

WESTPORT INNOVATIONS INC
Form SUPPL
June 01, 2016
Table of Contents

Filed pursuant to General
Instruction II.L. of Form F-10;
File No. 333-205869

No securities regulatory authority has expressed an opinion about these securities and it is an offence to claim otherwise.

*This prospectus supplement (the **Prospectus Supplement**), together with the accompanying short form base shelf prospectus dated August 6, 2015 to which it relates, as amended or supplemented (the **Prospectus**), and each document incorporated by reference into the Prospectus constitutes a public offering of these securities only in those jurisdictions where they may be lawfully offered for sale and therein only by persons permitted to sell such securities.*

Information has been incorporated by reference in the Prospectus from documents filed with securities commissions or similar authorities in Canada. Copies of the documents incorporated by reference into the Prospectus may be obtained on request without charge from the Vice President, Investor Relations & Communications of Westport Innovations Inc. at 101 1750 West 75th Avenue, Vancouver, British Columbia V6P 6G2, telephone (604) 718-2046 and are also available electronically at www.sedar.com. See Documents Incorporated by Reference in this Prospectus Supplement.

**PROSPECTUS SUPPLEMENT TO THE SHORT FORM
BASE SHELF PROSPECTUS DATED AUGUST 6, 2015**

New Issue

May 31, 2016

U.S.\$17,500,000

9.0% Convertible Unsecured Notes

Due June 1, 2021

This Prospectus Supplement is being filed with the securities regulatory authority in each of the provinces of Canada, except Québec, in order to qualify the distribution (the **Offering**) of an aggregate principal amount of U.S.\$17,500,000 9.0% convertible unsecured notes of Westport Innovations Inc. (**Westport** or the **Corporation**) due June 1, 2021 (the **Notes**). The Notes are being issued to one or more purchasers, as directed by Pangaea Two Management, LP (such purchaser being referred to herein as **Cartesian**), pursuant to an investment agreement entered into on January 11, 2016, between Westport and Cartesian, and amended on March 6, 2016 (the **Investment Agreement**). See Recent Developments .

The Notes will bear interest at the rate of 9.0% per annum, payable in cash annually in arrears on December 31 in each year commencing December 31, 2016 and, unless earlier converted, the Note will mature on June 1, 2021 (the **Maturity Date**).

The Notes (including the accrued but unpaid interest thereon) are convertible into common shares in the capital of the Corporation (**Common Shares**), in whole or in part, at Cartesian's option, at any time following the twelve-month anniversary of the Closing Date (as defined herein) and prior to 4:00 p.m. (Vancouver time) on the Business Day (as defined in Schedule A hereto) immediately preceding the Maturity Date at the Valuation Price (as defined in Schedule A hereto) per Common Share, subject to adjustment in certain circumstances (each a **Conversion Price**). The number of Common Shares to be issued upon such a conversion shall be equal to the quotient obtained by dividing the principal amount outstanding under the Notes that Cartesian elects to convert (plus the amount of accrued but unpaid interest applicable to such principal amount being converted) by the applicable Conversion Price, provided that the aggregate of all conversions by Cartesian shall not result in the issuance of greater than 16,000,000 Common Shares (subject to adjustment in certain circumstances).

Table of Contents

If a Conversion Event (as defined in Schedule A hereto) shall have occurred, then Westport shall prior to the fifth Business Day following such Conversion Event have the option to convert, as a whole or in part, up to U.S.\$8,750,000 principal amount (including the accrued but unpaid interest thereon) of the Notes into Common Shares from the day that is twenty four calendar months after the Closing Date and at any time or from time to time thereafter prior to 4:00 p.m. (Vancouver time) on the Business Day immediately preceding the Maturity Date, at the Conversion Price, subject to adjustment in certain circumstances. The number of Common Shares to be issued upon such a conversion shall be equal to the quotient obtained by dividing the principal amount outstanding under the Notes that Westport elects to convert (plus all accrued but unpaid interest on the principal amount being converted) by the applicable Conversion Price, provided that the aggregate of all conversions by the Company shall not result in the conversion of greater than U.S.\$8,750,000 principal amount of the Notes.

The Notes will be our unsecured obligation and will rank equal in right of payment with our existing and future unsecured debt, and will be senior in right of payment to any future debt that is expressly subordinated to the Notes. The Notes will be effectively subordinated to any secured debt that we have incurred or may incur to the extent of the value of the assets securing such debt. See Description of the Notes .

The Notes will not be listed on any national securities exchange. Currently there is no public market for the Notes. Our Common Shares are listed for trading on the NASDAQ under the symbol WPRT , and on the Toronto Stock Exchange (the TSX) under the trading symbol WPT . The Common Shares issuable on the conversion of the Notes will be listed on NASDAQ. The TSX has conditionally approved the listing of the Common Shares issuable on the conversion of the Notes. Listing on the TSX is subject to our fulfillment of all of the listing requirements of the TSX on or before June 8, 2016. On May 27, 2016, the closing price of the Common Shares on NASDAQ and the TSX was U.S.\$2.06 and \$2.70, respectively.

An investment in the Notes offered by this Prospectus Supplement is speculative and involves a high degree of risk. The risk factors referred to under Risk Factors beginning on page S-12 in this Prospectus Supplement, in the accompanying Prospectus beginning on page 7 and in the documents incorporated by reference herein and therein, should be reviewed carefully.

The Notes offered under this Prospectus Supplement and the accompanying Prospectus are to be taken up, if at all, on a date not later than 42 days after the date of this Prospectus Supplement. See Plan of Distribution for additional information.

There is currently no market through which the Notes may be sold and Cartesian may not be able to resell the Notes purchased under this Prospectus Supplement. This may affect the pricing of the Notes in the secondary market, the transparency and availability of trading prices, the liquidity of the Notes and the extent of issuer regulation. See Risk Factors .

We are permitted, as a Canadian issuer, under the multi-jurisdictional disclosure system adopted by the United States and Canada (MJDS), to prepare this Prospectus Supplement and the Prospectus in accordance with Canadian disclosure requirements. You should be aware that such requirements are different from those of the United States. We have prepared our annual financial statements as at December 31, 2015 and 2014 and for the years ended December 31, 2015, 2014 and 2013 in accordance with United States generally accepted accounting principles (U.S. GAAP).

Cartesian should be aware that the acquisition of the Notes may have tax consequences both in the United States and in Canada. Cartesian should consult its own tax advisors prior to deciding to purchase the Notes.

The enforcement by Cartesian of civil liabilities under United States federal securities laws may be affected adversely by the fact that we are incorporated or organized under the laws of Alberta, Canada,

S-ii

Table of Contents

that some or all of our officers and directors are residents of Canada, that some or all of the experts named in this Prospectus Supplement are residents of Canada, and that all or a substantial portion of our assets and the assets of such persons are located outside the United States.

The directors of Westport, the other person listed in the table below and PricewaterhouseCoopers LLP, auditors of Fuel Systems, reside outside of Canada or are otherwise organized under the laws of a foreign jurisdiction. Each of the persons named below has appointed the following agent for service of process:

Name of Person or Company	Name and Address of Agent
Ashoka Achuthan	Bennett Jones LLP, 4500 Bankers Hall East 855 2nd Street S.W., Calgary, Alberta, Canada T2P 4K7
Warren Baker	Bennett Jones LLP, 4500 Bankers Hall East 855 2nd Street S.W., Calgary, Alberta, Canada T2P 4K7
Peter Yu	Bennett Jones LLP, 4500 Bankers Hall East 855 2nd Street S.W., Calgary, Alberta, Canada T2P 4K7

Cartesian is advised that it may not be possible for it to enforce judgments obtained in Canada against any person or company that is incorporated, continued or otherwise organized under the laws of a foreign jurisdiction or resides outside of Canada, even if the party has appointed an agent for service of process.

No underwriter has been involved in the preparation of, or has performed a review of, the contents of this Prospectus Supplement or the Prospectus.

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION (THE SEC) NOR HAS THE SEC PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS SUPPLEMENT OR THE PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

You should rely only on the information contained in this Prospectus Supplement and the Prospectus. We have not authorized anyone to provide you with information different from that contained in this Prospectus Supplement and the Prospectus.

The earnings coverage ratios relating to the Notes for the twelve-month periods ending December 31, 2015 and March 31, 2016 are less than one-to-one. See Earnings Coverage .

The Notes and the Common Shares issuable upon conversion of the Notes are not deposits within the meaning of the Canada *Deposit Insurance Corporation Act* (Canada) and are not insured under the provisions of that Act or any other legislation.

Our head office is located at 101 1750 West 75th Avenue, Vancouver, British Columbia V6P 6G2, and our registered office is located at 4500, 855 2nd Street S.W., Calgary, Alberta T2P 4K7.

Table of Contents

TABLE OF CONTENTS
PROSPECTUS SUPPLEMENT

<u>Important Notice About Information in this Prospectus Supplement and the Accompanying Prospectus</u>	S-1
<u>Definitions</u>	S-1
<u>Special Notice Regarding Forward-Looking Statements</u>	S-1
<u>Documents Incorporated by Reference</u>	S-2
<u>Exchange Rate Information</u>	S-3
<u>Business of Westport</u>	S-3
<u>Recent Developments</u>	S-4
<u>Earnings Coverage</u>	S-6
<u>Description of Other Indebtedness</u>	S-7
<u>Description of the Notes</u>	S-8
<u>Use of Proceeds</u>	S-9
<u>Plan of Distribution</u>	S-9
<u>Prior Sales</u>	S-10
<u>Market for Securities</u>	S-11
<u>Consolidated Capitalization</u>	S-11
<u>Risk Factors</u>	S-12
<u>Legal Matters</u>	S-16
<u>Auditors, Transfer Agent and Registrar</u>	S-16
<u>Documents Filed as Part of the Registration Statement</u>	S-17
<u>Purchasers' Statutory Rights</u>	S-17
<u>Schedule A Form of Convertible Note</u>	A-1
<u>Schedule B Fuel Systems Financial Information</u>	B-1

PROSPECTUS

<u>Definitions and Other Matters</u>	1
<u>Special Notice Regarding Forward-Looking-Statements</u>	1
<u>Documents Incorporated by Reference</u>	2
<u>Where You Can Find Additional Information</u>	4
<u>Enforceability of Civil Liabilities</u>	5
<u>Westport Innovations Inc.</u>	5
<u>Our Business</u>	6
<u>Recent Developments</u>	7
<u>Risk Factors</u>	7
<u>Description of Common Shares</u>	21
<u>Description of Preferred Shares</u>	21
<u>Description of Subscription Receipts</u>	22
<u>Description of Warrants</u>	23
<u>Description of Debt Securities</u>	24
<u>Description of Units</u>	32
<u>Prior Sales</u>	33
<u>Market for Securities</u>	34
<u>Consolidated Capitalization</u>	35

<u>Use of Proceeds</u>	35
<u>Selling Securityholders</u>	37
<u>Plan of Distribution</u>	37
<u>Earnings Coverage</u>	40
<u>Certain Income Tax Considerations</u>	40
<u>Legal Matters</u>	40
<u>Auditors</u>	40
<u>Documents Filed as Part of the Registration Statement</u>	41
<u>Purchasers' Statutory and Contractual Rights</u>	41
<u>Certificate of the Corporation</u>	C-1

S-iv

Table of Contents

IMPORTANT NOTICE ABOUT INFORMATION IN THIS

PROSPECTUS SUPPLEMENT AND THE ACCOMPANYING PROSPECTUS

This document is in two parts. The first part is this Prospectus Supplement, which describes the terms of the securities the Corporation is offering and adds to and updates certain information contained in the Prospectus and the documents incorporated by reference therein. The second part, the Prospectus, gives more general information, some of which may not apply to the Notes. This Prospectus Supplement is deemed to be incorporated into the accompanying Prospectus solely for the purpose of qualifying the distribution of the Notes hereunder.

You should rely only on the information contained in this Prospectus Supplement and the Prospectus or incorporated by reference into the Prospectus. We have not authorized any other person to provide you with additional or different information. If anyone provides you with different or inconsistent information, you should not rely on it. You should assume that the information appearing in this Prospectus Supplement and the Prospectus, as well as information we have previously filed with the SEC and with the securities regulatory authority in each of the provinces of Canada that is incorporated in the Prospectus by reference, is accurate as of their respective dates only. Our business, financial condition, results of operations and prospects may have changed since those dates.

DEFINITIONS

In this Prospectus Supplement and the Prospectus, unless otherwise indicated, references to **we** , **us** , **our** , **Westport** the **Corporation** are to Westport Innovations Inc. All references to **dollars** , **Cdn.\$** or **\$** are to Canadian dollars and references to **U.S.\$** are to United States dollars.

SPECIAL NOTICE REGARDING FORWARD-LOOKING STATEMENTS

Certain statements contained in this Prospectus Supplement and the Prospectus, and in certain documents incorporated by reference in the Prospectus, may constitute forward-looking statements . When used in such documents, the words **may** , **would** , **could** , **will** , **intend** , **plan** , **anticipate** , **believe** , **estimate** , **expect** , **project** and similar relate to us or our management, are intended to identify forward-looking statements. In particular, this Prospectus Supplement contains forward-looking statements including, but not limited to the issuance of, and the terms of, the Notes, the terms of the Investment Agreement, the anticipated closing date of the Merger and the expected closing date of the Offering and the expected use of proceeds therefrom.

In addition, readers should also refer to the Prospectus, under the heading **Special Notice Regarding Forward-Looking Statements** , the AIF (as defined below), under the heading **Forward-Looking Information** and the Annual MD&A (as defined below) under the heading **Forward Looking Statements** , each of which are incorporated by reference into the Prospectus, for a list of some additional forward-looking statements made by us in this Prospectus Supplement, the Prospectus and the documents incorporated by reference into the Prospectus.

Such statements reflect our current views with respect to future events and are subject to certain risks, uncertainties and assumptions. Actual results may differ materially from those expressed in these forward-looking statements due to a number of uncertainties and risks, including the risks described in this Prospectus Supplement, the Prospectus and in the documents incorporated by reference into the Prospectus and other unforeseen risks, including, without limitation, those risks discussed in this Prospectus Supplement, the accompanying Prospectus under the heading **Risk Factors** and in the documents incorporated by reference herein and therein.

S-1

Table of Contents

You should not rely on any forward-looking statements. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after we distribute this Prospectus Supplement, except as otherwise required by law.

DOCUMENTS INCORPORATED BY REFERENCE

This Prospectus Supplement is deemed to be incorporated by reference into the Prospectus solely for the purpose of qualifying the distribution of the Notes hereunder. Other documents are also incorporated or deemed to be incorporated by reference into the Prospectus and reference should be made to the Prospectus for full particulars thereof.

Information has been incorporated by reference into the Prospectus from documents filed with securities commissions or similar authorities in Canada. Copies of the documents incorporated by reference may be obtained on request without charge from our Vice President, Investor Relations & Communications at 101 1750 West 75th Avenue, Vancouver, British Columbia, V6P 6G2, telephone (604) 718-2046. Copies of documents incorporated by reference may also be obtained by accessing the website located at www.sedar.com.

We have filed the following documents with the securities commissions or similar regulatory authorities in each of the provinces of Canada, and such documents are specifically incorporated by reference into, and form an integral part of, the Prospectus as supplemented by this Prospectus Supplement:

our annual information form dated March 29, 2016 for the year ended December 31, 2015 (the **AIF**);

our audited consolidated financial statements as at December 31, 2015 and December 31, 2014 and for the years ended December 31, 2015, December 31, 2014 and December 31, 2013, together with the notes thereto, and the auditors' reports thereon;

our management's discussion and analysis of financial condition and results of operations dated March 29, 2016, for the fiscal year ended December 31, 2015 (the **Annual MD&A**);

our interim consolidated financial statements as at March 31, 2016 and for the three month periods ended March 31, 2016 and 2015 (the **Q1 Financial Statements**);

our interim management's discussion and analysis of financial condition and results of operations dated May 12, 2016, for the three months ended March 31, 2016 (the **Q1 MD&A**);

the unaudited pro forma condensed combined financial information of Westport and Fuel Systems Solutions, Inc. (**Fuel Systems**) as at March 31, 2016, for the three months ended March 31, 2016 and for the year ended December 31, 2015, filed on SEDAR on May 12, 2016 (the **Pro Forma Financial Information**);

our management information circular dated May 19, 2016 relating to the annual and special meeting of shareholders to be held on June 28, 2016 (the **Management Information Circular**);

our management information circular and proxy statement (the **Merger Circular**) dated February 12, 2016 relating to the special meeting of shareholders held on March 18, 2016 in respect of the merger (the **Merger**) with Fuel Systems, as supplemented by the supplement (the **Supplement**) to the management information circular and proxy statement dated March 7, 2016; and

our management information circular dated March 11, 2015 relating to the annual and special meeting of shareholders held on April 30, 2015.

Any document of the type described in Section 11.1 of Form 44-101F1 *Short Form Prospectuses* filed by us with a securities commission or similar authority in any province of Canada subsequent to the date of this Prospectus Supplement and before withdrawal or completion of the distribution of the Notes will be deemed to be incorporated by reference into this Prospectus Supplement and the Prospectus.

Table of Contents

In addition, to the extent that any document or information incorporated by reference into this Prospectus Supplement is filed with, or furnished to, the SEC pursuant to the United States Securities Exchange Act of 1934, as amended (the **U.S. Exchange Act**), after the date of this Prospectus Supplement, such document or information will be deemed to be incorporated by reference as an exhibit to the registration statement of which this Prospectus Supplement forms a part (in the case of a report on Form 6-K, if and to the extent expressly provided therein).

To the extent that any document or information incorporated by reference into this Prospectus Supplement or the Prospectus is included in a report that is filed with the SEC on Form 40-F or Form 6-K (or any respective successor form), such document or information shall also be deemed to be incorporated by reference into this Prospectus Supplement and the Prospectus. In addition, we have and will incorporate by reference into this Prospectus Supplement and the Prospectus from documents that we file with the SEC pursuant to Section 13(a) or 15(d) of the U.S. Exchange Act. Our U.S. filings are electronically available from the SEC's Electronic Document Gathering and Retrieval System, which may be accessed at www.sec.gov.

Any statement contained in this Prospectus Supplement, the Prospectus or in a document incorporated or deemed to be incorporated by reference into the Prospectus Supplement or the Prospectus will be deemed to be modified or superseded for purposes of this Prospectus Supplement to the extent that a statement contained in this Prospectus Supplement or in any other subsequently filed document which also is, or is deemed to be, incorporated by reference into the Prospectus modifies or supersedes that statement. The modifying or superseding statement need not state that it has modified or superseded a prior statement or include any other information set forth in the document that it modifies or supersedes. The making of a modifying or superseding statement shall not be deemed an admission for any purposes that the modified or superseded statement when made, constituted a misrepresentation, an untrue statement of a material fact or an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in light of the circumstances in which it was made. Any statement so modified or superseded shall not be deemed, except as so modified or superseded, to be incorporated by reference into the Prospectus or to constitute part of this Prospectus Supplement.

EXCHANGE RATE INFORMATION

The following table sets out, for each period indicated, the high and low rates of exchange of Canadian dollars into U.S. dollars, the average of the exchange rates during each such period and the end-of-period rate, based on the U.S.-Canada dollar noon exchange rates published by the Bank of Canada. On May 27, 2016, the noon buying rate was Cdn.\$1.3003 equals U.S.\$1.00.

	Three Months Ended March 31, 2016	Three Months Ended March 31, 2015	Year Ended December 31,		
			2015	2014	2013
Highest rate during the period	1.4589	1.2803	1.3990	1.1643	1.0697
Lowest rate during the period	1.2962	1.1728	1.1728	1.0614	0.9839
Average rate for the period	1.3732	1.2412	1.2787	1.1045	1.0299
Rate at the end of the period	1.2971	1.2683	1.3840	1.1601	1.0636

BUSINESS OF WESTPORT

We are a leading provider of high-performance, low-emission engine and fuel system technologies utilizing gaseous fuels. Our technology and products enable light- (less than 5.9 litre), medium- (5.9 to 10 litre), heavy-duty (10 to 16 litre) and high-horsepower (greater than 16 litre) petroleum-based fuel engines and vehicles to use

S-3

Table of Contents

primarily gaseous fuels such as natural gas, giving users a cleaner and generally less expensive alternative fuel based on a more abundant natural resource. Through our partnerships and direct sales efforts, we sell natural gas and propane engines, fuel systems, and components to customers globally. Our strategic relationships with original equipment manufacturers provide us with access to their manufacturing capacity, supply chain and global distribution networks without incurring the considerable investment associated with these assets. We commercialize our technology throughout the world where demand for clean, low emission engines exists.

For additional information on our business readers are referred to our AIF, which is incorporated by reference herein and is available on SEDAR at www.sedar.com.

RECENT DEVELOPMENTS

Cartesian Investment Agreements

On January 11, 2016, Westport entered into the Investment Agreement with Cartesian (and entered into an amending agreement to the Investment Agreement on March 6, 2016) for financing through a series of four tranches:

U.S.\$17.5 million immediately, in consideration for a technology income streaming facility: Contingent payments to Cartesian are based on a percentage of amounts received by Westport on: (i) certain future high pressure direct injection product sales (the **HPDI Contingent Payment Amount**); and (ii) certain joint venture products (together with the HPDI Contingent Payment Amount, the **Contingent Payment Right**) in excess of agreed thresholds through 2025 but subject to certain minimum payment obligations.

U.S.\$17.5 million aggregate principal amount of Notes. We currently expect the Offering to close on or about June 1, 2016, or such later date as may be agreed to by us and Cartesian (**Closing Date**).

Up to U.S.\$16.3 million through the sale of assets: Westport has agreed to sell up to U.S.\$16.3 million in assets to Cartesian (the **Cartesian Asset Sale**).

Up to U.S.\$20 million in additional streaming capacity: Cartesian has committed up to an additional U.S.\$20 million to Westport to support two or more product development ventures as may be agreed upon between the parties. The new streaming facilities would provide development funding for Westport in exchange for a contingent payment on products developed by the new ventures.

The Investment Agreement also provides that if, after 54 months from the date of closing of the Contingent Payment Rights, Cartesian has realized a return on its investment greater than 3.5 times the purchase price of the Contingent Payment Rights, the Notes, and the Cartesian Asset Sale (\$179,655,000 or the **Threshold Amount**), Cartesian must pay to Westport 30% of all amounts received in excess of the Threshold Amount and 30% of any HPDI Contingent Payment Amount following the date on which the Threshold Amount is attained.

On April 20, 2016, Westport announced that it had sold a derivative economic interest (the **Derivative**) in its Hong Kong subsidiary, Westport (Hong Kong) Limited (**Westport HK**), to Cartesian in satisfaction of the Cartesian Asset Sale for an upfront payment of U.S.\$6.3 million plus a potential future payment to be determined by Cartesian's return on investment in respect of the Derivative. Westport HK is a wholly owned subsidiary of Westport formed to hold a

35% equity interest in a certain Chinese joint venture (the **PRC Joint Venture**) in which Westport participates. The Derivative provides Cartesian with an economic interest in the PRC Joint Venture equivalent to an 18.78% equity ownership interest, with Westport, indirectly, retaining a 16.22% economic interest in the PRC Joint Venture.

Under the terms of sale, Cartesian (i) immediately paid to Westport U.S.\$6.3 million in cash as consideration for the Derivative and (ii) by the earlier of (a) the 44-month anniversary date of the Investment

Table of Contents

Agreement or (b) the date on which Westport HK, Cartesian and their respective affiliates have sold all or substantially all of their shares representing an 18.78% interest in the PRC Joint Venture, is obligated to pay Westport an amount equal to 30% of any amounts received by Cartesian over a 3.5x return on its investment in the Derivative. In addition, Westport granted Cartesian a call option in respect of all of the outstanding shares of Westport HK that may be exercised after April 19, 2017, the first anniversary of the Cartesian Asset Sale transaction, and, prior to the exercise of the call option, certain rights with respect to the management and operation of Westport HK and the PRC Joint Venture. The call option may be exercised by Cartesian in its sole discretion for nominal consideration. Prior to the exercise of the call option, Westport retains the rights to the anticipated income and dividends from Westport HK from the PRC Joint Venture, subject (in the case of amounts received by Westport HK other than certain specified dividends) to Westport making payments to Cartesian in an amount equivalent to that which Cartesian would have received had it held a direct 18.78% interest in the PRC Joint Venture.

The payment of the Derivative and the call option are secured by a security interest in certain of Westport's assets related to Westport HK and the PRC Joint Venture.

The terms of the sale transaction permit Westport to transfer its remaining 16.22% economic interest in the PRC Joint Venture at any time, provided that Westport HK will hold in the aggregate not less than an 18.78% direct or indirect interest in the PRC Joint Venture.

Fuel Systems Merger

On September 1, 2015, Westport entered into an Agreement and Plan of Merger (the **Merger Agreement**) with Fuel Systems, and Whitehorse Merger Sub Inc. (**Merger Sub**), a Delaware corporation and a direct wholly-owned subsidiary of Westport, pursuant to which Merger Sub will be merged with and into Fuel Systems. In connection with the Merger, all of the outstanding shares of common stock, par value U.S.\$0.001, of Fuel Systems will be exchanged for Common Shares.

On March 6, 2016, Westport, Merger Sub and Fuel Systems entered into Amendment No. 1 to the Agreement and Plan of Merger amending certain of the terms of the Merger Agreement (the **Amendments**).

We currently expect the Merger to close by June 1, 2016. For more detailed information in respect of the Merger and the Amendments please see the Merger Circular and the Supplement which are incorporated by reference herein and are available under the Corporation's profile on SEDAR at www.sedar.com. Readers are also referred to the Pro Forma Financial Information, and the financial information in respect of Fuel Systems set out at Schedule B hereto.

Table of Contents**EARNINGS COVERAGE****Earnings Coverage Ratios Before Giving Effect to the Merger**

The following table sets out the earnings coverage ratios after giving effect to the issuance of the Notes to be distributed under this Prospectus Supplement subsequent to the respective calculation periods as if the issuance of the Notes had occurred at the beginning of the respective calculation periods and the related servicing costs had been incurred during the respective calculation periods, but prior to giving effect to the Merger. The amounts do not include any additional earnings that may be derived from the use of the net proceeds of the Offering.

(U.S.\$ thousands, except Earnings Coverage Ratio)	For the 12 months ended December 31, 2015	For the 12 months ended March 31, 2016
Interest Expense (Denominator for Earnings Coverage Ratio) ⁽¹⁾ (including Cartesian financing based on U.S.\$17.5 million at 9.0%)	7,100	7,900
Net loss before deducting interest and income taxes (Numerator for Earnings Coverage Ratio)	92,100	98,100
Earnings Coverage Ratio ⁽²⁾⁽³⁾		

Notes:

- (1) Includes a full 12 months of interest expense calculated on the value of the Notes incurred subsequent to the end of the calculation period as if the Notes were incurred at the beginning of the calculation period but gives no credit to income derived from the associated use of proceeds. Interest expense included in the calculation is for long-term debt.
- (2) The earnings coverage ratio is less than 1:1. To achieve an earnings coverage ratio of one-to-one, we require an increase in earnings of approximately U.S.\$99.2 million for the twelve month period ended December 31, 2015 and approximately U.S.\$106 million for the twelve month period ended March 31, 2016.
- (3) Under U.S. GAAP, a portion of the Notes will be classified as a liability and a portion as equity (related to the conversion feature), with the related accretion added to interest expense as incurred over the term of such Notes to increase the carrying value of the liability portion to the principal amount of the Notes. The valuation of the Notes has not been calculated to determine this bifurcation, and as such, the interest expense includes only the interest expense on the Notes. We do not believe the impact to the earnings coverage ratio is significant as the ratio would still be less than 1.

Westport's borrowing cost requirements, after giving effect to the issue of the Notes, amounted to approximately U.S.\$7.1 million for the 12 months ended December 31, 2015 and approximately U.S.\$7.9 million for the 12 months ended March 31, 2016. Westport's loss attributable to owners of the parent before borrowing costs and income tax for the 12 month periods ended December 31, 2015 and March 31, 2016 was approximately U.S.\$92.1 million and U.S.\$98.1 million, respectively, which is approximately 13 times and 12.4 times Westport's borrowing cost requirements for the respective period.

Table of Contents**Earnings Coverage Ratios After Giving Effect to the Merger**

The following table sets out the pro forma earnings coverage ratios after giving pro forma effect to: (i) the issuance of the Notes to be distributed under this Prospectus Supplement subsequent to the respective calculation periods as if the issuance of the Notes had occurred at the beginning of the respective calculation periods and the related servicing costs had been incurred during the respective calculation periods, and (ii) the Merger. The pro forma amounts do not include any additional earnings that may be derived from the use of the net proceeds of the Offering.

(U.S.\$ thousands, except Earnings Coverage Ratio)	Pro forma for the 12 months ended December 31, 2015	Pro forma for the 12 months ended March 31, 2016
Interest Expense (Denominator for Earnings Coverage Ratio) ⁽¹⁾ (including Cartesian financing based on U.S.\$17.5 million at 9.0%)	7,100	7,900
Net pro forma loss after giving pro forma effect to the issue of the Notes and the closing of the Merger before deducting interest and income taxes (Numerator for Earnings Coverage Ratio)	119,000	121,400
Earnings Coverage Ratio⁽²⁾⁽³⁾		

Notes:

- (1) Includes a full 12 months of pro forma interest expense calculated on the value of the Notes incurred subsequent to the end of the calculation period as if the Notes were incurred at the beginning of the calculation period but gives no credit to income derived from the associated use of proceeds. Interest expense included in the calculation is for long-term debt.
- (2) The earnings coverage ratio is less than 1:1. To achieve an earnings coverage ratio of one-to-one, we require an increase in earnings of approximately U.S.\$126.1 million for the twelve month period ended December 31, 2015 and approximately U.S.\$120.8 million for the twelve month period ended March 31, 2016.
- (3) Under U.S. GAAP, a portion of the Notes will be classified as a liability and a portion as equity (related to the conversion feature), with the related accretion added to interest expense as incurred over the term of such Notes to increase the carrying value of the liability portion to the principal amount of the Notes. The valuation of the Notes has not been calculated to determine this bifurcation, and as such, the interest expense includes only the interest expense on the Notes. We do not believe the impact to the earnings coverage ratio is significant as the ratio would still be less than 1.

Westport's borrowing cost requirements, after giving pro forma effect to the issue of the Notes and the closing of the Merger, amounted to approximately U.S.\$7.1 million for the 12 months ended December 31, 2015 and approximately U.S.\$7.9 million for the 12 months ended March 31, 2016. Westport's pro forma loss attributable to owners of the parent before borrowing costs and income tax for the 12 month periods ended December 31, 2015 and March 31, 2016 was approximately U.S.\$119.0 million and U.S.\$121.4 million, respectively, which is approximately 16.8 times and 15.4 times Westport's borrowing cost requirements for the respective period.

DESCRIPTION OF OTHER INDEBTEDNESS

On September 23, 2011, we issued \$36 million principal amount of debentures (the **Initial Debentures**) in order to replace previously issued debentures that matured in July 2011. The Initial Debentures are governed by the terms of

an indenture (as amended, the **Debenture Indenture**), are unsecured and subordinated to senior indebtedness, and bear interest at 9% per annum, payable in cash semi-annually in arrears on March 15th and September 15th of each year during the term of the Initial Debentures.

S-7

Table of Contents

On June 27, 2014, we extended the maturity date of the Initial Debentures from September 22, 2014 to September 15, 2017 and issued an additional \$19 million in debentures (together with the Initial Debentures, the **Existing Debentures**), on the same terms as the Initial Debentures. The maturity date of the Initial Debentures was extended by an extraordinary resolution of the holders of the Initial Debentures authorizing the execution of a supplemental indenture (the **First Supplemental Indenture**) to the Debenture Indenture.

On June 12, 2015, the holders of the Existing Debentures passed an extraordinary resolution authorizing the execution of a second supplemental indenture (the **Second Supplemental Indenture**) to the Debenture Indenture, amending the Debenture Indenture to allow us to incur additional unsecured indebtedness for borrowed money ranking pari passu with the Existing Debentures, provided that the proceeds of such indebtedness are used to, among other things and subject to certain conditions, redeem the Existing Debentures. The issuance of the Notes pursuant to the Offering does not require us to redeem the Existing Debentures.

The Debenture Indenture, the First Supplemental Indenture and the Second Supplemental Indenture have each been filed on SEDAR at www.sedar.com. The Existing Debentures are not listed on any stock exchange.

In addition to the Existing Debentures described above, we have additional debt of U.S.\$24.3 million, mostly held in our European subsidiaries. These loans bear interest at 3 or 6 month Euribor plus a fixed percentage ranging from 1% to 3.5%.

DESCRIPTION OF THE NOTES

The Notes will bear interest at the rate of 9.0% per annum, payable in cash annually in arrears on December 31 in each year commencing December 31, 2016 and, unless earlier converted, the Note will mature on June 1, 2021.

The Notes (including the accrued but unpaid interest thereon) are convertible into Common Shares, in whole or in part, at Cartesian's option, at any time following the twelve-month anniversary of the Closing Date and prior to 4:00 p.m. (Vancouver time) on the Business Day immediately preceding the Maturity Date at the Valuation Price per Common Share, subject to adjustment in certain circumstances. The number of Common Shares to be issued upon such a conversion shall be equal to the quotient obtained by dividing the principal amount outstanding under the Notes that Cartesian elects to convert (plus the amount of accrued but unpaid interest applicable to such principal amount being converted) by the applicable Conversion Price, provided that the aggregate of all conversions by Cartesian shall not result in the issuance of greater than 16,000,000 Common Shares (subject to adjustment in certain circumstances).

If a Conversion Event shall have occurred, then Westport shall prior to the fifth Business Day following such Conversion Event have the option to convert, as a whole or in part, up to U.S.\$8,750,000 principal amount (including the accrued but unpaid interest thereon) of the Notes into Common Shares from the day that is twenty four calendar months after the Closing Date and at any time or from time to time thereafter prior to 4:00 p.m. (Vancouver time) on the Business Day immediately preceding the Maturity Date, at the Conversion Price, subject to adjustment in certain circumstances. The number of Common Shares to be issued upon such a conversion shall be equal to the quotient obtained by dividing the principal amount outstanding under the Notes that Westport elects to convert (plus all accrued but unpaid interest on the principal amount being converted) by the applicable Conversion Price, provided that the aggregate of all conversions by the Company shall not result in the conversion of greater than U.S.\$8,750,000 principal amount of the Notes.

The Notes will be our unsecured obligation and will rank equal in right of payment with our existing and future unsecured debt, and will be senior in right of payment to any future debt that is expressly subordinated to the Notes. The Notes will be effectively subordinated to any secured debt that we have incurred or may incur to the extent of the

assets securing such debt.

S-8

Table of Contents

For additional details regarding the terms of the Notes, see Schedule A .

USE OF PROCEEDS

We expect the net proceeds to us from the sale of the Notes will be approximately U.S.\$17,000,000, after deducting estimated expenses of the Offering. We expect to use the net proceeds from this Offering for general corporate purposes, including but not limited to, advanced technology license and joint commercialization programs to support next generation natural gas vehicles, working capital requirements, infrastructure development, market creation activities, potential acquisitions of businesses, technologies or other assets, debt repayments, general and administrative expenses, and supply chain development.

We will have significant discretion in the use of any net proceeds and such proceeds may be used differently than estimated above. We may invest the net proceeds temporarily in compliance with our Investment Policy approved by our Chief Financial Officer until we use them for their stated purpose. The ultimate use of any remaining proceeds of the Offering will depend on the performance of our existing joint ventures, the pace of development of markets for our products, our ability to negotiate supply arrangements, our engineering abilities, the emergence of technical issues in relation to our products in the future and any other unforeseen developments in relation to our markets or to our products. We have incurred substantial losses since our inception in 1995 and continue to incur losses and experience negative cash flows. We cannot predict the future amount of such negative operating cash flows, nor can we predict whether we will be able to generate positive operating cash flows in the future. We may, therefore, use all or a portion of the net proceeds of the Offering to fund negative operating cash flows to the extent we are required or believe it is in our interest to do so. We likewise cannot guarantee that we will be successful in achieving product commercialization in respect of the products referred to in the documents incorporated by reference herein. See Risk Factors Risks Related to Our Business We have incurred and continue to incur losses in the Prospectus.

PLAN OF DISTRIBUTION

The Corporation is proposing to issue U.S.\$17,500,000 aggregate principal amount 9.0% convertible unsecured notes due June 1, 2021 to Cartesian. It is expected that the closing date of the Offering will be on or about June 1, 2016, or such later date as may be agreed to by us and Cartesian.

No underwriter has been involved in the preparation of, or has performed a review of, the contents of this Prospectus Supplement or the Prospectus, and no underwriter will be involved in the Offering. Rothschild Inc. (**Rothschild**), has acted as our financial advisor in connection with the Investment Agreement, of which this Offering forms a part. Rothschild is not acting as an underwriter in connection with the Offering.

We estimate expenses payable by us in connection with this Offering will be approximately U.S.\$500,000, including fees payable to Rothschild pursuant to its role as financial advisor in connection with the Investment Agreement.

The Notes will not be listed on any securities exchange or included in any quotation system. Our outstanding Common Shares are listed for trading on the TSX under the trading symbol **WPT** and on NASDAQ under the trading symbol **WPRT** . The Common Shares issuable on the conversion of the Notes will be listed on NASDAQ. The TSX has conditionally approved the listing of the Common Shares issuable on the conversion of the Notes. Listing on the TSX is subject to our fulfillment of all of the listing requirements of the TSX on or before June 8, 2016.

Table of Contents**PRIOR SALES**

The following description of securities issuances, together with the information contained under the heading "Prior Sales" in the Prospectus, contains information with respect to all issuances of our securities during the twelve-month period prior to the date of this Prospectus Supplement.

Common Shares

We have issued the following Common Shares during the periods indicated:

Date	Price per Common Share⁽¹⁾⁽²⁾ (Cdn.\$)	Number of Common Shares⁽³⁾
2015		
August	N/A	
September	\$ 4.13 - \$4.65	14,572
October	\$ 4.28	1,007
November	\$ 3.38 - \$4.81	135,487
December	\$ 2.48 - 3.46	46,562
2016		
January	\$ 2.12 - 3.08	19,226
February	\$ 2.33 - 2.64	13,108
March	\$ 2.62 - \$3.92	75,209
April	\$ 3.26 - \$3.29	14,157
May (1 - 30)	\$ 2.60 - \$3.21	42,675

Notes:

- (1) Represents a price range indicating the lowest and highest prices at which our Common Shares were issued during the relevant period.
- (2) Common Shares issued upon exercise of restricted share units (**RSUs**) have no exercise price. The price per Common Share set forth in the above table is the fair value per Common Share as of the issuance date.
- (3) All Common Shares were issued upon exercise of RSUs under the Westport Omnibus Plan (as defined in the Management Information Circular).

Share-based Awards

We have, during the periods indicated, granted the following PSUs and RSUs pursuant to the Westport Omnibus Plan:

Date	Share-based Awards Number of securities granted (#)	Per Share market value of shares underlying securities at time of unit issuance (\$)
September 3, 2015	78,988 ⁽¹⁾	4.74

Edgar Filing: WESTPORT INNOVATIONS INC - Form SUPPL

September 3, 2015	35,000 ⁽²⁾	4.74
November 12, 2015	99,010 ⁽¹⁾	3.91

Notes:

- (1) Represents a grant of RSUs pursuant to the Westport Omnibus Plan.
- (2) Represents a grant of PSUs pursuant to the Westport Omnibus Plan.

S-10

Table of Contents**MARKET FOR SECURITIES**

Our outstanding Common Shares are listed and posted for trading on NASDAQ under the trading symbol WPRT and on the TSX under the trading symbol WPT. The following table, together with the information contained under the heading Market For Securities in the Prospectus, sets forth the market price ranges, the closing price on the last day of trading and the aggregate volume of trading of the Common Shares on NASDAQ and the TSX for the twelve-month period prior to the date of this Prospectus Supplement.

Period	NASDAQ Global Select Market				Toronto Stock Exchange			
	High (U.S.\$)	Low (U.S.\$)	Close (U.S.\$)	Volume (Shares)	High (\$)	Low (\$)	Close (\$)	Volume (Shares)
2015								
August	4.00	3.00	3.54	6,046,300	5.14	3.98	4.63	680,100
September	3.67	2.47	2.49	7,004,800	4.85	3.29	3.32	453,000
October	4.01	2.42	3.10	6,954,000	5.18	3.23	4.07	598,400
November	3.64	2.42	2.46	6,562,900	4.81	3.17	3.17	707,400
December	2.66	1.70	2.01	9,821,100	3.66	2.34	2.78	985,400
2016								
January	2.32	1.30	1.92	12,076,400	3.30	1.79	2.70	1,024,800
February	2.00	1.51	1.87	4,588,800	2.77	2.11	2.52	287,300
March	3.09	1.88	2.61	8,770,614	3.99	2.52	3.38	761,673
April	2.69	2.10	2.46	4,653,476	3.38	2.69	3.08	439,593
May (1 - 27)	2.63	1.81	2.06	4,146,291	3.34	2.35	2.70	451,787

CONSOLIDATED CAPITALIZATION

The following table sets forth our consolidated cash and cash equivalents and capitalization as of March 31, 2016 on an actual basis and on an as adjusted basis to give effect to the issue of the Notes. This table should be read in conjunction with the Q1 Financial Statements, including the notes thereto and the Q1 MD&A, which have been incorporated by reference into this Prospectus Supplement.

	As at March 31, 2016	
	Actual	As Adjusted ⁽²⁾
(expressed in thousands of U.S. dollars, except for shares outstanding)		
Cash, cash equivalents and short-term investments	\$ 24,621	\$ 41,621
Debt:		
Notes payable		
9.0% unsecured subordinated debentures ⁽¹⁾	\$ 41,108	\$ 41,108
9.0% convertible unsecured notes due 2021	\$ Nil	\$ 17,000 ⁽³⁾
Other Debt: Euribor plus 3.5%	\$ 24,275	\$ 24,275
Shareholders' equity:		

Edgar Filing: WESTPORT INNOVATIONS INC - Form SUPPL

Common Shares	\$	937,864	\$	937,864
		(64,488,362 Common Shares)		(64,488,362 Common Shares)
Preferred Shares		Nil		Nil

Notes:

(1) See Description of Other Indebtedness .

S-11

Table of Contents

- (2) As Adjusted reflects the net proceeds of the Offering after deduction of the estimated expenses of the Offering and assumes no Common Shares will be issued on conversion of the Notes.
- (3) We estimate expenses payable by us in connection with this Offering will be approximately U.S.\$500,000.

RISK FACTORS

*An investment in the Notes is speculative and involves a high degree of risk. In addition to the other information contained in this Prospectus Supplement, in the Prospectus and in the documents incorporated by reference into this Prospectus Supplement and the Prospectus, you should carefully consider the risk factors set forth below, as well as the risk factors referenced under the heading *Risk Factors* , which begins on page 6 of the accompanying Prospectus.*

Risk Factors Relating to the Offering

The Notes will not be secured by any of our assets and will be effectively subordinated to any secured indebtedness to the extent of the value of the collateral securing such indebtedness. We do not expect to have any secured debt outstanding at the time of issuance of the Notes. However, the Notes do not prohibit us from incurring certain secured indebtedness or from pledging any of our assets as collateral for any of our other existing indebtedness. In such a case, we will not be able to use those assets to make payments under the Notes until we have paid the holders of the secured debt in full. As a result, in the event of our bankruptcy, liquidation, dissolution or reorganization, or of a similar proceeding, any assets that we pledge as collateral for any of our other obligations will not be available to pay our obligations under the Notes until we have paid our other secured obligations in full. Moreover, the Notes are our obligation exclusively and are not guaranteed by any of our subsidiaries. Our subsidiaries are separate and distinct legal entities and have no obligation, contingent or otherwise, to make payments on the Notes or to make any funds available for that purpose.

Servicing our debt requires a significant amount of cash, and we may not have sufficient cash flow from our business to pay our substantial debt.

Our ability to make scheduled payments of the principal of, to pay interest on or to refinance our indebtedness, including the Notes, depends on our future performance, which is subject to economic, financial, competitive and other factors beyond our control. Our business may not continue to generate cash flow from operations in the future sufficient to service our debt because of factors beyond our control. If we are unable to generate such cash flow, we may be required to adopt one or more alternatives, such as selling assets, restructuring debt or obtaining additional equity capital on terms that may be onerous or highly dilutive, if at all. Our ability to refinance our indebtedness will depend on the capital markets and our financial condition at such time. We may not be able to engage in any of these activities or engage in these activities on desirable terms, which could result in a default on our debt obligations.

Despite our current consolidated debt levels, we may still incur substantially more debt or take other actions which would intensify the risks discussed above.

Despite our current consolidated debt levels, we may be able to incur substantial additional debt in the future, including secured debt. We will not be restricted under the terms of the Notes from incurring additional debt, securing existing or future debt, recapitalizing our debt or taking a number of other actions that are not limited by the terms of the Notes but that could diminish our ability to make payments on the Notes.

We may not have the ability to raise the funds necessary to pay interest on the Notes.

The Notes bear interest annually at a rate of 9.0% per annum. Our ability to repurchase the Notes may be limited by law or regulatory authority. Any of the cash payments described above could be significant, and we

Table of Contents

may not have enough available cash or be able to obtain financing so that we can make such payments when due. If we fail to pay interest on the Notes we will be in default under the Notes.

Upon conversion of the Notes, you may receive less valuable consideration than expected because the value of our Common Shares may decline after you exercise your conversion right but before we settle our conversion obligation.

A converting holder will be exposed to fluctuations in the trading price of our Common Shares during the period from the date the holder elects to convert the Notes until the date we settle our conversion obligation. The amount of consideration that you will receive upon conversion of the Notes will be determined by reference to the Conversion Price. Accordingly, if the trading price of our Common Shares decreases during this period, or after this period and until we deliver the consideration due upon conversion, the amount or value of consideration you receive will be adversely affected.

We cannot assure you that an active trading market will develop for the Notes.

Prior to this Offering, there has been no trading market for the Notes, and we do not intend to apply for listing of the Notes on any securities exchange or to arrange for its quotation on any automated dealer quotation system. In addition, the liquidity of the trading market in the Notes, and the trading price of the Notes, may be adversely affected by changes in the overall market for this type of security and by changes in our financial performance or prospects or in the prospects for companies in our industry generally. As a result, we cannot assure you that an active trading market will develop for the Notes. If an active trading market does not develop or is not maintained, the trading price and the liquidity of the Notes may be adversely affected. In that case, you may not be able to sell your Notes at a particular time, or you may not be able to sell your Notes at a favorable price.

Our management will have broad discretion over the use of the proceeds to us from this Offering and might not apply the proceeds of this Offering in ways that increase the value of your investment.

Our management will have broad discretion to use the net proceeds from this Offering and you will be relying on the judgment of our management regarding the application of these proceeds. They might not apply the net proceeds of this Offering in ways that increase the value of your investment. Although we expect to use the net proceeds from this Offering as described in this Prospectus Supplement under *Use of Proceeds*, our management will retain significant discretion with respect to the use of proceeds. Our management might not be able to yield a significant return, if any, on any investment of these net proceeds.

You may be subject to tax if we make or fail to make certain adjustments to the conversion rate of the Note, even though you do not receive a corresponding cash distribution.

The conversion rate of the Notes is subject to adjustment in certain circumstances. If the conversion rate is adjusted as a result of a distribution that is taxable to our common shareholders, you may be deemed to have received a dividend subject to U.S. federal income tax without the receipt of any cash. In addition, a failure to adjust (or to adjust adequately) the conversion rate after an event that increases your proportionate interest in us could be treated as a deemed taxable dividend to you.

Risk Factors Relating to Ownership of our Common Shares

Our Common Share price may fluctuate.

The stock market in general, and the market prices of securities of technology companies in particular, can be extremely volatile, and fluctuations in our Common Share price may be unrelated to our operating performance. Our Common Share price could be subject to significant fluctuations in response to many factors,

S-13

Table of Contents

including: actual or anticipated variations in our results of operations; the addition or loss of customers; announcements of technological innovations, new products or services by us or our competitors; changes in financial estimates or recommendations by securities analysts; conditions or trends in our industry; our announcements of significant acquisitions, strategic relationships, joint ventures or capital commitments; additions or departures of key employees; general market conditions; and other events or factors, many of which may be beyond our control. Additionally, the price of our Common Shares has historically been strongly correlated with the differential between the prices of natural gas, diesel fuel and crude oil. The prices of such commodities have been subject to significant volatility. As of May 30, 2016, the 52-week trading price of our Common Shares on NASDAQ and the TSX ranged from a low of U.S.\$1.30 to a high of U.S.\$5.95, and a low of \$1.79 to a high of \$7.36, respectively.

Litigation, including litigation due to Common Share price volatility, the Merger, or other factors, could cause us to incur substantial costs and divert our management's time and attention.

From time to time, we may become involved in, or become liable for legal, contractual and other claims by various parties, including customers, suppliers, former employees, class action plaintiffs and others, including litigation related to the volatility of our Common Shares, or the Merger. On an ongoing basis, we attempt to assess the likelihood of any adverse judgments or outcomes to these proceedings or claims, although it is difficult to predict final outcomes with any degree of certainty. Except as disclosed from time to time in our financial statements, we do not believe that any of the proceedings or claims to which we are party will have a material adverse effect on our financial position; however, we cannot provide any assurance to this effect.

We do not currently intend to pay any cash dividends on our Common Shares in the foreseeable future; therefore, our shareholders may not be able to receive a return on their Common Shares until they sell them.

We have never paid or declared any cash dividends on our Common Shares. We do not anticipate paying any cash dividends on our Common Shares in the foreseeable future because, among other reasons, we currently intend to retain any future earnings to finance our business. The future payment of dividends will be dependent on factors such as cash on hand and achieving profitability, the financial requirements to fund growth, our general financial condition and other factors our board of directors may consider appropriate in the circumstances. Until we pay dividends, which we may never do, our shareholders will not be able to receive a return on their Common Shares unless they sell them.

If we are characterized as a passive foreign investment company, U.S. holders may be subject to adverse U.S. federal income tax consequences.

Based in part on current operations and financial projections, we do not expect to be a passive foreign investment corporation, or PFIC, for U.S. federal income tax purposes for our current taxable year or in the foreseeable future. However, we must make an annual determination (after the close of each taxable year) as to whether we are a PFIC based on the types of income we earn and the types and market value of our assets and our cash spending schedules from time to time, all of which are subject to change (including as a result of this Offering). Therefore, we cannot assure you that we will not be a PFIC for our current taxable year or any future taxable year. A non-U.S. corporation generally will be considered a PFIC for any taxable year if either (1) at least 75% of its gross income is passive income or (2) at least 50% of the value of its assets (based on an average of the fair market values of the assets determined at the end of each quarter in such taxable year) is attributable to assets that produce or are held for the production of passive income. The market value of our assets may be determined in large part by the market price of our Common Shares, which is likely to fluctuate. In addition, the composition of our income and assets will be affected by how, and how quickly, we use any cash that we raise. If we were to be treated as a PFIC for any taxable year during which you hold Common Shares, certain adverse U.S. federal income tax consequences could apply to U.S. holders.

S-14

Table of Contents

As a foreign private issuer, we are subject to different U.S. securities laws and rules than a domestic U.S. issuer, which may limit the information publicly available to our U.S. shareholders.

We are a foreign private issuer under applicable U.S. federal securities laws and, therefore, we are not required to comply with all the periodic disclosure and current reporting requirements of the U.S. Exchange Act and related rules and regulations. As a result, we do not file the same reports that a U.S. domestic issuer would file with the SEC, although we will be required to file with or furnish to the SEC the continuous disclosure documents that we are required to file in Canada under Canadian securities laws. In addition, our officers, directors and principal shareholders are exempt from the reporting and short swing profit recovery provisions of Section 16 of the U.S. Exchange Act. Therefore, our shareholders may not know on as timely a basis when our officers, directors and principal shareholders purchase or sell our Common Shares as the reporting periods under the corresponding Canadian insider reporting requirements are longer. In addition, as a foreign private issuer, we are exempt from the proxy rules under the U.S. Exchange Act.

We may lose our foreign private issuer status in the future, which could result in significant additional costs and expenses to us.

In order to maintain our current status as a foreign private issuer, a majority of our Common Shares must be either directly or indirectly owned by non-residents of the United States unless we also satisfy one of the additional requirements necessary to preserve this status. We may in the future lose our foreign private issuer status if a majority of our Common Shares are held in the United States and we fail to meet the additional requirements necessary to avoid loss of foreign private issuer status. The regulatory and compliance costs to us under U.S. federal securities laws as a U.S. domestic issuer may be significantly more than the costs we incur as a Canadian foreign private issuer eligible to use the MJDS. If we are not a foreign private issuer, we would not be eligible to use the MJDS or other foreign issuer forms and would be required to file periodic and current reports and registration statements on U.S. domestic issuer forms with the SEC, which are more detailed and extensive than the forms available to a foreign private issuer. In addition, we may lose the ability to rely upon exemptions from corporate governance requirements of the NASDAQ Listing Rules that are available to foreign private issuers.

U.S. investors may not be able to obtain enforcement of civil liabilities against us.

The enforcement by investors of civil liabilities under the U.S. federal or state securities laws may be affected adversely by the fact that we are governed by the *Business Corporations Act* (Alberta), a statute of the Province of Alberta, Canada, that the majority of our officers and directors and some of the experts named in this Prospectus Supplement, are residents of Canada or otherwise reside outside the United States, and that all, or a substantial portion of their assets and a substantial portion of our assets, are located outside the United States. It may not be possible for investors to effect service of process within the United States on certain of our directors and officers or the experts named in this Prospectus Supplement or enforce judgments obtained in the United States courts against us, certain of our directors and officers or the experts named in this Prospectus Supplement based upon the civil liability provisions of United States federal securities laws or the securities laws of any state of the United States.

There is some doubt as to whether a judgment of a United States court based solely upon the civil liability provisions of U.S. federal or state securities laws would be enforceable in Canada against us, our directors and officers or the experts named in this Prospectus Supplement. There is also doubt as to whether an original action could be brought in Canada against us or our directors and officers or the experts named in this Prospectus Supplement to enforce liabilities based solely upon U.S. federal or state securities laws.

If securities analysts stop publishing research or reports about us or our business or if they downgrade our Common Shares, the market price of our Common Shares could decline.

The market for our Common Shares relies in part on the research and reports that industry or financial analysts publish about us or our business. We do not control these analysts. If any analyst who covers us

S-15

Table of Contents

downgrades our shares or lowers its future share price targets or estimates of our operating results, our share price could decline rapidly. Furthermore, if any analyst ceases to cover our company, we could lose visibility in the market, which in turn could cause the market price of our Common Shares to decline.

LEGAL MATTERS

Certain legal matters relating to the Offering and to the Notes distributed under this Prospectus Supplement and the Common Shares issuable upon conversion of such Notes will be reviewed on our behalf by Bennett Jones LLP and Willkie Farr & Gallagher LLP.

As at the date hereof, the partners and associates of Bennett Jones LLP and Willkie Farr & Gallagher LLP, as a group, beneficially own, directly or indirectly, less than 1% of our securities.

AUDITORS, TRANSFER AGENT AND REGISTRAR

Our auditors are KPMG LLP, Chartered Accountants, PO Box 10426, 777 Dunsmuir Street, Vancouver, British Columbia V7Y 1K3. Our financial statements as at December 31, 2015 and for the years ended December 31, 2015 and 2013, incorporated by reference into the Prospectus have been audited by KPMG LLP, independent auditors, as indicated in their report dated March 29, 2016, and are incorporated into the Prospectus in reliance upon the authority of said firm as experts in accounting and auditing in giving said report. KPMG LLP has advised the Corporation that they are independent with respect to the Corporation within the meaning of the Rules of Professional Conduct of the Chartered Professional Accountants of British Columbia and in accordance with the applicable rules and regulations of the SEC and the Public Company Accounting Oversight Board (United States).

Our financial statements as at December 31, 2014 and for the year ended December 31, 2014, incorporated by reference into the Prospectus have been audited by Deloitte LLP, independent auditors, as indicated in their report dated March 9, 2015 (October 15, 2015 as to Note 23) relating to the 2014 consolidated financial statements (before the effects of the retrospective adjustments to the consolidated financial statements and financial statement disclosures) and which are incorporated into the Prospectus. Such financial statements are incorporated in reliance upon the report of such firm given upon their authority as experts in accounting and auditing. Deloitte LLP has advised the Corporation that they were independent with respect to the Corporation at the date of their report within the meaning of the Rules of Professional Conduct of the Chartered Professional Accountants of British Columbia and in accordance with the applicable rules and regulations of the SEC and the Public Company Accounting Oversight Board (United States).

Fuel Systems financial statements as at December 31, 2015 and for the three years in the period ended December 31, 2015 and management's assessment of the effectiveness of internal control over financial reporting (which is included in Management's Report on Internal Control over Financial Reporting) as of December 31, 2015 attached as Schedule B in this Prospectus Supplement have been so included in reliance on the report dated March 14, 2016 (which contains an explanatory paragraph relating to the company's significant transactions with related parties as discussed in Note 17 to the financial statements and the company's change in the manner in which deferred tax assets and liabilities, along with any related valuation allowance, are classified on the balance sheet as discussed in Note 2 to the financial statements) of PricewaterhouseCoopers LLP, an independent registered public accounting firm within the meaning of the Public Company Accounting Oversight Board (United States) and any applicable legislation or regulations, given on the authority of said firm as experts in auditing and accounting.

The transfer agent and registrar for our Common Shares is Computershare Trust Company of Canada at its principal offices in the cities of Vancouver, British Columbia, Calgary, Alberta and Toronto, Ontario.

S-16

Table of Contents

DOCUMENTS FILED AS PART OF THE REGISTRATION STATEMENT

The documents referred to under Documents Incorporated by Reference in this Prospectus Supplement have been or will be filed with the SEC as part of the registration statement to which this Prospectus Supplement and the Prospectus relates.

PURCHASERS STATUTORY RIGHTS

Securities legislation in certain of the provinces of Canada provides purchasers with the right to withdraw from an agreement to purchase securities. This right may be exercised within two business days after receipt or deemed receipt of a prospectus, the accompanying prospectus supplement relating to securities purchased by a purchaser and any amendment thereto. The legislation further provides a purchaser with remedies for rescission or damages if the prospectus, the accompanying prospectus supplement relating to securities purchased by a purchaser or any amendment contains a misrepresentation or are not delivered to the purchaser, provided that the remedies for rescission or damages are exercised by the purchaser within the time limit prescribed by the securities legislation in the purchaser's province. The purchaser should refer to any applicable provisions of the securities legislation of the purchaser's province for the particulars of these rights or consult with a legal advisor.

In an offering of convertible securities, investors are cautioned that the statutory right of action for damages for a misrepresentation contained in the prospectus is limited, in certain provincial securities legislation, to the price at which the convertible security is offered to the public under the prospectus offering. This means that, under the securities legislation of certain provinces, if the purchaser pays additional amounts upon conversion of the security, those amounts may not be recoverable under the statutory right of action for damages that applies in those provinces. The purchaser should refer to any applicable provisions of the securities legislation of the purchaser's province for the particulars of this right of action for damages or consult with a legal adviser.

Table of Contents

SCHEDULE A
FORM OF CONVERTIBLE NOTE
CONVERTIBLE PROMISSORY NOTE

[\$] UNITED STATES DOLLARS (the **Principal Amount**)

June [], 2016

Vancouver, British Columbia

FOR VALUE RECEIVED, WESTPORT INNOVATIONS INC., a corporation incorporated under the laws of the Province of Alberta (the **Company**), promises to pay to the order of [] (the **Lender**), or its registered assigns, in accordance with Section 18, (as applicable, the **Holder**), the Principal Amount, together with interest thereon from the date hereof until paid in full. All references to dollars or **\$** shall mean United States Dollars, unless specifically stated otherwise. The Company, the Lender and the Holder are sometimes referred to herein individually as a **Party** and collectively as the **Parties** .

This Convertible Note is issued pursuant to the Investment Agreement (the **Investment Agreement**) dated as of January 11, 2016 by and among the Lender and the Company.

The following is a statement of the rights of the Holder and the conditions to which this Convertible Note is subject, and to which the Holder hereof, by the acceptance of this Convertible Note, agrees:

1. **Definitions.** Capitalized terms defined in the Investment Agreement and used herein without definition have the same meaning herein as in the Investment Agreement provided that, if the Investment Agreement is terminated, such definitions shall be incorporated herein as set forth in the Investment Agreement as of the date hereof.

In addition, as used in this Convertible Note, the following capitalized terms have the following meanings:

- (a) **Affiliate** has the meaning attributed thereto under the *Business Corporations Act* (Alberta).
- (b) **Applicable Securities Legislation** means applicable securities Laws in each of the Provinces of Canada.
- (c) **Business Day** means any day other than a Saturday, Sunday or any other day that banks in Calgary, Alberta and Vancouver, British Columbia are not generally open for business.
- (d) **Confidential Information** has the meaning attributable thereto in Section 14(b).
- (e) **Conversion Event** means the date that: (i) the Common Shares trade at a price equal to or greater than 200% of the Valuation Price for 20 out of any 30 consecutive trading days on either the TSX or NASDAQ; and (ii) the daily trading volume in United States dollars of the Common Shares on either the TSX or NASDAQ

on such dates averages more than \$3,000,000.

- (f) **Conversion Price** has the meaning attributable thereto in Section 9(a) and 9(b), as applicable.
- (g) **Convertible Note** means this convertible promissory note.
- (h) **Convertible Note Liabilities** has the meaning attributable thereto in Section 13(a).
- (i) **Date of Original Issue** means June [], 2016, the date of issuance of the Convertible Note by the Company under the Investment Agreement.
- (j) **Debenture** means the debentures outstanding as of the Date of Original Issue pursuant to the Indenture and any debenture issued in substitution, or repayment or refinancing thereof.
- (k) **Debt** means indebtedness of the Company for borrowed money, including obligations under bankers acceptances, commercial paper, bonds and debentures.
- (l) **Default Interest Rate** means the lesser of 11% or the maximum rate allowed by applicable Laws.
- (m) **Event of Default** has the meaning attributed thereto in Section 6.

Table of Contents

- (n) **Existing Debentures** means any and all debentures outstanding from time to time under the Debenture Indenture dated September 22, 2011 between the Company and Computershare Trust Company of Canada, as amended by that certain First Supplemental Indenture dated June 26, 2014 and by that certain Second Supplemental Indenture dated June 12, 2015.
- (o) **Indenture** means the Debenture Indenture between the Company and Computershare Trust Company of Canada dated September 22, 2011, as amended by First Supplemental Indenture dated June 26, 2014 and by Second Supplemental Indenture dated June 12, 2015, and as the same may be amended, supplemented or restated from time to time.
- (p) **Ineligible Consideration** means any security or property other than a share of the capital stock of the Company that would be a prescribed security for purposes of clause 212(1)(b)(vii)(E) of the *Income Tax Act* (Canada) as that provision read immediately prior to its repeal.
- (q) **Maturity Date** has the meaning attributed thereto in Section 2.
- (r) **Merger** means the previously announced merger between the Company and Fuel Systems Solutions, Inc. to be completed pursuant to the terms of an Agreement and Plan of Merger between Fuel Systems Solutions, Inc., Whitehorse Merger Sub Inc. and the Company dated September 1, 2015.
- (s) **Minimum Threshold** means Common Shares (or Common Shares issuable in respect of the conversion of this Convertible Note) representing either (x) five (5%) of the Company's outstanding Common Shares, which shall be calculated by including in the numerator of such calculation: (i) the number of Common Shares which the Holder or any permitted assignee of the Holder holds; plus (ii) the number of Common Shares into which this Convertible Note may be converted, and by including in the denominator of such calculation the number of shares in (i) and (ii) above *plus* all issued and outstanding Common Shares or (y) at least seventy-five percent (75%) of the original number of Common Shares issuable in respect of the conversion of this Convertible Note, as adjusted for any stock split or other similar adjustment and treating the number of Common Shares into which this Convertible Note may be converted as Common Shares held by the Holder. Upon consummation of the Merger, the definition of **Minimum Threshold** shall mean Common Shares (or Common Shares into which this Convertible Note may be converted) representing at least eighty percent (80%) of the original number of Note Shares, as adjusted for any stock split or other similar adjustment and treating the number of Common Shares into which this Convertible Note may be converted as Common Shares held by the Holder.
- (t) **Obligations** means the principal, interest and all other amounts, in any form and at any time, arising or owing under this Convertible Note.
- (u) **Officer's Certificate** means a certificate of the Company signed by any one authorized officer or director of the Company in his or her capacity as an officer or director of the Company, and not in his or her personal capacity.

- (v) **Restructuring Event** has the meaning attributable thereto in Section 13(b).

- (w) **Senior Security** means all mortgages, liens, pledges, charges (whether fixed or floating), or security interests held by or on behalf of any Senior Creditor and in any manner securing any Senior Indebtedness.

- (x) **Subsidiary** has the meaning ascribed thereto in the *Securities Act* (Alberta).

- (y) **Successor Debentures** shall mean any successor or replacement indebtedness to the Existing Debentures, provided that: (i) any such replacement indebtedness shall be limited in principal amount to the principal amount plus the amount of any accrued interest outstanding with respect to the Existing Debentures as at the date of such replacement and applicable fees to finance the replacement, (ii) the terms and conditions shall not be more favorable to the lender than the Existing Debentures, and (iii) such replacement indebtedness shall not have a maturity date on or before the maturity date of Convertible Note, if any. For greater certainty, if the Holder together with its Affiliates shall hold less than the Minimum Threshold the provisions in (i), (ii) and (iii) above shall not apply.

A-2

Table of Contents

- (a) **Valuation Price** means \$2.17.
2. **Interest and Maturity.**
- (a) All unpaid principal, together with any accrued but unpaid interest and all other amounts of any kind arising at any time and payable hereunder, shall be due and payable on the date that is five years plus one day from the Date of Original Issue (the **Maturity Date**). Interest on this Convertible Note shall be payable in arrears annually, on December 31. The first payment of interest shall be on December 31, 2016, and shall be calculated from the Date of Original Issue to December 31, 2016.
- (b) Prior to the Maturity Date, interest on this Convertible Note shall be payable at a rate equal to 9.0% per annum, compounding annually, computed on the basis of the actual number of days elapsed and a year consisting of 365 or 366 days, as applicable, payable up to and including December 31 in each year other than 2021 in which case interest shall be calculated and payable on the Maturity Date. Interest shall be calculated based on the weighted average principal outstanding for such period.
- (c) Interest shall be payable in cash in same day funds on the date such interest is due pursuant to Section 2(a), including the Maturity Date, or if this Convertible Note is not paid in full on the Maturity Date, the date thereafter when this Convertible Note is paid in full.
3. **Interest Adjustment.** In the event that a court of competent jurisdiction determines that any provision of this Convertible Note obligates the Company to make any payment of interest, or other amount payable to the Holder, in an amount, or calculated at a rate, which would be prohibited by applicable Laws or would result in receipt by the Holder of interest at a rate in excess of the maximum rate permissible under such Laws then, notwithstanding such provision, such amount or rate shall be deemed to have been adjusted, with retroactive effect, to the maximum amount or rate of interest, as the case may be, as would not be so prohibited by Law or so result in receipt by the Holder of interest at a rate in excess of the maximum rate permissible. Each interest rate which is calculated under this Convertible Note on any basis other than a full calendar year (the **deemed interest period**) is, for the purposes of the *Interest Act* (Canada), equivalent to a yearly rate calculated by dividing such interest rate by the actual number of days in the deemed interest period, then multiplying such result by the actual number of days in the calendar year (365 or 366).
4. **Prepayment and Effect on Conversion Rights.** Subject to Section 9, the Company shall have no right to prepay this Convertible Note, or any interest or fees accruing or incurred with respect to this Convertible Note, without the prior written consent of the Holder.
5. **Collateral.** This Convertible Note is an unsecured obligation of the Company.
6. **Events of Default.** The occurrence of any of the following shall constitute an **Event of Default** under this Convertible Note:

- (a) a failure for 10 days to pay interest on this Convertible Note when due;
- (b) a failure to pay principal or premium, if any, on this Convertible Note when due whether at maturity or otherwise;
- (c) except for a failure to pay any Obligation when due, a default in the observance or performance of any covenant or condition of this Convertible Note by the Company which if remediable remains unremedied for a period of 20 days after notice in writing has been given by the Holder to the Company specifying such default and requiring the Company to remedy such default;
- (d) if a decree or order of a court having jurisdiction is entered adjudging the Company or a material Subsidiary thereof a bankrupt or insolvent under the *Bankruptcy and Insolvency Act* (Canada) or any other bankruptcy, insolvency or analogous Laws, or issuing sequestration or process of execution against, or against any substantial part of, the property of the Company or a material Subsidiary thereof, or appointing a receiver of, or of any substantial part of, the property of the Company or a material Subsidiary thereof or ordering the winding-up or liquidation of its affairs, and any such decree or order continues unstayed and in effect for a period of 60 days;

Table of Contents

- (e) if the Company or a material Subsidiary thereof institutes proceedings to be adjudicated a bankrupt or insolvent or seeking liquidation, dissolution, winding up, reorganization, arrangement, protection, relief or composition of it or any of its property or debt, or consents to the institution of bankruptcy or insolvency proceedings against it under the *Bankruptcy and Insolvency Act* (Canada), *Companies Creditors Arrangement Act* (Canada) or any other bankruptcy, insolvency or analogous Laws, or consents to the filing of any such petition or to the appointment of a receiver of, or of any substantial part of, the property of the Company or a material Subsidiary thereof or makes a general assignment for the benefit of creditors, or admits in writing its inability to pay its debts generally as they become due;
- (f) if a resolution is passed for the winding-up or liquidation of the Company or a material Subsidiary thereof, other than pursuant to an internal reorganization or other similar transaction, following which the activities of such material Subsidiary are assumed or continued by another Subsidiary of the Company which other Subsidiary is ultimately owned and controlled by the same persons in the same proportions;
- (g) if, after the date of this Convertible Note, any proceedings with respect to the Company or a material Subsidiary thereof are taken with respect to a compromise or arrangement, with respect to creditors of the Company or a material Subsidiary thereof generally, under the applicable legislation of any jurisdiction;
- (h) if an event of default has occurred and is continuing and has not been remedied or waived by the applicable Senior Creditor within 30 days or such longer period (not to exceed 120 days) as may be permitted by the Senior Creditor;
- (i) if an event of default (as defined in the Indenture) has occurred and is continuing and has not been remedied or waived by the applicable holders of Debentures within 30 days or such longer period (not to exceed 60 days) as may be permitted by the trustee or the Indenture;
- (j) for so long as [**original Holder**] or an Affiliate thereof, a default by the Company or its Affiliates in the observance or performance of any material covenant, condition or provision in any material contract, arrangement or agreement by and among the Lender or any of its Affiliates, on the one hand, and the Company or any of its Affiliates, on the other hand (which, for the avoidance of doubt, shall include, but not be limited to, all of the Transaction Documents); or
- (k) the failure to make the offer to prepay or the prepayments in respect of a Change of Control as set forth in Section 12(b) and 12(d), respectively.

7. **Rights of Holder upon Default**

- (a) Upon the occurrence or existence of any Event of Default (other than an Event of Default referred to in Section 6(d) or 6(e) hereof) and at any time thereafter during the continuance of such Event of Default, the Holder may declare all outstanding Obligations payable by the Company hereunder to be immediately due

and payable without presentment, demand, protest or any other notice of any kind, all of which are hereby expressly waived, anything contained herein or in the other Transaction Documents to the contrary notwithstanding. Upon the occurrence or existence of any Event of Default described in Section 6(d) or 6(e) hereof, immediately and without notice, all outstanding Obligations payable by the Company hereunder shall automatically become immediately due and payable, without presentment, demand, protest or any other notice of any kind, all of which are hereby expressly waived, anything contained herein or in the other Transaction Documents to the contrary notwithstanding. In addition to the foregoing remedies, upon the occurrence or existence of any Event of Default, the Holder may exercise any other right, power or remedy granted to it by the Transaction Documents or otherwise permitted to it by law, either by suit in equity or by action at law, or both.

- (b) Notwithstanding anything to the contrary contained herein, in addition to the rights of the Holder specified in subsection (a) of this Section 7, on the date an Event of Default under this Convertible Note occurs, the interest rate on this Convertible Note shall increase, from that date forward for so long as an Event of Default is continuing, to the Default Interest Rate, with such interest payable on the last

Table of Contents

Business Day of each month in cash and compounding annually. For the avoidance of doubt, (i) following an Event of Default and until such Event of Default is cured, the interest rate payable on this Convertible Note, as increased pursuant to this Section 7(b), shall continue to accrue, and (ii) following any cure of an Event of Default, the interest rate payable on this Convertible Note shall revert to such rate indicated in Section 2, and shall continue to accrue theretofor until the later of the Maturity Date or until the obligation to repay this Convertible Note in full has been satisfied.

8. **Covenants**

- (a) **Affirmative Covenants.** The Company covenants that, so long as this Convertible Note shall remain outstanding, the Company shall:
- (i) **Preservation of Corporate Existence.** Subject to the express provisions hereof, the Company will carry on and conduct its activities in a proper, efficient and business-like manner and in accordance with good business practices; and, subject to the express provisions hereof, it will do or cause to be done all things necessary to preserve and keep in full force and effect its existence and rights.
 - (ii) **Compliance with Laws.** Comply with all applicable Laws of any Governmental Entity, noncompliance with which could materially adversely affect its business or condition, financial or otherwise, on a consolidated basis, except non-compliance being contested in good faith through appropriate proceedings so long as the Company shall have set up and funded sufficient reserves, if any, required under generally accepted accounting principles with respect to such items.
 - (iii) **Performance under the Convertible Note and the Investment Agreement.** Pay, observe or perform any other covenant, obligation, condition or agreement contained in this Convertible Note or, for so long as **[original Holder]** or an Affiliate thereof holds this Convertible Note, the Investment Agreement.
 - (iv) **Financial Statements.** The Company shall deliver, or otherwise make available via SEDAR, to the Holder all information (including, without restriction, quarterly unaudited and annual audited financial statements and related management's discussion and analysis) required to be delivered by it to its shareholders pursuant to Applicable Securities Legislation, within the time periods required thereby.
- (b) **Negative Covenants.** The Company covenants that prior to the payment in full in cash of all Obligations, the Company shall not, and shall cause its Subsidiaries not to, directly or indirectly take any of the following actions without the prior written consent of the Holder:
- (i) **Limitation on Additional Debt.** During the period in which the Holder together with its Affiliates continues to hold the Minimum Threshold:

- (A) issue or permit any Subsidiary to issue guarantees of any indebtedness of any other person;

- (B) issue or incur any indebtedness ranking senior to or *pari passu* with the Convertible Notes, other than any indebtedness incurred in connection with the refinancing or repayment of indebtedness in existence as at the date hereof (provided that the amount of any such indebtedness issued in connection with such refinancing or repayment shall not exceed the amount of the indebtedness being refinanced or repaid); or

- (C) permit any subsidiary to issue or incur any indebtedness, other than any indebtedness incurred in connection with the refinancing or repayment of indebtedness in existence as at the date hereof (provided that the amount of any such indebtedness issued in connection with such refinancing or repayment shall not exceed the amount of the indebtedness being refinanced or repaid);
provided that notwithstanding the foregoing the Company and its Subsidiaries may issue or incur indebtedness constituted of (x) Successor Debentures and (y) the unutilized portion (as measured on the date hereof) of any lines of credit or existing credit facilities, bankers acceptances, letters of credit, hedging agreements, credit cards, leases and similar indebtedness (including any such

Table of Contents

facilities or indebtedness assumed by the Company as part of the Merger) and (z) other indebtedness, which if such indebtedness is issued by the Company must rank *pari passu* with or junior to the Convertible Notes; and provided, further, that the total amount of the indebtedness collectively referred to in (y) and (z) above (including principal and accrued interest thereon and whether issued by the Company or any Subsidiary thereof) shall not exceed, at any point in time following its issuance or incurrence, \$3,270,000. For purposes of calculating such \$3,270,000 amount, in the event that any such additional incurred indebtedness is denominated in a currency other than U.S. dollars the foreign exchange rate to be used in determining such amount shall be the rate in effect as at the original date of this Agreement.

- (ii) Dividend. The Company shall not declare or pay any dividend on the Common Shares; provided, however, that if, notwithstanding this Section 8(b)(ii), the Company declares or pays a cash dividend on the Common Shares prior to repayment in full of this Convertible Note, the Company shall pay the Holder liquidated damages equal to the amount of dividends that would have been paid to the Holder assuming the Principal Amount then outstanding was converted into Common Shares in accordance with Section 9 on the day prior to the declaration of such dividend, which damages shall be paid concurrently with the payment of the applicable dividend. For purposes of clarity, it is agreed that the damages payment payable to the Holder under this clause (ii) shall constitute part of the Obligations and such payment is not a penalty but a genuine pre-estimate of damages.

- (iii) Refrain from Violating the Convertible Note and the Investment Agreement. The Company shall not, and shall cause its Subsidiaries to not, violate or breach any covenant, obligation, condition or agreement contained in this Convertible Note or, for so long as **[original Holder]** or an Affiliate thereof holds this Convertible Note, the Investment Agreement.

9. Conversion

- (a) Conversion into Common Shares by the Holder. From the date that is twelve calendar months after the Date of Original Issue and at any time or from time to time thereafter prior to 4:00 p.m. (Vancouver time) on the Business Day immediately preceding the Maturity Date, the Holder shall have the option to convert, as a whole or in part, up to the entire amount then outstanding under this Convertible Note (including the accrued but unpaid interest thereon) into Common Shares at the Valuation Price per Common Share, subject to adjustment as provided in Section 10 hereof, as determined on the Business Day immediately prior to the date of conversion (each such adjusted Valuation Price, whether pursuant to a conversion by the Holder or the Company, a Conversion Price). The number of Common Shares to be issued upon such a conversion shall be equal to the quotient obtained by dividing (x) the principal outstanding under the Convertible Note that the Lender elects to convert (plus the accrued but unpaid interest thereon) by (y) the applicable Conversion Price; provided that the aggregate of all conversions by the Holder under this Section 9(a) shall not result in the issuance of the greater of (i) 16,000,000 Common Shares (subject to adjustment pursuant to Section 10 for a stock split, subdivision or other adjustment of the outstanding Common Shares) and (ii) as of any date of determination, one Common Share less than the number of Common Shares that if issued pursuant to this Section 9(a) would, pursuant to applicable Law or any regulation promulgated by any Governmental Entity, the TSX or NASDAQ, require the Company's shareholders to approve such issuance, in each case subject to any adjustments pursuant to Section 10.

- (b) Conversion by the Company. From the day that is twenty-four calendar months after the Date of Original Issue and at any time or from time to time thereafter prior to 4:00 p.m. (Vancouver time) on the Business Day immediately preceding the Maturity Date, if a Conversion Event shall have occurred, then the Company shall prior to the 5th Business Days following such Conversion Event have the option to convert up to the entire amount outstanding under this Convertible Note (including the accrued but unpaid interest thereon) into Common Shares at the Conversion Price. The number of Common Shares to be issued upon such a conversion shall be equal to the quotient obtained by dividing (x) the principal amount outstanding under the Convertible Note that the Company elects to

A-6

Table of Contents

convert (plus the accrued but unpaid interest thereon) by (y) the applicable Conversion Price; provided that the aggregate of all conversions by the Company under this Section 9(b) shall not result in the conversion of greater than \$8,750,000 of principal amount, subject to any adjustments pursuant to Section 10.

- (c) **Mechanics and Effect of Conversion.** No fractional Common Shares shall be issued upon conversion of this Convertible Note. Upon the conversion of all of the principal and accrued interest outstanding under this Convertible Note, in lieu of the Company issuing any fractional shares to the Holder, the Company shall pay to the Holder the amount of outstanding principal that is not so converted. On partial conversion of this Convertible Note, the Company shall issue to the Holder (i) the Common Shares into which a portion of this Convertible Note is converted and (ii) an amended and restated version of this Convertible Note with a principal amount hereof that shall be equal the difference between (A) the principal amount of this Convertible Note immediately prior to such conversion minus (B) the portion of such principal amount converted into Common Shares. Upon any conversion of this Convertible Note pursuant to this Section 9, the Holder shall surrender this Convertible Note, duly endorsed, at the principal office of the Company. At its expense, the Company shall contemporaneously with such surrender issue and deliver to the Holder at such principal office a certificate or certificates for the number of shares of such Common Shares to which the Holder shall be entitled upon such conversion (bearing such legends as are required by Applicable Securities Legislation and stock exchange regulations or policies, as required by applicable Laws), together with any other securities and property to which the Holder is entitled upon such conversion under the terms of this Convertible Note.

- (d) **Reservation of Stock Issuable Upon Conversion.** The Company shall at all times reserve and keep available out of its authorized but unissued Common Shares, solely for the purpose of effecting the conversion of this Convertible Note such number of its Common Shares as shall from time to time be sufficient to effect the conversion of this Convertible Note; and if at any time the number of authorized but unissued Common Shares shall not be sufficient to effect the conversion of this Convertible Note the Company will take such corporate action as may be necessary to increase its authorized but unissued Common Shares to such number of shares as shall be sufficient for such purpose.

- (e) **Payment of Taxes.** The Company will pay all transfer taxes or charges that may be imposed with respect to the issue or delivery of Common Shares upon conversion of this Convertible Note.

- (f) **Personal Information Form.** Notwithstanding any other provision of this Section 9, in the event that Holder is the holder of 10% or more of the Company's outstanding Common Shares, no conversion of any principal or interest of this Convertible Note shall occur until the individuals that would control the votes of any Common Shares held by the Holder (upon conversion of this Convertible Note) shall have registered on the System for Electronic Disclosure by Insiders and provided to the TSX a **Personal Information Form** and such form shall have been cleared by the TSX. The Company shall assist the Holder, with the filing of such form as necessary.

10. **Conversion Price Adjustments**

- (a) Adjustment for Splits and Combinations. If the Company shall at any time or from time to time after the Date of Original Issue effect a stock split or subdivision of the outstanding Common Shares, the Conversion Price shall be proportionately decreased, and, conversely, if the Company shall at any time or from time to time after the Date of Original Issue combine the outstanding Common Shares into a smaller number of shares, the Conversion Price in effect immediately before the combination shall be proportionately increased. Any adjustment under this Section 10(a) shall become effective contemporaneously with the stock split, subdivision or combination.
- (b) Adjustment for Common Shares Dividends and Distributions. If the Company at any time or from time to time after the Date of Original Issue issues, or fixes a record date for the determination of holders of Common Shares entitled to receive, a dividend or other distribution payable solely in additional Common Shares, in each such event the Conversion Price that is then in effect shall be decreased as of

A-7

Table of Contents

the time of such issuance or, in the event such record date is fixed, as of the close of business on such record date, by multiplying the Conversion Price then in effect by a fraction: (i) the numerator of which is the total number of Common Shares issued and outstanding immediately prior to the time of such issuance or the close of business on such record date; and (ii) the denominator of which is the sum of the total number of Common Shares issued and outstanding immediately prior to the time of such issuance or the close of business on such record date plus the number of Common Shares issuable in payment of such dividend or distribution; provided, however, that if such record date is fixed and such dividend is not fully paid or if such distribution is not fully made on the date fixed therefore, the Conversion Price shall be recomputed accordingly as of the close of business on such record date and thereafter the Conversion Price shall be adjusted pursuant to this Section 10(b) to reflect the actual payment of such dividend or distribution.

- (c) Adjustments for Other Dividends and Distributions. Subject to Section 10(k), if the Company at any time or from time to time after the Date of Original Issue issues, or fixes a record date for the determination of holders of Common Shares entitled to receive, a dividend or other distribution in each case payable in securities of the Company other than Common Shares or other property, in each such event provision shall be made so that the Holder of this Convertible Note shall receive upon conversion hereof, in addition to the number of Common Shares receivable hereupon, the amount of securities of the Company or other property which such Holder would have received had this Convertible Note been converted into Common Shares on the date of such event and had they thereafter, during the period from the date of such event to and including the conversion date, retained such securities or other property receivable by them as aforesaid during such period, subject to all other adjustments called for during such period under this Section 10 with respect to the rights of the Holder of this Convertible Note or with respect to such other securities or other property by their terms. As used herein, the term "other property" does not include cash.
- (d) Adjustment for Reclassification, Exchange and Substitution. Subject to Section 10(k), if at any time or from time to time after the Date of Original Issue, the Common Shares issuable upon the conversion of this Convertible Note is changed into the same or a different number of shares of any class or series of stock, whether by recapitalization, reclassification or otherwise (other than a subdivision or combination of shares or stock dividend or a reorganization, merger, consolidation or sale of assets provided for elsewhere in this Section 10), then in any such event the Holder shall have the right thereafter to convert this Convertible Note into the kind and amount of stock and other securities and property receivable upon such recapitalization, reclassification or other change by holders of the number of Common Shares into which this Convertible Note could have been converted immediately prior to such recapitalization, reclassification or change, all subject to further adjustment as provided herein or with respect to such other securities or property by the terms thereof.
- (e) Reorganizations. Subject to Section 10(k), if at any time or from time to time after the Date of Original Issue there is a capital reorganization of the Common Shares (other than a recapitalization, subdivision, combination, reclassification, exchange or substitution of shares provided for elsewhere in this Section 10), as a part of such capital reorganization provision shall be made so that the Holder shall thereafter be entitled to receive upon conversion of this Convertible Note the number of shares or other securities or property of the Company to which a holder of the number of Common Shares deliverable upon such conversion would have been entitled on such capital reorganization, subject to adjustment in respect of such securities by the terms thereof. In any such case, appropriate adjustment shall be made in the application of the provisions of this Section 10 with respect to the rights of the Holder after such capital reorganization to the end that the

provisions of this Section 10 (including adjustment of the Conversion Price then in effect and the number of shares issuable upon conversion of this Convertible Note) shall be applicable after that event and be as nearly equivalent as practicable.

- (f) Certificate of Adjustment. In each case of an adjustment or readjustment of any Conversion Price for the number of Common Shares or other securities issuable upon conversion of this Convertible Note, the Company, at its own expense, shall cause its Chief Financial Officer to compute such adjustment or

Table of Contents

readjustment in accordance with the provisions hereof and prepare a certificate showing such adjustment or readjustment, and shall mail such certificate, by first class mail, postage prepaid, to the Holder at the Holder's address as shown in the Company's books. The certificate shall set forth such adjustment or readjustment, showing in detail the facts upon which such adjustment or readjustment is based. No adjustment in the Conversion Price shall be required to be made unless it would result in an increase or decrease of at least one cent, but any adjustments not made because of this sentence shall be carried forward and taken into account in any subsequent adjustment otherwise required hereunder.

- (g) Notices of Record Date. Upon (i) the establishment by the Company of a record date of the holders of any class of securities for the purpose of determining the holders thereof who are entitled to receive any dividend or other distribution, or (ii) any capital reorganization of the Company, any reclassification or recapitalization of the shares of the Company, any merger or consolidation of the Company with or into any other Company, or any transfer of all or substantially all the assets of the Company to any other person or any voluntary or involuntary dissolution, liquidation or winding up of the Company, the Company shall mail to the Holder at least the later of (x) 20 Business Days prior to the record date specified therein and (y) concurrent with the notice to the holders of the Common Shares, a notice specifying (A) the date on which any such record is to be taken for the purpose of such dividend or distribution and a description of such dividend or distribution, (B) the date on which any such reorganization, reclassification, transfer, consolidation, merger, dissolution, liquidation or winding up is expected to become effective, and (C) the date, if any, that is to be fixed as to when the holders of record of Common Shares (or other securities) shall be entitled to exchange their Common Shares (or other securities) for securities or other property deliverable upon such reorganization, reclassification transfer, consolidation, merger, dissolution, liquidation or winding up.
- (h) No Impairment. The Company shall not amend its Articles of Incorporation or participate in any reorganization, transfer of assets, consolidation, merger, dissolution, issue or sale of securities or any other voluntary action for the purpose of avoiding or seeking to avoid the observance or performance of any of the terms to be observed or performed hereunder by the Company, but shall at all times in good faith assist in carrying out all such action as may be reasonably necessary or appropriate in order to protect the conversion rights of the Holder of this Convertible Note against dilution or other impairment as provided herein.
- (i) Other Adjustments. If and whenever the Company shall take any action affecting or relating to the Common Shares, other than any action described in this Section 10, which would prejudicially affect the rights of the Holder, the Conversion Price and, if required, the number of Common Shares to be issued upon exercise of the Convertible Note will be adjusted by the Board in such manner, if any, and at such time, as the Board may, acting reasonably and in good faith, subject to the approval of any stock exchange(s) on which the Common Shares are listed and posted for trading, reasonably determine to be equitable in the circumstances to the Holder.
- (j) Governmental Requirements. If any Common Shares, reserved or to be reserved for the purpose of conversion of the Convertible Note hereunder, require qualification with or approval of any Governmental Entity under any federal or provincial Law applicable in British Columbia before such Common Shares may be validly issued upon conversion, the Company shall take such action as may be necessary to secure such qualification or approval, as the case may be.

(k) Ineligible Consideration. Notwithstanding anything to the contrary in Section 10, if the Holder would otherwise be entitled to receive, upon conversion of the Convertible Note, any Ineligible Consideration, the Holder shall not be entitled to receive such Ineligible Consideration but the Company shall have the right (at the sole option of the Company) to deliver either such Ineligible Consideration or prescribed securities for the purposes of former clause 212(1)(b)(vii)(E) of the *Income Tax Act* (Canada) with a market value equal to the market value of such Ineligible Consideration.

11. Withholding Taxes. Notwithstanding any other provision of this Convertible Note, the Company shall:

(a) not be obliged to reimburse, indemnify, make whole or otherwise pay to the Holder; and

A-9

Table of Contents

- (b) be entitled to deduct and withhold from all amounts payable pursuant to this Convertible Note, any amounts required by applicable law to be deducted or withheld for any and all Taxes so long as the Company promptly pays the full amount deducted or withheld to the applicable Governmental Entity in accordance with applicable law; and
- (c) assist the Holder in preparing all necessary forms and other paperwork to obtain any tax credits, refunds or exemptions to which the Holder is entitled in respect of any such amounts deducted or withheld; and
- (d) make any filings or assist the Holder in making any filings and take other required actions to assist the Holder in recovering any such amounts deducted or withheld.

Any such amounts deducted and not owed or paid to the applicable Governmental Entity in accordance with applicable law shall be returned to the Holder promptly. The Holder shall provide any information reasonably requested by the Company to enable it to determine whether taxes must be withheld or deducted and the amount of such withholding or deduction. Prior to deducting and withholding any amount required by applicable law to be deducted or withheld for any and all Taxes, the Company shall provide the Holder with written notice of the claim of the applicable Governmental Entity that such withholding is required by applicable law and the Company shall take all reasonable actions, at the request of the Holder, to reduce or eliminate any proposed withholding taxes, at the Holder's expense.

12. Change of Control

- (a) Notice of Change in Control. The Company will, within 5 Business Days after the Board has knowledge of the occurrence of any Change in Control, give written notice of such Change in Control to the Holder. Such notice shall refer to this Section 12, shall contain and constitute an offer to prepay this Convertible Note as described in Section 12(b) and shall be accompanied by the certificate described in Section 12(e).
- (b) Offer to Prepay. The offer to prepay this Convertible Note contemplated by Section 12(a) shall be an offer to prepay, in accordance with and subject to this Section 12, all, but not less than all, this Convertible Note on a date specified in such offer (the **Proposed Prepayment Date**), which date shall be not less than 10 Business Days and not more than 20 Business Days after the date of such offer (if the Proposed Prepayment Date shall not be specified in such offer, the Proposed Prepayment Date shall be the first Business Day after the 25th Business Day after the date of such offer).
- (c) Acceptance/Rejection. The Holder may accept the offer to prepay made pursuant to this Section 12 by causing a notice of such acceptance to be delivered to the Company not later than 5 Business Days after receipt by the Holder of the most recent offer of prepayment, but in any event at least 5 Business Days prior to the Proposed Prepayment Date. A failure by the Holder to respond to an offer to prepay made pursuant to this Section 12 shall be deemed to constitute a rejection of such offer by such holder.
- (d) Prepayment. Prepayment of this Convertible Note to be prepaid pursuant to this Section 12 shall be at 100% of the principal amount of such Note, together with interest on such Note accrued to the date of prepayment.

- (e) Officer's Certificate. Each offer to prepay this Convertible Note pursuant to this Section 12 shall be accompanied by a certificate, signed by an officer of the Company and dated the date of such offer, specifying: (i) the Proposed Prepayment Date; (ii) that such offer is made pursuant to this Section 12; (iii) the principal amount of this Convertible Note offered to be prepaid; (iv) the interest that would be due on this Convertible Note, accrued to the Proposed Prepayment Date; (v) that the conditions of this Section 12 have been fulfilled; and (vi) in reasonable detail, the nature and date of the Change in Control.

13. Subordination of this Convertible Note

- (a) Subordination. The indebtedness, liabilities and obligations of the Company under this Convertible Note, whether on account of principal, interest or otherwise, upon maturity (collectively the Convertible Note Liabilities), shall be subordinated and postponed and subject in right of payment, to the extent and in the manner hereinafter set forth in the following sections of this Section 13, to the full and final payment of all Senior Indebtedness and the Holder agrees to and shall be bound by the

A-10

Table of Contents

provisions of this Section 13. For the purpose of clarity, the foregoing shall not in any way limit the right of the Holder to receive, or the obligation of the Company to pay, any of the Obligations due and owing prior to the Maturity Date.

(b) **Order of Payment.** In the event of any dissolution, winding-up, liquidation, bankruptcy, insolvency, receivership, creditor enforcement, reorganization or realization or other similar proceedings relating to the Company or any of its property or assets (whether voluntary or involuntary, partial or complete) or any other marshalling of the assets and liabilities of the Company or any sale of all or substantially all of the assets of the Company (a **Restructuring Event**):

- (i) all Senior Indebtedness shall first be paid in full, or provision made for such payment, before any payment is made on account of Convertible Note Liabilities;
- (ii) any payment or distribution of assets of the Company, whether in cash, property or securities, to which the Holder would be entitled except for the provisions of this Section 13, shall be paid or delivered by the trustee in bankruptcy, receiver, assignee for the benefit of creditors, or other liquidating agent making such payment or distribution, to the Senior Creditors to the extent necessary to pay all Senior Indebtedness in full after giving effect to any concurrent payment or distribution, or provision therefore, to the Senior Creditors; and
- (iii) the Senior Creditors or a receiver or a receiver-manager of the Company or of all or part of its assets or any other enforcement agent may sell, mortgage, or otherwise dispose of the Company assets in whole or in part, free and clear of all Convertible Note Liabilities and without the approval of the Holder or any requirement to account to the Holder; provided, however, that the consideration from any such sale, mortgage or disposal shall be utilized to repay the Convertible Note Liabilities and other *pari passu* debt following the repayment (or provision made for such repayment of) Senior Indebtedness.

The rights and priority of the Senior Indebtedness and the subordination pursuant hereto shall not be affected by:

- (A) the time, sequence or order of creating, granting, executing, delivering of, or registering, perfecting or failing to register or perfect any security notice, caveat, financing statement or other notice in respect of the Senior Security;
- (B) the time or order of the attachment, perfection or crystallization of any security constituted by the Senior Security;
- (C) the taking of any collection, enforcement or realization proceedings pursuant to the Senior Security;
- (D)

the date of obtaining of any judgment or order of any bankruptcy court or any court administering bankruptcy, insolvency or similar proceedings as to the entitlement of the Senior Creditors, or any of them or the Holder or any of them to any money or property of the Company;

- (E) the failure to exercise any power or remedy reserved to the Senior Creditors under the Senior Security or to insist upon a strict compliance with any terms thereof;
- (F) whether any Senior Security is now perfected, hereafter ceases to be perfected, is avoidable by any trustee in bankruptcy or like official or is otherwise set aside, invalidated or lapses;
- (G) the date of giving or failing to give notice to or making demand upon the Company; or
- (H) any other matter whatsoever.

For purposes of clarity, prior to or following a Restructuring Event, neither the foregoing Section 13(b) nor any other provision herein shall prevent the Holder from exercising its rights to convert pursuant to Section 9(a).

- (c) Subrogation to Rights of Senior Creditors. Subject to the prior payment in full of all Senior Indebtedness, the Holder shall be subrogated to the rights of the Senior Creditors to receive payments or distributions of assets of the Company to the extent of the application thereto of such payments or

Table of Contents

other assets which would have been received by the Holder but for the provisions hereof until the principal of and interest on this Convertible Note shall be paid in full, and no such payments or distributions to the Holder of cash, property or securities, which otherwise would be payable or distributable to the Senior Creditors, shall, as between the Company, its creditors other than the Senior Creditors, and the Holder, be deemed to be a payment by the Company to the Senior Creditors or on account of the Senior Indebtedness, it being understood that the provisions of this Section 13 are intended solely for the purpose of defining the relative rights of the Holder, on the one hand, and the Senior Creditors, on the other hand.

The Holder, hereby waives any and all rights to require a Senior Creditor to pursue or exhaust any rights or remedies with respect to the Company or any property and assets subject to the Senior Security or in any other manner to require the marshalling of property, assets or security in connection with the exercise by the Senior Creditors of any rights, remedies or recourses available to them.

- (d) Obligation to Pay Not Impaired. Nothing contained in this Section 13 or elsewhere in this Convertible Note is intended to or shall impair, as between the Company, its creditors other than the Senior Creditors, and the Holder, the obligation of the Company, which is absolute and unconditional, to pay to the Holder the principal of and interest on this Convertible Note, as and when the same shall become due and payable in accordance with its terms, or affect the relative rights of the Holder and creditors of the Company other than the Senior Creditors, nor shall anything herein or therein prevent the Holder from exercising all remedies otherwise permitted by applicable Law upon default under this Convertible Note, subject to the rights, if any, under this Section 13 of the Senior Creditors.

- (e) No Payment if Senior Indebtedness in Default. Upon the maturity of any Senior Indebtedness by lapse of time, acceleration or otherwise, or any other enforcement following acceleration of the obligations under the Senior Indebtedness, then, except as provided in Section 13(f), all such Senior Indebtedness shall first be paid in full, or shall first have been duly provided for, before any payment is made on account of the Convertible Note Liabilities or otherwise in respect of this Convertible Note.

In case of an event of default that is continuing with respect to any Senior Indebtedness permitting (either at that time or upon notice, lapse of time or satisfaction of other condition precedent) a Senior Creditor to demand payment or accelerate the maturity thereof, unless and until such event of default shall have been cured or waived or shall have ceased to exist, and provided the Senior Creditor to whom the default relates has given notice of such default to the Company, no payment (by purchase of this Convertible Note) shall be made by the Company with respect to the Convertible Note Liabilities and the Holder shall not be entitled to demand, accelerate, institute proceedings for the collection of, or receive any payment or benefit (including without limitation by set-off, combination of accounts or otherwise in any manner whatsoever) on account of this Convertible Note after the happening of such a default, and unless and until such event of default shall have been cured or waived or shall have ceased to exist, such payments shall be held in trust for the benefit of, and, if and when such Senior Indebtedness shall have become due and payable, shall be paid over to, the Senior Creditors or to the trustee or trustees under any note under which any instruments evidencing an amount of such Senior Indebtedness remaining unpaid until all such Senior Indebtedness shall have been paid in full, after giving effect to any concurrent payment or distribution to such Senior Creditors.

The fact that any payment hereunder is prohibited by this Section 13(e) shall not prevent the failure to make such payment from being an Event of Default hereunder.

- (f) Payment on Note Permitted. Nothing contained in this Section 13 or elsewhere in this Convertible Note shall affect the obligation of the Company to make, or prevent the Company from making, at any time, except as prohibited by Section 13(b) or 13(e), any payment of principal of, interest on, or any other Obligation under this Convertible Note. The fact that any such payment is prohibited by Section 13(b) or Section 13(e) shall not prevent the failure to make such payment from being an Event of Default hereunder. Nothing contained in this Section 13 or elsewhere in this Convertible Note, shall prevent, except as prohibited by Section 13(b) or 13(e), the application by the Holder of any monies deposited for the purpose, to the payment of or on account of the Convertible Note Liabilities.

Table of Contents

- (g) Confirmation of Subordination. The Holder by its acceptance thereof agrees to take such action as may be necessary or appropriate to effect the subordination as provided in this Section 13. Upon request of the Company, and upon being furnished an Officer's Certificate stating that one or more named Persons are Senior Creditors and specifying the amount and nature of the Senior Indebtedness of such Senior Creditor, the Holder shall enter into a written agreement or agreements, in a form acceptable to the Senior Creditor, each acting reasonably and in good faith, with the Company and the Persons named in such Officer's Certificate providing that such Persons are entitled to all the rights and benefits of this Section 13 as Senior Creditors and for such other matters (such as standstill periods and an agreement not to amend the provisions of this Section 13 and the definitions used herein without the consent of such Senior Creditors), as the Senior Creditors may reasonably request. Such agreement shall be conclusive evidence that the indebtedness specified therein is Senior Indebtedness; however, nothing herein shall impair the rights of any Senior Creditor who has not entered into such an agreement.
- (h) Rights of Senior Creditors Not Impaired. No right of any present or future holder of any Senior Indebtedness to enforce the subordination herein will at any time or in any way be prejudiced or impaired by any act or failure to act on the part of the Company or by any non-compliance by the Company with the terms, provisions and covenants of this Convertible Note, regardless of any knowledge thereof which any such holder may have or be otherwise charged with.
- (i) Altering the Senior Indebtedness. Subject to Section 8(b)(i) hereof, the holders of the Senior Indebtedness have the right to increase, extend, renew, revise, restate, modify or amend the terms of the Senior Indebtedness or any security therefor and to release, sell or exchange such security and otherwise to deal freely with the Company, all without notice to or consent of the Holder and without affecting the liabilities and obligations of the parties to this Convertible Note or the Holder.
- (j) Invalidated Payments. In the event that any of the Senior Indebtedness shall be paid in full and subsequently, for whatever reason, such formerly paid or satisfied Senior Indebtedness becomes unpaid or unsatisfied, the terms and conditions of this Section 13 shall be reinstated and the provisions of this Article shall again be operative until all Senior Indebtedness is repaid in full, provided that such reinstatement shall not give the Senior Creditors any rights or recourses against the Holder for amounts paid to the Holder subsequent to such payment or satisfaction in full and prior to such reinstatement.
- (k) Contesting Security. The Holder agrees that it shall not contest or bring into question the validity, perfection or enforceability of any of the Senior Security, or the relative priority of the Senior Security.
- (l) Obligations Created by Section 13. The Company and the Holder agree that:
 - (i) the provisions of this Section 13 are an inducement and consideration to each Senior Creditor to give or continue credit to the Company, its Subsidiaries or others or to acquire Senior Indebtedness;
 - (ii)

each Senior Creditor may accept the benefit of this Section 13 on the terms and conditions set forth in this Section 13 by giving or continuing credit to the Company, its Subsidiaries or others or by acquiring Senior Indebtedness, in each case without notice to the Holder and without establishing actual reliance on this Section 13; and

- (iii) each obligation created by this Section 13 is created for the benefit of the Senior Creditors and is hereby declared to be created in their favour by the Company and the Holder and shall be binding on the Company and the Holder whether or not the confirmation described in Section 13(g) is requested, executed or delivered.

- (m) No Set-Off. The Company and the Holder agree, that the Holder shall not have any rights of set-off or counterclaim with respect to the principal of and interest on this Convertible Note at any time when any payment of, or in respect of, such amounts to the Holder is prohibited by this Section 13 or is otherwise required to be paid to the Senior Creditors.

Table of Contents

14. **Additional Covenants of Holder**

- (a) **No Short Sales.** So long as Holder is the holder of this Convertible Note, Holder will not and will ensure that its Affiliates do not engage in any transaction which is designed to sell short the Common Shares or any other publicly traded securities of the Company.
- (b) **Confidentiality.** All material non-public information and data, in whatever form, obtained by Holder in respect of the Company and the subject-matter of the Investment Agreement (the **Confidential Information**) shall be held by Holder in the strictest confidence and shall not be disclosed to any third party; provided that such Confidential Information may be disclosed if the disclosure (i) is made with the consent of the Company; (ii) is made to an Affiliate (including any limited partner, general partner, member, manager, shareholder, director, officer or employee) of Holder and such Affiliate agrees to be subject to such confidentiality provisions; (iii) is required by Law or by a Governmental Entity; (iv) is in respect of information or data that is in the public domain at the time of the disclosure through no fault of Holder or any party to which it has disclosed the information; (v) to the extent that the Holder can demonstrate that such information was, prior to the receipt thereof from the Company, in the possession of the Holder or was subsequently independently developed by the Holder; (vi) is made to Holder's advisors or representatives, which agree to maintain the confidentiality of the Confidential Information; or (vii) is received from a third party not subject to confidentiality obligations with respect to such information.
15. **Further Assurances.** Each Party shall promptly do, make, execute, deliver, or cause to be done, made, executed or delivered, all such further acts, documents and things as the other Party may require, acting reasonably, from time to time, for the purpose of giving effect to the Investment Agreement and this Convertible Note, and shall take such steps as may be reasonably within its power to implement the full extent of the Investment Agreement and this Convertible Note.
16. **Waiver and Amendment.** Any provision of this Convertible Note may be amended, waived or modified upon the written consent of the Company and the Holder. Additionally, the Holder shall be deemed to have waived any breach of any covenant set forth in Section 8 in the event that each member of the Board appointed by Lender votes in favor of the action that causes such breach, *provided* that all material terms related to the cause thereof were disclosed to such Board members.
17. **Transfer of this Convertible Note or Securities Issuable on Conversion or Payment Hereunder.** Transfers of this Convertible Note shall be registered upon registration books maintained for such purpose by or on behalf of the Company. Prior to presentation of this Convertible Note for registration of transfer, the Company shall treat the registered holder hereof as the owner and holder of this Convertible Note for the purpose of receiving all payments of principal and interest hereon and for all other purposes whatsoever, whether or not this Convertible Note shall be overdue and the Company shall not be affected by notice to the contrary.
- Assignment.** Neither this Convertible Note nor any of the rights, interests or obligations hereunder may be assigned, by operation of law or otherwise, as a whole or in part, (i) by the Company without the prior written consent of the Holder, or (ii) by the Holder without the prior written consent of the Company; *provided* that the Holder or an

Affiliate of the Lender may assign the whole of this Convertible Note and the rights, interests or obligations hereunder to any other Affiliate of the Lender without the prior written consent of the Company, so long as the Holder provides prompt written notice to the Company of such assignment. Notwithstanding the foregoing (i) this Convertible Note may only be assigned in whole and not in part, (ii) the Company may, in its reasonable discretion, refuse to consent to the transfer of this Convertible Note to any direct competitor of the Company, including but not limited to Volvo Truck Corporation, Cummins Inc., AVL LIST GmbH and Weichai Power Co., Ltd. or any Affiliates thereof and (iii) until the Company receives notice in accordance with this section the Company shall treat the registered holder hereof as the owner and holder of this Convertible Note for the purpose of receiving all payments of principal and interest hereon and for all other purposes whatsoever, whether or not this Convertible Note shall be overdue.

18. Treatment of Note. The Company will treat, account and report the Convertible Note in accordance with generally accepted accounting principles in the United States of America.

Table of Contents

19. Notices. Any notice, request or other communication required or permitted hereunder shall be in writing and shall be deemed to have been duly given if personally delivered or mailed by registered or certified mail, postage prepaid, or by recognized overnight courier, personal delivery or facsimile transmission at the respective addresses or facsimile number of the parties as set forth in or otherwise designated by either party pursuant to the Investment Agreement or on the register maintained by the Company. Any party hereto may by notice so given change its address or facsimile number for future notice hereunder. Notice shall conclusively be deemed to have been given when received if received prior to 4:00 p.m. (local time) otherwise it shall be deemed to have been received the following Business Day.
20. Interaction with other Unsecured Notes or Debentures. The Convertible Note and the Debentures shall rank *pari passu* notwithstanding date of issue.
21. Expenses; Waivers. If action is instituted to collect this Convertible Note, the Company shall pay all costs and expenses, including, without limitation, reasonable attorneys' fees and costs, incurred in connection with such action. The Company hereby waives notice of default, presentment or demand for payment, protest or notice of nonpayment or dishonor and all other notices or demands relative to this instrument.
22. Successors and Assigns. Subject to the restrictions on transfer described in Sections 17 and 18 hereof, the rights and obligations of the Company and the Holder shall be binding upon and benefit the successors, assigns, heirs, administrators and transferees of the parties.
23. Governing Law; Jury Waiver. This Convertible Note and all actions arising out of or in connection with this Convertible Note shall be governed by and construed in accordance with the laws of the State of New York. Any action or proceeding brought by a Party arising out of or in connection with this Convertible Note may be brought in a court of competent jurisdiction located in the City of New York, New York. The Parties agree not to contest such jurisdiction or seek to transfer any action relating to such dispute brought in New York to any other jurisdiction. Service of process on the Parties in any action arising out of or relating to this Convertible Note shall be effective if delivered to the Parties in accordance with Section 8.7 of the Investment Agreement. **THE PARTIES HERETO WAIVE ALL RIGHT TO TRIAL BY JURY IN ANY ACTION OR PROCEEDING TO ENFORCE OR DEFEND ANY RIGHTS UNDER THIS CONVERTIBLE NOTE.**

[Remainder of Page Intentionally Left Blank; Signature Page Follows]

Table of Contents

IN WITNESS WHEREOF, the Company has caused this Convertible Note to be issued as of the date first written above.

WESTPORT INNOVATIONS INC.

Per:
Name:

Title:

Per:
Name:

Title:

A-16

Table of Contents**SCHEDULE B****FUEL SYSTEMS FINANCIAL INFORMATION****SIGNATURES & POWER OF ATTORNEY**

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Mariano Costamagna and Pietro Bersani, and each of them, his true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any or all amendments to this annual report on Form 10-K under the Securities Exchange Act of 1934, as amended, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents or any of them, or their or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ MARIANO COSTAMAGNA Mariano Costamagna	Chief Executive Officer and Director (Principal Executive Officer)	March 14, 2016
/s/ PIETRO BERSANI Pietro Bersani	Chief Financial Officer (Principal Financial Officer)	March 14, 2016
/s/ MICHAEL HELFAND Michael Helfand	Senior Vice President Finance and Chief Accounting Officer (Principal Accounting Officer)	March 14, 2016
/s/ JOSEPH E. POMPEO Joseph E. Pompeo	Director	March 14, 2016
/s/ COLIN S. JOHNSTON Colin S. Johnston	Director	March 14, 2016
/s/ TROY A. CLARKE Troy A. Clarke	Director	March 14, 2016

Edgar Filing: WESTPORT INNOVATIONS INC - Form SUPPL

/s/ JAMES W. NALL Director March 14, 2016

James W. Nall

/s/ ANTHONY HARRIS Director March 14, 2016

Anthony Harris

/s/ STEVEN R. BECKER Director March 14, 2016

Steven R. Becker

B-1

Table of Contents

FUEL SYSTEMS SOLUTIONS, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	Page
CONSOLIDATED FINANCIAL STATEMENTS FUEL SYSTEMS SOLUTIONS, INC.	
<u>Report of Independent Registered Public Accounting Firm</u>	B-3
<u>Consolidated Balance Sheets</u>	B-4
<u>Consolidated Statements of Operations</u>	B-5
<u>Consolidated Statements of Comprehensive Income (Loss)</u>	B-6
<u>Consolidated Statements of Stockholders' Equity</u>	B-7
<u>Consolidated Statements of Cash Flows</u>	B-8
<u>Notes to Consolidated Financial Statements</u>	B-9
SUPPLEMENTAL FINANCIAL STATEMENT SCHEDULES:	
<u>Schedule II Valuation Accounts Fuel Systems Solutions, Inc.</u>	B-38

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

Fuel Systems Solutions, Inc.:

In our opinion, the consolidated financial statements listed in the accompanying index located on page F-1 present fairly, in all material respects, the financial position of Fuel Systems Solutions, Inc. and its subsidiaries (the Company) at December 31, 2015 and 2014, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2015 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index located on page F-1, presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2015, based on criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company’s management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management’s Annual Report on Internal Control Over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company’s internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 2 to the consolidated financial statements, in 2015 the Company changed the manner in which deferred tax assets and liabilities, along with any related valuation allowance, are classified on the balance sheet. Additionally, as discussed in Note 17 to the consolidated financial statements, the Company has significant transactions with related parties.

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

New York, New York

March 14, 2016

B-3

Table of Contents**FUEL SYSTEMS SOLUTIONS, INC.****CONSOLIDATED BALANCE SHEETS****(In Thousands, Except Share and Per Share Data)**

	December 31, 2015	December 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 60,162	\$ 85,180
Accounts receivable less allowance for doubtful accounts of \$3,005 and \$3,129 at December 31, 2015 and December 31, 2014, respectively	44,524	46,952
Inventories	62,717	80,001
Other current assets	15,523	21,271
Short-term investments	1,000	6,614
Related party receivables, net	316	5,094
Total current assets	184,242	245,112
Equipment and leasehold improvements, net	35,583	48,937
Goodwill	0	7,363
Deferred tax assets, net	4,552	14,564
Intangible assets, net	2,680	6,964
Other assets	1,382	1,065
Total Assets	\$ 228,439	\$ 324,005
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable	\$ 34,117	\$ 39,918
Accrued expenses	26,859	33,446
Income taxes payable	233	445
Term loans and debt	9	207
Related party payables	2,525	2,744
Total current liabilities	63,743	76,760
Other liabilities	9,858	9,745
Deferred tax liabilities, net	751	765
Total Liabilities	74,352	87,270
Commitments and contingencies (Note 18)		
Equity:		
Preferred stock, \$0.001 par value, authorized 1,000,000 shares; none issued and outstanding at December 31, 2015 and 2014	0	0

Edgar Filing: WESTPORT INNOVATIONS INC - Form SUPPL

Common stock, \$0.001 par value, authorized 200,000,000 shares; 20,143,108 issued and 18,094,043 outstanding at December 31, 2015; and 20,114,427 issued and 19,769,617 outstanding at December 31, 2014	20	20
Additional paid-in capital	322,144	320,820
Shares held in treasury, 2,049,065 and 344,810 shares at December 31, 2015 and 2014, respectively	(20,742)	(3,692)
Accumulated Deficit	(101,286)	(54,151)
Accumulated other comprehensive loss	(46,049)	(26,403)
Total Fuel Systems Solutions, Inc. Equity	154,087	236,594
Non-controlling interest	0	141
Total Equity	154,087	236,735
Total Liabilities and Equity	\$ 228,439	\$ 324,005

See accompanying notes to consolidated financial statements.

B-4

Table of Contents

FUEL SYSTEMS SOLUTIONS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

(In Thousands Except Share and Per Share Data)

	Years Ended December 31,		
	2015	2014	2013
Revenue	\$ 263,397	\$ 339,128	\$ 399,841
Cost of revenue	204,023	264,471	312,703
Gross profit	59,374	74,657	87,138
Operating Expenses:			
Research and development expense	21,223	26,194	27,540
Selling, general and administrative expense	61,862	58,341	55,189
Impairments	13,766	44,341	0
Total operating expenses	96,851	128,876	82,729
Operating (loss) income	(37,477)	(54,219)	4,409
Other (expense) income, net	(141)	1,266	(1,536)
Interest income	424	980	1,062
Interest expense	(445)	(829)	(847)
(Loss) income from operations before income taxes and non-controlling interest	(37,639)	(52,802)	3,088
Income tax expense	(9,521)	(610)	(3,566)
Net loss	(47,160)	(53,412)	(478)
Less: net loss (income) attributed to non-controlling interests	25	(4)	18
Net loss attributable to Fuel Systems Solutions, Inc.	\$ (47,135)	\$ (53,416)	\$ (460)
Net loss per share attributable to Fuel Systems Solutions, Inc.:			
Basic	\$ (2.55)	\$ (2.66)	\$ (0.02)
Diluted	\$ (2.55)	\$ (2.66)	\$ (0.02)
Number of shares used in per share calculation:			
Basic	18,486,083	20,074,773	20,073,360
Diluted	18,486,083	20,074,773	20,073,360

See accompanying notes to consolidated financial statements.

B-5

Table of Contents**FUEL SYSTEMS SOLUTIONS, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

(In Thousands)

Years Ended Decetock, \$0.10 par value:
 Authorized shares-5,000, 194 shares (2003
 and 2002) -- -- STOCKHOLDERS' EQUITY
 Common stock, \$0.10 par - shares,
 Authorized 40,000 Issued and outstanding
 25,785 (2003), and 14,901 (2002) 2,579 1,491
 Additional paid-in capital 59,077 40,343
 Accumulated deficit (41,824) (33,507)
 Promissory note-officer (703) (703) Treasury
 stock, 71 shares (2003) and 58 shares (2002)
 (2,588) (2,537) Accumulated other
 comprehensive loss (59) (19) -----
TOTAL STOCKHOLDERS' EQUITY 16,482
5,068 ----- TOTAL LIABILITIES
and STOCKHOLDERS' EQUITY \$ 46,365 \$
15,143 ===== See
accompanying notes F-2 INNOVO GROUP
INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF
OPERATIONS (in thousands, except per
share data) Year Ended
 ----- 11/29/03 11/30/02
 12/01/01 ----- NET SALES \$
 83,129 \$ 29,609 \$ 9,292 COST OF GOODS
 SOLD 70,153 20,072 6,335 -----
 ----- Gross profit 12,976 9,537 2,957
 OPERATING EXPENSES Selling, general
 and administrative 19,264 8,092 3,189
 Depreciation and amortization 1,227 256 167
 ----- 20,491 8,348 3,356
 INCOME (LOSS) FROM OPERATIONS
 (7,515) 1,189 (399) INTEREST EXPENSE
 (1,216) (538) (211) OTHER INCOME 526 235
 84 OTHER EXPENSE (68) (174) (3) -----
 ----- INCOME (LOSS) BEFORE
 INCOME TAXES (8,273) 712 (529) INCOME
 TAXES 44 140 89 ----- NET
 INCOME (LOSS) \$ (8,317) \$ 572 \$ (618)2
 ===== NET
 INCOME (LOSS) PER SHARE: Basic \$

(0.49) \$ 0.04 \$ (0.04) Diluted \$ (0.49) \$ 0.04 \$
 (0.04) WEIGHTED AVERAGE SHARES
 OUTSTANDING Basic 17,009 14,856 14,315
 Diluted 17,009 16,109 14,315 See
 accompanying notes F-3 INNOVO GROUP
 INC AND SUBSIDIARIES
 CONSOLIDATED STATEMENTS OF
 STOCKHOLDERS' EQUITY (in thousands)
 Common Stock Additional Promissory
 ----- Paid-In Accumulated Note
 Shares Par Value Capital Deficit Officer

 Balance, November 30, 2000 13,721 \$ 1,371 \$
 38,977 \$ (33,461) \$ (703) Issuance of common
 stock for acquisitions 1,200 120 1,249 -- --
 Common stock offering expenses -- -- (35) -- --
 Expense associated with options and warrants
 -- -- 86 -- -- Treasury Stock Purchased -- -- --
 -- -- Net Loss -- -- -- (618) -- -----
 ----- Balance, December 1,
 2001 14,921 1,491 40,277 (34,079) (703) Net
 Income -- -- -- 572 -- Foreign currency
 translation adjustment -- -- -- --
 Comprehensive income -- -- -- -- Common
 stock offering expenses -- -- (25) -- -- Expense
 associated with options and warrants -- -- 91
 -- -- Cancelled shares (20) -- -- -- Treasury
 stock purchased -- -- -- -- -----
 ----- Balance, November 30,
 2002 14,901 1,491 40,343 (33,507) (703) Net
 loss -- -- -- (8,317) -- Foreign currency
 translation adjustment -- -- -- --
 Comprehensive loss -- -- -- -- Proceeds from
 sale of stock, net 6,236 624 16,916 -- --
 Treasury stock purchased -- -- -- -- Expense
 associated with options and warrants -- -- 101
 -- -- Exercise of stock options 50 5 77 -- --
 Exercise of warrants 4,598 459 1,640 -- --

 Balance, November 29, 2003 25,785 \$ 2,579 \$
 59,077 \$ (41,824) \$ (703) =====
 =====
 ===== Other Total Treasury
 Comprehensive Stockholders' Stock Loss
 Equity ----- Balance,
 November 30, 2000 \$ (2,426) \$ -- \$ 3,758
 Issuance of common stock for acquisitions --
 -- 1,369 Common stock offering expenses -- --
 (35) Expense associated with options and
 warrants -- -- 86 Treasury Stock Purchased
 (41) -- (41) Net Loss -- -- (618) -----

----- Balance, December 1, 2001 (2,467) --
4,519 Net Income -- -- 572 Foreign currency
translation adjustment -- (19) (19) -----
Comprehensive income -- -- 553 Common
stock offering expenses -- -- (25) Expense
associated with options and warrants -- -- 91
Cancelled shares -- -- -- Treasury stock
purchased (70) -- (70) ----- -----
Balance, November 30, 2002 (2,537) (19) 5,068
Net loss -- -- (8,317) Foreign currency
translation adjustment -- (40) (40) -----
Comprehensive loss -- -- (8,357) Proceeds
from sale of stock, net -- -- 17,540 Treasury
stock purchased (51) -- (51) Expense
associated with options and warrants -- -- 101
Exercise of stock options -- -- 82 Exercise of
warrants -- -- 2,099 ----- -----
Balance, November 29, 2003 \$ (2,588) \$ (59) \$
16,482 =====
See accompanying notes F-4 INNOVO
GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF
CASH FLOWS (in thousands) Year Ended
----- 11/29/03 11/30/02
12/01/01 ----- ----- Net income
(loss) \$ (8,317) \$ 572 \$ (618) Adjustment to
reconcile net income (loss) to cash provided
by (used in) operating activities: Depreciation
232 86 92 Loss on sale of fixed assets 9 90 2
Amortization of intangibles 943 122 35
Amortization of licensing rights 48 48 40
Stock compensation expenses 101 91 86
Provision for uncollectible accounts 1,775 219
128 Changes in current assets and liabilities:
Accounts receivable (721) (1,490) (882)
Inventories (1,814) (3,300) 933 Prepaid
expenses and other (1,746) (117) (86) Due to
related parties (3,976) 3,444 698 Other long
term assets (61) (3) 4 Accounts payable and
accrued expenses 3,670 1,742 (1,064) -----
----- Cash (used in) provided by
operating activities \$ (9,857) \$ 1,504 \$ (632)
CASH FLOWS FROM INVESTING
ACTIVITIES Proceeds from sale of fixed
assets \$ 6 \$ -- \$ 1,082 Proceeds from
investment in real estate 1,013 436 --
Redemption of preferred shares (798) (436) --
Purchases of fixed assets (895) (622) (61)
Acquisition costs (62) -- (36) -----
----- Cash (used in) provided by investing
activities \$ (736) \$ (622) \$ 985 CASH FLOWS

FROM FINANCING ACTIVITIES Purchase of treasury stock \$ (51) \$ (70) \$ (41) Payments on notes payables and long term debt (744) (838) (1,164) Factor borrowings 332 -- -- Proceeds from note payable to officer 500 -- -- Exercise of stock options 82 -- -- Proceeds from issuance of stock, net 17,540 (25) (35) ----- ----- Cash provided by (used in) financing activities \$ 17,659 \$ (933) \$ (1,240) Effect of exchange rate on cash (40) (19) -- **NET CHANGE IN CASH AND CASH EQUIVALENTS \$ 7,026 \$ (70) \$ (887)** **CASH AND CASH EQUIVALENTS, at beginning of period 222 292 1,179** ----- ----- **CASH AND CASH EQUIVALENTS, at end of period \$ 7,248 \$ 222 \$ 292** =====

===== Supplemental Disclosures of Cash Flow Information: Cash Paid for Interest \$ 1,008 \$ 519 \$ 110 Cash Paid for Taxes \$ 89 \$ 28 \$ -- During fiscal 2002, the Company issued 195,295 shares of its cumulative non-convertible preferred stock with an 8% coupon in exchange for real estate partnership interests. See accompanying notes F-5 INNOVO GROUP INC. NOTES TO CONSOLIDATED FINANCIAL

STATEMENTS 1. Business Description Innovo Group Inc.'s (Innovo Group) principle business activity involves the design, development and worldwide marketing of high quality consumer products for the apparel and accessory markets. Innovo Group operates its consumer products business through three wholly-owned, operating subsidiaries, Innovo, Inc. (Innovo), Joe's Jeans, Inc. (Joe's), and Innovo Azteca Apparel, Inc. (IAA) with Innovo Group and Joe's having two wholly-owned operating subsidiaries, Innovo Hong Kong Limited (IHK) and Joe's Jeans Japan, Inc. (JJJ), respectively. Innovo Group's products are manufactured by independent contractors located in Los Angeles, Mexico and/or Asia, including, Hong Kong, China, Korea, Vietnam and India. The products are then distributed out of Los Angeles or directly from the factory to the customer. During fiscal year 2001, Innovo Group changed its fiscal year end from November 30 of each year to the Saturday closest to November 30. For fiscal years 2003, 2002 and 2001, the years

ended on November 29, 2003, November 30, 2002 and December 1, 2001, respectively. These fiscal year periods are referred to as 2003, 2002 and 2001, respectively, in the accompanying Notes to Consolidated Financial Statements. Restructuring of Operations In connection with a strategic equity investment by Commerce Investment Group, LLC (Commerce) in 2000, Innovo Group shifted manufacturing to third-party foreign manufacturers and outsourced certain distribution functions to Commerce to increase the effectiveness of its distribution network and to reduce freight costs. Innovo Group entered into certain supply and distribution agreements with Commerce. These agreements provide for Commerce or its designated affiliates to manufacture and supply specified products to Innovo Group at agreed upon prices. In addition, Commerce provides distribution services to Innovo Group for certain of its products for an agreed upon fee, including warehousing, shipping and receiving, storage, order processing, billing, customer service, information systems, maintenance of inventory records, and direct labor and management services. These agreements were renewed for a two-year term ending fiscal 2004 and are renewable thereafter for consecutive two-year terms unless terminated by either party with 90 days notice. There are no minimum purchase or distribution obligations during these renewal periods. Pursuant to the Commerce transaction and related agreements, Innovo Group relocated its headquarters and distribution operations to Los Angeles, California, and transitioned its manufacturing needs to Mexican production facilities operated by an affiliate of Commerce. Innovo Group continues to maintain its Innovo subsidiary operations, which focuses on accessory products, in Knoxville, Tennessee, the site of its former headquarters. Innovo Group experienced a significant operating loss and negative cash flow from operations for the year ended November 29, 2003. Innovo Group historically has funded operations by equity financing through private placements, credit arrangements with suppliers and factoring

agreements for working capital needs. >From time to time, Innovo Group has obtained short-term working capital loans from senior members of management and/or members of the Board of Directors. Other Operations

Innovo Group, through its wholly-owned operating subsidiary Leasall Management, Inc. (Leasall) owns real property located in Springfield, Tennessee which formerly served as Innovo Group's headquarters. Leasall currently leases this property to third parties.

In April 2002, Innovo Group, through its wholly owned operating subsidiary, Innovo Group Realty Inc. (IRI), entered into a real estate investment transaction by purchasing limited partnership interests in 22 limited partnerships that subsequently acquired limited partnerships in 28 apartment buildings consisting of approximately 4,000 apartment units. See Note 5. F-6 2. Summary of Significant Accounting Policies Principles of Consolidation The accompanying consolidated financial statements include the accounts of Innovo Group and its wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated. Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant estimates affect the evaluation of contingencies, and the determination of allowances for accounts receivable and inventories. Actual results could differ from these estimates. Revenue Recognition Revenues are recorded when title transfers to the customer, which is typically at the shipping point. Innovo Group records estimated reductions to revenue for customer programs, including co-op advertising, other advertising programs or allowances which are based upon a percentage of sales. Innovo Group also allows for returns based upon pre-approval or for damaged goods. Such

returns are estimated and an allowance is provided at the time of sale. Shipping and Handling Costs Innovo Group outsources its distribution functions to an affiliate of Commerce or, in certain cases, to other third party distributors. Shipping and handling costs include costs to warehouse, pick, pack and deliver inventory to customers. In certain cases Innovo Group is responsible for the cost of freight to deliver goods to the customer.

Shipping and handling costs were approximately \$1,834,000, \$1,023,000 and \$408,000 for the years ended 2003, 2002, and 2001, respectively, and are included in cost of goods sold. Freight billed to customers that is included in Innovo Group sales for the years ended 2003, 2002 and 2001 were \$24,000, \$201,000 and \$77,000 respectively. Earnings (loss) Per Share Net income (loss) per share

has been computed in accordance with Financial Accounting Standard Board (FASB) Statement No. 128, "Earnings Per Share."

Comprehensive Income (loss) Assets and liabilities of the Japan and Hong Kong divisions are translated at the rate of exchange in effect on the balance sheet date.

Income and expenses are translated at the average rates of exchange prevailing during the year. The functional currency in which Innovo Group transacts business is the

Japanese yen and Hong Kong dollar.

Comprehensive income (loss) consists of net income (loss) and foreign currency gains and losses resulting from translation of assets and liabilities. Advertising Costs Advertising costs are expensed as incurred, or, in the case of media ads, upon first airing, except for brochures and catalogues that are capitalized and amortized over their expected period of future benefits. Capitalized costs related to catalogues and brochures are included in prepaid expenses and other current assets.

Advertising expenses included in selling, general and administrative expenses were approximately \$985,000, \$287,000, and \$114,000 for the years ended 2003, 2002, and 2001, respectively. Advertising costs include items incurred in connection with royalty agreements or amounts paid to licensors pursuant to royalty agreements. Included in prepaid expenses is \$985,000, representing

prepaid advertising royalties pursuant to license agreements for the year ended 2003.

F-7 Financial Instruments The fair values of Innovo Group's financial instruments (consisting of cash, accounts receivable, accounts payable, due to factor and notes payable) do not differ materially from their recorded amounts because of the relatively short period of time between origination of the instruments and their expected realization. Management believes it is not practicable to estimate the fair value of the first mortgage loan as the loan has a fixed interest rate secured by real property in Tennessee. Innovo Group neither holds, nor is obligated under, financial instruments that possess off-balance sheet credit or market risk.

Impairment of Long-Lived Assets and Intangibles Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 142 "Goodwill and Other Intangible Assets," which establishes financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, Intangible Assets. Innovo Group adopted SFAS No. 142 beginning with the first quarter of fiscal 2002. SFAS No. 142 requires that goodwill and intangible assets that have indefinite useful lives not be amortized but, instead, tested at least annually for impairment while intangible assets that have finite useful lives continue to be amortized over their respective useful lives. Accordingly, Innovo Group has not amortized goodwill. SFAS No. 142 requires that goodwill and other intangibles

be tested for impairment using a two-step process. The first step is to determine the fair value of the reporting unit, which may be calculated using a discounted cash flow methodology, and compare this value to its carrying value. If the fair value exceeds the carrying value, no further work is required and no impairment loss would be recognized.

The second step is an allocation of the fair value of the reporting unit to all of the reporting unit's assets and liabilities under a hypothetical purchase price allocation. Based on the evaluation performed by Innovo Group, there is no impairment to be recorded at November 29, 2003. Cash Equivalents

Innovo Group considers all highly liquid investments that are both readily convertible into known amounts of cash and mature within 90 days from their date of purchase to be cash equivalents. Concentration of Credit Risk Financial instruments that potentially subject Innovo Group to significant concentrations of credit risk consist principally of cash, accounts receivable and amounts due from factor. Innovo Group maintains cash and cash equivalents with various financial institutions. Its policy is designed to limit exposure to any one institution. Innovo Group performs periodic evaluations of the relative credit rating of those financial institutions that are considered in Innovo Group's investment strategy. Concentrations of credit risk with respect to accounts receivable are limited due to the number of customers comprising Innovo Group's customer base. However, for the years ended November 29, 2003 and November 30, 2002, \$1,301,000 and \$1,652,000, respectively of total non-factored accounts receivables, (or 37% and 60%) were due from three and four customers. Innovo Group does not require collateral for trade accounts receivable, and, therefore, is at risk for up to \$3,388,000 and \$2,813,000, respectively, if these customers fail to pay. Innovo Group provides an allowance for estimated losses to be incurred in the collection of accounts receivable based upon the ageing of outstanding balances and other account monitoring analysis. Such losses have historically been within management's

expectations. Uncollectible accounts are written off once collection efforts are deemed by management to have been exhausted. F-8 During fiscal 2003, 2002 and 2001, sales to customers representing greater than 10 percent of sales are as follows: 2003 2002 2001

----- American Eagle
Outfitters 38% * * Target 12% * * Wal-Mart
Stores * * 27% * Less than 10%.

Manufacturing, Warehousing and Distribution Innovo Group purchases a significant portion of finished goods and obtains certain warehousing and distribution services from Commerce and its affiliates and obtains credit terms which Innovo Group believes are favorable. The loss of Commerce as a vendor, or material changes to the terms, could have an adverse impact on the business. Commerce and its affiliates are controlled by two significant stockholders of Innovo Group. Innovo Group's products are manufactured by contractors located in Los Angeles, Mexico and/or Asia, including, Hong Kong, China, Korea, Vietnam and India. The products are then distributed out of Los Angeles or directly from the factory to the customer. For the year ended 2003, 22% of its apparel and accessory products were manufactured outside of North America. The rest of its accessory and apparel products were manufactured in the United States (21%) and Mexico (57%). All of its products manufactured in Mexico are manufactured by an affiliate of Commerce, Azteca Productions International, Inc. (Azteca) or its affiliates. Stock-Based Compensation Statement of Financial Accounting Standards No. 123, "Accounting for Stock Based Compensation" (SFAS No. 123), encourages, but does not require, companies to record compensation cost for stock-based employee compensation plans at fair value. Innovo Group has chosen to continue to account for employee stock-based compensation using the method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Innovo Group has adopted the disclosure-only provisions of SFAS No. 123. Accordingly, no compensation expense has been recorded in conjunction with options issued to employees. Had

compensation costs been determined based upon the fair value of the options at the grant date and amortized over the option's vesting period, consistent with the method prescribed by SFAS No. 123, Innovo Group's net income (loss) would have been increased to the pro forma amounts indicated below for the years ended November 29, 2003, November 30, 2003 and December 1, 2001 (in thousands, except per share data): F-9 Year Ended (in thousands, except per share data)

	2003	2002	2001
Net (loss) income as reported	\$ (8,317)	\$ 572	\$ (618)
Add: Stock based employee compensation expense included in reported net income, net of related tax effects	101	91	86
Deduct: Total stock based employee compensation expense determined under fair market value based method for all awards, net of related tax effects	504	140	454
Pro forma net (loss) income	\$ (8,720)	\$ 523	\$ (986)

Net (loss) income per share As reported - basic \$ (0.49) \$ 0.04 \$ (0.04) As reported - diluted \$ (0.49) \$ 0.04 \$ (0.04) Pro forma - basic \$ (0.51) \$ 0.04 \$ (0.07) Pro forma - diluted \$ (0.51) \$ 0.03 \$ (0.07) The fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions used for grants in 2003 and 2002: 2003 2002 2001

	2003	2002	2001
Estimated dividend yield	0.0%	0.0%	0.0%
Expected stock price volatility	48%	38%	68%
Risk-free interest rate	5.0%	6.0%	6.0%
Expected life of options	4 yrs.	2-4 yrs.	2-4 yrs.

The Black-Scholes model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including, the expected stock price volatility. Because Innovo Group's employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimates, in

management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options. Property, Plant and Equipment Property, plant and equipment are stated at the lesser of cost or fair value in the case of impaired assets. Depreciation is computed on a straight-line basis over the estimated useful lives of the assets and includes capital lease amortization. Leasehold improvements are amortized over the lives of the respective leases or the estimated service lives of the improvements, whichever is shorter. Routine maintenance and repairs are charged to expense as incurred. On sale or retirement, the asset cost and related accumulated depreciation or amortization is removed from the accounts, and any related gain or loss is included in the determination of income. Reclassifications Certain reclassifications have been made to prior year consolidated financial statements to conform to the current year presentation. F-10 Recently Issued Financial Accounting Standard In May 2003, FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS No. 150 requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003 and is not expected to have a material impact on Innovo Groups' consolidated results of operations or financial position. In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. In

particular, SFAS No. 149 clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative and when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS No. 149 is generally effective for contracts entered into or modified after June 30, 2003 and is not expected to have a material impact on Innovo Group's consolidated results of operations or financial position. In January 2003, the FASB issued Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities." FIN 46 requires companies to evaluate variable interest entities to determine whether to apply the consolidation provisions of FIN 46 to those entities. Companies must apply FIN 46 to entities created after January 31, 2003, and to variable interest entities in which a company obtains an interest after that date. It applies in the first fiscal year or interim period endings after December 15, 2003, to variable interest entities in which a company holds a variable interest that it acquired before February 1, 2003. Adoption of FIN 46 is not expected to have a material impact on Innovo Group's consolidated results of operations or financial position 3.

Acquisitions Blue Concept Division
Acquisition On July 17, 2003, IAA entered into an asset purchase agreement (APA), with Azteca, Hubert Guez and Paul Guez, (the Sellers), whereby IAA acquired the division known as the Blue Concept Division of Azteca (the Blue Concept Division). The Blue Concept Division sells primarily denim jeans to American Eagle Outfitters, Inc. (AEO), a national retailer. Pursuant to the terms of the APA, IAA paid \$21.8 million for the Blue Concept Division, subject to adjustment as noted below. Pursuant to the APA, IAA employed all of the existing employees of the Blue Concept Division but did not assume any of the Blue Concept Division's or the Sellers' existing liabilities. In connection with the purchase of the Blue Concept Division from the Sellers, IAA issued a seven-year convertible promissory note for \$21.8 million (the Blue Concept Note). The Blue Concept Note bears interest at a rate of 6% and requires payment of interest only during the

first 24 months and then is fully amortizing over the remaining five-year period. The terms of the transaction further allows Innovo Group, upon stockholder approval, to convert a portion of the Blue Concept Note into equity through the issuance of 3,125,000 shares of its common stock valued at the greater of \$4.00 per share or the market value of our common stock on the day prior to the date of the stockholder meeting at which approval for this conversion is sought (Conversion Price) and up to an additional 1,041,667 shares upon the occurrence of certain future contingencies relating to Innovo Group's stock price for the thirty day period ending March 6, 2005. Presently, a special stockholder meeting is scheduled for March 5, 2004 to vote on the approval of this conversion of the Blue Concept Note into equity. In the event stockholder approval is obtained, the Blue Concept Note will be reduced by an amount equal to the product of the Conversion Price and 3,125,000 shares, so long as the principal amount of the Blue Concept Note is not reduced below \$9.3 million. The shares issued pursuant to the conversion will be subject to certain lock-up periods. In the event that sales of the Blue Concept Division fall below \$70 million during the first 17 month period, (Period I), following the closing of the acquisition, or \$65 million during the 12 month period (Period II) following Period I, certain terms of the APA allow for a reduction in the purchase price through a decrease in the principal balance of the Blue Concept Note and/or the return of certain locked-up shares of Innovo Group's common stock. In the event the Blue Concept Note is reduced during Period I and the sales of the Blue Concept Division in Period II are greater than \$65 million, the Blue Concept Note shall be increased by half of the amount greater than \$65 million, but in no event shall the Blue Concept Note be increased by an amount greater than the decrease in Period I. In the event the principal amount of the Blue Concept Note needs to be reduced beyond the outstanding principal balance, then an amount of the locked-up shares equal to the balance of the required reduction shall be returned to Innovo Group. For these

purposes, the locked-up shares shall be valued at \$4.00 per share. Additionally, if during the 12 month period following the closing, AEO is no longer a customer of IAA, the locked-up shares will be returned to Innovo Group, and any amount remaining on the balance of the Blue Concept Note will be forgiven. In the event the revenues of the Blue Concept Division decrease to \$35 million or less during Period I or Period II, IAA shall have the right to sell the purchased assets back to the Sellers, and the Sellers shall have the right to buy back the purchased assets for the remaining balance of the Blue Concept Note and any and all Locked Up Shares shall be returned. As part of the transaction, IAA and AZT International SA de CV (AZT), a Mexico corporation and wholly-owned subsidiary of Azteca entered into a two-year, renewable, non-exclusive supply agreement (Supply Agreement) for products to be sold by the Blue Concept Division. In addition to the customary obligations, the Supply Agreement requires that AZT will receive payment immediately upon receipt of invoices for purchase orders and that AZT will charge a per unit price such that IAA will have a guaranteed profit margin of 15 percent on a "per unit" basis. In addition, AZT is responsible for all quality defects in merchandise manufactured. The acquisition of the Blue Concept Division was accounted for under the purchase method of accounting. Of the \$21.8 million purchase price, \$13.2 million was recorded as an intangible asset representing the value of the customer relationship, \$361,000 was recorded as an intangible asset representing the fair value of the existing purchase orders at the closing of the acquisition and the balance of the purchase price of \$8.32 million was recorded as goodwill. The purchase price allocation was based upon a third party valuation. The results of operations of the Blue Concept Division are included in Innovo Group's consolidated results of operations beginning July 17, 2003. The value assigned to the existing purchase orders was amortized during 2003 at the time the goods were shipped and the value of the customer list is being amortized over 10 years. The goodwill is

expected to be amortizable for income tax purposes. The acquisition was consummated to enable Innovo Group to expand its private label operations. The following table presents the unaudited pro forma consolidated results of operations for the years ended 2003 and 2002 assuming the Blue Concept Division had been acquired as of December 2, 2001. Year Ended (in thousands, except per share data)

	2003	2002
Net sales	\$ 130,720	\$ 105,496
Net income (loss)	(4,343)	4,681
Earnings (loss) per share: Basic	\$ (0.22)	\$ 0.26
Diluted	\$ (0.22)	\$ 0.24

The pro forma operating results do not reflect any anticipated operating efficiencies or synergies and are not necessarily indicative of the actual results which might have occurred had the operations and management of the companies been combined for the fiscal years included above. Azteca Production International, Inc.

Knit Division On August 24, 2001, Innovo Group through its subsidiary, IAA, completed the first phase of a two phase acquisition of Azteca knit apparel division (Knit Division or Knit Acquisition). As discussed previously, Azteca is an affiliate of Commerce. Pursuant to the terms of the first phase closing, Innovo Group purchased the Knit Division's customer list, the right to manufacture and market all of the Knit Division's current products and entered into certain non-compete and non-solicitation agreements and other intangible assets associated with the Knit Division (Phase I Assets). As consideration F-12 for the Phase I Assets, Innovo Group issued to Azteca, 700,000 shares of its common stock valued at \$1.27 per share based upon the closing price of the common stock on August 24, 2001, and promissory notes in the amount of \$3.6 million. The second phase of the Knit Acquisition called for Innovo Group to purchase for cash the inventory of the Knit Division prior to November 30, 2001, with the consideration not to exceed \$3 million. The acquisition of the inventory was subject to Innovo Group obtaining adequate financing. Upon the mutual agreement of both parties, Innovo Group did not complete the second phase of the acquisition prior to the

expiration date due to Innovo Group's inability to obtain the necessary funding. The Knit Acquisition was accounted for under the purchase method of accounting for business combinations pursuant to FAS 141.

Accordingly, the accompanying consolidated financial statements include the results of operations and other information for the Knit Division for the period from August 24, 2001 through December 1, 2001. The Acquisition was consummated to allow Innovo Group to continue its expansion into various segments of the apparel industry. Of the aggregate purchase price of \$4,521,000, including acquisition costs of \$36,000, \$250,000 has been allocated to the non-compete agreement and the remaining amount of \$4,271,000 has been allocated to goodwill. The non-compete agreement was amortized over two years, based upon the term of the agreement. The total amount of the goodwill is expected to be deductible for income tax purposes. The following table shows Innovo Group's unaudited pro forma consolidated results of operations for the fiscal year ended December 1, 2001, assuming the Knit Acquisition had occurred at the beginning of the year: Year Ended (in thousands, except per share data)

-----	2001
-----	Net sales
\$17,243	Loss before extraordinary item (406)
Net Loss (406)	Loss per share: Basic (\$0.03)
Diluted (\$0.03)	Joe's Jeans License On
February 7, 2001, Innovo Group acquired the license rights to the Joe's Jeans label from JD Design, LLC (JD Design), along with the right to market the previously designed product line and existing sales orders, in exchange for 500,000 shares of Innovo Group's common stock and, if certain sales and gross margin objectives are reached, a warrant with a four year term granting JD Design the right to purchase 250,000 shares of Innovo Group's common stock at a price of \$1.00 per share. As of November 29, 2003, the sales and gross margin objectives had not been reached. Additionally, Joe Dahan, the designer of the Joe's Jeans line joined Innovo Group as President of its newly formed and wholly owned subsidiary, Joe's Jeans, Inc. and received an option, with a four-year term, to	

purchase 250,000 shares of Innovo Group's common stock at \$1.00 per share, vesting over 24 months. These options were granted pursuant to the employment agreement between Innovo Group and Joe Dahan. These options vest over the term of employment. Under the terms of the license, Innovo Group is required to pay a royalty of 3% of net sales, with additional royalty amounts due in the event Innovo Group exceeds certain minimum sales and gross profit thresholds. Innovo Group recorded \$339,000, \$277,000 and \$46,000 in royalty expense for the license in the years ended 2003, 2002 and 2001, respectively. The purchase price for the Joe's Jeans license of \$480,000 was determined based upon the fair value of the 500,000 shares issued in connection with the acquisition using the average of the quoted market price of \$0.96 for a period of 5 days prior F-13 to and 5 days after the commitment date. No value was assigned to the warrant for 250,000 shares of common stock because the warrant only vests in the event that Joe's Jeans meets certain sales and gross profit targets. The remaining sales target for 2004 is \$15 million, provided, that the sales have a minimum gross profit of 55%. In the event that both the net sales and gross margin target is achieved, JD Design will receive a warrant for 250,000 shares of Innovo Group common stock with an exercise price of \$1.00 per share, with a 4-year term and equal-monthly vesting over the first 24 months. The entire purchase price was allocated to license rights that are being amortized over the 10-year term of the license.

4. Inventories Inventories are stated at the lower of cost, as determined by the first-in, first-out method, or market. Inventories consisted of the following (in thousands):

	2003	2002
Finished goods	\$ 10,189	\$ 5,741
Work in progress	199	--
Raw materials	1,329	74
	-----	-----
	\$ 11,717	\$ 5,815
Less allowance for obsolescence and slow moving items	(4,193)	(105)
	-----	-----
	\$ 5,710	\$ 5,710

5. Real Estate Transactions In April 2002, Innovo Group's wholly-owned subsidiary IRI acquired a 30% limited partnership interest

in each of 22 separate partnerships. These partnerships simultaneously acquired 28 apartment complexes at various locations throughout the United States consisting of approximately 4,000 apartment units (the Properties). A portion of the aggregate \$98,080,000 purchase price was paid through the transfer of 195,295 shares of our \$100, 8% Series A Redeemable Cumulative Preferred Stock (the Series A Preferred Shares) to the sellers of the Properties. The balance of the purchase price was paid by Metra Capital, LLC (Metra Capital) in the amount of \$5,924,000 (the Metra Capital Contribution) and through proceeds from a Bank of America loan, in the amount \$72,625,000. Innovo Group had originally issued the Series A Preferred Shares to IRI in exchange for all shares of its common stock. IRI then acquired a 30% limited partnership interest in each of the 22 separate limited partnerships in exchange for the Series A Preferred Stock, which then transferred the Series A Preferred Shares to the sellers of the Properties. Each of Messrs. Hubert Guez and Simon Mizrachi and their affiliates have invested in each of the 22 separate partnerships. Each of Messrs. Guez and Mizrachi, together with their respective affiliates, own 50% of the membership interests of Third Millennium. Third Millennium is the managing member of Metra Capital, which owns 100% of the membership interest in each of the 22 separate limited liability companies collectively the General Partners and together with Metra Capital, the Metra Partners, that hold a 1% general partnership interest in each of the 22 separate limited partnerships that own the Properties. Metra Capital also owns 69% of the limited partnership interest in each of the 22 separate limited partnerships. At the time of the transaction, Messrs. Guez and Mizrachi and their affiliates owned more than 5 percent of Innovo Group's outstanding shares. Pursuant to each of the limited partnership agreements, the Metra Partners receive at least quarterly (either from cash flow and/or property sale proceeds) an amount sufficient to provide the Metra Partners (1) a 15% cumulative compound annual rate of return on the

outstanding amount of the Metra Capital Contribution that has not been previously returned to them through prior distributions of cash flow and/or property sale proceeds and (2) a cumulative annual amount of .50% of the average outstanding balance of the average outstanding balance of the mortgage indebtedness secured by any of the Properties.

In addition, in the event of a distribution solely due to a property sale proceeds after the above distributions have been made to the Metra Partners, Metra Partners also receive an amount equal to 125% of the amount of the Metra F-14 Capital Contribution allocated to the Property sold until the Metra Partners have received from all previous cash flow or property sale distributions an amount equal to its Metra Capital Contribution.

Third Millennium receives on a quarterly basis from cash flows and/or property sale proceeds an amount equal to \$63,000 until it receives an aggregate of \$252,000. After the above distributions have been made, and if any cash is available for distribution, IRI. is to receive at least quarterly in the case of cash flow distributions and at the time of property sale distributions an amount sufficient for it to pay the 8% coupon on the Series A Preferred Shares and then any remaining amounts left for distribution to redeem a portion or all of the Series A Preferred Shares. After all of the Series A Preferred Shares have been redeemed (\$19.5 million), future distributions are split between Metra Partners and IRI, with Metra Partners receiving 70% of such distribution and Innovo Realty, Inc. receiving the balance. In addition, IRI. receives a quarterly sub-asset management fee of \$85,000. IRI may also be liable to the holders of the Series A Preferred Shares for the breach of certain covenants, including, but not limited to, failure (i) to deposit distributions from the partnerships into a sinking fund which funds are to be distributed to the holders of the Preferred Shares as a dividend or redemption of Series A Preferred Shares or (ii) to enforce its rights to receive distributions from the partnerships. Innovo Group has not given accounting recognition to the value of its investment in the Limited Partnerships, because Innovo

Group has determined that the asset is contingent and will only have value to the extent that cash flows from the operations of the properties or from the sale of underlying assets is in excess of the 8% coupon and redemption of the Series A Preferred Shares. Innovo Group is obligated to pay the 8% coupon and redeem the Series A Preferred Shares from its partnership distributions, prior to Innovo Group being able to recover the underlying value of its investment. Additionally, Innovo Group has determined that the Series A Preferred Shares will not be accounted for as a component of equity as the shares are redeemable outside of Innovo Group's control. No value has been ascribed to the Series A Preferred Shares for financial reporting purposes as Innovo Group is obligated to pay the 8% coupon or redeem the shares only if Innovo Group receives cash flow from the Limited Partnerships adequate to make the payments. Innovo Group has included the quarterly management fee paid to IRI in other income using the accrual basis of accounting. During 2002 and 2003, IRI recorded \$329,000 and \$173,000, respectively, as management fee income. As of November 29, 2003, \$175,000 was due to Innovo Group representing unpaid sub-management fees. 194,000 shares of the Series A Preferred Shares remain outstanding and redeemable at November 29, 2003 and the cumulative amount of the unpaid 8% coupon aggregated \$822,000. Such amount has not been recorded as an obligation by Innovo Group as the funds had not been received by IRI from the Limited Partnerships.

6. Accounts Receivable
Accounts receivable consist of the following (in thousands):

	2003	2002	
Nonrecourse receivables assigned to factor, net of advances	\$ 453	\$ 307	
Nonfactored accounts receivable	3,388	2,813	
Allowance for customer credits and doubtful accounts	(2,158)	(383)	
	\$ 1,683	\$ 2,737	

===== As of November 29, 2003, there were \$600,000 of client recourse receivables assigned to factor for which Innovo Group bears collection risk in the event of non-payment by the customers. F-15 CIT Commercial Services On June 1, 2001, Innovo Group's subsidiaries, Innovo

and Joe's, entered into accounts receivable factoring agreements with CIT Commercial Services, a unit of CIT Group, Inc. (CIT) which may be terminated with 60 days notice by CIT, or on the anniversary date, by Innovo or Joe's. Under the terms of the agreements, Innovo or Joe's has the option to factor receivables with CIT on a non-recourse basis, provided that CIT approves the receivable in advance. Innovo or Joe's may, at their option, also factor non-approved receivables on a recourse basis. Innovo or Joe's continue to be obligated in the event of product defects and other disputes, unrelated to the credit worthiness of the customer. Innovo or Joe's has the ability to obtain advances against factored receivables up to 85% of the face amount of the factored receivables. The agreement calls for a 0.8% factoring fee on invoices factored with CIT and a per annum rate equal to the greater of the Chase prime rate plus 0.25% or 6.5% on funds borrowed against the factored receivables. On September 10, 2001, IAA entered into a similar factoring agreement with CIT upon the same terms. On or about August 20, 2002, Innovo Group's Innovo and Joe's subsidiaries each entered into certain amendments to their respective factoring agreements, which included inventory security agreements, to permit the subsidiaries to obtain advances of up to 50% of the eligible inventory up to \$400,000 each. According to the terms of the agreements, amounts loaned against inventory are to bear an interest rate equal to the greater of the bank's prime rate plus 0.75% or 6.5% per annum. On or about June 10, 2003, the existing financing facilities with CIT for these subsidiaries were amended, to be effective as of April 11, 2003, primarily to remove the fixed aggregate cap of \$800,000 on their inventory security agreement to allow for Innovo and Joe's to borrow up to 50% of the value of certain eligible inventory calculated on the basis of the lower of cost or market, with cost calculated on a first-in-first out basis. In connection with these amendments, IAA, entered into an inventory security agreement with CIT based on the same terms as Joe's and Innovo. IAA did not previously have an inventory security

agreement with CIT. Under the factoring arrangements, Innovo Group through its subsidiaries may borrow up to 85% of the value of eligible factored receivables outstanding. The factoring rate that Innovo Group pays to CIT to factor accounts, on which CIT bears some or all of the credit risk, was lowered to 0.4% and the interest rate associated with borrowings under the inventory lines and factoring facility were reduced to the bank's prime rate. Innovo Group has also established a letter of credit facility with CIT whereby Innovo Group can open letters of credit, for 0.125% of the face value, with international and domestic suppliers provided Innovo Group has availability on its inventory line of credit. In addition, Innovo Group also may elect to factor with CIT its receivables by utilizing an adjustment of the interest rate as set on a case-by-case basis, whereby certain allocation of risk would be borne by Innovo Group, depending upon the interest rate adjustment. Innovo Group records its accounts receivables on the balance sheet net of receivables factored with CIT, since the factoring of receivables is non-recourse to Innovo Group. Further, in the event Innovo Group's loan balance with CIT exceeds the face value of the receivables factored with CIT, Innovo Group records the difference between the face value of the factored receivables and the outstanding loan balance as a liability on Innovo Group's balance sheet as "Due to Factor". At November 29, 2003, Innovo Group's loan balance with CIT was \$8,786,000 and Innovo Group had \$8,536,000 of factored receivables with CIT. At November 29, 2003, an aggregate amount of \$2,149,000 of unused letters of credit were outstanding. Cross guarantees were executed by and among the subsidiaries, Innovo, Joe's, and IAA and Innovo Group entered into a guarantee for its subsidiaries' obligations in connection with the amendments to the existing credit facilities. In connection with the agreements with CIT, receivables and inventory are pledged to CIT. F-16 7. Property, Plant and Equipment Property, plant and equipment consisted of the following (in thousands): Useful Lives (years)

2003 2002 ----- Building, land and improvements 8-38 \$ 1,679 \$ 1,582
Machinery and equipment 5-10 394 258
Furniture and fixtures 3-8 760 212
Transportation equipment 5 13 13 Leasehold improvements 5-8 116 14 ----- 2,962
2,079 Less accumulated depreciation and amortization (895) (660) ----- Net property, plant and equipment \$ 2,067 \$ 1,419
===== Depreciation expense aggregated \$232,000, \$86,000 and \$88,000 for the years ended 2003, 2002 and 2001, respectively.

8. Intangible Assets Identifiable intangible assets resulting from acquisitions consist of the following (in thousands): 2003 2002 ----- License rights, net of \$136 and \$88 accumulated amortization for 2003 and 2002, respectively \$ 344 \$ 392
Covenant not to compete, net of \$250 and \$155 accumulated amortization for 2003 and 2002, respectively -- 95 Customer relationship, net of \$486 and \$0 accumulated amortization for 2003 and 2002, respectively 12,714 -- ----- \$ 13,058 \$ 487
===== Amortization expense related to the license rights, covenant not to compete, customer relationships and acquired purchase orders total \$991,000 \$168,000 and \$75,000 for the years ended 2003, 2002 and 2001, respectively. Aggregate amortization expense will be approximately \$1,368,000, \$1,368,000, \$1,368,000, \$1,368,000, \$1,368,000 and \$6,218,000 for fiscal years ending November 29, 2004 through November 30, 2008 and thereafter, respectively.

9. Long-Term Debt Long-term debt consists of the following (in thousands): 2003 2002 ----- First mortgage loan on Springfield property \$ 476 \$ 558 Promissory note to Azteca (Blue Concepts) 21,800 -- Promissory note to Azteca (Knit Div. Note 1) 68 786 Promissory note to Azteca (Knit Div. Note 2) -- 2,043 ----- Total long-term debt \$ 22,344 \$ 3,387 Less current maturities 168 756 ----- Total long-term debt \$ 22,176 \$ 2,631
===== F-17 First Mortgage Loan on Springfield, Tennessee property The first mortgage loan is collateralized by a first deed of trust on real property in Springfield, Tennessee (with a

carrying value of \$1.2 million at November 29, 2003), and by an assignment of key-man life insurance on the President of Innovo in the amount of \$1 million. The loan bears interest at 2.75% over the lender's prime rate per annum (which was 6.75% at November 29, 2003 and 7.50% at November 30, 2002) and requires monthly principal and interest payments of \$9,900 through February 2008.

The loan is also guaranteed by the Small Business Administration (SBA). In exchange for the SBA guarantee, Innovo Group and certain subsidiaries and the President of Innovo have also agreed to act as guarantors for the obligations under the loan agreement. Promissory Note to Azteca in connection with

Blue Concept Division Acquisition In connection with the purchase of the Blue Concept Division from Azteca, IAA issued a seven-year unsecured, convertible promissory note for \$21.8 million. The Blue Concept Note bears interest at a rate of 6% and requires payment of interest only during the first 24 months and then is fully amortized over the remaining five-year period. The terms of the transaction further allow Innovo Group, upon shareholder approval, to convert a portion of the Blue Concept Note into equity through the issuance of 3,125,000 shares of common stock valued at the greater of \$4.00 per share or the market value of Innovo Group's common stock on the day prior to the date of the shareholder meeting at which approval for this conversion is sought and up to an additional 1,041,667 shares upon the occurrence of certain future contingencies relating to Innovo Group's stock price for the thirty day period ending March 6, 2005. Presently, a special stockholder meeting is scheduled for March 5, 2004 to vote on the approval of this conversion of the Blue Concept Note into equity. In the event shareholder approval is obtained, the Blue Concept Note will be reduced by an amount equal to the product of the Conversion Price and 3,125,000, so long as the principal amount of the Blue Concept Note is not reduced below \$9.3 million and the shares issued pursuant to the conversion will be subject to certain lock-up periods. The Blue Concept Note is subject to further reduction as a result of

other events. See Note 3. Promissory Notes to Azteca in connection with acquisition of Knit Division In connection with the acquisition of the Knit Division from Azteca (see Note 3), Innovo Group issued promissory notes in the face amounts of \$1.0 million and \$2.6 million, which bear interest at 8.0% per annum and require monthly payments of \$20,000 and \$53,000, respectively. The notes have a five-year term and are unsecured. At the election of Azteca, the balance of the promissory notes may be offset against monies payable by Azteca or its affiliates to Innovo Group for the exercise of issued and outstanding stock warrants that are owned by Azteca or its affiliates, including Commerce. During 2003, Azteca offset \$2.1 million in face amount of the notes in connection with the exercise of 1 million warrants for Innovo Group common stock. Principal maturities of long-term debt, assuming none of the Blue Concept Note is converted into equity, as of November 29, 2003 are as follows (in thousands): 2004 \$ 168 2005 1,355 2006 4,035 2007 4,284 2008 4,500 Thereafter 8,002 ----- Total \$ 22,344 ===== F-18 10.

Income Taxes The provision (credit) for domestic and foreign income taxes is as follows: (in thousands)

	2003	2002	2001
Current: Federal	\$ --	\$ --	\$ --
State	27	94	89
Foreign	17	46	--
Deferred: Federal	44	140	89
State	--	--	--
Foreign	--	--	--
Total	\$ 44	\$ 140	\$ 89

The source of income (loss) before the provision for taxes is as follows: Year Ended (in thousands) -----
 2003 2002 2001 ----- Federal \$ (7,259) \$ 599 \$ (529) Foreign (1,014) 113 --
 ----- Total \$ (8,273) \$ 712 \$ (529) ===== F-19

10. Income Taxes (continued) Net deferred tax assets result from the following temporary differences between the book and tax bases of assets and liabilities at (in thousands): 2003 2002 ----- Deferred tax assets: Allowance for doubtful accounts \$ -- \$ 102 Inventory 234 310 Benefit of net operating loss carryforwards: 7,411 13,129 Capital loss

carryforwards 280 280 Amortization of
 intangibles (9) (77) Other 282 174 -----
 ----- Gross deferred tax assets 8,198 13,918
 Valuation allowance (8,198) (13,918) -----
 ----- Net deferred tax assets \$ -- \$ --
 =====
 ===== The reconciliation of
 the effective income tax rate to the federal
 statutory rate for the years ended is as
 follows: Year Ended (in thousands)
 ----- 2003 2002 2001 -----
 ----- Computed tax provision (benefit) at
 the statutory rate (34%) (34%) (34%) State
 income tax -- 13 18 Foreign taxes in excess of
 statutory rate -- 2 -- Utilization of
 unbenefitted net operating loss carryforwards
 -- 45 -- Change in valuation allowance 34 16
 34 ----- ----- 0% 20% 18% =====
 =====
 ===== Innovo Group has
 consolidated net operating loss carryforwards
 of approximately \$20.8 million expiring
 through 2023. Such net operating loss
 carryforwards have been reduced as a result
 of "changes in control" as defined in Section
 382 of the Internal Revenue Code. Such
 limitation has had the effect of limiting annual
 usage of the carryforwards in future years.
 Additional changes in control in future
 periods could result in further limitations of
 Innovo Groups's ability to offset taxable
 income. Management has determined that
 realization of the net deferred tax assets does
 not meet the more likely than not criteria. As
 a result, a valuation allowance has been
 provided for.

**11. Stockholders' Equity Private
 Placements and Stock Issuances** In fiscal
 2003, Innovo Group consummated five
 private placements of its common stock
 resulting in net proceeds of approximately
 \$17,540,000, after deducting commissions.
 During its first private placement completed
 on March 19, 2003, Innovo Group issued
 165,000 shares of common stock to 17
 accredited investors at \$2.65 per share,
 raising net proceeds of approximately
 \$407,000. During its second private placement
 completed on March 26, 2003, Innovo Group
 issued 63,500 shares of common stock to 5
 accredited investors at \$2.65 per share,
 raising net proceeds of approximately
 \$156,000. During its third private placement
 completed on July 1, 2003, Innovo Group

issued 2,835,000 shares to 34 accredited investors at \$3.33 per share, raising net proceeds of approximately \$8,751,000. As part of this private placement, and in addition to commissions paid, warrants to purchase 300,000 shares of common stock at \$4.50 per share were issued to the placement agent, Sanders Morris Harris, Inc. During its fourth private placement completed on August 29, 2003, Innovo Group issued 175,000 shares of common stock to 5 accredited investors at \$3.62 per share, raising net F-20 proceeds of approximately \$592,000. As part of this private placement, and in addition to commissions paid, warrants to purchase 17,500 shares of common stock at \$3.62 per share were issued to the placement agent, Pacific Summit Securities. During its fifth private placement funded on or before November 29, 2003, but completed on December 1, 2003, Innovo Group issued 2,997,000 shares of common stock to 14 accredited investors at \$3.00 per share and warrants to purchase an additional 599,333 shares of common stock at \$4.00 per share to certain of these investors, raising net proceeds of approximately \$10,704,000. During fiscal 2002, Innovo Group did not issue any shares of common stock. During fiscal 2002, Innovo Group issued preferred shares in association with the purchase of limited partnerships in certain real estate properties. See Note 5. During fiscal 2001, in connection with the Acquisition of the Knit Division from Azteca (see Note 3), Innovo Group issued 700,000 shares of its common stock, and in connection with the acquisition of the Joe's Jeans license from JD Design, Innovo Group issued 500,000 shares of its common stock and a warrant to purchase 250,000 shares of its common stock at a price of \$1.00 per share, provided certain sales and gross margin targets are met. Warrants Innovo Group has issued warrants in conjunction with various private placements of its common stock, debt to equity conversions, acquisitions and in exchange for services. All warrants are currently exercisable. As of November 29, 2003, outstanding common stock warrants are as follows:

Exercise Price	Shares Issued	Expiration
----------------	---------------	------------

**\$2.10 300,000 October 2000 October 2005
 \$1.50 100,000 March 2001 March 2004 \$2.00
 100,000 March 2001 March 2004 \$2.50 50,000
 March 2001 March 2004 \$0.90 20,000
 December 2001 December 2005 \$2.75 100,000
 May 2002 May 2004 \$2.50 75,000 June 2002
 May 2004 \$3.00 75,000 June 2002 May 2004
 \$4.50 300,000 June 2003 June 2008 \$3.62
 17,500 August 2003 August 2008 \$4.00
 599,333 November 2003 November 2008
 ----- 1,736,833 ===== During
 fiscal 2000, Innovo Group issued 1,787,365
 shares of common stock and warrants to
 purchase an additional 1,500,000 shares of
 common stock at \$2.10 per share to the Sam
 Furrow and Jay Furrow (collectively, the
 Furrow Group) in exchange for the Furrow
 Group's assumption of \$1,000,000 of Innovo
 Group's debt and the cancellation of
 \$1,000,000 of indebtedness owed to members
 of the Furrow Group. The issuance of the
 shares of common stock and warrants
 resulted in a \$1,095,000 charge for the
 extinguishment of debt. During fiscal 2003,
 the warrants issued to the Furrow Group to
 purchase an additional 1,500,000 shares were
 exercised pursuant to a cashless exercise
 provision contained in the warrants and the
 members of the Furrow Group were issued an
 aggregate of 1,061,892 shares of common
 stock. During fiscal 2000, Innovo Group
 issued warrants to purchase an additional
 102,040 shares at \$1.75 per share to private
 investors for \$179,000. Commerce received
 warrants to purchase an additional 3,300,000
 shares of common stock with warrants for
 3,000,000 shares of common stock exercisable
 over a three-year period at \$2.10 per share
 and the remaining warrants for 300,000
 shares of common stock subject to a two-year
 vesting period and exercisable over a five-year
 period at \$2.10 per share. The proceeds from
 the sale of these warrants were used to
 purchase inventory and services from
 Commerce and its affiliates and to repay
 certain outstanding debt. F-21 In October and
 November 2000, Innovo Group issued
 warrants to purchase an additional 1,700,000
 shares of common stock in private placements
 to JAML, LLC, Innovation, LLC and Third**

Millennium Properties, Inc. (collectively, the Mizrachi Group) for \$1,700,000 in cash. During fiscal 2003, prior to the scheduled expiration date, the warrants issued to the Mizrachi Group to purchase an additional 1,696,875 shares were exercised pursuant to cashless exercise provision contained in the warrants and the members of the Mizrachi Group were issued an aggregate of 1,195,380 shares of common stock. During fiscal 2001, Innovo Group issued a warrant related to the Joe's License to purchase 250,000 shares of common stock at a price of \$1.00 per share, in the event that certain future sales and gross margin performance criteria are met. The sales targets are \$2 million, \$4 million, \$8 million and \$15 million for each of the years ended December 31, 2001, 2002, 2003, and 2004, respectively, provided, that the sales have a minimum gross profit of 55%. In the event that both net sales and gross margin targets are achieved in any one of the scheduled years, JD Design will receive a warrants for 250,000 shares of Innovo Group common stock with an exercise price of \$1.00 per share, with a 4-year term and equal-monthly vesting over the first 24 months. When a revenue target is achieved, the warrants will be issued immediately following the year end of the year in which the Net Sales Target is achieved and the vesting period and term will commence immediately upon issuance. JD Designs will not be entitled to any additional warrants if the Net Sales Targets are reached in more than one of the scheduled years. This warrant has not been included in the table above as the performance criteria has not been met. During fiscal 2001, Innovo Group also issued warrants to a company in exchange for certain services. Warrants to purchase 20,000, 100,000, 100,000 and 50,000, shares exercisable at \$0.90, \$1.50, \$2.00 and \$2.50 per share, respectively, which were vested on the date of issuance and have a term of three years, were issued in exchange for services which are to be rendered over a four-year term. During fiscal 2002, Innovo Group issued warrants to companies in exchange for certain services. Warrants to purchase 100,000, 75,000 and 75,000 shares exercisable at \$2.75,

\$2.50 and \$3.00 per share, respectively, which were vested on the date of issuance and have a term of two years, were issued in exchange for services to be rendered over three, four and four year terms, respectively. During fiscal 2003, Innovo Group issued warrants to its placement agents as compensation pursuant to a private placement in August 2003 and other certain investors on or before November 29, 2003. Innovo Group issued warrants to purchase 300,000 shares of common stock at \$4.50 per share, warrants to purchase 17,500 shares of common stock at \$3.62 per share and warrants to purchase 599,333 shares at \$4.00 per share. During fiscal 2003, warrants to purchase an aggregate of 5,298,915 shares were exercised pursuant to cashless exercise provisions contained in the warrants and an aggregate of 3,597,938 shares of common stock was issued in fiscal 2003. During fiscal 2003, Commerce elected to exercise warrants to purchase 1,000,000 shares and in lieu of payment therefore, Commerce elected to offset \$2.1 million in debt due from Innovo Group pursuant to certain promissory notes. As of November 29, 2003, 4,500,000 shares of common stock of Innovo Group were reserved for the exercise of warrants, options, conversion of debt. Stock Based Compensation In March 2000, Innovo Group adopted the 2000 Employee Stock Option Plan ("2000 Employee Plan"). In May, 2003, the 2000 Employee Plan was amended to provide for incentive and nonqualified options for up to 3,000,000 shares of common stock that may be granted to employees, officers, directors and consultants. The 2000 Employee Plan limits the number of shares that can be granted to any employee in one year to 1,250,000 and the total market value of common stock that becomes exercisable for the first time by any grantee during a calendar year. Exercise price for incentive options may not be less than the fair market value of Innovo Group's common stock on the date of grant and the exercise period may not exceed ten years. Vesting periods and option terms are determined by the Board of Directors. The 2000 Employee Plan will expire in March 2010. In September 2000, Innovo Group adopted the 2000 Director

Stock Incentive Plan ("2000 Director Plan"), under which nonqualified options for up to 500,000 shares of common stock may be granted. At the first annual meeting of F-22 stockholders following appointment to the board and annually thereafter during their term, each director will receive options for common stock with aggregate fair value of \$10,000. These options are exercisable beginning one year from the date of grant and expire in ten years. Exercise price is set at 50% of the fair market value of the common stock on the date of grant. The discount is lieu of cash director fees. The 2000 Director Plan will expire in September 2010. The following summarizes option grants to members of the Board of Directors for the fiscal years 2001 through 2003: Number of Exercise Options Price ----- 2001 102,564 \$0.39 2002 40,000 \$1.00 2003 30,768 \$1.30 Stock option activity, including grants to members of the Board of Directors, during the periods indicated is as follows: 2003 2002 2001

----- Weighted Weighted Weighted Average Average Average Exercise Exercise Exercise Options Price Options Price Options Price -----

----- Outstanding at beginning of year 1,257,981 \$2.07 1,517,981 \$2.33 685,417 \$3.89 Granted 1,330,768 2.74 40,000 1.00 832,564 1.06 Exercised 50,000 1.64 -- -- -- Forfeited (185,417) (3.93) (300,000) (3.28) -- -- -----

----- Outstanding at end of year 2,353,332 \$2.31 1,257,981 \$2.07 1,517,981 \$2.33 Exercisable at end of year 1,686,665 1,220,452 1,305,443 Weighted average per option fair value of options granted during the year \$1.21 \$1.26 \$0.59 Weighted average contractual life remaining 6.1 years 3.7 years 3.4 years Exercise prices for options outstanding as of November 29, 2003 are as follows: Number of Options Exercise Price ----- 102,564 \$0.39 290,000 \$1.00 480,768 \$1.25 - \$1.30 280,000 \$2.40 - \$2.60 1,000,000 \$2.86 200,000 \$4.75 ----- 2,353,332 ===== F-23

Earnings (Loss) Per Share Earnings (loss) per share are computed using weighted average common shares and dilutive common

equivalent shares outstanding. Potentially dilutive securities consist of outstanding options and warrants. A reconciliation of the numerator and denominator of basic earnings per share and diluted earnings per share is as follows: Year Ended (in thousands, except per share data) ----- 2003

2002	2001	-----	-----	-----	Basic EPS
					Computation: Numerator \$(8,317) \$572
					\$(618) Denominator: Weighted average
					common shares outstanding 17,009 14,856
					14,315 -----
					Total shares
					17,009 14,856 14,315 -----
					Basic EPS \$(0.49) \$0.04 \$(0.04) =====

					===== Diluted EPS
					Calculation: Numerator \$(8,317) \$572 \$(618)
					Denominator: Weighted average common
					shares outstanding 17,009 14,856 14,315

Incremental shares outstanding from assumed exercise of options and warrants -- 1,253 --

					Total shares 17,009
					16,109 14,315 -----
					Diluted
					EPS \$(0.49) \$0.04 \$(0.04) =====

===== Potentially dilutive options and warrants in the aggregate of 4,090,000 and 8,397,000 in fiscal 2003 and fiscal 2001, respectively, have been excluded from the calculation of the diluted loss per share as their effect would have been anti-dilutive. 12. Commitments and

Contingencies Leases Innovo Group leases certain properties, buildings, office spaces, showrooms and equipment. Certain leases contain provisions for renewals and escalations. Rental expense for the years ended November 29, 2003, November 30, 2002, and December 1, 2001 was approximately \$367,000, \$136,000, and \$107,000, respectively. During September 2000, Innovo Group entered into a lease agreement with a related party, which is owned by Innovo Group's Chairman, Sam Furrow, to lease office space in Knoxville, Tennessee. The lease rate is \$3,500 per month for approximately 5,000 square feet of office space, has a ten-year term and is cancelable with six months written notice. Innovo Group also utilizes office space and office equipment under a cost sharing arrangement with Commerce and its affiliates. Under the terms of the verbal arrangement, Innovo Group is

allocated a portion of costs incurred by Commerce and its affiliates for rent, insurance, office supplies, certain employees' wages and benefits, security and utilities. F-24 Expenses for the years ended 2003, 2002 and 2001 under this arrangement were \$343,000, \$25,000, and \$25,000, respectively. 12.

Commitments and Contingencies (continued)

The future minimum rental commitments under operating leases as of November 29, 2003 are as follows (in thousands): 2004 \$ 616
2005 568 2006 500 2007 411 2008 401

Thereafter 316 ----- Total future minimum lease payments \$ 2,812 =====

License Agreements Joe's Jeans On February 7, 2001, in connection with the acquisition of the Joe's Jeans license rights, Innovo Group entered into a ten- year license agreement that requires the payment of a royalty based upon 3% of net sales, subject to additional royalty amounts in the event certain sales and gross profit thresholds are met on an annual basis.

Bongo(R). On March 26, 2001, Innovo Group entered into a license agreement with IP Holdings LLC, the licensor of the Bongo(R) mark, pursuant to which Innovo Group obtained the right to design, manufacture and distribute bags, belts and small leather/pvc goods bearing the Bongo(R) trademark. The agreement was amended on July 26, 2002 that extended the term of the license agreement commencing as of April 1, 2003 and continuing through March 31, 2007, unless the Bongo(R) brand is sold in its entirety, in which case the license agreement would terminate immediately. Innovo Group pays a 5% royalty and a 2% advertising fee on the net sales of Innovo Group's goods bearing the Bongo(R) trademark.

Mattel, Inc. In fiscal 2002, IAA entered into a five-year license agreement with Mattel, Inc. to produce Hot Wheels(R)branded adult apparel and accessories in the United States, Canada and Puerto Rico. Under the terms of the license agreement, IAA may produce apparel and accessory products targeted to men and women in the junior and contemporary markets. The products lines may include active wear, sweatshirts and pants, outerwear, t-shirts, "baby tees" for women, headwear, bags, backpacks and totes, which will be

emblazoned with the Hot Wheels(R) flame logo. IAA may terminate the agreement in any year by paying the remaining balance of that years minimum royalty guarantees plus the subsequent years minimum royalty guarantees. Royalties paid by IAA earned in excess of the minimum royalty requirements for any one given year, may be credited towards the shortfall amount of the minimum required royalties in any subsequent period during the term of the license agreement. According to the terms of the agreement, IAA has the right to sublicense the accessory product's category to Innovo. The agreement calls for a royalty rate of seven percent and a two percent advertising fee on the net sales of goods bearing the Hot Wheels(R) trademark. In the event IAA defaults upon any material terms of the agreement, the licensor shall have the right to terminate the agreement. As of November 29, 2003, Innovo Group had not yet commenced sales of the Hot Wheels(R) apparel and accessory products. Innovo Group has accrued for the minimum royalties under the terms of the agreement. F-25 Bow Wow On August 1, 2002, IAA entered into an exclusive 42-month worldwide agreement for the Bow Wow license, granting IAA the right to produce and market products bearing the mark and likeness of the popular stage and screen performer. The IAA division has created and market a wide range of apparel and coordinating accessories for boys and plans on creating and marketing a wide range of apparel and coordinating accessories for girls. The license agreement between IAA, Bravado International Group, the agency with the master license rights to Bow Wow, and LBW Entertainment, Inc. calls for the performer to make at least one public appearance every six months during the term of the agreement to promote the Bow Wow products, as well as use his best efforts to promote and market these products on a daily basis. Additional terms of the license agreement allows IAA to market boys and girls products bearing the Bow Wow brand to all distribution channels, the right of first refusal on all other Bow Wow related product categories during the term of the license agreement, and the right of first of refusal on

proposed transactions by the licensor with third parties upon the expiration of the agreement. The agreement calls for IAA to pay an eight percent royalty on the nets sales of goods bearing Bow Wow related marks. In the event IAA defaults upon any material terms of the agreement, the licensor shall have the right to terminate the agreement.

Furthermore, IAA has the right to sublicense the accessory product's category to Innovo.

Fetish(TM) On February 13, 2003, IAA entered into a 44 month exclusive license agreement for the United States, its territories and possessions with the recording artist and entertainer Eve for the license of the

Fetish(TM) trademark for use with the production and distribution of apparel and accessory products. IAA has guaranteed

minimum net sales obligations of \$8,000,000 in the first 18 months of the agreement,

\$10,000,000 in the following 12 month period and \$12,000,000 in the 12 month period

following thereafter. According to the terms of the agreement, IAA is required to pay an

8% royalty and a 2% advertising fee on the net sales of products bearing the **Fetish(TM)**

logo. In the event IAA does not meet the minimum guaranteed sales, IAA will be

obligated to make royalty and advertising payments equal to the minimum guaranteed

sales multiplied by the royalty rate of 8% and the advertising fee of 2%. IAA also has the

right of first refusal with respect to the license rights for the **Fetish(TM)** trademark in the

apparel and accessories category upon the expiration of the agreement, subject to

meeting certain sales performance targets during the term of the agreement.

Additionally, IAA has the right of first refusal for the apparel and accessory categories in

territories in which it does not currently have the license rights for the **Fetish(TM)**

trademark. In connection with the launch and subsequent promotion of the **Fetish(TM)**

brand, IAA incur certain advertising and promotion expenses in excess of the required

2% advertising royalty, which the licensor has agreed represent a prepayment against future

advertising royalties under the license. Accordingly, Innovo Group has recorded

approximately \$985,000 of advertising

expenses as prepaid royalties in the accompanying balance sheet. Innovo Group displays names and logos on its products under license agreements that require royalties ranging from 3% to 8% of sales and required annual advance payments (included in prepaid expenses) and certain annual minimum payments. Royalty expense was \$1,338,000, \$463,000, and \$132,000 for the years ending 2003, 2002, and 2001, respectively. The future minimum royalty commitments under royalty agreements as of November 29, 2003 are as follows (in thousands): 2004 \$ 832 2005 1,188 2006 885 2007 417 ----- Total future minimum royalty payments \$ 3,322 ===== F-26 Litigation Innovo Group is involved from time to time in routine legal matters incidental to its business.

In the opinion of Innovo Group's management, resolution of such matters will not have a material effect on its financial position or results of operations. 13. Segment Disclosures Current Operating Segments During fiscal 2003, Innovo Group operated in two segments, accessories and apparel. The Accessories segment represents Innovo Group's historical line of business as conducted by Innovo Group. The apparel segment is comprised of the operations of Joe's and IAA, both of which began in fiscal 2001, as a result of acquisitions. Innovo Group's real estate operations and real estate transactions of Innovo Group's Leasall and IRI subsidiaries do not require substantial management oversight and have therefore been treated as "other" for purposes of segment reporting. The operating segments have been classified based upon the nature of their respective operations, customer base and the nature of the products sold. Innovo Group evaluates performance and allocates resources based on gross profits, and profit or loss from operations before interest and income taxes.

The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies. F-27 Information for each reportable segment during the three years ended November 29, 2003, is as follows (in thousands): November 29, 2003 Accessories Apparel Other (A) Total

----- (in thousands) Net Sales \$ 14,026 \$ 69,103 \$ -- \$ 83,129
 Gross Profit 3,095 9,881 -- 12,976
 Depreciation & Amortization 39 1,087 101 1,227
 Interest Expense 214 946 56 1,216
 Segment Assets 4,218 33,571 8,576 46,365
 Expenditures for Segment Assets 186 563 146 895
 (A) Other includes corporate expenses and assets and expenses related to real estate transactions. November 30, 2002 Accessories Apparel Other (A) Total

----- (in thousands) Net Sales \$ 12,072 \$ 17,537 \$ -- \$ 29,609
 Gross Profit 3,393 6,144 -- 9,537
 Depreciation & Amortization 21 183 52 256
 Interest Expense 140 339 59 538
 Segment Assets 3,820 9,343 1,980 15,143
 Expenditures for Segment Assets 70 97 455 622
 (A) Other includes corporate expenses and assets and expenses related to real estate transactions. December 1, 2001 Accessories Apparel Other (A) Total

----- (in thousands) Net Sales \$ 5,642 \$ 3,650 \$ -- \$ 9,292
 Gross Profit 1,749 1,208 -- 2,957
 Depreciation & Amortization 45 35 87 167
 Interest Expense 32 79 100 211
 Segment Assets 2,705 6,658 884 10,247
 Expenditures for Segment Assets 32 -- 29 61
 (A) Other includes corporate expenses and assets and expenses related to real estate transactions.

F-28 Operations by Geographic Areas
 Information about Innovo Group's operations in the United States and Asia is presented below (in thousands). Inter-company revenues and assets have been eliminated to arrive at the consolidated amounts.

Adjustments & United States Asia
Eliminations Total -----
 ----- (in thousands) Novmeber 29, 2003 Sales \$ 80,111 \$ 3,018 \$ -- \$ 83,129
 Intercompany sales 959 -- (959) -- -----
 ----- Total sales \$ 81,070 \$ 3,018 \$ (959) \$ 83,129 =====
 =====
 Income from operations \$ (6,964) \$ (1,093) \$ 541 \$ (7,516) =====
 ===== Total assets \$ 48,386 \$ (743) \$ (1,278) \$ 46,365 =====
 =====
 Novmeber 30, 2002 Sales \$ 27,707 \$ 1,902 \$ --

\$ 29,609 Intercompany sales 2,228 -- (2,228) --
----- Total sales \$
29,935 \$ 1,902 \$ (2,228) \$ 29,609 =====
=====
Income from operations \$ 1,558 \$ 115 \$ (484)
\$ 1,189 =====
===== Total assets \$
13,693 \$ 1,974 \$ (524) \$ 15,143 =====
=====
December 1, 2001 Sales \$ 9,292 \$ -- \$ -- \$
9,292 Intercompany sales -- -- -- -----
----- Total sales \$ 9,292 --
-- \$ 9,292 =====
===== Income from
operations \$ (399) -- -- \$ (399) =====
=====
Total assets \$ 10,247 \$ -- \$ -- \$ 10,247
=====

===== 14. Related Party Transactions
Innovo Group has adopted a policy requiring
that any material transaction between Innovo
Group and persons or entities affiliated with
officers, directors or principal stockholders of
Innovo Group be on terms no less favorable to
Innovo Group than reasonably could have
been obtained in arms' length transactions
with independent third parties. Anderson
Stock Purchase Agreement Pursuant to a
Stock Purchase Right Award granted in
February 1997, Innovo Group's president
purchased 250,000 shares of common stock
(the Award Shares) with payment made by
the execution of a non-recourse note (the
Note) for the exercise price of \$2.81 per share
(\$703,125 in the aggregate). The Note was
due, without interest, on April 30, 2002, and
was collateralized by the 1997 Award Shares.
The Note may be paid or prepaid (without
penalty) by (i) cash, or (ii) the delivery of
Innovo Group's common stock (other than the
Award Shares) held for a period of at least six
months, which shares would be credited
against the Note on the basis of the closing bid
price for the common stock on the date of
delivery. On July 18, 2002, the Board of
Directors voted in favor of extending the term
of Note until April 30, 2005. The remaining
provisions of the Note remained the same. As
of November 29, 2003, \$703,125 remains
outstanding under this promissory note. F-29
Crossman Loan On February 7, 2003 and on

February 13, 2003, Innovo Group entered into a loan agreement with Marc Crossman, then a member of our Board of Directors and now also our Chief Financial Officer. The loan was funded in two phases of \$250,000 each on February 7, 2003 and February 13, 2003 for an aggregate loan value of \$500,000. In the event of default, each loan is collateralized by 125,000 shares of Innovo Group common stock as well as a general unsecured claim on the assets of Innovo Group, subordinate to existing lenders. Each loan matures six months and one day from the date of its respective funding, at which point the principal amount loaned and any unpaid accrued interest is due and payable in full without demand. The loan carries an 8% annualized interest rate with interest payable in equal monthly installments. The loan may be repaid by us at any time during the term of the loan without penalty. Further, prior to the maturity of the loan and the original due dates, Innovo Group elected, at its sole option, to extend the term of the loan for an additional period of six months and one day. Innovo Group's disinterested directors approved the loan from Mr. Crossman. Subsequent to the year ended November 29, 2003 and prior to the maturity of the loans in February 2004, the parties agreed to extend the term of the loan for an additional period of ninety days. Further, pursuant to the extension of the loan, the loan was amended to provide Mr. Crossman with the sole and exclusive option to continue to extend the term of the loan for three additional ninety day periods by giving notice of such extension on or before the due date of the loan. Purchases of Goods and Services As required under the terms of the Commerce investment, Innovo Group's Innovo, Joe's and IAA subsidiaries each purchased its craft goods and distribution and operational services from Commerce in fiscal 2003, fiscal 2002 and fiscal 2001. The services purchased included but were not limited to accounts receivable collections, certain general accounting functions, inventory management and distribution logistics. The following schedule represents Innovo's, Joe's and IAA's purchases from Commerce during fiscal 2003,

fiscal 2002 and fiscal 2001 (in thousands):
Innovo ----- Year
Ended (in thousands)
----- 2003 2002 2001
----- Goods \$ 2,898 \$
3,317 \$ 2,320 Distribution Services 615 644
362 Operational Services 228 203 112
----- Total \$ 3,741 \$
4,164 \$ 2,794

=====
Joe's IAA -----
----- Year Ended Year
Ended (in thousands) (in thousands)

----- 2003 2002 2001 2003
2002 2001 -----
----- Goods \$ 2,195 \$
6,102 \$ 1,102 \$ 41,798 \$ 6,171 \$ 1,794
Distribution Services 127 107 20 -- -- --

----- Total \$ 2,322 \$ 6,209
\$ 1,122 \$ 41,798 \$ 6,171 \$ 1,794

=====
 Additionally, Innovo Group is charged an allocation expense from Commerce for expenses associated with Innovo Group occupying space in Commerce's Commerce, California facility and the use of general business machines and communication services. These expenses totaled approximately \$343,000 for fiscal 2003 and \$25,000 for fiscal 2002 and fiscal 2001. Innovo Group also utilizes office space and office equipment under a cost sharing arrangement with Commerce and its affiliates. Innovo Group believes that all the transactions conducted between Innovo Group and Commerce were completed on terms that were competitive and at market rates. Included in due to related parties is \$390,000 and \$4,159,000 at November 29, 2003 and November 30, 2002, respectively, relating to amounts due to Commerce and affiliated entities for goods and services described above. F-30 Azteca Production International, Inc. In the third quarter of fiscal 2001, Innovo Group acquired Azteca Productions International, Inc.'s Knit Division and formed the subsidiary Innovo Azteca Apparel, Inc. Pursuant to equity transactions completed in

fiscal 2000, the principals of Azteca Production International, Inc. became affiliates of Innovo Group. Innovo Group purchased the Division's customer list, the right to manufacture and market all of the Knit Division's current products and entered into certain non-compete and non-solicitation agreements and other intangible assets associated with the Knit Division. As consideration, Innovo Group issued to Azteca, 700,000 shares of Company's common stock valued at \$1.27 per share based upon the closing price of the common stock on August 24, 2001, and promissory notes in the amount of \$3.6 million. As part of the acquisition of the Blue Concept Division from Azteca in July 2003, IAA and AZT entered into a two-year, renewable, non-exclusive Supply Agreement for products to be sold by the Blue Concept Division. In addition to the customary obligations, the Supply Agreement requires that AZT will receive payment immediately upon receipt of invoices for our purchase orders and that AZT will charge a per unit price such that IAA will have a guaranteed profit margin of 15 percent on a "per unit" basis. In addition, AZT is responsible for all quality defects in merchandise manufactured. IAA also utilizes AZT to distribute goods manufactured under the Supply Agreement, and temporarily has AZT invoice and collect payments from AEO, for goods manufactured in Mexico, until such time that we can establish a Mexican subsidiary to invoice and collect payments from AEO. JD Design, LLC Pursuant to the license agreement entered into with JD Design, LLC under which Innovo Group obtained the license rights to Joe's Jeans, Joe's is obligated to pay a 3% royalty on the net sales of all products bearing the Joe's Jeans or JD trademark or logo. For fiscal 2003, fiscal 2002 and fiscal 2001, this amount totaled \$339,000, \$277,000 and \$46,000, respectively. Included in due to related parties on our balance sheet are accrued royalties of \$189,000 and \$91,000 for fiscal 2003 and fiscal 2002, respectively.

F-31
15. Quarterly Results of Operations (Unaudited) The following is a summary of the quarterly results of operations for the three years ended November 29, 2003,

November 30, 2002 and December 1, 2001, respectively: (in thousands, except per share amounts) 2003 Quarter Ended (in thousands, except per share data)

----- March
 1 May 31 August 30 November 29 -----
 ----- Net Sales \$ 11,915 \$
 12,013 \$ 21,906 \$ 37,295 Gross Profit 3,310
 3,456 3,893 2,317 Income (Loss) before
 Income Taxes 345 (503) (2,288) (5,827) Net
 Income (Loss) 282 (493) (2,312) (5,794) Net
 Income (Loss) per Share: Basic \$ 0.02 \$ (0.03)
 \$ (0.14) \$ (0.27) Diluted \$ 0.02 \$ (0.03) \$ (0.14)
 \$ (0.27) 2002 Quarter Ended (in thousands,
 except per share data)

----- March
 2 June 1 August 31 November 30 -----
 ----- Net Sales \$ 3,201 \$
 6,802 \$ 10,148 \$ 9,458 Gross Profit 912 2,345
 3,357 3,156 Income (Loss) before Income
 Taxes (475) 223 932 32 Net Income (Loss)
 (496) 207 820 41 Net Income (Loss) per Share:
 Basic \$ (0.03) \$ 0.01 \$ 0.06 \$ 0.00 Diluted \$
 (0.03) \$ 0.01 \$ 0.05 \$ 0.00

16. Employee Benefit Plans On December 1, 2002, Innovo Group established a tax qualified defined contribution 401(k) Profit Sharing Plan (the "Plan"). All employees who have worked for Innovo Group for 30 consecutive days may participate in the Plan and may contribute up to 100% of their salary to the plan. Innovo Group's contributions may be made on a discretionary basis. All employees who have worked 500 hours qualify for profit sharing in the event at the end of each year Innovo Group decides to do so. Costs of the plan charged to operations were \$20,000 for the year ended November 29, 2003. F-32

17. Other Income and Expense. Other income and expense consist of the following: Year Ended (in thousands) -----
 2003 2002 2001 ----- Rental, real estate, and management fee income \$ 366 \$ 217 \$ 71 Unrealized gain on foreign currency 154 -- -- Other items 6 18 13 -----
 Total other income \$ 526 \$ 235 \$ 84 =====
 ===== Rental expense \$ 58 \$ 43 \$ --
 Unrealized loss on foreign currency -- 41 --
 Other items 10 90 3 ----- Total other expense \$ 68 \$ 174 \$ 3 =====
 ===== F-33 You should rely only on the

information contained in this document or to which we have referred you. We have not authorized anyone to provide you with information that is different. This document may only be used where it is legal to sell these securities. The information contained in this document is current only as of its date.

**298,590 SHARES INNOVO GROUP INC.
COMMON STOCK ----- PROSPECTUS
----- March 23, 2004**