation of the financial position, results of operations and cash flows as at February 28, 2003 and for all periods presented, have been included. Interim results for the three-month and six month periods ended February 28, 2003 are not necessarily indicative of the results that may be expected for the fiscal year as a whole.

The unaudited consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Intrinsyc Software (USA) Inc., Intrinsyc Inc., Linar Ltd. and Intrinsyc Europe Ltd., formerly NMI Electronics Ltd. The Company has eliminated all significant intercompany balances and transactions. These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles for interim financial information.

These interim consolidated financial statements should be read in conjunction with the annual consolidated financial statements and notes thereto included in the Company's annual report for the fiscal year ended August 31, 2002.

### 2. Significant accounting policies:

These interim consolidated financial statements have been prepared in accordance with the same accounting policies and methods as the annual consolidated financial statements of the Company, except as described below and in note 3.

(a) Goodwill:

Goodwill is the residual amount that results when the purchase price of an acquired business exceeds the sum of the amounts allocated to the identifiable assets acquired, less liabilities assumed, based on their fair values. Goodwill is allocated as of the date of the business combination to the Company's reporting units that are expected to benefit from the synergies of the business combination.

Goodwill is not amortized and is tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test is carried out in two steps. In the first step, the carrying amount of the reporting unit is compared with its fair value. When the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not to be impaired and the second step of the impairment test is unnecessary. The Company currently has one reporting unit and the first step in the impairment test was completed by February 28, 2003. The transitional steps that have been performed are described in note 3(a).

The second step has not been required, but would be carried out if the carrying amount of a reporting unit exceeds its fair value, in which case the implied fair value of the reporting unit's goodwill is compared with its carrying amount to measure the amount of the impairment loss, if any. The implied fair value of the reporting unit's goodwill is determined in the same manner as the value of goodwill is determined in a business combination described in the first paragraph, using the fair value of the reporting unit as if it was the purchase price. When the carrying amount of a reporting unit's goodwill exceeds the implied fair value of the goodwill, an impairment loss is recognized in an amount equal to the excess and is presented as a separate line item in the earnings statement before extraordinary items and discontinued operations.

(b) Stock-based compensation:

The Company accounts for all stock-based payments to non-employees, and employee awards that are direct awards of stock, granted on or after September 1, 2002, using the fair value based method. The Company has granted no such awards during the periods presented. The Company uses the settlement method to account for all other stock-based employee compensation awards. Consideration paid by employees on the exercise of stock options is recorded as share capital. The Company discloses the pro forma effect of accounting for these awards under the fair value based method (see note 5).

**3. Changes in accounting policies:**

(a) Goodwill and other intangible assets:

In August 2001, the Accounting Standards Board of the CICA issued Handbook Section 3062, Goodwill and Other Intangible Assets. Under Section 3062, goodwill and other intangible assets having indefinite lives are not amortized and are tested for impairment at least annually. Intangible assets with definite lives are amortized over their estimated useful lives. The transitional requirements of Section 3062 required the Company to have assessed by February 28, 2003 whether there was an indication that goodwill was impaired at September 1, 2002. The Company identified one reporting unit and determined the fair value of the reporting unit and compared it to its carrying value. As the fair value of the reporting unit exceeded its carrying value at September 1, 2002, there was no indication of goodwill impairment at that date.

The Company has adopted Section 3062 effective September 1, 2002. As of the date of adoption, the Company had unamortized goodwill in the amount of \$6,784,821, which is no longer being amortized. This change in accounting policy resulted in a reduction in amortization expense related to goodwill of \$337,138 for the six months ended and \$168,569 for the three months ended February 28, 2003. In accordance with the requirements of Section 3062, this change in accounting policy is not applied retroactively and the amounts presented for prior periods have not been restated for this change. The earnings and earnings per share before amortization of goodwill for all periods presented are as follows:

|                                      | Three months ended |            | Six months ended |            |
|--------------------------------------|--------------------|------------|------------------|------------|
|                                      | February 28,       |            | February 28,     |            |
|                                      | 2003               | 2002       | 2003             | 2002       |
| Loss for the period                  | \$ 2,495,638       | \$ 592,897 | \$ 3,660,900     | \$ 918,800 |
| Amortization of goodwill             | -                  | (110,350)  | -                | (220,700)  |
| Loss before amortization of goodwill | \$ 2,495,638       | \$ 482,547 | \$ 3,660,900     | \$ 698,100 |
| Loss per share:                      |                    |            |                  |            |
| Before amortization of goodwill      | \$ 0.07            | \$ 0.01    | \$ 0.10          | \$ 0.02    |

(b) Stock based compensation plans:

In December 2001, the Accounting Standards Board of the CICA issued Handbook Section 3870, Stock-based Compensation and Other Stock-based Payments. Section 3870 is effective for stock-based compensation issued by the company on or after September 1, 2002, and is not required to be applied retroactively. The Company is not required to record compensation expense for stock-based compensation awards granted to employees, except for employee awards that are direct awards of stock, call for settlement in cash or other assets, or that call for settlement by the issuance of equity instruments. The adoption of the new standard has had no impact on the figures presented.

#### 4. Acquisition:

NMI Electronics Ltd.

On June 26, 2002, the Company acquired all of the outstanding shares of NMI Electronics Ltd. ("NMI"), a U.K.-based company that is a developer of Windows CE-based products, intelligent device applications and smart phone solutions. The acquisition has been accounted for using the purchase method of accounting and the results of operations have been consolidated since the date of acquisition.

Additional consideration of up to £2,057,000 (\$4,813,380) of guaranteed loan notes, £1,176,000 (\$2,751,840) of cash translated at current exchange rates, and 1,856,000 common shares are contingently payable or issuable on June 26, 2003 and June 26, 2004 upon the achievement of certain revenue targets. The maximum additional consideration will be payable when NMI achieves revenues of £3,100,000 in the first year and £3,750,000 in the second year. The purchase accounting for this transaction will be adjusted for the value of the contingent consideration when the revenue targets are determined to have been met. A total of £2,145,671 (\$5,021,729), including interest, to guarantee the ability to issue the above mentioned loan notes is held as restricted cash.

During the three months ended February 28, 2003 additional contingent consideration of \$350,614 and 1,948,586 common shares with a fair value of \$1,364,010 have been accrued as certain revenue targets within NMI have been achieved. For the six months ended February 28, 2003, \$1,029,562 in additional consideration and 2,263,498 common shares with a fair value of \$1,735,606 have been accrued. This amount of contingent consideration has been recorded as additional goodwill.

#### 5. Stock-based compensation:

No compensation expense has been recognized for the Company's fixed stock option plan. Had compensation expense for the Company's stock based compensation issued on or after September 1, 2002 been determined based on the fair value at the applicable grant dates, the Company's loss would have been increased to the pro forma amount indicated below. The increase in loss would not change the disclosed loss per common share amount.

|             | Three months ended<br>February 28, 2003 | Six months ended<br>February 28, 2003 |
|-------------|---|---------------------------------------|
| Loss:       |   |                                       |
| As reported | \$ 2,495,638                            | \$ 3,660,900                          |
| Pro forma   | 2,545,300                               | 3,757,778                             |

The fair value of each option grant was estimated on the date of the grant using the Black-Scholes option pricing model with the following assumptions for the three and six months ended February 28, 2003: risk-free interest rate of 3.35%, dividend yield of 0%, expected life of 2.62 years, and volatility of 84%.

**6. Share capital:**

(a) Authorized:

100,000,000 common shares without par value  
10,000,000 preference shares without par value

(b) Issued:

|                                      | Number<br>of shares | Amount        |
|--------------------------------------|---------------------|---------------|
| Outstanding, August 31, 2002         | 38,216,965          | \$ 48,697,555 |
| Shares issued for cash on:           |                     |               |
| Exercise of options                  | 67,000              | 51,590        |
| Share price guarantee <sup>(i)</sup> | -                   | (445,435)     |
| Outstanding, February 28, 2003       | 38,283,965          | \$ 48,303,710 |

<sup>(i)</sup> Pursuant to the Linar Ltd. acquisition on January 26, 2001, the Company agreed to a floor price cash guarantee on the common shares equal to 75% of the issuance price of \$3.20 per share to January 26, 2003. The consideration payable does not change the amount recognized as purchase price and, therefore, goodwill, but is recorded as a reduction in the carrying value of shares previously issued.

(c) Stock options:

A summary of the Company's stock option activity for the six months ended February 28, 2003 is as follows:

|                                | Outstanding options |                                       |
|--------------------------------|---------------------|---------------------------------------|
|                                | Number<br>of shares | Weighted<br>average<br>exercise price |
| Outstanding, August 31, 2002   | 4,471,837           | \$ 2.26                               |
| Options granted                | 1,077,375           | 1.18                                  |
| Options exercised              | (67,000)            | (0.77)                                |
| Options cancelled              | (588,526)           | (1.47)                                |
| Outstanding, February 28, 2003 | 4,893,686           | \$ 1.87                               |

The following table summarizes the share options outstanding at February 28, 2003:

| Range of<br>exercise<br>price | Options outstanding |  |  | Options exercisable   |  |
|-------------------------------|---------------------|--|--|-----------------------|--|
|                               | Number<br>of shares | Weighted<br>average<br>remaining<br>contractual life | Weighted<br>average<br>exercise<br>price | Number<br>exercisable | Weighted<br>average<br>exercise<br>price |
| \$ 0.91 - \$ 1.21             | 2,321,856           | 3.25 years   | \$ 1.18                                  | 961,192               | \$ 1.18                                  |
| \$ 1.26 - \$ 2.97             | 1,863,935           | 2.37 years   | \$ 2.02                                  | 1,469,649             | \$ 2.04                                  |
| \$ 3.01 - \$5.30              | 707,895             | 2.85 years   | \$ 3.72                                  | 514,643               | \$ 3.81                                  |
|                               | 4,893,686           | 2.86 years   | \$ 1.87                                  | 2,945,484             | \$ 2.07                                  |

During the three months ended February 28, 2003, the Company increased the amount of options reserved for issuance from 9,647,581 to 11,095,774.

(d) Warrants:

As at February 28, 2003, 391,699 common share purchase warrants are outstanding at a weighted average exercise price of \$2.79, with 291,699 warrants expiring July 29, 2003 and 100,000 warrants expiring January 26, 2006.

**7. Goodwill and other assets:**

(a) The changes in the carrying amount of goodwill for the three and six months ended February 28, 2003 are as follows:

|   |    |           |
|---|----|-----------|
| Balance, September 1, 2002                            | \$ | 6,784,821 |
| Goodwill related to contingent consideration (note 4) |    | 1,050,544 |
| Balance, November 30, 2002                            |    | 7,835,365 |
| Goodwill related to contingent consideration (note 4) |    | 1,714,624 |
| Expenses on acquisition                               |    | 133,756   |
| Balance, February 28, 2003                            | \$ | 9,683,745 |

(b) Other assets as at February 28, 2003 are as follows:

|                       | Gross<br>carrying<br>amount | Accumulated<br>amortization | Total        |
|-----------------------|-----------------------------|-----------------------------|--------------|
| Intellectual property | \$ 3,070,000                | \$ 1,043,548                | \$ 2,026,452 |

There have been no additions of intangible assets for the periods presented. The aggregate amortization expense for the three and six months ended February 28, 2003 was \$178,833 and \$357,670, respectively.

**8. Government assistance:**

Government assistance represents funding received or receivable under the Technology Partnership Canada ("TPC") program. The amount recorded is net of a 15% commission that is payable to a consultant for services performed in securing the funding.

**9. Comparative figures:**

Certain comparative figures have been reclassified to conform with the basis of presentation adopted in the current period.