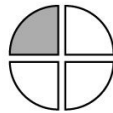




# **Intrinsic Software Inc.**

**Quarterly Report 2003**



**First Quarter**



## Executive Officers

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Neil McDonnell, B.Comm., MBA  
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, Intrinsyc Europe

Derek W. Spratt, P.Eng.  
Chief Strategist

## 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

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

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

## Corporate Office

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10th Floor  
700 West Pender St.  
Vancouver, BC  
Canada V6C 1G8  
604.801.6461 *Telephone*  
604.801.6417 *Facsimile*

[invest@intrinsyc.com](mailto:invest@intrinsyc.com)

**Market Information Symbol:** ICS:TSX

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

## Report To Shareholders

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January 2003

### Dear Shareholder:

I'm pleased to report this quarter we realized revenues of \$4.5M, a 42% increase from quarterly revenues of \$3.1M for the same period in fiscal 2002. Despite a challenging economy, we ended the quarter in strong financial shape with a cash position of \$8.9M, no long-term bank debt and healthy working capital of \$11.4M.

The integration of our recent acquisition, NMI Electronics Ltd., now known as Intrinsic Europe Ltd., has exceeded our expectations as shown by the successful development and launch of the  $\mu$ PDA (MicroPDA). This wireless handheld development platform converges cell phone and PDA technologies. It has already generated revenues, expanded Intrinsic's profile and leadership position in the specialized, intelligent device market and is receiving significant industry attention, including being selected as a finalist for EDN Magazine's prestigious Innovation of the Year Award.

Another major strategic investment which reached a successful milestone this quarter was CerfWorks, our device management and data collection software suite. CerfWorks was fully deployed with its first customer, Philips Electronics, who integrated it into the iPronto, a new high-end multimedia remote control. The iPronto won a Best of Innovation Award at the Consumer Electronics Show in January of 2003 and as Philips' key technology partner in the iPronto's development, we are proud to be part of this success.

During the quarter, we continued to review our operations to ensure we remained focused on core market opportunities. By reducing head count and eliminating non-core initiatives, we significantly reduced our annual operating costs by \$1.2M this quarter, and by \$3.5M since the beginning of July 2002. Our net loss this quarter of \$1.16M was primarily attributable to one-time costs associated with strategic research and development costs associated with new product development and to discontinuing non-core operations as we focused on key market and product initiatives.

The milestones we achieved this quarter include:

- » **Achieved Revenues of \$4.5M.** Despite a slow economy and a challenging technology market, targeted revenues were met.
- » **Awarded Microsoft® Windows® Embedded Partner of the Year.** For the second year in a row Intrinsic received Microsoft Windows Embedded Partner of the Year Award. This recognition acknowledges Intrinsic's expertise and strength in its market and our collaborative partnership with Microsoft.

- » **Developed the  $\mu$ PDA in collaboration with Intel.**

This world class development platform for wireless handheld devices was taken from concept to completion in record time - just 4 months. The first units shipped this quarter to Intel.

- » **Signed multiple contracts in key vertical markets.**

Leading global companies in targeted markets including consumer electronics, telematics, and mobile telephony purchased our intelligent device solutions for the development of next-generation products.

- » **Further strengthened the Board of Directors.**

Building on the strategy of attracting key US technology experts to the Board, Moiz Beguwala, a senior executive at Conexant Systems, was added as a Director. This quarter Ron Erickson, former CEO of eCharge, was also appointed Chairman of the Board. Four of the Company's six Directors are now independent.

- » **CerfWorks deployed by Philips Electronics.**

Intrinsic's new device management software suite, CerfWorks, became commercially available and was deployed by its first customer, Philips Electronics.

We understand the importance of creating shareholder value. In the second quarter of fiscal 2003, we will continue to tightly control operating costs while investing in our core products such as CerfWorks and the  $\mu$ PDA. We will continue to lay a solid foundation for future growth and build shareholder value by continuing to forge new profitable partnerships with industry leaders and channel partners and by capitalizing on the interest in our product innovations.

Opportunities exist, our solutions are proven, and our strategy and vision are in line with industry leaders such as Microsoft, Philips, IBM and Samsung who are making significant investments in embedded computing. We have a world-class team of people at Intrinsic, and the right business resources and partnerships to continue to make substantial inroads in the specialized, intelligent devices market. I remain both confident and excited about the long-term potential and prospects for Intrinsic.

On behalf of Management and the Board of Directors, I would like to thank all of Intrinsic's shareholders, stakeholders and employees for their continued support during this quarter and throughout our fiscal year 2003.



Neil McDonnell  
President & CEO, Intrinsic Software, Inc.



## Management's Discussion & Analysis

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*This discussion and analysis covers our interim consolidated financial statements for the three months ended November 30, 2002 and 2001. 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 November 30, 2002 was \$1,165,262 (\$0.03 per share) compared to \$325,903 (\$0.01 per share) for the quarter ended November 30, 2001. The current quarter operating loss was \$781,737 greater than the operating loss of \$383,525 (\$0.01 per share) for the previous quarter ended August 31, 2002.

**Revenue** for the three months ended November 30, 2002 was \$4.48 million compared with \$3.15 million during the same period in fiscal 2002, an increase of 42 percent, and a decrease of \$635,566 or 12 percent from the previous quarter revenue of \$5.11 million. During the quarter there were no customers that accounted for more than 10 percent of recognized revenue.

**Licensing revenue** comprised 18 percent of the revenue in the period, down slightly from 19 percent in the fourth quarter of 2002, with services revenue amounting to 54 percent of revenue, down from 62 percent in the fourth quarter, and sales of products generating 28 percent of revenue, up from 19 percent in the fourth quarter. The gross margin on sales for the quarter was 43 percent on par with 43 percent in the fourth quarter of 2002 and down from 64 percent in the first quarter of fiscal 2002. The decline in gross margin over the quarter last year is primarily attributable to lower licensing revenue offset by higher sales of products.

**General administration expenses** for the quarter ended November 30, 2002 were \$654,700, an increase of 57 percent or \$237,408, over the same period last year. Administration expenses decreased by \$273,112 or 29 percent compared to the fourth quarter of 2002. This decrease in costs from the preceding quarter is primarily attributable to implementation of various cost reduction programs and through improved synergies with the integration of NMI Electronics Ltd. ("NMI")

**Marketing and sales expenses** for the quarter ended November 30, 2002 were \$1,351,206, an increase of 60 percent or \$508,006, compared to the same period last year. Expenses decreased by 14 percent or \$220,648 compared to the fourth quarter of 2002 as the result of streamlining the sales operations. The increase over the same period last year is predominantly attributable to the growth in operations through the addition of NMI.

**Research and development expenses** for the quarter ended November 30, 2002 were \$1,308,875, an increase of 45 percent or \$403,111, compared to the same period last year and an increase of 49 percent or \$429,934 from the fourth quarter of 2002. This increase in costs for

research and development is predominantly attributable to the development of the first generation prototypes of the  $\mu$ PDA. 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 \$49,176 for the quarter, down by 50% or \$50,171 from \$99,347 in the same period last year and down 45% or \$40,968 from \$90,144 in the fourth quarter of 2002. The decrease in the quarter is primarily attributable to lower average cash balances as compared to the previous quarter last year as well as in the fourth quarter.

### Liquidity and Capital Resources

**Cash and cash equivalents** decreased to \$8.9 million as of November 30, 2002, compared to \$9.2 million as at August 31, 2002 and working capital decreased to \$11.4 million as of November 30, 2002 from \$13.1 million as of August 31, 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 November 30, 2002, \$502,651 has been deferred compared to \$439,050 as of August 31, 2002.

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

The Company's operating activities resulted in cash outflows of \$185,791 for the three months ended November 30, 2002 compared to cash outflows of \$1,492,196 during the same period in 2001. Cash of \$160,340 was used in the quarter to acquire capital assets, compared to \$98,792 during the same period last year. Capital assets purchased in the quarter were primarily computer equipment. Restricted cash of \$74,734 was used during the quarter to pay costs associated with the acquisition of NMI. Financing activities in the quarter generated cash of \$51,590 from the issuance of common shares on exercise of stock options compared to \$869,447 during the same period last year from common shares issued on exercise of stock options and warrants. In addition, non-cash investing activities of \$1,050,544 was to accrue for the contingent consideration payable for the NMI acquisition as certain revenue targets within NMI have been achieved.



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

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Three months ended November 30, 2002 and 2001  
(Unaudited)



## Consolidated Balance Sheets

(Unaudited)

	November 30, 2002	August 31, 2002
	(Unaudited)	(Audited)
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 8,855,587	\$ 9,226,932
Funds held in trust	519,759	517,700
Accounts receivable	4,589,782	5,159,369
Other receivable	738,653	1,256,418
Inventory	1,014,906	753,155
Prepaid expenses	239,519	263,609
	<u>15,958,206</u>	<u>17,177,183</u>
Funds held in trust	522,531	520,461
Restricted cash	5,206,972	5,132,238
Capital assets	1,483,793	1,472,962
Goodwill	7,835,365	6,784,821
Other assets (note 7)	2,205,285	2,384,122
	<u>\$ 33,212,152</u>	<u>\$ 33,471,787</u>
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 3,888,491	\$ 3,428,276
Deferred revenue	502,651	439,050
Future income taxes	179,600	179,600
	<u>4,570,742</u>	<u>4,046,926</u>
Future income taxes	481,984	535,633
Shareholders' equity:		
Share capital (note 6(b))	48,749,145	48,697,555
Shares to be issued (note 4)	371,596	-
Share purchase warrants	140,000	140,000
Cumulative translation adjustment	41,184	28,910
Deficit	(21,142,499)	(19,977,237)
	<u>28,159,426</u>	<u>28,889,228</u>
	<u>\$ 33,212,152</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)

Three months ended November 30, 2002 and 2001

	2002 (Unaudited)	2001 (Unaudited)
Revenues	\$ 4,476,610	\$ 3,147,669
Cost of sales	2,538,828	1,124,097
	1,937,782	2,023,572
Expenses:		
Administration	654,700	417,292
Marketing and sales	1,351,206	843,200
Research and development	1,308,875	905,764
Amortization	328,348	312,566
Less: Government assistance	(510,000)	-
	3,133,129	2,478,822
Loss before interest income	1,195,347	455,250
Interest income	49,176	99,347
Loss before income taxes	1,146,171	355,903
Income tax expense (recovery)		
Current	72,741	-
Future	(53,650)	(30,000)
	19,091	(30,000)
Loss for the period	1,165,262	325,903
Deficit, beginning of period	19,977,237	16,202,283
Deficit, end of period	\$ 21,142,499	\$ 16,528,186
Loss per share	\$ 0.03	\$ 0.01
Weighted average number of shares outstanding	38,283,965	32,748,599

See accompanying notes to consolidated financial statements.



## Consolidated Statements of Cash Flows

(Unaudited)

Three months ended November 30, 2002 and 2001

	2002	2001
	(Unaudited)	(Unaudited)
Cash provided by (used in):		
Operations:		
Loss for the period	\$ (1,165,262)	\$ (325,903)
Items not involving cash:		
Amortization	328,348	312,566
Foreign exchange	12,273	-
Future income taxes	(53,650)	(30,000)
Changes in non-cash operating working capital:		
Funds held in trust (current)	(2,059)	(6,566)
Accounts receivable	569,587	(245,102)
Other receivable	517,765	-
Prepaid expenses	24,090	37,520
Inventory	(261,751)	(111,795)
Accounts payable and accrued liabilities	(218,733)	(589,801)
Deferred revenue	63,601	(533,115)
	(185,791)	(1,492,196)
Investments:		
Purchase of capital assets	(160,340)	(98,792)
Restricted cash	(74,734)	-
Funds held in trust (long-term)	(2,070)	(76,233)
	(237,144)	(175,025)
Financing:		
Issuance of common shares for cash:		
Options	51,590	193,225
Warrants	-	690,000
Repayment of obligation under capital lease	-	(13,778)
	51,590	869,447
Decrease in cash and cash equivalents	(371,345)	(797,774)
Cash and cash equivalents, beginning of period	9,226,932	15,065,099
Cash and cash equivalents, end of period	\$ 8,855,587	\$ 14,267,325
Supplementary information:		
Interest paid	\$ 662	\$ 830
Non-cash investing activities:		
Contingent consideration payable (note 4)	1,050,544	-

See accompanying notes to consolidated financial statements.

## Notes to Consolidated Financial Statements

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(Unaudited)

(Expressed in Canadian dollars)

Three months ended November 30, 2002 and 2001

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### 1. Basis of presentation:

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. The disclosures in these interim consolidated financial statements do not meet all disclosure requirements of Canadian generally accepted accounting principles for annual financial statements.

### 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. 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 preceding paragraph, using the fair value of the reporting unit as if it was the purchase price. 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 second step is carried out when 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. 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. The Company currently has one reporting unit. The first step in the impairment test must be completed within the first six months of fiscal 2003. The Company will complete the first step by February 28, 2003.

#### (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 quarter. 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 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 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 \$168,569 for the three months ended November 30, 2002. 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 before amortization of goodwill for all periods presented is as follows:

	2002	2001
Loss for the period	\$ 1,165,262	\$ 325,903
Amortization of goodwill	-	(110,350)
Loss before amortization of goodwill	\$ 1,165,262	\$ 215,553

Goodwill amortization has had no impact on loss per share for the quarter.

(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. Under Section 3870, this 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 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 (\$5,206,972) of guaranteed loan notes, £1,176,000 (\$2,978,926) 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 £2,057,000 (\$5,206,972) including interest revenue to guarantee the ability to issue the above mentioned loan notes is held as restricted cash.

During the three months ended November 30, 2002 contingent consideration of \$678,948 and 314,912 common shares with a fair value of \$371,596 have been accrued as certain revenue targets within NMI have been achieved. This amount of the 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 November 30, 2002
Loss:	
As reported	\$ 1,165,262
Pro forma	1,212,478



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 months ended November 30, 2002: 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 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
Exercise of warrants	-	-
Outstanding, November 30, 2002	38,283,965	\$ 48,749,145

(c) Stock options:

A summary of the Company's share option activity for the quarter ended November 30, 2002 is as follows:

	Outstanding options	
	Number of shares	Weighted average exercise price
Outstanding, August 31, 2002	4,471,837	\$ 2.26
Options granted	1,028,850	1.18
Options exercised	(67,000)	0.77
Options cancelled	(278,450)	1.62
Outstanding, November 30, 2002	5,155,237	\$ 2.10

The following table summarizes the share options outstanding at August 31, 2002:

Range of exercise price	Options outstanding			Options exercisable	
	Number of shares	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable	Weighted average exercise price
\$0.77 - \$1.21	1,638,278	3.53 years	\$ 1.18	782,278	\$ 1.18
\$1.26 - \$2.97	2,449,373	2.76 years	\$ 1.99	1,686,382	\$ 2.01
\$3.01 - \$5.30	1,067,586	3.03 years	\$ 3.77	673,464	\$ 3.88
	5,155,237	3.06 years	\$ 2.10	3,142,124	\$ 2.20



(d) Warrants:

As at November 30, 2002 and August 31, 2002, 391,699 common share purchase warrants are outstanding at a weighted average exercise price of \$2.79.

**7. Other assets:**

Other assets as at November 30, 2002 are as follows:

	Gross carrying amount	Accumulated amortization	Total
Intellectual property	\$ 3,070,000	\$ 864,715	\$ 2,205,285

There have been no additions of intangible assets for the three months ended November 30, 2002. The aggregate amortization expense for the three months ended November 30, 2002 was \$178,837.