

**Sterne Stackhouse Inc.**  
**Annual Report**  
**2002**



For the Year Ended October 31, 2002

## Corporate Profile

Since 1981, Sterne Stackhouse Inc. ("SSI") (TSX:SSX) has been developing data query, reporting, and analysis software solutions for a broad range of clients. Using Labrador®, the Company can build corporate query and reporting applications, in web-based and client/server environments, faster and better than any other company. SSI's database integration services provide a query and reporting infrastructure that enables corporations to be self-sufficient, at a business user level, with minimal need for I.T. assistance.

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## AGM

The Annual General Meeting of the Shareholders of Sterne Stackhouse Inc. will be held at 2:00 p.m. on April 25th, 2003 in the SSI Corporate Office at 900, 700 4th Avenue S.W., Calgary, Alberta. All shareholders are encouraged to attend and participate. Those who are unable to attend are requested to return their proxies to the registrar within the times specified in the Notice of Meeting.

Information on Sterne Stackhouse Inc.  
is available through our  
Internet site at

**[www.sternestackhouse.com](http://www.sternestackhouse.com)**

## MESSAGE TO OUR SHAREHOLDERS

### Rigor, Ingenuity, and the Future

A software company that ceases to develop new products has made the decision to focus on deriving the best financial benefit from its past. Conversely, and despite prolonged economic adversity and uncertainty, SSI has steadfastly invested in its future through continued research and development.

Since inception, the core members of SSI's software design and development staff have remained with the Company. Their software development standard is high. As a result, the Company has been able to apply the same rigor and ingenuity that produced the Labrador®/Petro-LAB™ success to all of its products. U.S./International Petro-LAB™ is ready for market. The same is true of Web-LAB™. QueryJoiner™, the Company's newest product, is scheduled for release in the 3rd Quarter of this fiscal year. Management is confident about the viability of each of these products. All have been developed to minimize maintenance and maximize scope and scalability.

### The Strategy of Software Convergence

Since 1981, the company has been committed to providing business users with increasing levels of self-sufficiency for their query and reporting requirements. In fact, all of the Company's current products converge around this central theme, each with a view to complement the others.

The technical infrastructure for Petro-LAB™ was developed to accommodate both Canadian and U.S./International oil and gas industry requirements. In fact, Canadian companies operating in the U.S. have already used Petro-LAB™ successfully to query and report on their U.S. properties in a map-based context.

Web-LAB™ has been developed so that clients who have modelled/reverse-engineered databases with Model-LAB™ can have Labrador®'s agile query and reporting in both client/server and Internet environments. On the other hand, Web-LAB™ is self sustaining, and does not rely on the client/server version.

QueryJoiner™ is being developed to respond to the ever-elusive and longstanding need for clients to 'join' queries across different/heterogeneous servers and populate reports without the need for I.T. assistance. Although QueryJoiner™ will work independently against any SQL data source, it will also work particularly well with Labrador® files. QueryJoiner™ will raise the bar materially in terms of enabling client/user self-sufficiency.

### Multiple Database Integration Achieved "Virtually"

Underlying the Company's strategy of software product convergence is the often talked about, but seldom delivered, need for true database integration. Self-sufficient query and reporting for business users necessitates the ability to distribute queries across any number of internal and external data sources, with the same 'friendly' user interface. It also necessitates swift, agile software on both client/server and Internet platforms. Each of SSI's complementary products enhances user self-sufficiency, and contributes to a business user's view of what database integration means in practical terms.

What is particularly compelling about SSI's approach is that multiple database integration is achieved without the need for physical data warehousing. SSI's software works with the metadata, and therefore 'understands' the database structure virtually, without the need to move it, or to recreate it, using excessive amounts of

disk space. Equally importantly, SSI's software is 'read-only', thereby ensuring the ongoing integrity of any of the physical database structures being queried.

With the exception of QueryJoiner™, all of the Company's products, and its distribution strategy through partnership, are incorporated and explained on SSI's web-site at [www.sternestackhouse.com](http://www.sternestackhouse.com).

## **Effective Distribution is the Key to SSI Profitability**

Although the Company has a well-rounded suite of products, it did not set itself up to be a direct marketing/sales and distribution vehicle when it went public in 1997. SSI's business model has been to prove out, as much as necessary, the value of its products by working directly with clients and partners, and then create/negotiate an appropriate distribution agreement. The sale of Canadian Petro-LAB™ to QByte/PwC (now QByte/IBM Canada Ltd.), over a 5-year term, provides an excellent illustration.

As of February 2003, QByte has paid SSI approximately \$5.8 Million CDN. QByte Payments from March 2003 to February 2004 are expected to total over \$900,000. Further payments to SSI, in years 2005 and 2006, at which time the 5-year sale of Canadian Petro-LAB™ will be complete, cannot be accurately predicted yet, as the Bonus Clause impacts on these calculations. In addition, prior to and after the completion of the sale, QByte is obligated to pay the Company a 25% Petro-LAB™ new business royalty, in perpetuity.

The Company has every reason to believe that its other products are equal to the quality and potential of Canadian Petro-LAB™.

## **The QByte Agreement Past, Present, and Future**

Two years later, it is worthwhile to re-examine the Company's rationale for negotiating the QByte distribution agreement with Canadian Petro-LAB™:

In 2001, QByte had about 70 of the top 100 Canadian oil and gas companies as clients, and Petro-LAB™ had about 20. QByte's demonstrated strength and experience are on the financial/accounting side. SSI's Petro-LAB™ not only addresses the earth sciences' disciplines, but also has the proven capability to query and report on the financial and accounting disciplines. Hence, Canadian Petro-LAB™ provides petroleum companies with a fully integrated, enterprise-wide, query and reporting software solution. The clear opportunity for QByte and SSI is for QByte to cross-sell Petro-LAB™ to its existing clients.

A recent independent software survey indicates an unusually high satisfaction rate with Canadian Petro-LAB™'s clients/users. SSI's Petro-LAB™ revenue stream, despite all the consolidation in the oil industry over the past two years, remains strong. With all the differences in corporate culture and outlook, during very trying economic times, SSI and QByte have demonstrated a remarkable ability to work well together.

## **The U.S./International Petro-LAB™ Opportunity**

Canadian Petro-LAB™ comes prepackaged with the capability to access a number of database vendors that sell production, drilling, land, pipeline, and seismic data, to name some. This is not true outside of Canada. The types of data regulatory bodies common to Canada are uncommon in the U.S./International oil and gas marketplace.

The Company knew that using Petro-LAB™'s comprehensive infrastructure would only be practical internationally if it was combined with the capability to model/reverse-engineer relational databases quickly and efficiently. Accordingly, the Company has spent a good deal of effort developing and enhancing Model-

LAB™, SSI's database 'modelling' software. In Canada, Model-LAB™ gives QByte the ability to continually respond to client requests to make additional proprietary databases accessible under the Petro-LAB™ query and reporting umbrella.

The Company believes that selling U.S./International Petro-LAB™ is largely a consultative process. Consequently, Model-LAB™ is highly automated so that proof of concept on a pilot database can be provided convincingly in a matter of days. Thus, the Company has been searching to find an international entity that chooses to wrap consulting services around software infrastructure which both enhances and accelerates the process of providing corporate-wide query and reporting software.

The crisis over Iraq has dramatically exacerbated the U.S./International perception of the importance of oil and gas properties and reserves. SSI's management believes that U.S./International Petro-LAB™ is unrivalled, and offers an excellent means to enable agile query and reporting, on-demand, in both client/server and Internet environments. The revenue scope and scalability for U.S./International Petro-LAB™ dwarfs any similar initiative in Canada. Finding the right distribution partner is a difficult, but achievable, undertaking.

## **Labrador Applications in Other Verticals**

In previous publications, the Company has outlined its suitability for developing Labrador applications in the Healthcare, Insurance, Aerospace, Client Relationship Management, and Finance verticals. Nothing has changed in this respect, as the generic nature of the Company's products has been demonstrated repeatedly. The holdback has been, and still is, the need to negotiate an appropriate win/win relationship with a distributor that the Company can support in the same manner it supports QByte.

The Company continues to work with independent agencies in this regard. Although the challenge of negotiating suitable distribution agreements is daunting, and continues to take more time than anticipated, delays in closure should not be an indication of the lack of value of the Company's software products. No matter how frustrating it is for management and shareholders, experience graphically illustrates that the lack of a deal(s) is far superior to poorly, or naively, conceived agreements, which can easily cripple a small company like SSI. Management has learned to be patient, as it believes that the Company's software products offer immense upside if the Company can find the 'right' distribution partner(s).

## **Risk, Uncertainty, and "Total Value" of Intangible Assets**

Although the Company takes pride in the clear, succinct content of its Balance Sheet, it is also ruefully aware that there is no credible place on it to reflect the intangible value of its software products, as well as the very considerable intellectual capital that comes with its people. While SSI has invested in research and development for over 22 years, the Company decided two years ago to expense all software development. This was not a simple decision. However, notwithstanding the accounting pros and cons about capitalizing software development as an intangible asset, the reality is that there is no way to reflect the 'true' value of software products on the Balance sheet with any degree of certainty.

As a consequence, the Company attributes no accounting value to its products on the Balance Sheet, as is the practice of most conservative software companies. The irony of this is that it is easy to argue compellingly that a software company is as much a manufacturing company as one that manufactures furniture, for example. Furniture and its components, throughout the manufacturing process, are reflected on the Balance Sheet. Nevertheless, software is intangible, and there is no way to reflect its 'capacity' to generate revenue on a company's financial statements.

From an assessment of corporate value perspective, management has wrestled with the inevitably negative impact of standard accounting principles on the intangible assets of the Company since incorporation. Fortunately, F. Peter Boer has just written a logical, insightful book on this subject, "The Real Options Solution: Finding Total Value in a High Risk World". Boer articulates a methodology for assessing the difference between value according to accounting principles versus what Boer terms "Total Value". From a shareholder's perspective, it is useful to know that management has adopted Boer's rigorous framework for evaluating SSI's assets, even though 'Forward Looking Statements' requirements prevent their public disclosure. Regardless, management believes that shareholders who are perplexed by the often roller coaster ride in the perceived value of many high tech companies will find Boer's approach to Total Value enlightening, and perhaps, even reassuring.

Clearly, the last two years have amply demonstrated that the business of technology development, with all of its variables and imponderables, is both risky and uncertain. The secret is capable 'risk management', as the business of technology development is not only here to stay, it also represents the 'new-world economy'. As a result, there is a critical need to assess credible value to intangible assets, beyond the intrinsic book value derived from traditional accounting principles. Otherwise, there is no logical way to determine fair market value for technology companies. Unfortunately, market capitalization of high tech companies can be very misleading, particularly in today's inordinately depressed market conditions. Certainly, management believes that this is the case with SSI

### **Looking Forward to Fiscal 2003**

Since October 31st, 2002, expenses have been further reduced, without compromising either the Company's ability to support its existing software, or its ability to develop new products. Significantly, the current infrastructure of the Company is funded throughout Fiscal 2003. Therefore, new business royalties on Petro-LAB, and revenue from new and existing products all have the potential to augment the Company's financial position. In the meantime, management continues to go about the challenging process of endeavouring to negotiate suitable distribution agreements with the capacity to capitalize on SSI's valuable software assets.

On behalf of the Board of Directors



H. Ronald Sterne  
Chief Executive Officer

## STERNE STACKHOUSE INC.

### MANAGEMENT'S REPORT

The consolidated financial statements of Sterne Stackhouse Inc. were prepared by management to fairly present the financial position of the company in all material respects and are in accordance with accounting principles generally accepted in Canada. Management is responsible for ensuring that the financial and operating information presented in this annual report is consistent with that shown in the consolidated financial statements.

The consolidated financial statements have been prepared by management in accordance with the accounting policies as described in the notes to the consolidated financial statements. Timely release of financial information sometimes necessitates the use of estimates when transactions affecting the current accounting period cannot be finalized until future periods. When necessary, such estimates are based on informed judgments made by management.

Management has designed and maintains an appropriate system of internal controls to provide reasonable assurance that all assets are safeguarded and financial records properly maintained to facilitate the preparation of financial statements for reporting purposes.

KPMG LLP, an independent firm of Chartered Accountants appointed by the shareholders, has conducted an examination of the corporate and accounting records in order to express their opinion on the consolidated financial statements. The Audit Committee, consisting of a majority of non-management directors, has met with representatives of Sterne Stackhouse Inc. and management in order to determine if management has fulfilled its responsibilities in the preparation on the consolidated financial statements. The Board of Directors has approved the consolidated financial statements on the recommendation of the Audit Committee.

H. Ronald Sterne



Chief Executive Officer  
Sterne Stackhouse Inc.

Darryl Stackhouse



President & CFO  
Sterne Stackhouse Inc.

### AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the balance sheets of Sterne Stackhouse Inc. as at October 31, 2002 and 2001 and the statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Corporation as at October 31, 2002 and 2001 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Chartered Accountants



Calgary, Canada  
February 3, 2003

## MANAGEMENT'S DISCUSSION & ANALYSIS

October 31, 2002

*The following discussion should be read in conjunction with the audited financial statements presented in accordance with accounting principles generally accepted in Canada. All amounts are stated in Canadian dollars.*

### Corporate Profile

Since 1981, Sterne Stackhouse Inc. ("SSI") (TSX:SSX) has been developing data query, reporting, and analysis software solutions for a broad range of clients. Using Labrador®, the Company can build corporate query and reporting applications, in web-based and client/server environments, faster and better than any other company. SSI's database integration services provide a query and reporting infrastructure that enables corporations to be self-sufficient, at a business user level, with minimal need for I.T. assistance.

### Financial Results

During the year, the Company increased its cash by \$133,850 to \$407,506. At the same time, expenses have been substantially reduced and will continue to be monitored closely.

#### Cash Flow Analysis

	Year ended	
	October 31 <u>2002</u>	October 31 <u>2001</u>
<b>Sources of cash</b>		
Operations	\$ —	\$ 174,354
Decrease in accounts receivable – QByte	<b>756,138</b>	—
Decrease in accounts receivable – other	<b>26,491</b>	1,230,981
Increase in accounts payable	—	—
Issuance of share capital	—	944,000
	<b>\$ 782,629</b>	<b>\$ 2,349,335</b>
<b>Uses of cash</b>		
Operations	<b>566,502</b>	—
Increase in accounts receivable – QByte	—	1,422,958
Increase in accounts receivable – other	—	—
Decrease in accounts payable	<b>35,321</b>	9,235
Expenditures on software development	—	122,061
Capital asset additions	<b>46,956</b>	73,944
Repayment of loans	—	397,736
	<b>\$ 648,779</b>	<b>\$ 2,025,934</b>
<b>Sources of cash minus uses of cash</b>	<b>133,850</b>	<b>\$ 323,401</b>
Cash balance at the beginning of the year	<b>\$ 273,656</b>	<b>\$ (49,745)</b>
<b>Cash balance at the end of the year</b>	<b>\$ 407,506</b>	<b>\$ 273,656</b>

In the foregoing table, cash used in operations is equal to the net income (loss) shown on the Statement of Operations and Deficit adjusted for: depreciation and amortization, deferred revenue and prepaid expenses. These adjustments are shown in the following table.

## Cash Used in Operations

	Year ended	
	October 31 <u>2002</u>	October 31 <u>2001</u>
<b>Operations:</b>		
Revenue	\$ 1,817,395	\$ 1,776,789
Expenses	(2,562,484)	(4,760,392)
Gain on sale of Petro-LAB	—	4,480,619
Bad debt expense	—	(300,000)
Net income (loss)	\$ (745,089)	\$ 1,197,016
<b>Non-cash adjustments</b>		
Non-cash reorganization and related costs	\$ 96,000	\$ —
Depreciation and amortization	95,039	232,193
Deferred revenue	(32,000)	(1,963,751)
Prepaid expenses	19,548	15,826
Write-off of software development costs	—	693,070
<b>Cash provided by (used in) operations</b>	<b>\$ (566,502)</b>	<b>\$ 174,354</b>

## Results of Operations

### Financial Summary

As explained in previous reports, according to the terms of the QByte Agreement, revenue is only recognized as the licenses are renewed. During the year, there was renewal revenue of \$1,463,862.

### Financial Summary

	Year ended	
	October 31 <u>2002</u>	October 31 <u>2001</u>
Revenue	\$ 1,817,395	\$ 1,776,789
Expenses	2,562,484	4,760,392
Loss	(745,089)	(2,983,603)
Gain on sale of Petro-LAB	—	4,480,619
Bad debt expense	—	(300,000)
Net income (loss)	(745,089)	1,197,016
Net income (loss) per share	(0.09)	0.14
Outstanding shares	8,549,685	8,549,685
	<b>October 31</b>	<b>October 31</b>
	<b><u>2002</u></b>	<b><u>2001</u></b>
Cash balance	\$ 407,506	\$ 273,656
Shareholders' equity	1,113,045	1,858,134
Total assets	1,239,575	2,051,985

## Revenue

SSI's total revenue for the year ended October 31, 2002 was \$1,817,395 compared to \$1,776,790 for the previous year ended October 31, 2001, an increase of \$40,606. The revenue for the period is comprised of \$1,463,862 recognized on the renewal of Petro-LAB™ licenses, \$27,402 for new business royalties arising from the QByte Agreement (see below), \$271,331 for consulting services to QByte related to Petro-LAB™, and \$54,800 for the sale of Labrador® licenses.

## Petro-LAB™ - QByte Agreement

On March 16th, 2001, the Company negotiated a cash and royalty-bearing agreement with QByte, a leading provider of software to the Canadian oil and gas industry. Under the agreement, QByte will acquire the rights to SSI's Petro-LAB™ application over 5 years. The effective date of the agreement was February 28th, 2001.

## Terms of the Agreement

Under the terms of the agreement, SSI has agreed to grant to QByte an exclusive, royalty-bearing license to develop, market, and license Petro-LAB™. SSI has granted these rights for the Canadian oil and gas up-stream and mid-stream market for 5 years. Title to the existing Petro-LAB™ software becomes QByte's at the end of the 5 year term provided all payments have been made, and all obligations have been fulfilled. Since the Petro-LAB™ software requires the use of Labrador®, SSI's dynamic query generation engine, to function, SSI has also granted QByte an exclusive, perpetual, royalty-bearing license to use, market, and license Labrador®, to the mid-stream and up-stream oil and gas market in Canada.

The Agreement provides for the following payments to SSI:

- A royalty prepayment of \$1,500,000 that was paid on signing;
- An annual payment, paid monthly, of \$1,900,000 from March 2001 to February 2002; \$2,380,000 from March 2002 to February 2003; \$530,000 from March 2003 to February 2004 (\$530,000 is the net royalty payment after deduction of the royalty prepayment of \$1,500,000); \$398,750 from March 2004 to February 2005; and \$290,000 from March 2005 to February 2006;
- SSI's payments will be adjusted, after the end of years 2, 3, 4, and 5 of the agreement, based on a comparison of actual Petro-LAB™ license renewal revenues from existing clients to the following forecast of license renewal revenues from existing clients: \$1,900,000 from March 2001 to February 2002; \$2,380,000 from March 2002 to February 2003; \$2,030,000 from March 2003 to February 2004; \$1,595,000 from March 2004 to February 2005; and \$1,160,000 from March 2005 to February 2006. SSI will receive 50% of any excess of actual revenues above, and QByte will reduce its royalty obligation by 50% of any shortfall of actual revenues below the agreed to Petro-LAB™ license renewal revenue forecast from existing clients;
- A 25% royalty, in perpetuity, on all revenue from new clients of Petro-LAB™, on all new business from existing Petro-LAB™ clients, and on all business from existing Petro-LAB™ clients after year 5 using Labrador®; and
- 65% of all revenue generated from Labrador® licenses not associated with the Petro-LAB™ software.

Based on the above, if actual Petro-LAB™ license renewals were equal to the license renewal revenue forecast stated above and there was no new business (i.e. no revenue from the 25% royalty in perpetuity), SSI would still receive total payments of \$6,998,750. Nevertheless, as indicated below, there has been new Petro-LAB™ business.

From the effective date of the Agreement (February 28, 2001) to October 31, 2002, SSI has received cash payments from QByte, related to the sale of Petro-LAB, of \$4,986,666 (\$1,500,000 from the royalty prepayment, \$1,900,000 from the first year of monthly payments, \$1,586,666 being eight months payments from the second year of monthly payments, and \$45,912 from new business royalties). In addition, from the effective date of the Agreement to October 31, 2002, actual Petro-LAB™ license renewal revenue from existing clients was \$4,308,225.

On the effective date of the agreement, February 28th, 2001, the Company recorded a cash receipt of \$1,500,000 from the QByte agreement and an account receivable of \$1,999,375. The account receivable is reduced by the monthly payments received from QByte, and is increased by an amount equal to the royalty revenue recognized when a license renewal occurs. As a result, the account receivable from QByte at October 31, 2002 was equal to \$666,821 (i.e. \$1,999,375 less monthly payments totaling \$3,486,666, plus royalty revenue recognized from Petro-LAB™ license renewals from existing clients of \$2,154,112).

## Revenue Recognition

Royalty revenue from the QByte agreement is recognized as follows:

- Royalty revenue from Petro-LAB™ license renewals from existing clients is recognized when the license renewals occur. Since \$0.50 of each \$1.00 of license renewal revenue has already been recognized in the one-time gain of \$4,480,619, the remaining \$0.50 of each \$1.00 of license renewal revenue is recognized when the renewal invoice is sent to the client. As a result, as of October 31, 2002, QByte had invoiced \$4,308,224 of Petro-LAB™ license renewal fees. SSI recognized \$2,154,112, or half of these renewal fees, as revenue; and
- Royalty revenue from new Petro-LAB™ business is recognized when QByte pays the royalties to SSI. During the three months ended October 31, 2002, there was \$27,402 of royalty revenue from new Petro-LAB™ business.

## Expenses

### General and Administrative

This category of expenses is comprised primarily of office rent, office equipment rentals, administrative salaries, corporate expenses related to shareholder reporting, and professional fees. G&A expenses for the year ended October 31, 2002 were \$1,108,473 compared to \$1,788,496 for the year ended October 31, 2001, a decrease of \$680,023. The decrease is due primarily to a reduction in salary costs of \$241,621, a reduction in legal expenses of \$161,622 primarily due to legal expenses related to the QByte Agreement, and a reduction in office equipment rentals of \$88,107 as agreements matured. In an effort to further reduce costs, the Company is continuing to attempt to sub-lease its excess office space. The space has been on the market for the past nine months, but a sub-tenant has not yet been found.

### **Sales, Marketing and Support**

Sales and marketing expenses include expenses for sales and support salaries, sales commissions, and promotion/advertising. For the year ended October 31, 2002, sales and marketing expenses were \$404,965 compared to \$1,569,541 for the year ended October 31, 2001, a decrease of \$1,164,576. The decrease is due mainly to a reduction in salary costs of \$868,622, a reduction in promotion/advertising expenses of \$130,861, and a reduction in third party consulting fees of \$82,636.

### **Computer and Related Costs**

Computer and related costs include hardware maintenance, programmer's salaries, and software costs. This category of expenses totaled \$831,090 for the year ended October 31, 2002, compared to \$1,159,669 for the year ended October 31, 2001, a decrease of \$328,579. The decrease is due primarily to reduced software costs of \$128,750 related to the QByte transaction and reduced salary costs of \$130,985.

### **Reorganization and related costs**

During the past year, the Company underwent an internal reorganization. As a result, Reorganization and related costs for the period include a write-off of capital assets totaling \$96,000 relating to the fact that certain assets were no longer being fully utilized. Severance costs of \$26,364 from the first quarter were also reclassified as Reorganization and related costs.

### **Depreciation**

Depreciation expense for the year ended October 31, 2002 was \$95,039 compared to \$112,193 for the previous fiscal period. The reduction of \$17,154 is due to reduced capital acquisitions during the year.

### **Amortization of Software Development Costs**

The Company's accounting policy is to amortize capitalized software development costs on a straight-line basis over three years. For the year ended October 31, 2002, the amortization expense was nil compared to \$120,000 for the previous year. The reduction is attributable to management's decision to write-off previously capitalized software development costs against the QByte gain (see the Company's Annual Report for October 31, 2001) and to not capitalize any further software development costs.

## **Operating Segments**

The Company has two operating segments, the development and marketing of data retrieval technology for the oil and gas industry (Petro-LAB™), and the development and marketing of data retrieval technology and services for generic markets (Labrador®).

## **Financing and Investing**

During the year ended October 31, 2002, the Company's cash position increased by \$133,850. During the period, the Company did not undertake any financing or investing activities.

## **Financial Condition, Liquidity and Requirements Outlook**

At October 31, 2002, SSI had cash of \$407,506, no debt, and working capital of \$992,279. The Company has guaranteed monthly cash inflow from QByte of \$198,333 through February 2003 (see Petro-LAB™ - QByte Agreement above) and an estimated cash inflow from QByte of \$75,000 per month from March 2003 to February 2004.

## Forward Looking Statements

Certain statements in Management's Financial Discussion and Analysis, other than statements of historical fact, are forward-looking information that involves various risks and uncertainties. These risks and uncertainties include, but are not restricted to, the Company's continuing ability to promote and license its products, the Company's ability to attract and retain key employees, and the Company's ability to raise capital on acceptable terms when needed. These uncertainties may cause actual results to differ from information contained herein. There can be no assurance that such statements will prove to be accurate. Actual results and future events could differ materially from those anticipated in such statements. These forward-looking statements are based on the estimates and opinions of management on the dates they are made and are expressly qualified in their entirety by this notice. The Company assumes no obligation to update forward-looking statements should circumstances, management's estimates, or opinions change.

## STERNE STACKHOUSE INC.

### Balance Sheets

October 31, 2002 and 2001

	2002	2001
<b>ASSETS</b>		
Current assets:		
Cash	\$ 407,506	\$ 273,656
Accounts receivable (notes 6 and 9)	685,006	1,467,635
Prepaid expenses	26,297	45,845
	<u>1,118,809</u>	<u>1,787,136</u>
Capital assets (note 2)	120,766	264,849
	<u>\$ 1,239,575</u>	<u>\$ 2,051,985</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 126,530	161,851
Deferred revenue	—	32,000
	<u>126,530</u>	<u>193,851</u>
Shareholders' equity:		
Share capital (note 3)	5,081,178	5,081,178
Deficit	(3,968,133)	(3,223,044)
	<u>1,113,045</u>	<u>1,858,134</u>
Commitments (note 8)		
Subsequent events (note 3)		
	<u>\$ 1,239,575</u>	<u>\$ 2,051,985</u>

See accompanying notes to financial statements.

## STERNE STACKHOUSE INC.

### Statements of Operations and Deficit

Years ended October 31, 2002 and 2001

	2002	2001
<b>REVENUES:</b>		
Royalty income	\$ 1,491,264	\$ 708,760
Consulting fees	271,331	187,844
License fees	54,800	880,185
	<b>1,817,395</b>	<b>1,776,789</b>
<b>EXPENSES:</b>		
General and administration	1,108,473	1,788,496
Computer and related costs	831,090	1,159,669
Sales and marketing	404,965	1,569,541
Reorganization and related costs (note 5)	122,364	—
Depreciation	95,039	112,193
Interest	553	10,493
Amortization of software development costs	—	120,000
	<b>2,562,484</b>	<b>4,760,392</b>
Loss before the following	<b>(745,089)</b>	<b>(2,983,603)</b>
Other income (expense) items:		
Gain on sale of Petro- LAB (note 6)	—	4,480,619
Bad debt expense	—	(300,000)
	<b>—</b>	<b>4,180,619</b>
Net income (loss)	<b>(745,089)</b>	<b>1,197,016</b>
Deficit, beginning of year	<b>(3,223,044)</b>	<b>(4,420,060)</b>
Deficit, end of year	<b>\$(3,968,133)</b>	<b>\$(3,223,044)</b>
Net income (loss) per share (note 3):		
Basic and diluted	<b>\$ (0.09)</b>	<b>\$ 0.14</b>

See accompanying notes to financial statements.

## STERNE STACKHOUSE INC.

### Statements of Cash Flows

Years ended October 31, 2002 and 2001

	2002	2001
Cash provided by (used in):		
<b>Operating activities:</b>		
Net income (loss)	\$ (745,089)	\$ 1,197,016
Items not involving cash:		
Non-cash reorganization and related costs (note 5)	96,000	–
Depreciation and amortization	95,039	232,193
Gain on sale of Petro-LAB	–	(4,480,619)
Bad debt expense	–	300,000
	<b>(554,050)</b>	<b>(2,751,410)</b>
Changes in non-cash working capital (note 7)	<b>2,148</b>	<b>1,957,260</b>
	<b>(551,902)</b>	<b>(794,150)</b>
<b>Financing activities:</b>		
Issuance of share capital	–	944,000
Repayment of loans	–	(397,736)
	–	546,264
<b>Investing activities:</b>		
Change in non-cash working capital relating to investing activities (note 7)	732,708	(732,708)
Proceeds on the sale of Petro-LAB	–	1,500,000
Expenditures on software development	–	(122,061)
Capital assets additions	(46,956)	(73,944)
	<b>685,752</b>	<b>571,287</b>
Net increase in cash position	<b>133,850</b>	<b>323,401</b>
Cash (bank indebtedness), beginning of year	<b>273,656</b>	<b>(49,745)</b>
Cash, end of year	\$ 407,506	\$ 273,656

Bank indebtedness consists of cheques issued in excess of cash in bank.

See accompanying notes to financial statements.

Sterne Stackhouse Inc. (the "Corporation") is engaged in the research and development and marketing of data retrieval technology for customers.

# STERNE STACKHOUSE INC.

## Notes to Financial Statements

Years ended October 31, 2002 and 2001

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### 1. Significant accounting policies:

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(a) Revenue recognition:

Substantially all revenue is derived from one customer as a result of the sale of the Petro-LAB software (see notes 6 and 9). Royalty income is recognized as a percentage of the fees generated and collected by the customer.

Revenue from the sale of licenses as well as revenue attributable to undelivered elements, including maintenance and other post-customer support services, is recognized ratably over the contract period. Revenue from consulting services is recognized when the services are performed and/or when earned.

(b) Capital assets:

Capital assets are recorded at cost upon acquisition. Depreciation is provided annually over the estimated useful lives of the assets as follows:

Asset	Basis	Rate
Computer equipment	Declining balance	30%
Furniture and equipment	Declining balance	20%
Purchased computer software	Declining balance	50%
Leasehold improvements	Straight line	5 years

(c) Stock based compensation plan:

Consideration paid by employees or directors on the exercise of stock options under the employee stock option plan is recorded as share capital.

(d) Per share amounts:

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares. The treasury stock method is used to determine the dilutive effect of stock options, warrants and other dilutive instruments.

## STERNE STACKHOUSE INC.

### Notes to Financial Statements

Years ended October 31, 2002 and 2001

#### 1. Significant accounting policies (continued):

(e) Income taxes:

The Corporation uses the liability method of accounting for income taxes (see note 4). Under this method, future income tax liabilities and future income tax assets are recorded based on temporary differences – the difference between the carrying amount of an asset and liability in the balance sheet and its tax basis using income tax rates enacted at the balance sheet date. The effect of changes in rates on future income tax liabilities and assets is recognized in the period that the change occurs.

#### 2. Capital assets:

2002	Cost	Accumulated depreciation	Net book value
Computer equipment	\$ 461,217	\$ 413,273	\$ 47,944
Furniture and equipment	184,456	158,618	25,838
Purchased computer software	288,492	266,128	22,364
Leasehold improvements	76,045	51,425	24,620
	<u>\$ 1,010,210</u>	<u>\$ 889,444</u>	<u>\$ 120,766</u>
2001			
Computer equipment	\$ 430,919	\$ 330,935	\$ 99,984
Furniture and equipment	181,807	120,192	61,615
Purchased computer software	274,483	206,041	68,442
Leasehold improvements	76,045	41,237	34,808
	<u>\$ 963,254</u>	<u>\$ 698,405</u>	<u>\$ 264,849</u>

During the year ended October 31, 2002, the Corporation assessed the carrying value of its capital assets and determined that a write-down totaling \$96,000 was required (see note 5).

## STERNE STACKHOUSE INC.

### Notes to Financial Statements

Years ended October 31, 2002 and 2001

### 3. Share capital:

(a) Authorized:

Unlimited preferred shares, Series A and Series B; and

Unlimited common shares.

(b) Issued and outstanding:

	2002		2001	
	Number of shares	Amount	Number of shares	Amount
Common shares				
Balance, beginning of year	8,549,685	\$ 5,081,178	7,593,685	\$ 4,137,178
Issued for cash	–	–	906,000	906,000
Issued on exercise of stock options	–	–	50,000	38,000
Balance, end of year	8,549,685	\$ 5,081,178	8,549,685	\$ 5,081,178

(c) Stock option plan:

The Corporation has a stock option plan for its directors, officers and employees. At October 31, 2002, stock options outstanding under this plan were as follows:

	Number	Exercise price	Weighted average exercise price
Outstanding at October 31, 2000	685,000	\$ 0.60 – 1.55	\$ 0.78
Granted	415,000	0.25 – 1.05	0.49
Exercised	(50,000)	0.60 – 0.80	0.76
Cancelled	(195,000)	0.60 – 1.00	0.94
Outstanding at October 31, 2001	855,000	0.25 – 1.55	0.60
Granted	(465,000)	0.60 – 1.55	0.66
Exercised	570,000	0.35	0.35
Cancelled	(200,000)	0.25 – 1.05	0.61
Outstanding at October 31, 2002	760,000	\$ 0.25 – 1.50	\$ 0.38

## STERNE STACKHOUSE INC.

### Notes to Financial Statements

Years ended October 31, 2002 and 2001

### 3. Share capital (continued):

#### (c) Stock option plan (continued):

Exercise price outstanding	Options outstanding and exercisable	
	Number outstanding at October 31, 2002	Weighted average remaining contractual life (months)
\$ 0.25		155,000
0.35	565,000	50
0.80	10,000	1
1.50	30,000	1
	760,000	40

Subsequent to October 31, 2002, 15,000 options exercisable at a price of \$0.25 per share, 10,000 options exercisable at a price of \$0.80 per share and 30,000 options exercisable at a price of \$1.50 per share expired unexercised.

#### (d) Warrants:

Information with respect to the outstanding warrants is as follows:

Outstanding at October 31, 2000	288,750
Granted	568,000
Cancelled	(75,000)
Outstanding at October 31, 2001	781,750
Cancelled	(631,750)
Outstanding at October 31, 2002	150,000

  

Expiry Date	Exercise Price	Number Outstanding and Exercisable
December 26, 2002	\$ 2.00	150,000

The warrants expired unexercised on December 26, 2002.

## STERNE STACKHOUSE INC.

### Notes to Financial Statements

Years ended October 31, 2002 and 2001

### 3. Share capital (continued):

(e) Per share amounts:

The weighted average number of common shares outstanding during the year ended October 31, 2002 was 8,549,685 (2001 – 8,267,575).

The dilutive effect of options and warrants for the year ended October 31, 2002 was nil (2001 – 236,181) and nil (2001 – nil) respectively.

### 4. Income taxes:

Effective November 1, 2000, the asset and liability method of accounting for income taxes was retroactively adopted without restatement of the prior years' financial statements. No adjustment was required to the financial statements as a result of the new accounting standard.

Total income taxes are different from the amount computed by applying the combined expected Canadian Federal and Provincial tax rate of 39.7% (2001 – 42.6%) to income before income taxes and other items. The reasons for the difference are as follows:

	2002	2001
Computed expected tax provision (recovery)	\$ (296,000)	\$ 510,000
Add (deduct) the following:		
Recognized benefit of losses	–	(548,000)
Non-deductible expenses	21,000	38,000
Net increase in valuation allowance	275,000	–
	\$ –	\$ –

The components of the future income tax assets and liabilities at October 31, 2002 is as follows:

	2002	2001
Future income tax assets:		
Share issue costs	\$ 37,000	\$ 60,000
Non-capital losses	1,342,000	1,580,000
Capital assets	61,000	–
Bad debt reserve	105,000	114,000
Future income tax liabilities:		
Accounts receivable reserve	(218,000)	(563,000)
Capital assets	–	(7,000)
	1,327,000	1,184,000
Less valuation allowance	(1,327,000)	(1,184,000)
Net future income tax asset	\$ –	\$ –

## **STERNE STACKHOUSE INC.**

### Notes to Financial Statements

Years ended October 31, 2002 and 2001

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As at October 31, 2002, the Corporation has investment tax credits carryforward of approximately \$363,000 (2001 - \$363,000), which may be used to offset federal taxes payable in future years. These investment tax credits expire in the years 2007 to 2010. As at October 31, 2002, the Corporation has federal non-capital losses totalling approximately \$3,900,000, and Alberta non-capital losses totaling approximately \$3,686,000, which expire in 2007. The potential income tax benefit arising from these amounts has not been reflected in these financial statements.

#### **5. Reorganization and related costs:**

During the year ended October 31, 2002 the Corporation underwent an internal reorganization. As a result, reorganization and related costs include an additional write-off of capital assets totaling \$96,000 relating to the fact that certain capital assets were no longer being fully-utilized and \$26,364 relating to severance related costs.

#### **6. Gain on sale of Petro-LAB:**

Effective February 28, 2001, the Corporation closed a transaction with a provider of software to the Canadian oil and gas industry which resulted in the sale of the Petro-LAB software and the granting of an exclusive, perpetual, royalty-bearing license to use, market and license Labrador to the mid and upstream oil and gas market in Canada. The rights to use Petro-LAB outside of Canada have not been sold and have been retained by the Corporation. Under the terms of the agreement, the Corporation received an immediate \$1,500,000 royalty pre-payment and will receive additional payments based on the following:

- (a) an annual royalty, paid monthly, of 100% of the mutually agreed to revenue stream of \$6,310,000 from existing clients of the Corporation for the period from March 1, 2001 to February 28, 2004;
- (b) an annual royalty, paid monthly, of 25% of the mutually agreed to revenue stream of \$2,755,000 from existing clients of the Corporation for the period from March 1, 2004 to February 28, 2006;
- (c) the royalty will be adjusted against actual revenue at the end of years 2, 3, 4 and 5 of the agreement. The Corporation will receive 50% of any excess of actual revenue above agreed revenue, and the purchaser will reduce its royalty obligation by 50% of any shortfall of actual revenue below agreed revenue; and
- (d) a 25% royalty, in perpetuity, on all revenue from new clients for Petro-LAB and the Petro-LAB/Web Solution, on all new business from existing Petro-LAB clients, and on all business from existing clients of the Corporation commencing March 1, 2006 using Labrador.

## STERNE STACKHOUSE INC.

### Notes to Financial Statements

Years ended October 31, 2002 and 2001

#### 6. Gain on sale of Petro-LAB (continued):

As a result of the transaction, the Corporation recognized a gain on the sale of the Petro-LAB assets totaling \$4,480,619 based upon the minimum level of cash to be received. Details of the gain are as follows:

Cash	\$ 1,500,000
Accounts receivable	1,999,375
Deferred revenue	1,674,314
	5,173,689
Less associated software development costs	693,070
Gain on sale of Petro-LAB	\$ 4,480,619

The portion of the gain related to deferred revenue results from the inclusion of revenue previously deferred. The acceleration of the deferred revenue arises because of the transfer of Petro-LAB maintenance and support obligations to the purchaser of the Petro-LAB assets.

The reduction in license fees results primarily from the sale of the Petro-LAB assets.

#### 7. Supplemental cash flow disclosure:

(a) Changes in non-cash working capital are as follows:

	2002	2001
Accounts receivable	\$ 782,629	\$ 1,507,398
Prepaid expenses	19,548	15,826
Accounts payable and accrued liabilities	(35,321)	(9,235)
Deferred revenue	(32,000)	(289,437)
	734,856	1,224,552
Add (deduct) changes in non-cash working capital relating to investing activities	(732,708)	732,708
	\$ 2,148	\$ 1,957,260

(b) The following cash payments were made:

	2002	2001
Interest	\$ 553	\$ 10,493

## STERNE STACKHOUSE INC.

### Notes to Financial Statements

Years ended October 31, 2002 and 2001

#### 8. Commitments:

The Corporation has leases on its premises and certain computer and office equipment, which expire through 2005. Minimum annual payments under the leases are approximately as follows:

2003	\$ 334,000
2004	303,000
2005	72,000

#### 9. Segmented information and customer concentration:

(a) Segment information:

The Corporation has two operating segments for the development and marketing of data retrieval technology: 1) for the oil and gas industry (Petro-LAB); and 2) for other commercial applications (Labrador).

Information with respect to the industry segments is as follows:

October 31, 2002	Petro-LAB	Labrador	Total
Revenues:			
License fees	\$ —	\$ 54,800	\$ 54,800
Royalty income	—	1,491,264	1,491,264
Consulting fees	—	271,331	271,331
	—	1,817,395	1,817,395
Expenses:			
General and administrative	—	1,108,473	1,108,473
Sales and marketing	—	404,965	404,965
Computer and related costs	—	831,090	831,090
Reorganization and related costs	—	122,364	122,364
Amortization of software development costs	—	—	—
Depreciation	—	95,039	95,039
Interest	—	553	553
	—	2,562,484	2,562,484
Net income (loss)	\$ —	\$ (745,089)	\$ (745,089)

## STERNE STACKHOUSE INC.

### Statements of Operations and Deficit

Years ended October 31, 2001 and 2000

#### 9. Segmented information and customer concentration:

(a) Segment information (continued):

October 31, 2001	Petro-LAB	Labrador	Total
Revenues:			
License fees	\$ 809,585	\$ 70,600	\$ 880,185
Royalty income	–	708,760	708,760
Consulting fees	–	187,844	187,844
	809,585	967,204	1,776,789
Expenses:			
General and administrative	306,666	1,481,830	1,788,496
Sales and marketing	279,266	1,290,275	1,569,541
Computer and related costs	134,027	1,025,642	1,159,669
Amortization of software development costs	–	120,000	120,000
Depreciation	19,200	92,993	112,193
Interest	3,694	6,799	10,493
	742,853	4,017,539	4,760,392
Other income (expense) items:			
Gain on sale of Petro-LAB	4,480,619	–	4,480,619
Bad debt expense	–	(300,000)	(300,000)
	4,480,619	(300,000)	4,180,619
<b>Net income (loss)</b>	<b>\$ 4,547,351</b>	<b>\$ (3,350,335)</b>	<b>\$ 1,197,016</b>

	Year ended October 31, 2002			Year ended October 31, 2001		
	Expenditures on capital assets	Expenditures on software development costs	Total identifiable assets	Expenditures on capital assets	Expenditures on software development costs	Total identifiable assets
Petro-LAB	\$ –	\$ –	\$ –	\$ 36,972	\$ –	\$ 1,422,959
Labrador	46,956	–	1,239,575	36,972	122,061	629,026
	\$ 46,956	\$ –	\$ 1,239,575	\$ 73,944	\$ 122,061	\$ 2,051,985

Inter-segment transactions were not significant.

## **STERNE STACKHOUSE INC.**

### Notes to Financial Statements

Years ended October 31, 2002 and 2001

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#### **9. Segmented information and customer concentration (continued):**

(b) Customer concentration:

As a result of the Corporation's sale of Petro-LAB, substantially all the Corporation's current revenues are derived from one customer. As such, accounts receivable from this customer totaled \$685,006 (2001 - \$1,427,825) as at October 31, 2002.

#### **10. Fair values:**

As at October 31, 2002 and 2001, the fair values of the Corporation's monetary assets and liabilities approximated their carrying values.

## CORPORATE INFORMATION

### Board of Directors

H. Ronald Sterne, Calgary, Alberta  
Darryl K. Stackhouse, Calgary, Alberta  
George A. Wilson\*, Q.C., Toronto, Ontario  
K. Garry Cook\*, Calgary, Alberta  
John D. Riddell\*, Calgary, Alberta

\* - members of the Audit Committee

### Executives and Officers

H. Ronald Sterne, Chief Executive Officer and  
Chief Operating Officer  
Darryl K. Stackhouse, President and Chief  
Financial Officer

### Auditors

Peter Henry  
KMPG LLP  
Chartered Accountants  
1200, 205 – 5th Avenue S.W.  
Calgary, Alberta, Canada T2P 4B9

### Transfer Agent

Computershare Trust Company of Canada  
Sixth Floor  
530 – 8th Avenue S.W.  
Calgary, Alberta, Canada T2P 3S8

### Solicitors

Jay Zammit  
Burstall Winger LLP  
Barristers & Solicitors  
Suite 3100 Home Oil Tower  
324 – 8th Avenue S.W.  
Calgary, Alberta, Canada T2P 2Z2

### Stock Exchange

The TSX Venture Exchange  
Trading Symbol: SSX

### Head Office

Sterne Stackhouse Inc.  
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