



**Annual Report 2004**

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## 2004 PRESIDENT'S LETTER TO SHAREHOLDERS

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Fiscal 2004 continued to be a trying year for Plaintree. However, although the wireless and Telecommunication world is not yet in a large growth phase, it appears to be showing real signs of life. This will be good news for Plaintree. For example, the decision by cable companies to enter the Voice over Internet Protocol (VOIP) market has forced both cable companies and the telephone companies to consider their equipment expansion needs to meet the new requirements demanded by VOIP.

Plaintree has worked long and hard to ensure that our products will satisfy the three main requirements of our customers: (1) economic; (2) ease of installation, and (3) reliability.

Our strategy appears to be showing some signs of success. At the present time, Plaintree has been advised by two large equipment providers that they have completed their evaluations of our WaveBridge product line and are in the process of drafting formal OEM agreements to resell this line.

Other sales have also started to occur in the month of June 2004, Plaintree sold more equipment than in the entire fourth quarter of 2004.

Based on this, we remain cautiously optimistic for fiscal 2005. Thank you for your continued support during these trying last few years.



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David Watson  
President and Chief Executive Officer  
July 26, 2004



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## Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of  
Plaintree Systems Inc.

We have audited the accompanying consolidated balance sheets of Plaintiff Systems Inc. as at March 31, 2004 and 2003 and the consolidated statements of operations, shareholders' deficiency and cash flows for each of the years in the three-year period ended March 31, 2004. These consolidated financial statements are the responsibility of the Company'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 and the standards of the Public Company Accounting Oversight Board (United States). 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. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at March 31, 2004 and 2003 and the results of its operations and its cash flows for each of the years in the three-year period ended March 31, 2004, in accordance with Canadian generally accepted accounting principles.

Chartered Accountants  
Ottawa, Canada

June 11, 2004

## Comments by Auditor on Canada-United States of America Reporting Difference

The standards of the Public Company Accounting Oversight Board (United States) require the addition of an explanatory paragraph when the financial statements are affected by conditions and events that cast substantial doubt on the Company's ability to continue as a going concern, such as those described in Note 1 to the financial statements. Although we conducted our audits in accordance with both Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States), our report to the Board of Directors dated June 11, 2004 is expressed in accordance with Canadian reporting standards which do not permit a reference to such conditions and events in the auditors' report when these are adequately disclosed in the financial statements.

Chartered Accountants  
Ottawa, Canada

June 11, 2004

# PLAINTREE SYSTEMS INC.

## Consolidated Balance Sheets

as at March 31, 2004 and 2003

(in Canadian dollars)

	<u>2004</u>	<u>2003</u>
<b>CURRENT ASSETS</b>		
Cash	\$ 395,536	\$ 42,148
Trade accounts receivable (net of allowance for doubtful accounts of \$56,390; 2003 - \$110,160)	19,445	90,884
Due from Partnership (Note 3)	69,283	-
Inventories - net (Note 4)	107,949	116,343
Deferred charges (Note 5)	393,643	-
Prepaid expenses and advance contract payments	21,392	27,384
	<b>1,007,248</b>	276,759
INVESTMENT IN PARTNERSHIP (Note 3)	16,000,000	-
CAPITAL ASSETS - NET (Note 6)	196,556	263,655
	<b>\$ 17,203,804</b>	<b>\$ 540,414</b>
<b>CURRENT LIABILITIES</b>		
Bank loan (Note 7)	\$ 16,300,000	\$ -
Credit facilities due to related party (Note 8)	-	297,856
Due to related party (face value - \$900,000) (Note 8)	366,000	-
Due to related parties (Note 9)	979,021	377,808
Accounts payable and accrued liabilities (Note 10)	87,229	745,363
Deferred revenue	11,691	25,073
	<b>17,743,941</b>	1,446,100
<b>GUARANTEES, CONTINGENCIES AND COMMITMENTS (Note 18)</b>		
<b>SHAREHOLDERS' DEFICIENCY</b>		
Share capital (Note 11)		
Common shares (unlimited number of shares authorized, 90,221,634 outstanding; 2003 - 90,221,634)	97,561,140	97,561,140
Additional paid in capital (Note 11)	451,000	-
Equity component of convertible debentures (Note 8)	625,000	-
Deficit	(98,730,202)	(98,019,751)
Accumulated foreign currency translation adjustment	(447,075)	(447,075)
	<b>(540,137)</b>	<b>(905,686)</b>
	<b>\$ 17,203,804</b>	<b>\$ 540,414</b>

APPROVED BY THE BOARD:

original signed:

"David Watson"

"Girvan Patterson"

See accompanying Notes to the Consolidated Financial Statements

**PLAINTREE SYSTEMS INC.**  
**Consolidated Statements of Operations**  
for the years ended March 31, 2004, 2003 and 2002  
(in Canadian dollars)

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Revenue			
Product and service revenue	\$ 258,739	\$ 1,304,068	\$ 1,071,596
Management service revenue (Note 9)	-	-	275,000
	<b>258,739</b>	<b>1,304,068</b>	<b>1,346,596</b>
Cost of revenue			
Product and service costs	35,618	199,370	578,109
Management service costs (Note 9)	-	-	77,145
	<b>35,618</b>	<b>199,370</b>	<b>655,254</b>
Gross margin	<b>223,121</b>	<b>1,104,698</b>	<b>691,342</b>
Operating expenses			
Sales and marketing	453,718	756,414	2,794,261
Finance and administration (Notes 5 and 8)	605,764	583,303	970,440
Research and development	424,431	765,472	2,094,823
Restructuring (Note 12)	-	200,603	-
Write-down of inventories (Note 12)	-	2,081,792	1,362,840
Write-down of intangible assets (Note 12)	-	-	742,538
	<b>1,483,913</b>	<b>4,387,584</b>	<b>7,964,902</b>
Loss from operations	<b>(1,260,792)</b>	<b>(3,282,886)</b>	<b>(7,273,560)</b>
Interest (expense) income (Note 9)	<b>(68,067)</b>	<b>(54,847)</b>	<b>65,317</b>
Other income (loss) (Note 13)	<b>385,452</b>	<b>(125,533)</b>	<b>(114,683)</b>
Partnership income (Note 3)	<b>845,730</b>	-	-
Other partnership related expenses (Note 3)	<b>(121,382)</b>	-	-
Bank loan interest (Note 7)	<b>(491,392)</b>	-	-
NET LOSS	<b>\$ (710,451)</b>	<b>\$ (3,463,266)</b>	<b>\$ (7,322,926)</b>
Basic and diluted loss per common share (Note 14)	<b>\$ (0.01)</b>	<b>\$ (0.04)</b>	<b>\$ (0.08)</b>
Weighted average common shares outstanding	<b>90,221,634</b>	<b>90,221,634</b>	<b>86,958,580</b>

See accompanying Notes to the Consolidated Financial Statements

**PLAINTREE SYSTEMS INC.**  
**Consolidated Statements of Cash Flows**  
for the years ended March 31, 2004, 2003 and 2002  
(in Canadian dollars)

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<b>OPERATING</b>			
Net loss	\$ (710,451)	\$ (3,463,266)	\$ (7,322,926)
Items not affecting cash			
Amortization	61,934	200,798	738,690
Amortization of deferred charges (Note 5)	164,368	-	-
Amortization of debt discount (Note 8)	91,000	-	-
Shares issued for services	-	-	77,500
Write-down of intangible assets	-	-	742,538
Loss on disposal of capital assets	5,165	113,805	-
Changes in non-cash operating working capital items (Note 15)	(654,974)	2,522,546	918,727
	<b>(1,042,958)</b>	<b>(626,117)</b>	<b>(4,845,471)</b>
<b>INVESTING</b>			
Purchases of capital assets	-	-	(132,465)
Payment of deferred charges	(107,011)	-	-
Partnership interest (Note 3)	(20,000,000)	-	-
Partnership distributions (Note 3)	4,000,000	-	-
Decrease in loans receivable from related parties	-	8,243	26,586
Proceeds from disposition of short-term investments	-	27,328	1,925,888
	<b>(16,107,011)</b>	<b>35,571</b>	<b>1,820,009</b>
<b>FINANCING</b>			
Due to related parties	1,203,357	181,020	400,000
Payments on capital leases	-	-	(7,710)
Proceeds from bank loan (Note 7)	20,300,000	-	-
Payments on bank loan (Note 7)	(4,000,000)	-	-
Proceeds from disposal of capital assets	-	18,843	-
Proceeds on issuance of share capital - net of issue costs	-	-	1,294,030
	<b>17,503,357</b>	<b>199,863</b>	<b>1,686,320</b>
Increase (decrease) in cash	<b>353,388</b>	<b>(390,683)</b>	<b>(1,339,142)</b>
Cash, beginning of year	<b>42,148</b>	<b>432,831</b>	<b>1,771,973</b>
Cash, end of year	<b>\$ 395,536</b>	<b>\$ 42,148</b>	<b>\$ 432,831</b>

See accompanying Notes to the Consolidated Financial Statements

## PLAINTREE SYSTEMS INC.

### Consolidated Statements of Shareholders' Deficiency

as at March 31, 2004 and 2003

(in Canadian dollars)

	Common Shares		Accumulated Foreign Currency Translation Adjustment	Deficit	Equity Component of the convertible debentures	Additional Paid in Capital	Shareholders' Deficiency
	<u>Number</u>	<u>Amount</u>	<u>Adjustment</u>	<u>Deficit</u>	<u>debentures</u>	<u>in Capital</u>	<u>Deficiency</u>
Balance March 31, 2002	90,221,634	\$ 97,561,140	\$ (447,075)	\$ (94,556,485)	\$ -	\$ -	\$ 2,557,580
Net loss	-	-	-	(3,463,266)	-	-	(3,463,266)
Balance March 31, 2003	90,221,634	97,561,140	(447,075)	(98,019,751)	-	-	(905,686)
Equity component of the convertible debentures (Note 8)	-	-	-	-	625,000	-	625,000
Options granted to related parties (Note 11)	-	-	-	-	-	451,000	451,000
Net loss	-	-	-	(710,451)	-	-	(710,451)
Balance March 31, 2004	<b>90,221,634</b>	<b>\$ 97,561,140</b>	<b>\$ (447,075)</b>	<b>\$ (98,730,202)</b>	<b>\$ 625,000</b>	<b>\$ 451,000</b>	<b>\$ (540,137)</b>

See accompanying Notes to the Consolidated Financial Statements

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

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**1. DESCRIPTION AND CONTINUATION OF THE BUSINESS**

The Company designs, develops, manufactures, markets and supports optical wireless links, network switches and telecommunications products that allow its customers to improve the performance and increase the manageability of their existing local area networks, while providing a migration path to emerging networking technologies.

The financial statements have been prepared assuming that the Company will continue as a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. However, there is substantial doubt about the Company's ability to continue as a going concern because of the Company's losses during the past year of \$710,451, a working capital deficit and an accumulated deficit of \$98,730,202 as at March 31, 2004. The Company's continued existence is dependent upon its ability to raise additional capital, to increase sales and ultimately become profitable.

The Company believes that future funding and certain sales-related efforts will provide sufficient cash flow for it to continue as a going concern in its present form. However, there can be no assurances that the Company will achieve such results and to date, the Company has not secured such funding either through an equity investment or strategic partnership. Accordingly, the consolidated financial statements do not include any adjustments related to the recoverability and classification of recorded asset amounts or the amount and classification of liabilities or any other adjustments that might be necessary should the Company be unable to continue as a going concern.

**2. ACCOUNTING POLICIES**

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles. These principles conform in all material respects with accounting principles generally accepted in the United States of America except as disclosed in Note 19.

*Basis of presentation*

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. The Company's foreign subsidiaries are inactive. All significant intercompany accounts and transactions have been eliminated. The Company has a 49% interest in a partnership as disclosed in Note 3. The Company is accounting for the partnership using the equity method whereby net partnership income (loss) increases (decreases) the investment and cash distributions reduce the investment.

*Inventories*

Finished goods are valued at the lower of cost (first-in, first-out) and net realizable value. Work in process and raw materials are valued at the lower of cost and replacement cost.

Provisions for excess and obsolete inventory are made in the period in which management determines the inventory to be excess or obsolete.

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

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**2. ACCOUNTING POLICIES (Continued)**

*Capital assets*

Capital assets are stated at cost. Amortization is provided using the following methods and rates:

Software	2 years straight-line
Computer and office equipment	3 years straight-line
Other equipment	2 years straight-line
Furniture and fixtures	20% declining-basis
Building	20 years straight-line

The Company's policy is to review all long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount as an asset may not be recoverable. If events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable, the Company will estimate the future cash flows expected to result from the use of the assets and their eventual disposition and record an impairment of the assets if required.

*Research and development costs*

Research costs are expensed as incurred. Development costs are deferred once technical feasibility has been established and all criteria for deferral under generally accepted accounting principles are met. Such costs are amortized, commencing when the product is released, over the lesser of the expected life of the related product and three years.

*Revenue recognition and warranties*

Revenue from product sales is recorded on shipment provided evidence of an arrangement exists and collection is probable. In addition, a provision for potential warranty claims is recorded at the time of sale, based on warranty terms and prior claims experience. Extended warranty contracts are sold separately from the product and the associated revenue is recognized over the term of the agreement. Service revenue is recognized when the service is performed. Deferred revenue arises when extended warranty contracts are paid in advance.

Management service revenue is recognized when the service is performed.

*Foreign currency translation*

Other monetary assets and liabilities, which are denominated in currencies foreign to the local currency of the operation, are translated to the local currency at fiscal year-end exchange rates, and transactions included in earnings are translated at rates prevailing during the fiscal year. Exchange gains and losses resulting from the translation of these amounts are included in net earnings.

In prior years, the Company had active subsidiaries (reporting in foreign currencies) that were considered to be self-sustaining. The translation of the accounts of these subsidiaries resulted in the cumulative translation adjustment reported in the accounts.

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

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**2. ACCOUNTING POLICIES (Continued)**

*Stock option plans*

The Company has stock option plans as described in Note 11. Effective April 1, 2002, the Company adopted the new recommendations of section 3870 of the CICA Handbook ("CICA 3870") with respect to stock-based compensation. The Company records an expense for employee options only when the exercise price of the option is lower than the market price of the stock on the date of grant. To date, no option grants have met the criteria for expense recognition. The Company discloses in Note 11 the pro forma effect of the options on the net loss as if they were valued using a fair value method.

The Company uses the fair value based method to measure stock-based compensation for all stock-based awards made to non-employees, and for direct awards made to directors and employees of common shares, stock appreciation rights, and awards that call for settlement for cash or other assets. Awards that the Company has the ability to settle in shares are recorded as equity whereas awards that the Company required to or has a practice of settling in cash are recorded as liabilities.

*Use of accounting estimates*

The preparation of financial statements in conformity with generally accepted accounting principles requires the Company's management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods presented. Actual results could differ from the estimates made by management.

*Income taxes*

The Company uses the asset and liability method to account for income taxes. Future income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the carrying amounts of existing assets and liabilities for accounting purposes, and their respective tax bases. Future income tax assets and liabilities are measured using statutory tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in statutory tax rates is recognized in net income in the year of change. Future income tax assets whose recoverability is not sufficiently likely are not recorded in these financial statements.

**3. INVESTMENT IN PARTNERSHIP**

In July 2003, the Company made a capital contribution of \$20,000,000 in order to acquire a 49% interest in a general manufacturing partnership (the "Partnership"). The acquisition was financed through the credit facility (bank loan) referred to in Note 7. Additional capital requirements of the partnership must be approved unanimously by all partners. This Partnership interest was reduced to \$16,000,000 by March 31, 2004, as a result of cash distributions to the Company from the Partnership of \$4,000,000. These amounts were used to repay the bank loan.

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

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**3. INVESTMENT IN PARTNERSHIP (Continued)**

The carrying value of the partnership is assessed for impairment when there has been a loss in value that is other than temporary. An impairment is considered to exist when conditions exist for a period of three or four years suggesting there is a decline in value that is other than temporary.

Other partnership related expenses includes financing expense (\$59,217) and guarantee fees (\$62,165).

As at March 31, 2004, a quarterly Partnership income allocation of \$69,283 was made although not yet received and therefore recorded as a receivable on the balance sheet. The balance of the income allocation was received during the year.

The Partnership allocates income to its partners, and is not itself subject to tax.

**4. INVENTORIES**

	<u>2004</u>	<u>2003</u>
Raw materials	\$ 67,442	\$ 81,328
Work in process	40,429	34,820
Finished goods	78	195
	<u>\$ 107,949</u>	<u>\$ 116,343</u>

**5. DEFERRED CHARGES**

Deferred charges represent payments to various entities to secure related party loans including the placement of the related party convertible debenture issue, related party demand loan and for Partnership related legal and financing fees.

	<u>2004</u>	<u>2003</u>
Deferred charges	\$ 558,011	\$ -
Less accumulated amortization	(164,368)	-
	<u>\$ 393,643</u>	<u>\$ -</u>

These charges are being amortized over the term of the related debts and amortization of \$164,368 is included in finance and administration expenses in 2004.

Non-cash deferred charges relating to options granted to shareholders (Note 11) have been excluded from the payment of deferred charges reflected on the statement of cash flows.

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

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**6. CAPITAL ASSETS**

	<b>2004</b>		
	Cost	Accumulated Amortization	Net Book Value
Software	\$ 57,538	\$ 57,538	\$ -
Computer and office equipment	2,677,841	2,674,778	3,063
Other equipment	233,392	233,392	-
Furniture and fixtures	113,045	100,195	12,850
Land and building	218,672	38,029	180,643
	<b>\$ 3,300,488</b>	<b>\$ 3,103,932</b>	<b>\$ 196,556</b>
	<b>2003</b>		
	Cost	Accumulated Amortization	Net Book Value
Software	\$ 57,538	\$ 54,810	\$ 2,728
Computer and office equipment	2,724,702	2,675,759	48,943
Other equipment	233,392	233,392	-
Furniture and fixtures	134,213	112,379	21,834
Land and building	218,672	28,522	190,150
	<b>\$ 3,368,517</b>	<b>\$ 3,104,862</b>	<b>\$ 263,655</b>

**7. BANK LOAN**

In July 2003, Plaintiff obtained a non-recourse demand credit facility from a Canadian chartered bank in the amount of \$20,300,000. The credit facility was used to finance its capital contribution to the Partnership referred to in Note 3, to cover related acquisition expenses and to finance its payment obligations under the creditor proposal. Amounts outstanding under the credit facility will incur interest at the bank's prime rate. Payments of interest and principal are due quarterly following cash distributions by the Partnership to the partners, including Plaintiff. Pursuant to the credit facility, the bank is entitled to be paid 94.3% of the amount of the cash distributions from the Partnership paid to Plaintiff prior to a demand and/or default under the credit facility and 100% of such distributions thereafter until the credit facility is repaid. The credit facility is guaranteed by the Partnership. In order to secure the guarantee, Plaintiff is required to pay 1% of cash distributions from its Partnership interest up to a maximum of \$200,000 to the Partnership. Plaintiff has secured its obligations to the bank under the credit facility by way of a general security agreement over its assets and a specific pledge of its Partnership interest to the bank.

During fiscal 2004, the bank loan was repaid to the extent of \$4,000,000 as a result of distributions from the Partnership.

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

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**8. CREDIT FACILITIES AND CONVERTIBLE DEBENTURES DUE TO RELATED PARTIES**

On December 16, 2003, the Company completed a placement of secured convertible debentures ("Debentures") having a principal value of \$900,000. Targa Group Inc., ("Targa", the largest shareholder of the Company), purchased all the Debentures. Of the \$900,000 proceeds from the sale of the Debentures, \$710,386 was utilized to retire outstanding credit facilities granted by Targa or its affiliates. The balance of the Debenture proceeds, \$189,614, was satisfied by a cash payment by Targa to the Company.

The due date for the payment of the Debentures is December 16, 2005. The Debentures are non-interest bearing until the due date and thereafter bear 10% interest per annum until paid in full. Debentures are secured by a general security agreement over the assets of the Company.

At anytime while the Debenture is outstanding, Targa has the right to convert the amounts outstanding under the Debenture into Plaintiff common shares at a conversion price of \$0.115. In the event that the full amount of the Debenture is converted, Targa will be issued 7,826,087 Plaintiff common shares. The Company has the right to repay the Debenture at any time on 30 days prior notice, subject to Targa's right to convert the Debentures into Plaintiff common shares.

The Company has assigned carrying amounts to the liability and equity elements of the Convertible Debenture in accordance with the substance of the contractual agreement. The Company has determined the carrying amount of the equity component based on the application of the Black-Scholes pricing model. The carrying amount of the equity component of the Convertible Debentures is \$625,000 and is recorded in additional paid in capital. As at March 31, 2004, the Debentures are recorded net of a discount of \$534,000 which reflects the unamortized portion of the value attributed to the equity component. The Company is amortizing this discount over the two-year term to maturity and \$91,000 of amortization is included in finance and administration expenses in 2004.

**9. RELATED PARTY TRANSACTIONS**

On November 19, 2003, the Company agreed to accept a loan ("Loan") from Targa, its largest shareholder, of \$500,000 (net of related fees). The Loan is payable on demand and earns interest at a rate of prime plus 5% per annum. The Loan is also secured by an already existing General Security Agreement over Plaintiff's assets. On December 4, 2003, the Loan was reduced by a cash payment of \$189,614 from Targa in settlement of the purchase of Debentures referred to in Note 8. As of March 31, 2004, the total Loan amount outstanding was \$318,781 (\$310,386 principal plus \$8,395 of accumulated interest).

Until March 31, 2003, the Company leased facilities from a company controlled by Targa. Lease arrears including interest of \$35,705 owing to this related party amounted to \$254,513. In 2003, this related party entered into a forbearance agreement with the Company whereby the Company agreed to repay the amounts owing and the related party was provided with a security interest in the form of a mortgage on the property owned by the Company. As a result of the BIA proposal to creditors, the forbearance agreement is now in default and the amounts owing are due and payable. This amount is still outstanding as at March 31, 2004 and is included in due to related parties.

As of April 1, 2002, the Company's Senior Officers have agreed to defer payment of consulting fees and salaries payable. These fees and salaries to senior officers of the Company, who are also majority shareholders of Targa, amounted to \$383,847, plus interest charges of \$21,880 for a total payable of \$405,727. These amounts are included in due to related parties.

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

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**9. RELATED PARTY TRANSACTIONS (Continued)**

During fiscal 2004, total rent expense of \$17,000 was paid to companies controlled by Targa for storage services. This amount is included in finance and administration expenses.

Fiscal 2004 interest expense of \$68,067 (2003 - \$54,847) is primarily interest on related party balances as described in Note 8.

In the past, the Company performed consulting and management services under an agreement between the Company and corporations controlled by Targa Group Inc.. Consulting and management fees received under this agreement totalled \$275,000 in 2002. Since that time, no other management fees have been charged.

**10. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES**

Accounts payable and accrued liabilities are comprised of the following:

	<u>2004</u>	<u>2003</u>
Accounts payable	\$ 24,044	\$ 424,670
Accrued liabilities	46,657	117,526
Restructuring	-	200,603
Salaries and benefits payable	3,447	-
Commissions payable	13,081	2,564
	<u>\$ 87,229</u>	<u>\$ 745,363</u>

**11. SHARE CAPITAL**

Authorized

Unlimited number of preferred shares, issuable in series

Series I: 7,000 authorized, 7% cumulative dividend payable in cash or, subject to applicable law and stock exchange approval, common shares; semi-annually on the 30<sup>th</sup> day of May and November of each year; redeemable at the option of the Company and retractable at the option of the holder at \$1,000 per share after November 21, 2002 or on the occurrence of a merger event; convertible at the option of the holder to 1,647,058 common shares at any time prior to November 22, 2002; amounts due for redemption or retraction may be converted to common shares at the option of the Company; non-voting.

Series II: 9,000 authorized, 7% cumulative dividend payable in cash or, subject to applicable law and stock exchange approval, common shares; semi-annually on the 30<sup>th</sup> day of May and November of each year; redeemable at the option of the Company and retractable at the option of the holder at \$1,000 per share after June 3, 2003 or on the occurrence of a merger event; convertible at the option of the holder to 4,186,046 common shares at any time prior to June 4, 2003; amounts due for redemption or retraction may be converted to common shares at the option of the Company; voting.

Unlimited number of common shares

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
(in Canadian dollars)

**11. SHARE CAPITAL (Continued)**

*Warrants*

As at March 31, 2004, 3,911,765 (2003 - 3,911,765) common share purchase warrants remain outstanding. Each warrant is exercisable into one common share of the Company at an exercise price of \$0.51 per common share, expiring January 8, 2005.

*Stock option plans*

During fiscal 2002 the Company amended the 1994 Stock Option Plan to (i) change the name of the 1994 Stock Option Plan from "1994 Employee and Director Stock Option Plan" to "Stock Option Plan"; (ii) allow the Company to grant options to officers and service providers; and (iii) increase the maximum number of options which may be granted under the 1994 Stock Option Plan from 4,500,000 to up to 8,600,000.

The Company also has a 1993 stock option plan for key employees and directors. No further options are eligible for grant under the 1993 plan.

Options under the stock option plans may not expire later than 10 years from the date of grant and the exercise price may not be less than the latest closing price of the common shares on the last trading day preceding the date of grant. Eligibility is determined by the Company's Board of Directors and the aggregate number available for issuance to any one person may not exceed 5% of the issued and outstanding common shares.

Activity in the stock option plan is summarized as follows:

	Number of Options	Option Price	Weighted Average Option Price
Options outstanding March 31, 2002	3,851,000	\$ 0.29-\$7.00	\$1.06
Cancelled	(2,111,000)	\$ 0.29-\$4.80	\$0.79
Options outstanding March 31, 2003	1,740,000	\$ 0.29-\$7.00	\$1.40
Granted during fiscal 2004	7,525,000	\$ 0.105	\$0.11
Cancelled	(635,000)	\$ 0.29-\$7.00	\$2.13
Options outstanding March 31, 2004	<b>8,630,000</b>	<b>\$ 0.105-\$2.35</b>	<b>\$0.22</b>

Additional information regarding options outstanding as of March 31, 2004 is as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$0.105	7,525,000	4.6	\$0.105	7,037,500	\$0.105
\$0.29 - \$0.39	620,000	2.7	\$0.33	620,000	\$0.33
\$0.51 - \$0.72	125,000	1.7	\$0.69	121,250	\$0.70
\$1.40	50,000	1.0	\$1.40	50,000	\$1.40
\$2.31 - \$2.35	310,000	3.5	\$2.32	310,000	\$2.32
<b>\$0.105 - \$2.35</b>	<b>8,630,000</b>	<b>4.5</b>	<b>\$0.22</b>	<b>8,138,750</b>	<b>\$0.22</b>

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

**11. SHARE CAPITAL (Continued)**

*Stock option plans (Continued)*

Additional information regarding options outstanding as of March 31, 2003 is as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$0.29 - \$0.39	1,000,000	3.5	\$ 0.33	800,000	\$ 0.33
\$0.50 - \$0.72	165,000	2.4	0.67	128,750	0.68
\$0.95 - \$1.40	50,000	1.9	1.40	37,500	1.40
\$2.31 - \$2.35	375,000	3.9	2.32	375,000	2.32
\$7.00	150,000	0.2	7.00	150,000	7.00
<b>\$0.29 - \$7.00</b>	<b>1,740,000</b>	<b>3.1</b>	<b>\$1.40</b>	<b>1,491,250</b>	<b>\$ 1.56</b>

During fiscal 2004, of the 7,525,000 options granted, the Company granted 5,000,000 options to shareholders in exchange for assistance in raising financing and recorded a deferred charge and an increase to additional paid in capital of \$451,000 reflecting the fair market value of the options granted based on the application of the Black-Scholes pricing model. The deferred charge is being amortized over the period of the related debt (approximately one year).

CICA 3870 requires pro forma disclosures of the net loss and loss per share, as if a fair value based method of accounting had been applied. The following table presents the stock-based compensation expense that would have been recorded in the consolidated financial statements had the Company used the fair value based method of accounting for awards granted to employees:

	<b>2004</b>	2003
Net loss as reported	<b>\$ (710,451)</b>	\$ (3,463,266)
Add: stock-based compensation expense	<b>(195,498)</b>	-
Pro forma net loss	<b>\$ (905,949)</b>	\$ (3,463,266)
Pro forma basic and diluted loss per common share	<b>\$ (0.01)</b>	\$ (0.04)

The compensation expense presented above has been calculated using a Black-Scholes option pricing model which indicates a weighted average fair value for options granted in the year of \$0.09 per option. The fair value is estimated on the date of grant. Assumptions used in the pricing model include: (i) risk free interest rates for the period of 3.1%; (ii) expected volatility of 184%; (iii) expected dividend yield of NIL; and (iv) an estimated average life of 2.5 years.

The Black-Scholes model used by the Company to calculate option values, as well as other currently accepted option valuation models, were developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which significantly differ from the Company's stock option awards. These models also require highly subjective assumptions, including future stock price volatility and expected time until exercise, which greatly affect the calculated values. Accordingly, management believes that this model does not necessarily provide a reliable single measure of the fair value of the Company's stock option awards.

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

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**12. RESTRUCTURING, WRITE-DOWN OF INVENTORIES AND INTANGIBLE ASSETS**

During fiscal 2003 and 2002, it became evident that the Company would not recover the cost of certain inventories reflected on the balance sheet. Accordingly, the Company wrote down these inventories by \$2,081,792 in fiscal 2003 (2002 - \$1,362,840) to reflect estimated recoverable value.

During fiscal 2003, the Company restructured its operations in order to reduce costs and streamline operations. Restructuring charges, primarily workforce reduction related, recorded during fiscal 2003 were \$200,603. In total, 26 employees were terminated of which 7 performed research and development, 10 were involved in manufacturing and 9 were involved in sales and administration activities. There were no restructuring or inventory write-downs in fiscal 2004.

On March 29, 2000, the Company acquired all the business assets of A.T. Schindler Communications Inc. (ATS), a designer and manufacturer of the FiRLAN wireless networking products. The acquisition has been accounted for by the purchase method of accounting. The purchase consideration was comprised of \$346,655 cash and the issuance of 2,569,921 common shares. The difference between the purchase price valued at \$1,631,616 and the fair value of the acquired net tangible assets of \$146,541 amounted to \$1,485,075, which is attributable to acquired technology and goodwill (the "intangible assets"). The intangible assets were to be amortized over their expected useful lives of four years on a straight-line basis and reviewed periodically for impairment. At March 31, 2002, it became evident that the carrying amount of the intangible assets would not be recoverable. As a result, the net book value of intangible assets remaining on the books of \$742,538 was written off. There have been no other intangible asset write-downs since fiscal 2002.

**13. OTHER INCOME (LOSS)**

Other Income is comprised of the following items:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Foreign exchange loss	\$ (1,287)	\$ (23,213)	\$ (129,709)
Gain on creditor proposal	371,395	-	-
Loss on disposal of capital assets	-	(113,805)	-
Miscellaneous	15,344	11,485	15,026
	<u>\$ 385,452</u>	<u>\$ (125,533)</u>	<u>\$ (114,683)</u>

The Company filed a proposal with its creditors in December 2002. The Court approved the proposal in January 2003. The gain on creditor proposal of \$371,395 was realised on settlement of a proposal to creditors approved by the Ontario Superior Court of Justice on July 31, 2003. As part of this settlement, creditors received a maximum aggregate payout of \$150,000.

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

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**14. BASIC AND DILUTED LOSS PER COMMON SHARE**

Loss per share has been calculated on the basis of net loss divided by the weighted average number of common shares outstanding during the year. Diluted loss per common share is calculated by dividing the applicable net loss by the sum of the weighted average number of common shares outstanding and all additional common shares that would have been outstanding if potentially dilutive common shares had been issued during the period. The treasury stock method is used to compute the dilutive effect of options and warrants. For all years presented, diluted loss per share is the same as basic loss per share. For all years presented, basic and diluted loss per share under United States generally accepted accounting principles are the same as the amounts presented under Canadian generally accepted accounting principles.

**15. CHANGES IN NON-CASH OPERATING WORKING CAPITAL ITEMS**

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Trade accounts receivable	\$ 71,439	\$ 105,365	\$ 188,423
Investment tax credits receivable	-	246,000	(156,000)
Due to related parties	-	36,878	404,241
Due from Partnership	(69,283)	-	-
Inventories	8,394	1,946,575	454,874
Prepaid expenses and advance contract payments	5,992	76,084	94,327
Accounts payable and accrued liabilities	(658,134)	128,977	(43,455)
Deferred revenue	(13,382)	(17,333)	(23,683)
	<u>\$ (654,974)</u>	<u>\$ 2,522,546</u>	<u>\$ 918,727</u>

**16. BUSINESS SEGMENT INFORMATION**

The Company's chief decision maker, the Chief Executive Officer tracks the Company's operations as principally one business segment - the design, development, manufacture, marketing and support of computer networking products. The Company has in the past also provided management services primarily to related companies. The revenue and cost of sales related to these services are presented on the statement of operations. No other expenses or assets are attributable to this segment.

The Company determines the geographic location of revenues based on the location of its customers. All of the Company's assets are primarily located in Canada.

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

**16. BUSINESS SEGMENT INFORMATION (Continued)**

*Revenue by geographic location*

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Canada	\$ 106,092	\$ 81,610	\$ 519,559
United States	64,514	948,271	361,750
Europe	57,232	77,553	31,211
Other	30,901	196,633	434,076
	<u>\$ 258,739</u>	<u>\$ 1,304,067</u>	<u>\$ 1,346,596</u>

*Revenue concentration (Customers with revenues in excess of 10% of total revenues)*

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Number of Customers	5	2	1
% of total revenue	70%	59%	27%

**17. INCOME TAXES**

(a) Investment tax credits

At March 31, 2004, the Company has approximately \$4,258,000 (2003 - \$4,774,000) of investment tax credits, relating primarily to research and development, available to reduce future years Canadian federal income taxes. These potential benefits expire as follows:

2005	\$ 799,000
2006	1,314,000
2007	1,561,000
2011	240,000
2012	344,000
	<u>\$ 4,258,000</u>

(b) Tax losses available to carry forward

The Company has losses available to reduce future years' Canadian federal and provincial taxable income totalling approximately \$41,434,000 and \$43,480,000 respectively. These potential benefits expire as follows:

	<u>Federal</u>	<u>Provincial</u>
2005	\$ 12,908,000	\$ 13,872,000
2006	14,592,000	15,682,000
2007	880,000	872,000
2008	3,850,000	3,850,000
2009	5,032,000	5,032,000
2010	3,453,000	3,453,000
2011	719,000	719,000
	<u>\$ 41,434,000</u>	<u>\$ 43,480,000</u>

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

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**17. INCOME TAXES (Continued)**

(c) Research and development deductions

The Company has claimed less research and development expenses for income tax purposes than has been reflected in the financial statements. These unclaimed expenses total approximately \$20,593,000 (2003 - \$20,593,000; 2002 - \$20,593,000) for Canadian federal and provincial income tax purposes. These are available without expiry to reduce future years' taxable income.

The potential future benefits associated with investment tax credits, tax losses, and unclaimed research and development expenses have not been reflected in these financial statements.

Current federal and provincial tax law in Canada includes provisions limiting the annual use of net operating loss and credit carryforwards in the event of certain defined changes in stock ownership. Accordingly, the annual use of the Company's net operating loss and credit carryforwards could be limited according to these provisions in the event of certain changes in stock ownership.

The provision for income taxes reported differs from the amount computed by applying the Canadian statutory rate to the income (loss) before income taxes for the following reasons:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Statutory income tax rate (Canada)	<u>36.5%</u>	<u>38.1%</u>	<u>40.9%</u>
Expected recovery of income tax	\$ (259,279)	\$ (1,320,197)	\$ (2,993,612)
Reversal of timing differences, the benefit of which are not recorded	(85,842)	(1,728)	929,491
Benefit of loss carryforward not recorded	-	1,318,799	2,057,214
Utilization of losses not recorded	(646,387)	-	-
Other permanent differences	<u>991,508</u>	<u>3,126</u>	<u>6,907</u>
Reported income tax provision	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

The source of accumulated timing differences and the related future income taxes as at March 31 are as follows:

	<u>2004</u>	<u>2003</u>
Accounting amortization in excess of tax	\$ 2,480,000	\$ 2,048,000
Research and development expenses not deducted for tax purposes	10,755,000	6,203,000
Losses available to offset future income taxes	15,468,000	13,190,000
Other	<u>6,000</u>	<u>96,000</u>
Future income tax assets before valuation allowance	28,709,000	21,537,000
Less valuation allowance	<u>(28,709,000)</u>	<u>(21,537,000)</u>
Future income taxes	<u>\$ -</u>	<u>\$ -</u>

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

**18. GUARANTEES, COMMITMENTS AND CONTINGENCIES**

*Guarantees*

Plaintree has entered into agreements that contain features which meet the definition of a guarantee under Canadian Accounting Guideline (AG) 14 and U.S. FASB Interpretation (FIN 45), "Guarantor's accounting and Disclosure Requirements for Guarantees including indirect Guarantees of Indebtedness or others". The pronouncements define a guarantee to be a contract that contingently requires Plaintree to make payments (either in cash, financial instruments, other assets, common shares of the Company or through the provision of services) to a third party based on changes in an underlying economic characteristic (such as interest rates or market value) that is related to an asset, a liability or an equity security of the other party. Plaintree has the following major type of guarantee that is subject to the disclosure requirements of AG 14 and FIN 45:

*Product warranties*

As part of the normal sale of product, Plaintree provides its customers with standard one year product warranties and separately priced extended warranties. These warranties extend for periods generally ranging from one to two years from the date of sale. The following summarizes the accrual of product warranties and deferred revenue that is recorded as part of current liabilities and deferred revenue in the accompanying consolidated balance sheet as at March 31, 2004:

	<u>2004</u>	<u>2003</u>
Balance at the beginning of the year	\$ 25,073	\$ 42,406
Payments made during the year	(14,257)	(42,406)
Warranties issued during the year	875	25,073
Balance at end of year	<u>\$ 11,691</u>	<u>\$ 25,073</u>

**19. RECONCILIATION TO UNITED STATES GAAP**

The financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles (CND GAAP). The following adjustments and/or additional disclosures would be required in order to present the financial statements in accordance with United States generally accepted accounting principles (US GAAP):

Under US GAAP, the net loss and loss per common share figures for the years ended March 31, 2004, 2003, and 2002 would be adjusted as follows:

	<b>Net loss</b>		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
Canadian GAAP loss	\$ (710,451)	\$ (3,463,266)	\$ (7,322,926)
Adjustment to development costs (a)	-	-	114,717
Adjustment to operating expenses relating to share issuances (b)	-	-	121,875
US GAAP loss	<u>\$ (710,451)</u>	<u>\$ (3,463,266)</u>	<u>\$ (7,086,334)</u>
Basic and diluted loss per share based on US GAAP	<u>(0.01)</u>	<u>\$ (0.04)</u>	<u>\$ (0.08)</u>

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

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**19. RECONCILIATION TO UNITED STATES GAAP (Continued)**

(a) *Accounting for development costs*

Under US GAAP, development costs would not be deferred but rather expensed as incurred. Accordingly under US GAAP, research and development expenses and net loss would have been adjusted by \$NIL (2003 - \$NIL; 2002 - \$114,717). The basic and diluted loss per share would be (\$0.01) (2003 - (\$0.04); 2002 - (\$0.08)).

(b) *Accounting for stock options and share issuances*

For the year ended March 31, 2001, compensation expense of \$121,875 would be recorded under US GAAP pursuant to FASB Interpretation No. 28, "Accounting for Stock Appreciation Rights and other Variable Stock Option or Award Plans" as a result of 250,000 shares issuable to an employee related to development of products. If the Company reported under US GAAP, this accrual would change at each reporting date until the final measurement date. Under Canadian GAAP, compensation expense is based upon the market price at the time of share issuance which resulted in compensation expense of \$77,500 for the year ended March 31, 2002. Under US GAAP, the date of share issuance becomes the measurement date and compensation expense is fixed at \$77,500, resulting in a reduction of the previous accrual under US GAAP of \$44,375 and a reversal of the Canadian accrual of \$77,500 for a total reduction of Canadian GAAP loss of \$121,875 in fiscal 2002 to arrive at US GAAP loss. Accordingly, under US GAAP, fiscal 2002 finance and administration expenses and net loss would have been reduced by \$121,875 (2001 - increased by \$121,875). The basic and diluted loss per share would be \$(0.08) (2001 - \$(0.06)).

(c) *Accounting for stock options and share issuances*

The Company applies Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees", and related interpretations, in accounting for its employee stock option plan. Accordingly, no compensation expense has been recognized for its stock-based compensation plan. Had compensation cost for the Company's employee stock option plan been determined based on the fair value at the grant date for awards under the plan, consistent with the methodology prescribed under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," the Company's net loss would have decreased/increased to the pro forma amounts indicated below:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Net loss as reported for US GAAP purposes	\$ (710,451)	\$ (3,463,266)	\$(7,086,334)
Estimated stock based compensation (costs) reversal	<u>(204,181)</u>	255,199	<u>(385,519)</u>
Pro forma net loss	<u>\$ (914,632)</u>	<u>\$ (3,208,067)</u>	<u>\$(7,471,853)</u>
Pro forma basic net loss per share	<u>(0.01)</u>	\$ (0.04)	\$ (0.09)

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

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**19. RECONCILIATION TO UNITED STATES GAAP (Continued)**

*(c) Accounting for stock options and share issuances (Continued)*

The weighted average fair value of all options granted during 2004 and 2002 was estimated as of the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Expected option life (years)	2.5	N/A	4.5
Volatility	184%	N/A	130%
Risk free interest rate	3.1	N/A	3.5%
Dividend yield	NIL	N/A	NIL

The weighted average fair value of grant, for stock options granted during 2004 and 2002 were \$0.09 and \$0.29 per option, respectively (none were granted in 2003).

*(d) Accounting for investment tax credits*

Under US GAAP, the benefit of investment tax credit receivable would be recorded as an income tax recovery, rather than as a reduction of research and development expense under Canadian GAAP. Accordingly, under US GAAP, research and development expense and the loss from operations would increase by \$NIL (2003 - \$39,754 to \$805,226 and \$3,322,640; 2002 - \$156,000 to \$2,250,823 and \$7,429,560) respectively. An income tax recovery of \$NIL (2003 - \$39,754; 2002 - \$156,000) would be reflected resulting in no change to the net loss.

*(e) Accounting for write-down of inventories*

Under US GAAP, the write-down of inventories would be recorded in cost of sales, rather than operating expenses. Accordingly, under US GAAP, cost of sales would increase and the gross margin and operating expenses would decrease by \$NIL (2003 - \$2,081,792 to \$2,281,162, (\$977,094), and \$2,305,792; 2002 - \$1,362,840 to \$2,018,094, (\$671,498) and \$6,602,062) respectively, resulting in no change to the net loss.

*(f) Recent United States Accounting Standards*

In December 2003, the FASB revised Interpretation No. 46 (FIN 46) "Consolidation of Variable Interest Entities". FIN 46 clarifies the application of Accounting Research Bulletin No. 51 "Consolidated Financial Statements" to those entities defined as "Variable Interest Entities" (more commonly referred to as special purpose entities) in which equity investors do not have the characteristics of a "controlling financial interest" or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 applies immediately to all Variable Interest Entities created after January 31, 2003, and by the beginning of the first interim or annual reporting period commencing after June 15, 2003 for Variable Interest Entities created prior to February 1, 2003. The standard has not had a significant effect on the financial position or results of operation.

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

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**19. RECONCILIATION TO UNITED STATES GAAP (Continued)**

*(f) Recent United States Accounting Standards (Continued)*

In December 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 148 "Accounting for Stock-Based Compensation - Transition and Disclosure - an amendment of FASB Statement No. 123" (SFAS 148) which amended the transitional provisions of SFAS 123 for entities choosing to recognize stock-based compensation under the fair value based method of SFAS 123, rather than electing to continue to follow the intrinsic value method of APB 25. Under SFAS 148, Plaintiff may adopt the recommendations of SFAS 148 either in its fiscal year beginning April 1, 2003 using certain implementation procedures or in its fiscal year beginning April 1, 2004 using different implementation procedures. The Company has elected to defer implementation.

In November 2002, the FASB issued FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" (FIN 45), which requires elaborating on the disclosures that must be made by a guarantor in financial statements about its obligations under certain guarantees. It also requires that a guarantor recognize, at the inception of certain types of guarantees, a liability for the fair value of the obligation undertaken in issuing the guarantee. The disclosure requirements of FIN 45 are effective for financial statements issued after December 15, 2002, and have been applied in the presentation of the accompanying consolidated financial statements. The recognition requirements of FIN 45 are applicable for guarantees issued or modified after December 31, 2002 and have not had an effect on the Company's financial position or results of operations.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" (SFAS 146), which is effective for exit or disposal activities initiated after December 31, 2002. SFAS 146 supersedes Emerging Issues Task Force ("EITF") Issue No. 94-3 "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in Restructuring)" (EITF 94-3). SFAS 146 requires that costs associated with an exit or disposal activity be recognized when the liability is incurred, whereas EITF 94-3 required recognition of a liability when an entity committed to an exit plan. Therefore, the effect of SFAS 146 will be to change the timing of recognition of certain liabilities. Plans initiated before December 31, 2002 continue to be accounted for under EITF 94-3. The adoption of SFS 146 has not had a material impact on its results of operations.

**PLAINTREE SYSTEMS INC.**  
**Notes to the Consolidated Financial Statements**  
**(in Canadian dollars)**

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**20. FINANCIAL INSTRUMENTS**

*Concentration of credit risk*

Financial instruments which potentially subject the Company to a concentration of credit risk consist principally of cash investments and trade receivables. The Company invests its excess cash in high-quality financial instruments. The Company has credit evaluation, approval and monitoring processes intended to mitigate potential credit risks. Anticipated bad debt loss has been provided for in the allowance for doubtful accounts.

*Interest risk*

The Company is financed through loans from related parties and a bank loan which bear interest at rates tied to the Canadian bank prime rate. Consequently, the Company is exposed to the risk of increases in the prime rate.

*Fair values*

The fair values of amounts due to related parties are not determinable as comparable arm's length debts are not available.

The carrying amounts for accounts receivable due from Partnership, bank loan and accounts payable and accrued liabilities approximate fair market value due to the short maturity of these instruments or the terms of the instrument.

**21. COMPARATIVE FIGURES**

Certain of the 2003 and 2002 comparative figures have been reclassified to conform to the current year financial statement presentation.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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*For the years ended March 31, 2004, 2003 and 2002*

**Date – July 30, 2004**

*The following discussion of the financial condition, changes in financial condition and results of operations of Plaintiff Systems Inc. ("Plaintree" or the "Corporation") for the years ended March 31, 2004, 2003 and 2002 should be read in conjunction with the audited Consolidated Financial Statements and Notes for the year ended March 31, 2004 ("Fiscal 2004 Statements"). Historical results of operations, percentage relationships and any trends that may be inferred therefrom are not necessarily indicative of the operating results of any future period. All amounts are in Canadian dollars, unless otherwise stated, and in accordance with Canadian generally accepted accounting principles ("GAAP").*

Caution Regarding Forward Looking Information

*This Management's Discussion and Analysis ("MD&A") of the Corporation, contains certain statements in this MD&A Report, to the extent not based on historical events, are forward-looking statements based on certain assumptions and reflect Plaintiff's current expectations. Forward-looking statements include, without limitation, statements evaluating market and general economic conditions in the preceding sections, and statements regarding growth strategy and future-oriented project revenue, costs and expenditures. Actual results could differ materially from those projected and should not be relied upon as a prediction of future events. A variety of inherent risks, uncertainties and factors, many of which are beyond Plaintiff's control, affect the operations, performance and results of Plaintiff and its business, and could cause actual results to differ materially from current expectations of estimated or anticipated events or results. Some of these risks, uncertainties and factors include the impact or unanticipated impact of: companies evaluating Plaintiff's products delaying purchase decisions; current, pending and proposed legislative or regulatory developments in the jurisdictions where Plaintiff operates; change in tax laws; political conditions and developments; intensifying competition from established competitors and new entrants in the FSO industry; technological change; currency value fluctuation; general economic conditions worldwide, as well as in China; Plaintiff's success in developing and introducing new products and services, expanding existing distribution channels, developing new distribution channels and realizing increased revenue from these channels. This list is not exhaustive of the factors that may affect any of Plaintiff's forward-looking statements. Plaintiff undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made, or to reflect the occurrence of unanticipated events, whether as a result of new information, future events or results otherwise. Readers are cautioned not to put undue reliance on forward-looking statements. Readers should also carefully review the risks concerning the business of the Corporation and the industries in which it operates generally described in the documents filed from time to time with Canadian securities regulatory authorities and the United States Securities and Exchange Commission (SEC).*

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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### About Plaintree

Located in Arnprior, Ontario, Plaintree develops and manufactures the WAVEBRIDGE series of Free Space Optical wireless links using Class 1, eye-safe LED technology providing high-speed network connections for Cable companies, ISPs, traditional Telco's, GSM or cellular operators, airports and campus networks. Acting as a replacement for cable, fiber or radio frequency systems, the WAVEBRIDGE links offer broadband access with no spectrum interference problems, and same day installation for rapid network deployment. Plaintree also supports and manufactures its existing lines of robust and user friendly network switches.

### Overview

Once again, there was limited growth potential in the telecommunications and wireless industry during the fiscal year ended March 31, 2004 ("fiscal 2004"). However, interest in Plaintree's technology by potential users has continued to grow since the spring of 2003.

In the subsequent events section of the management's discussion and analysis of the Corporation for the year ended March 31, 2003 ("fiscal 2003"), Plaintree indicated serious interest by parties from Japan, England and Korea. To date the Ministry of Defence (UK) and Phi Co Ltd (Japan) both have ordered evaluation units, the evaluations have gone very well and their interest level remains high.

During fiscal 2004, a number of new customers began evaluating Plaintree's products, including Associated Press, Metropark Communications and Avaya Networks, (Lucent's IP Telephone and Enterprise switching Corporation). These companies have reported excellent test results.

The largest wireless integrator in Poland has purchased Plaintree's FSO equipment and has successfully promoted the product and Plaintree has received an indication that there may be additional customer orders to follow in the near future. Orascom (the largest Middle Eastern GSM Company) is in the final product testing stages with Plaintree's FSO equipment and has indicated that a large volume order may follow in the future. Other companies evaluating our product are located in Serbia, Czech Republic and the US.

Towards the end of fiscal 2004, Plaintree was approached by a number of Multiple Service Operators (MSO) in North America that indicated serious interest in Plaintree's FSO product. These MSOs are actually the traditional Cable providers that are now moving to converge voice, video and data into one connection. At their request, Plaintree designed a specific FSO product to be mounted on the actual strand between telephone poles to allow the MSO to connect this strand to individual customers locations.

A key evaluation link installed for one of these MSOs has been operating at 350 Meters for the past three months in an area prone to very high humidity, rain and fog. The link has been performing with over 99.99999% reliability and has surpassed customer expectations. The main decision point expressed by these MSOs is that Plaintree's FSO product is LED ensuring unconditional eye-safety, a wide beam and inexpensive price.

**Plaintree cautions readers that an expression of interest from a customer does not necessarily lead to a firm order for products.**

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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Throughout fiscal 2004, Plaintiffree has continued its policy of fiscal conservatism maintaining its streamlined workforce while recruiting two sales professionals to manage the growing volume of product inquiries Plaintiffree is now receiving.

### Selected Financial Information

The Corporation's consolidated financial statements are stated in Canadian dollars and are prepared in accordance with GAAP, which also conform in all material respects with accounting principles generally accepted in the United States, except as disclosed in note 19 to the Fiscal 2004 Statements.

As stated in Note 1 to the Fiscal 2004 Statements, the financial statements have been prepared assuming that the Corporation will continue as a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. However, there is substantial doubt about the Corporation's ability to continue as a going concern because of the Corporation's losses during the past year of \$710,451, a working capital deficit, and an accumulated deficit of \$98,730,202 as at March 31, 2004. The Corporation's continued existence is dependent upon its ability to raise additional capital, to increase sales and ultimately become profitable.

The Corporation believes that future funding and certain sales-related efforts will provide sufficient cash flow for it to continue as a going concern in its present form. However, there can be no assurances that the Corporation will achieve such results and to date, the Corporation has not secured such funding either through an equity investment or strategic partnership.

The following table sets forth selected financial information from the Corporation's Fiscal 2004 Statements.

### Statement of Operations Data

(\$000s, except per share data)

	Fiscal Year <u>2004</u>	Fiscal Year <u>2003</u>	Fiscal Year <u>2002</u>
Revenue	\$259	\$1,304	\$1,347
Operating loss	(1,261)	(3,283)	(7,273)
Net loss	(711)	(3,463)	(7,323)
Basic and diluted loss per share	\$(0.01)	\$(0.04)	\$(0.08)

### Balance Sheet Data

(\$000s)

	At March 31, <u>2004</u>	At March 31, <u>2003</u>	At March 31, <u>2002</u>
Total assets	\$17,204	\$540	\$3,711
Total liabilities	17,744	1,446	1,153
Long-term liabilities	nil	nil	nil
Cash dividends declared per share	nil	nil	nil

In July 2003 the Corporation acquired a 49% interest in a general manufacturing partnership ("Partnership") for \$20,000,000. The acquisition was financed through the credit facility (bank

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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loan) referred to in Note 7 to the Fiscal 2004 Statements. This Partnership interest was reduced to \$16,000,000 by March 31, 2004, as a result of distributions from the Partnership of \$4,000,000

during fiscal 2004. The Corporation is required to pay to the bank to repay the loan, 94.5% of the cash distributions it received from the Partnership until the bank loan is paid in full. In fiscal 2004 the Corporation reported \$845,730 of Partnership income from distributions received from the Partnership. Also recorded was Bank loan interest of \$491,392 and Other partnership related expenses of \$121,382, which is made up of Financing expense (\$59,217) and Guarantee fees (\$62,165). As of March 31, 2004, a quarterly Partnership income allocation of \$69,283 was due and payable and recorded as a receivable on the balance sheet.

### **Critical accounting estimates**

The following critical accounting policies and significant estimates are used in the preparation of our consolidated financial statements:

#### Revenue recognition and warranties

Revenue from product sales is recorded on shipment provided evidence of an arrangement exists and collection is probable. In addition, a provision for potential warranty claims is recorded at the time of sale, based on warranty terms and prior claims experience. Extended warranty contracts are sold separately from the product and the associated revenue is recognized over the term of the agreement. Service revenue is recognized when the service is performed. Deferred revenue arises when extended warranty contracts are paid in advance.

#### Equity accounting for Partnership

The Corporation has a 49% interest in a partnership. The Corporation is accounting for the partnership using the equity method whereby net partnership income (loss) increases (decreases) the investment and cash distributions reduce the investment

#### Research and development costs

Research costs are expensed as incurred. Development costs are deferred once technical feasibility has been established and all criteria for deferral under GAAP are met. Such costs are amortized, commencing when the product is released, over the lesser of the expected life of the related product and three years.

#### Inventories

Finished goods are valued at the lower of cost (first-in, first-out) and net realizable value. Work in process and raw materials are valued at the lower of cost and replacement cost. Provisions for excess and obsolete inventory are made in the period in which management determines the inventory to be excess or obsolete.

#### Use of accounting estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires the Corporation's management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods presented. Actual results could differ from the estimates made by management.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Stock option plan

The Corporation has implemented a stock option plan as described in Note 11 to the Fiscal 2004 Statements. Effective April 1, 2002, the Corporation adopted the new recommendations of section 3870 of the CICA Handbook ("CICA 3870") with respect to stock-based compensation. The

Company records an expense for employee options only when the exercise price of the option is lower than the market price of the stock on the date of grant. To date, no employee option grants have met the criteria for expense recognition. The Corporation has disclosed in Note 11 to the Fiscal 2004 Statements the pro forma effect of the options on the net loss as if they were valued using a fair value based method.

The Corporation uses the fair value based method to measure stock-based compensation for all stock-based awards made to non-employees, and for direct awards made to directors and employees of common shares, stock appreciation rights, and awards that result from settlement for cash or other assets. Awards that the Corporation has the ability to settle in shares are recorded as equity whereas awards that the Corporation is required to or has a practice of settling in cash are recorded as liabilities.

### Results of Operations

(\$000s, except per share and % amounts)

	Fiscal Year			Change from Fiscal	
	2004	2003	2002	2003 to 2004	2002 to 2003
Revenue	\$259	\$1,304	\$1,347	\$(1,045)	\$(43)
Cost of revenue	36	199	656	(163)	(457)
Gross margin	223	1,105	691	(882)	414
	86.2%	84.7%	51.3%		
<i>Operating expenses:</i>					
Sales & marketing	454	756	2,794	(302)	(2,038)
Finance & administration	606	583	970	23	(387)
Research & development	424	766	2,095	(342)	(1,329)
Restructuring	-	201	-	(201)	201
Write-down of inventory	-	2,082	1,363	(2,082)	719
Write-down of intangibles	-	-	742	-	(742)
	1,484	4,388	7,965	(2,904)	(3,576)
Loss from operations	(1,261)	(3,283)	(7,273)	2,022	3,990
Interest (expense) income	(68)	(55)	65	(13)	(120)
Other income (loss)	385	(125)	(115)	510	(10)
Partnership income	846	-	-	846	-
Other partnership expenses	(121)	-	-	(121)	-
Bank loan interest	(492)	-	-	(492)	-
Net loss	\$(711)	\$(3,463)	\$(7,323)	\$2,752	\$3,860
Basic and diluted loss per share	\$(0.01)	\$(0.04)	\$(0.08)	\$0.03	\$0.04

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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### Revenues

#### Product and service revenue

Total product and service revenue for fiscal 2004 was \$258,739 as compared to \$1,304,068 in fiscal 2003 and \$1,071,596 in fiscal 2002. Product and service revenue decreased from fiscal 2003 to fiscal 2004 by \$1,045,329 primarily due to continued weak demand for telecommunications and wireless products resulting in revenues being below expectations. It is important to note that the majority of fiscal 2004 revenues were the result of the sale of evaluation units to potential repeat customers such as Rapid IR, PHI CO and Gesto. There was no Management service revenue in fiscal 2004 or fiscal 2003. \$275,000 of Management service revenue was recorded in fiscal 2002.

### Gross Margin

Gross margin from product and service revenue for fiscal 2004 was 86.2% compared to 84.7% in fiscal 2003 and 51.3% in fiscal 2002. In fiscal 2004 and 2003, the high gross margin was a result of the sale of legacy products that had been previously written off from inventory. The Corporation expects that its current and future WAVEBRIDGE high speed optical wireless products will represent a greater portion of the Corporation's revenues in the future and that gross margins will return to the range of 30-50% as experienced in fiscal 2002.

### Operating Expenses

#### Sales and marketing expenses

Sales and marketing expenses were \$453,718, \$756,414 and \$2,794,261 in fiscal 2004, 2003 and 2002, respectively. These expenses consisted primarily of personnel and related costs associated with the Corporation's sales and marketing departments, which include sales commissions, advertising, travel, trade shows and other promotional activities.

The decrease of \$302,696 in sales and marketing expenses from fiscal 2003 to fiscal 2004 and the decrease of \$2,037,847 from fiscal 2002 to fiscal 2003 were due to major cutbacks in the international sales force and marketing initiatives in response to the decreased revenue levels experienced by the Corporation.

#### Finance and administration expenses

Finance and administrative expenses were \$605,764, \$583,303 and \$970,440, in fiscal 2004, 2003 and 2002, respectively. Finance and administration expenses consist primarily of costs associated with managing the Corporation's finances, which include financial staff, legal and audit activities as well as the amortization of capital assets. During fiscal 2004, finance and administrative expenses also included the amortization of deferred charges of \$164,368 and amortization of the fair value assigned to the equity component of convertible debentures of \$91,000 (see Note 5 and Note 8 to the fiscal 2004 financial statements). These additional amortization costs totaling \$255,358 mainly related to the fair value of stock options granted and the fair value assigned to the equity component of convertible debentures, based on the application of the Black-Scholes pricing model.

Finance and administrative expense increased by \$22,461 during fiscal 2004 as compared to fiscal 2003. Prior to the amortization charge of \$255,358 stated above, finance and

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

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administration expenses decreased from fiscal 2003 to fiscal 2004 by \$232,897 which was due to the reduction in personnel and other finance and administrative expenses. The decrease of \$387,137 in finance and administration expenses from \$970,440 in fiscal 2002 to 583,303 in fiscal 2003 was primarily attributable to a reduction in personnel.

### **Research and development expenses**

Research and development expenses were \$424,431, \$765,472 and \$2,094,823, in fiscal 2004, 2003 and 2002, respectively. Research and development expenditures consist primarily of software and hardware engineering personnel expenses, subcontracted research and development costs and costs associated with equipment and facilities.

The decrease in research and development expenses by \$341,041 from fiscal 2003 to fiscal 2004 and the decrease of \$1,329,351 from fiscal 2002 to fiscal 2003 were due to expense reductions predominately related to the reduction in personnel.

### **Write-down of Inventory**

There was no inventory write-down during fiscal 2004. During fiscal 2003, after reviewing the remaining switch and certain WAVEBRIDGE product inventory, management determined this inventory should be written down to reflect its estimated recoverable values resulting from the extensive redesign of the product line. This resulted in a \$2,081,792 charge against income in fiscal 2003. Accordingly, the revised WAVEBRIDGE product line represents 100% of the inventory as at March 31, 2003. During fiscal 2002, there was a similar write-down of obsolete inventory in the amount of \$1,362,840.

### **Write-down of Intangible assets**

During fiscal 2002 the Corporation wrote off intangible assets in the amount of \$742,538.

### **Interest Income (Expense) and Other**

Combined Interest and Other Income went from a loss of \$180,380 in fiscal 2003 to an income gain of \$317,385 in fiscal 2004. This \$497,765 positive change in Interest Income and Other was primarily due to the \$371,395 gain realized during fiscal 2004 on the settlement of claims and debts of the unsecured creditors of the Corporation pursuant to the BIA proposal completed. Also, no loss on disposal of capital assets was recorded during fiscal 2004 as compared to the loss recorded during fiscal 2003 of \$113,805.

Combined Interest and Other Income increased from a loss in fiscal 2002 of \$49,366 to a loss in fiscal 2003 of \$180,380. This increase was primarily due to the loss on disposal of capital assets, the effect of lower cash balances and an increase in interest expense incurred on lease arrears and credit facilities

### **Partnership income, Other partnership related expenses and Bank loan interest**

In fiscal 2004 the Corporation recorded Partnership income allocations of \$845,730. Also recorded was Bank loan interest of \$491,392 and other partnership related expenses of \$121,382, which is made up of Financing expense (\$59,217) and Guarantee fees (\$62,165).

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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### Net Loss

The net loss for fiscal 2004 was \$710,451 or \$0.01 per share as compared to a net loss of \$3,463,266 or \$0.04 per share in fiscal 2003 and \$7,322,926 or \$0.08 per share in fiscal 2002.

The fiscal 2004 net loss was significantly lower than experienced in fiscal 2003 largely due to the one time restructuring and inventory write-down expenses recorded in 2003 as well as management's aggressive cost cutting measures which have reduced Sales and Marketing and Research and Development expenses.

Similar cost cutting occurred in fiscal 2002 which resulted in the decrease in the net loss experienced from fiscal 2002 to fiscal 2003.

### Quarterly Results

The following table sets out selected unaudited consolidated financial information for each quarter in fiscal 2004 and fiscal 2003.

Quarters ended (unaudited, in \$000s except per share amounts)	Fiscal 2004				Fiscal 2003			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenue	\$122	\$52	\$82	\$3	\$528	\$584	\$114	\$78
Operating loss	(219)	(190)	(342)	(510)	(283)	(100)	(388)	(2,512)
Net inc (loss)	(229)	272	(301)	(453)	(285)	(1,592)	(972)	(614)
Basic and diluted loss per share	\$(0.00)	\$0.00	\$(0.00)	\$(0.01)	\$(0.00)	\$(0.02)	\$(0.01)	\$(0.01)

### Fourth quarter of fiscal 2004

During the fourth quarter of fiscal 2004 revenue was \$2,620 and the net loss was \$452,310. Expenses increased in the fourth quarter of fiscal 2004 as compared to the third quarter mainly as a result of the amortization of deferred charges of \$164,368 and amortization of the fair value assigned to the equity component of convertible debentures of \$91,000 (see Note 5 and Note 8 to the fiscal 2004 statements). These additional amortization costs totaling \$255,358 mainly related to the fair value of stock options granted and the fair value assigned to the equity component of convertible debentures, based on the application of the Black-Scholes pricing model.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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### Liquidity and Capital Resources

(\$000s)	Fiscal Year		Change from
	<u>2004</u>	<u>2003</u>	<u>Fiscal</u> <u>2003 to 2004</u>
Cash	\$396	\$42	\$354
Working Capital	(16,737)	(1,169)	(15,568)
<i>Net cash provided by (used in):</i>			
Operating activities	(1,043)	(626)	(417)
Investing activities	(16,107)	35	(16,142)
Financing activities	17,503	200	17,303

#### Cash

As at March 31, 2004, the Corporation held \$395,536 in cash, an increase of \$353,388 from March 31, 2003.

#### Working Capital

Working capital represents current assets less current liabilities. As at March 31, 2004, the Corporation had a working capital deficit of \$16,736,693 as compared to a working capital deficit of \$1,169,341 at March 31, 2003. The increase in the working capital deficit was primarily a result of the bank loan of \$20,300,000 obtained by the Corporation in July, 2003 to fund its investment in the Partnership less \$4,000,000 paid back on the loan during the year. Distributions from the partnership are being used to repay the Bank loan.

#### Cash used in Operating activities

Cash used in operating activities for fiscal 2004 was \$1,042,958, an increase of \$416,841 compared to the prior fiscal year. This increase was mainly attributable to the cash used to reduce accounts payable and accrued liabilities during fiscal 2004 relating to restructuring and relating to the payment to settle claims and debts of the unsecured creditors of the Corporation pursuant to the BIA proposal.

#### Cash used in Investing activities

Cash used in investing activities for fiscal 2004 was \$16,107,011, an increase of \$16,142,582 compared to the prior fiscal year. This increase was due to the Corporation's investment in the Partnership of \$20,000,000 partially offset by Partnership distributions of \$4,000,000 repaid by Plaintiff during fiscal 2004.

#### Cash provided by Financing activities

Cash provided by financing activities for fiscal 2004 was \$17,503,357, an increase of \$17,303,494 compared to the prior fiscal year. This increase was due to the bank loan of \$20,300,000 for the Partnership investment, partially offset by a payment of \$4,000,000 from the Partnership distribution which was used to reduce the bank loan by \$4,000,000. This was partially offset by the Convertible Debentures and the loan financing provided by Targa during the year in the amounts of \$900,000 and \$500,000, respectively.

Despite the financing obtained during fiscal 2004, the Corporation will require an additional capital infusion in order to continue to operate in its present form and develop its business. In this regard, management continues to investigate other sources of financing.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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### Related Party Transactions

#### December 16, 2003 - Convertible Debentures

On December 16, 2003, the Corporation completed a placement of secured convertible debentures ("Debentures") having a principal value of \$900,000. Targa, the largest shareholder of the Corporation, purchased all of the Debentures. Of the \$900,000 proceeds from the sale of the Debentures, \$710,386 was utilized to retire outstanding credit facilities granted by Targa or its affiliates. The balance of the Debenture proceeds, \$189,614, was satisfied by a cash payment by Targa to the Corporation. The due date for the payment of the Debentures is December 16, 2005. The Debentures are non-interest bearing until the due date and thereafter will bear 10% interest per annum until paid in full. Debentures are secured by a general security agreement over the assets of the Corporation. At anytime while the Debentures are outstanding, Targa has the right to convert the amounts outstanding thereunder into Plaintiff common shares at a conversion price of \$0.115. In the event that the full amount of the Debentures are converted, Targa will be issued 7,826,087 Plaintiff common shares. The Corporation has the right to repay the Debenture at any time on 30 days prior notice, subject to Targa's right to convert the Debentures into Plaintiff common shares.

#### November 19, 2003 - Loan

On November 19, 2003, the board of the Corporation agreed to accept a loan ("Loan") from Targa, its largest shareholder, of \$500,000 (net of related fees). The funds being advanced by Targa were the proceeds (net of related fees) received by Targa from the sale of a portion of its shares in Plaintiff. The Loan is payable on demand and earns interest at a rate of prime plus 5% per annum. As a condition of the Loan, Plaintiff agreed to pay for any agency fees incurred by Targa as a result of the sale of the Plaintiff shares. The Loan is also secured by an already existing general security agreement over Plaintiff's assets. As part of the \$500,000 demand loan arrangement with Targa, key shareholders of Targa, Bill and David Watson, who are also directors and officers of the Corporation, each received a total of 2,500,000 options exercisable at a share price of \$0.105. The options expire on November 19, 2008. The fair value of this option grant was recorded as a financing cost and is being amortized over one year. In June 2004, David Watson agreed to return to the Corporation for cancellation 300,000 of the 2,500,000 options granted to him as noted above.

On December 4, 2003, the Loan was reduced by a cash payment of \$189,614 from Targa in settlement of the purchase of Debentures referred to in Note 8 of the Fiscal 2004 Statements. As of March 31, 2004, the total Loan amount outstanding was \$318,781 (\$310,386 principle plus \$8,395 in accumulated interest).

#### Leased facilities

Until March 31, 2003, the Corporation leased facilities from a company controlled by Targa, the Corporation's largest shareholder. Lease arrears including interest of \$35,705 owing to this related party amounted to \$254,513. In fiscal 2003, this related party entered into a forbearance agreement with the Corporation whereby the Corporation agreed to repay the amounts owing and the related party was provided with a security interest in the form of a mortgage on the property owned by the Company. As a result of the BIA proposal to creditors, the forbearance agreement is now in default and the amounts owing are due and payable.

#### Salary deferrals by senior officers

As of April 1, 2002, the Corporation's senior officers have agreed to defer payment of consulting fees and salaries payable. These fees and salaries to senior officers of the Corporation, who are also majority shareholders of Targa, amounted to \$383,847, plus interest charges of \$21,880 for a total payable of \$405,727.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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### Prior credit facility with related party

Prior to the issuance of the Convertible Debentures referenced above, the Corporation had in place an operating credit facility with a Company controlled by Targa. This facility was secured by a general security agreement covering all assets of the Corporation and expired on March 25, 2003, at which time the principle and interest accrued was due and payable. Subsequent to March 31, 2003, a new \$225,000 additional credit line was extended by Targa to the Corporation at 2% above the prime rate charged by the Corporation's bank and secured by all of the assets of the Corporation. Both of these credit facilities were replaced by the Convertible Debentures.

### **Off-Balance Sheet Arrangement**

#### Investment in Partnership and related Bank Loan

On July 15, 2003, the Corporation completed the acquisition of a 49% minority interest (the "Partnership Interest") for \$20,000,000 in an unrelated manufacturing partnership doing business in Canada. Plaintree will not be involved in the day to day management of the partnership. In a related transaction, Plaintree obtained a non-recourse credit facility (the "Credit Facility") from a Canadian chartered bank in the amount of \$20,300,000 to fund its required \$20,000,000 capital contribution to the Partnership, to cover related acquisition expenses and to fund its payment obligations under the proposal approved by its creditors in July 2003. The only security for the Credit Facility will be the Partnership Interest itself and the Credit Facility will be repaid only from cash distributions received from the Partnership and not from Plaintree's general working capital. The credit facility is guaranteed by the Partnership. In order to secure the guarantee, Plaintree is required to pay 1% of cash distributions from its Partnership interest up to a maximum of \$200,000 to the Partnership. The Corporation anticipates generating approximately \$1,100,000 of cash flow from this investment over a five year period, following which the Partnership Interest will be terminated. In the event that the partnership is unable to execute on its business plan, the availability of anticipated cash flow will be diminished. During fiscal 2004, Partnership distributions in the amount of \$4,000,000 were received, resulting in the credit facility being paid down by the same amount.

As part of these transactions, Plaintree completed an internal restructuring of its operations, transferring primarily all of its business, its tangible assets (other than its intellectual property and its Partnership Interest) to a newly incorporated wholly-owned subsidiary of Plaintree, 4178611 Canada Inc. ("Newco"). Newco has also assumed all of the liabilities of Plaintree, except for its liabilities to Targa Electronics Systems Inc. pursuant to various credit facilities and its liabilities under the Credit Facility. Newco will continue to carry on the former business of Plaintree. This transfer was approved by the shareholders of Plaintree at its Annual and Special Meeting held on May 6, 2003.

### **Other Contracts and Commitments**

#### Product warranties

As part of the normal sale of product, Plaintree provides its customers with standard one year product warranties and separately priced extended warranties as stated in Note 18 to the Audited Consolidated Financial Statements. These warranties extend for periods generally ranging from one to two years from the date of sale.

#### Completion of Proposal to Creditors

On July 31, 2003, a certificate of full performance was received confirming that the Corporation had fulfilled its commitment to all creditors as agreed to under the formal proposal to creditors

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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and the Corporation is now released from the protection of the BIA (Bankruptcy and Insolvency Act).

### TSX Review

On July 9, 2003, the TSX (Toronto Stock Exchange) announced it was reviewing Plaintree's TSX listing eligibility for the following reasons: (1) Bankruptcy proceedings; (2) Financial condition and operating results; and (3) Payment of TSX listing fees. On July 24, 2003, David Watson and fellow director, Jerry Vickers attended a meeting of the TSX Listing Committee and explained that

Plaintree had obtained the required funding necessary to satisfy its obligations under its Second Creditor Proposal and as such would be able to successfully emerge from its BIA restructuring and that fees owed to the TSX were under the jurisdiction of the BIA and were therefore to be paid. The representatives of the Corporation then presented sales forecasts, cash flow projections and preliminary financial statements for fiscal 2004. After this presentation, the TSX Listing Committee agreed to defer its decision on Plaintree's listing eligibility until November 28, 2003, at which point the performance of the Corporation would again reviewed.

On November 27, 2003, the Corporation met with the TSX Listing Committee and on December 2, 2003 the committee informed the Corporation that Plaintree had regained compliance with all relevant sections and requirements under the TSX Company Listing Manual. Despite the favourable TSX decision above, the Corporation will require an infusion of additional capital in order to continue to operate in its present form and develop its business. In this regard, management continues to investigate other sources of financing.

### **Changes in accounting policies**

#### Stock-based compensation and other stock-based payments

Effective April 1, 2004, the Corporation adopted the fair value provisions in Handbook Section 3870, Stock-based compensation and other stock-based payments, on a retroactive basis. The recommendation requires the use of a fair value method for all awards to both employees and non-employees. Using the Black-Scholes option pricing model and amortizing the fair value on a straight-line basis, over the vesting period, the Corporation expects the following:

- increase in deficit, end of year fiscal 2003 by approximately \$nil
- increase in compensation cost during fiscal 2004 by approximately \$195,498

### **Summary of Outstanding Share Data**

As at March 31, 2004 the following equity instruments were issued and outstanding:

Common Shares of 90,221,634

Warrants of 3,911,765 - each convertible into one Common Share at a conversion price of \$0.51 with an expiry date of January 8, 2005.

Stock Options of 8,630,000 - exercisable to receive the same number of Common Shares at exercise prices ranging from \$.105 to \$2.35 with the latest expiry being November 19, 2008. At the September 16, 2004 Annual General and Special Meeting of Shareholders, the Corporation is presenting a resolution for approval, to amend the Stock Option Plan in order to increase the maximum number of options which may be granted under the Stock Option Plan from 8,600,000 to 12,000,000.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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Convertible Debenture of \$900,000 – a Secured Convertible Debenture with a principal value of \$900,000 is convertible into 7,826,087 Common Shares. The due date for the payment of the Debentures is December 16, 2005. The Debentures are non-interest bearing until the due date and thereafter will bear 10% interest per annum until paid in full. At anytime while the Debentures are outstanding, Targa has the right to convert the amounts outstanding under the Debenture into Plaintiff common shares at a conversion price of \$0.115.

## **PLAINTREE SYSTEMS INC.**

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### **Board of Directors**

W. David Watson II  
President & Chief Executive Officer

William D. Watson  
Chairman of the Board

Robert E. Shea  
Chairman, Shea Financial Group

Jerry Vickers  
Financial Advisor

Girvan L. Patterson  
CEO, Motepoint Inc.

Senator John Buchanan  
Senator

### **Executives and Officers**

W. David Watson II  
President & Chief Executive Officer

Lynn E. Saunders  
Vice President, Operations

Jason Lee  
Vice President, Business Development

### **Principal Office**

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Arnprior, Ontario, Canada K7S 2X1  
Telephone: (613) 623-3434  
Fax: (613) 623-4647

Website: <http://www.plaintree.com>

### **Auditors**

Deloitte & Touche, Ottawa, Ontario, Canada

### **Transfer Agent**

Computershare  
100 University Ave., 8<sup>th</sup> Floor  
Toronto, Ontario, Canada M5J 2Y1

### **Corporate Secretary**

Gary Jessop  
Partner  
Blake, Cassels & Graydon, LLP  
Ottawa, Ontario, Canada

### **Legal Counsel**

Blake, Cassels & Graydon, LLP  
Ottawa, Ontario, Canada

### **Stock Exchange Listings**

Toronto Stock Exchange: LAN  
NASDAQ OTC BB: LANPF