

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Financial Statements

June 30, 2009

(Unaudited)

**NOTICE OF NO AUDITOR REVIEW OF
INTERIM FINANCIAL STATEMENTS**

Section 4.3(3)(a) of National Instrument 51-102, Continuous Disclosure Obligations, provides that if an auditor has not performed a review of the interim financial statements, the interim financial statements must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

The Company's external auditors, PricewaterhouseCoopers LLP, have not performed a review of these interim financial statements of Deans Knight Income Corporation.

signed "Craig Langdon"

Craig Langdon
Chief Executive Officer

signed "Mark Myles"

Mark Myles
Chief Financial Officer

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Statement of Net Assets

As at June 30, 2009

(Unaudited)

	2009
	\$
Assets	
Current assets	
Investments – at fair value (cost - \$78,746,455)	87,219,244
Cash and short-term deposits	19,736,709
Accrued interest receivable	1,475,270
Prepaid expenses	174,153
Future income tax benefits (note 8)	2,000,000
	<u>110,605,376</u>
Future income tax benefits (note 8)	<u>9,065,000</u>
	<u>119,670,376</u>
Liabilities	
Accounts payable and accrued liabilities (note 6)	<u>498,831</u>
Net assets	<u>119,171,545</u>
Shareholders' equity	
Common shares (note 4)	97,735,007
Contributed surplus (note 4)	9,904,504
Retained earnings (note 5)	11,532,034
	<u>119,171,545</u>
Number of common shares outstanding (note 4)	<u>10,537,263</u>
Net assets per common share	<u>11.31</u>
Contingency (note 2)	

The accompanying notes are an integral part of these financial statements.

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Statement of Operations

For the six month period ended June 30, 2009

(Unaudited)

	2009
	\$
Investment income	
Interest and other	<u>1,725,068</u>
Expenses	
Management fees (note 6)	424,864
Public company reporting costs	69,468
Directors' fees and expenses	53,260
Custodial fees	12,891
Foreign exchange gain	(32,249)
Accretion on convertible debenture (note 2 and 4)	103,730
Interest on convertible debenture (note 2 and 4)	<u>215,213</u>
	<u>847,177</u>
Net investment income	<u>877,891</u>
Realized and unrealized gains (losses) on investments	
Net realized gain on investments sold (note 7)	4,890,066
Change in unrealized appreciation on investments	10,943,081
Unrealized depreciation on foreign currency contracts	<u>(2,470,292)</u>
Net gain on investments	<u>13,362,855</u>
Increase in net assets from operations before tax	14,240,746
Recovery of future income tax	<u>11,065,000</u>
Increase in net assets from operations	<u>25,305,746</u>
Increase in net assets from operations per weighted average common share (note 3)	<u>4.15</u>

The accompanying notes are an integral part of these financial statements.

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Statement of Changes in Net Assets

For the six month period ended June 30, 2009

(Unaudited)

	2009
	\$
Increase in net assets from operations	<u>25,305,746</u>
Dividends to common shareholders from:	
Net investment income	<u>(614,322)</u>
Shareholder transactions (note 4)	
Issuance of common shares on conversion of debenture	3,358,615
Conversion of equity component of convertible debenture	(398,615)
Issuance of common shares for payment of interest on convertible debenture	215,213
Issuance of common shares on initial public offering, net of issuance costs	<u>94,161,178</u>
	<u>97,336,391</u>
Increase in net assets during the period	122,027,815
Net liabilities - beginning of period	<u>(2,856,270)</u>
Net assets - end of period	<u>119,171,545</u>

The accompanying notes are an integral part of these financial statements.

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Statement of Cash Flows

For the six month period ended June 30, 2009

(Unaudited)

	2009
	\$
Operating activities	
Increase in net assets from operations	25,305,746
Items not affecting cash	
Net realized gain on investments sold	(4,890,066)
Change in unrealized appreciation in value of investments	(10,943,081)
Unrealized depreciation in foreign exchange contracts	2,470,292
Accretion on convertible debenture	103,730
Interest on convertible debenture	215,213
Future income tax recovery	(11,065,000)
	<u>1,196,834</u>
Cost of investments purchased	(85,827,511)
Proceeds from investments sold	11,971,122
Net change in non-cash balances related to operations	
Accrued interest receivable	(1,475,270)
Prepaid expenses	(174,153)
Accounts payable and accrued liabilities	498,831
	<u>(73,810,147)</u>
Net cash flow used in operating activities	
Financing activities	
Dividends paid to common shareholders (note 5)	(614,322)
Issuance of common shares on initial public offering, net of issuance costs (note 4)	94,161,178
	<u>93,546,856</u>
Net cash flow provided by financing activities	
Net increase in cash during the period	19,736,709
Cash and short-term deposits – beginning of period	-
	<u>19,736,709</u>
Cash and short-term deposits – end of period	
Cash and short-term deposits are comprised of:	
Cash	2,642,930
Short-term deposits	17,093,779
	<u>19,736,709</u>
Supplemental cash flow information (note 10)	

The accompanying notes are an integral part of these financial statements.

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Statement of Investments

As at June 30, 2009

(Unaudited)

	Par value ¹ \$	Average cost ² \$	Fair value ² \$	Percentage of total fair value ³ %
Fixed Income				
Canadian				
<i>Denominated in Canadian dollars</i>				
Athabasca Oil Sands Corp. 13.0% 07-31-2011	7,600,000	6,213,000	7,258,000	8.3
Sherritt International Corp. 7.75% 10-15-2015	3,500,000	2,718,438	3,080,000	3.5
Sherritt International Corp. 7.88% 11-26-2012	1,200,000	903,000	1,104,000	1.3
		9,834,438	11,442,000	13.1
<i>Denominated in United States dollars</i>				
Bombardier Inc. 8.00% 11-15-2014	3,828,000	3,483,772	4,183,047	4.8
CCS Inc. 11.0% 11-15-2015	7,750,000	3,879,423	5,675,906	6.5
CGA Mining Limited 12.0% 11-22-2012	1,000,000	1,028,565	1,104,375	1.3
Dollarama Group LP 8.88% 08-15-2012	4,100,000	4,520,510	4,587,516	5.3
Gibson Energy ULC 11.75% 05-27-2014	2,000,000	2,220,493	2,295,938	2.6
Harvest Operations 7.88% 10-15-2011	5,500,000	4,708,549	5,306,813	6.1
Methanex Corp. 6.0% 08-15-2015	1,000,000	879,586	892,219	1.0
Methanex Corp. 8.75% 08-15-2012	3,750,000	4,098,591	4,174,102	4.8
Opti Canada Inc. 7.88% 12-15-2014	2,000,000	1,257,971	1,499,625	1.7
Paramount Resources 8.5% 01-31-2013	6,250,000	6,653,783	6,738,867	7.7
Teck Resources Ltd. 10.75% 05-15-2019	5,500,000	6,297,137	6,873,281	7.9
West Fraser Timber 5.2% 10-15-2014	1,250,000	974,216	1,082,578	1.2
		40,002,596	44,414,267	50.9
Total Canadian Fixed Income		49,837,034	55,856,267	64.0

¹ Par values are presented in their source currency.

² All amounts are shown in Canadian dollars.

³ Percentages are shown as a percentage of total investments.

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Statement of Investments . . . *continued*

As at June 30, 2009

(Unaudited)

	Par value ¹ \$	Average cost ² \$	Fair value ² \$	Percentage of total fair value ³ %
Fixed Income				
United States				
<i>Denominated in United States dollars</i>				
Calfrac Holdings LP 7.75% 02-15-2015	2,750,000	2,152,126	2,749,313	3.2
Chesapeake Energy CO 7.5% 09-15-2013	4,500,000	4,987,710	4,995,844	5.7
Cott Beverages USA 8.0% 12-15-2011	6,837,000	5,754,777	7,391,652	8.5
Total United States fixed income		12,894,613	15,136,809	17.4
Foreign				
<i>Denominated in United States dollars</i>				
FMG FIN PTY LTD 10.63% 09-01-2016	1,750,000	1,834,705	1,953,000	2.2
Total fixed income		64,566,352	72,946,076	83.6
Convertible Debentures				
<i>Denominated in Canadian dollars</i>				
Harvest Energy 7.25% 09-20-2013	3,500,000	2,032,576	2,275,000	2.6
Pacific Rubiales Energy 8.0% 08-29-2013	7,250,000	6,395,313	7,467,500	8.5
Provident Energy 6.5% 04-30-2011	3,000,000	2,283,750	2,842,500	3.3
Trinidad Drilling 7.75% 07-31-2012	4,620,000	3,468,464	4,158,460	4.8
		14,180,103	16,743,460	19.2
Investments subtotal		78,746,455	89,689,536	102.8
Hedges				
<i>Denominated in United States dollars</i>				
Foreign currency exchange contracts (note 9)	54,000,000	-	(2,470,292)	-2.8
Portfolio Total			87,219,244	100.0

1 Par values are presented in their source currency.

2 All amounts are shown in Canadian dollars.

3 Percentages are shown as a percentage of total investments.

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Notes to Financial Statements

June 30, 2009

(Unaudited)

1 Nature of operations and basis of presentation

Deans Knight Income Corporation (the “Company”), formerly 3887685 Canada Inc., Forbes Medi-Tech Operations Inc. and Forbes Medi-Tech Inc., is a corporation continued under the laws of Canada on April 11, 2001. The Company is a closed-end, non-redeemable investment company. It invests primarily, in corporate debt rated BBB or below by recognized credit rating organizations.

Prior to the Company completing its reorganization in May 2008, it was in the business of pharmaceutical research. In May 2008, the Company was reorganized and the pharmaceutical research operations and all assets and liabilities were transferred out of the Company (note 2). In March 2009, the Company completed an initial public offering, whereby it raised gross proceeds of \$100,368,900 (note 4) and began operating its new business of investing in corporate debt.

Due to the change in the nature of the Company’s business resulting from the corporate reorganization, as explained in note 2 and its subsequent initial public offering, the comparative statements of net assets, operations, changes in net assets and cash flows for the prior period would not be meaningful and have therefore not been presented. The Company had no significant activities, income or expenses during the period January 1, 2009 to March 17, 2009, other than in respect of the initial public offering.

The accompanying unaudited interim financial statements are prepared in accordance with Canadian generally accepted accounting principles (“GAAP”). All amounts are presented in Canadian dollars, unless otherwise noted.

2 Reorganization

On February 27, 2008, the Company reorganized its corporate structure pursuant to a plan of arrangement under the Canada Business Corporations Act (the “Arrangement”). Pursuant to the Arrangement, the Company changed its name from “Forbes Medi-Tech Inc.” to “Forbes Medi-Tech Operations Inc.” and all of the Company’s then outstanding common shares, options and warrants were exchanged for common shares, options and warrants of Forbes, a newly formed entity. As a result of the exchange of shares, the Company became a wholly-owned subsidiary of Forbes and the common shares of Forbes began to trade on the TSX and NASDAQ in substitution for the common shares of the Company. On March 19, 2008, a third party, Forbes and the Company entered into an investment agreement pursuant to which the third party agreed to purchase a convertible debenture for \$2,960,000 and the Company and Forbes agreed to reorganize the business of the Company (the “Reorganization”). On May 9, 2008 the Company changed its name to “3887685 Canada Inc.” and the Company completed the reorganization pursuant to which it transferred all of its assets and operations, and their related liabilities to Forbes.

The Convertible Debenture was convertible into 20,683,685 voting common shares and 123,818,901 non-voting common shares at the option of the third party. On March 17, 2009, the third party opted to convert the full amount of the convertible debenture (note 4).

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Notes to Financial Statements . . . *continued*

June 30, 2009

(Unaudited)

Prior to the Reorganization, the Company was a life sciences company involved in the research, development and commercialization of innovative products for the prevention and treatment of life-threatening diseases. The Company's infrastructure supported a portfolio of discovery and development stage pharmaceutical compounds and nutraceutical products. Forbes continues to carry on the prior business of the Company and in accordance with the asset purchase agreement between the Company and Forbes providing for the Reorganization, Forbes provided an indemnity to the Company with respect to liabilities relating to the Company's assets transferred to Forbes and the Company's prior business. In addition, Forbes obtained, on behalf of the Company, product liability insurance for certain claims that may arise in the future in connection with the Company's prior business. To date, no such claims or potential claims have arisen. There can be no assurance that the above noted guarantee will be sufficient to cover any future claims.

On February 6, 2009, the Company filed articles of amendment to change its name to "Deans Knight Income Corporation". In connection with the reorganization of the Company into an investment company, the Company amended its Articles to, among other things, consolidate the issued and outstanding voting and non-voting common shares on the basis of one voting and non-voting common share for every 382 voting and non-voting common shares held, respectively (note 4). Further, the amendments provided for the Investment Objectives and Investment Restrictions of the Company and for the redemption of the voting and non-voting common shares by the Company for a cash amount equal to 100% of Net Asset Value per Share on April 30, 2014.

3 Summary of significant accounting policies

These financial statements include estimates and assumptions that affect the reported amounts of assets, liabilities, income and expenses during the period. Actual results could differ from these estimates. The following is a summary of significant accounting policies followed by the Company.

Investments

Investments are recorded at fair values and are determined as follows:

Short-term deposits

Short-term deposits are valued at cost plus accrued interest, which approximates market value.

Fixed income investments

Fixed income investments traded on a public securities exchange or traded on an over-the-counter market are valued at the closing bid price. Where no closing bid price is available, the last sale or close price is used, where, in management's opinion, this provides the best estimate of fair value.

Unlisted or non-exchange traded investments, or investments where a last bid, sale or close price is unavailable or investments for which market quotations are, in the Company's opinion, inaccurate, unreliable, or not reflective of all available material information, are valued at their fair value as determined by the Company using appropriate and accepted industry valuation techniques including valuation models. The fair value determined using valuation models requires the use of inputs and assumptions based on

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Notes to Financial Statements . . . *continued*

June 30, 2009

(Unaudited)

observable market data including volatility and other applicable rates or prices. In limited circumstances, the fair value may be determined using valuation techniques that are not supported by observable market data.

The resulting values for investments not traded in an active market may differ from values that would be determined had a ready market existed.

Forward currency contracts

Forward currency contracts are recorded at fair value. The proceeds (payments) on contracts settled during the period are included in the net realized gain on investments sold (note 7). The Company's policy is to hedge 95% - 106% of the fair value of foreign denominated investments with foreign exchange forward sell contracts.

The impact of changes in fair value on net income of the Company arising from changes in estimated fair value for private and public company investments is detailed in the statement of operations.

The net change in the fair value from the total cost of the investments is reflected in the statement of operations as changes in unrealized appreciation/depreciation in value of investments.

Investment transactions

Investment transactions are recorded on the trade date. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of an investment, which include fees and commissions paid to agents, advisors, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. These costs are expensed and are included in the statements of operations.

Cash and short-term deposits

Cash and short-term deposits consists of cash and deposits with maturities at time of purchase of three months or less and are held with a Canadian chartered bank.

Income recognition

Income from investments is recognized on an accrual basis. Interest income is accrued based on the number of days the investment is held during the period. Gain or loss on the sale of investments, including foreign exchange gain or loss on such investments, are calculated on an average cost basis.

Forward foreign currency contracts

Forward foreign currency contracts (note 9) entered into by the Company are valued at an amount that is equal to the gain or loss that would be realized if the position were to be closed out, which is equivalent to the difference between the deliverable asset and the value of the asset to be received. Changes in the value of a forward contract or the assets deliverable under such a contract are included as unrealized appreciation/depreciation of foreign currency contracts in the statement of operations.

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Notes to Financial Statements . . . *continued*

June 30, 2009

(Unaudited)

Foreign exchange

Assets and liabilities denominated in foreign currencies are translated into Canadian dollars at the exchange rate applicable on the valuation date. Purchases and sales of investments, investment income and expenses are calculated at the exchange rates prevailing on the dates of the transactions.

Accretion in carrying value of convertible debenture

The carrying value of the liability component of the redeemable convertible debenture is accreted to the estimated redemption value using the effective yield method through charges to income over the period up to the redemption date.

Income taxes

The Company follows the asset and liability method of accounting for income taxes. Future income tax assets and liabilities are measured using rates expected to apply to the taxable income in the years in which the temporary differences are expected to be settled.

A valuation allowance is recognized to the extent it is more likely than not that future income tax assets will not be realized. Management has estimated the income tax provision and future income tax balances taking into account its expectation of future income and an interpretation of the various income tax laws and regulations. It is possible, due to the complexity inherent in estimating income taxes, that the tax provision and future tax balances could change.

Future accounting standards

The Canadian Accounting Standards Board confirmed January 1, 2011 as the date international financial reporting standards (IFRS) will replace current Canadian standards and interpretations as GAAP for publicly accountable enterprises. Management has commenced activities to identify key issues and the likely impacts resulting from the adoption of IFRS.

Use of estimates

The preparation of financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, income and expenses during the reporting period. Actual results could differ from those reported and such differences could be material. Significant areas involving the use of estimates include determining the estimated fair value of private investments and future income tax assets. In calculating estimated fair value, the Portfolio Manager makes maximum use of publicly available market-based inputs.

Net assets per common share

The net assets per common share is computed by dividing the net assets of the Company by the total number of common shares outstanding on the valuation date.

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Notes to Financial Statements . . . *continued*

June 30, 2009

(Unaudited)

Increase in net assets from operation per weighted average common share

The increase in net assets from operations per common share represents the increase in net assets from operations divided by the weighted average number of common shares outstanding during the period.

The weighted-average number of shares outstanding during the period ended June 30, 2009 was 6,097,337. This weighted average includes both the voting common shares and non-voting common shares of the company, and has been calculated assuming the consolidation of both voting common shares and non-voting common shares occurred at the beginning of the period.

4 Share capital

The company is authorized to issue an unlimited number of voting common shares without par value, an unlimited number of non-voting common shares with par value.

	Voting common shares		Non-voting common shares	
	Number of shares	Amount \$	Number of shares	Amount \$
Balance – December 31, 2008	38,412,100	1	-	-
Shares issued on conversion of debenture	20,683,685	480,742	123,818,901	2,877,873
Shares issued for payment of interest owed on convertible debenture	-	-	8,227,260	215,213
Share consolidation	(58,941,083)	-	(131,700,490)	-
	154,702	480,743	345,671	3,093,086
Shares issued in initial public offering	10,036,890	100,368,900	-	-
Less: Offering costs		(6,207,722)	-	-
Balance – June 30, 2009	10,191,592	94,641,921	345,671	3,093,086
Common shares outstanding at June 30, 2009			10,537,263	97,735,007

On February 6, 2009, the Company cancelled its stock option plan (no options were outstanding at December 31, 2008) and cancelled the authorized, but unissued, preferred shares.

Initial Public Offering

On March 17, 2009, the Company completed an initial public offering.

Immediately prior to the initial public offering, the \$2,960,000 convertible debenture was converted at the holder's option, resulting in the issuance of 20,683,685 voting common shares and 123,818,901 non-voting common shares. The value ascribed to these shares was the value of the convertible debenture, being \$2,960,000, and the value of the equity component of the convertible debenture, being \$398,615. The Company

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Notes to Financial Statements . . . *continued*

June 30, 2009

(Unaudited)

also issued 8,227,260 non-voting common shares in satisfaction of the \$215,213 of interest owed on the convertible debenture.

Immediately after the issuance of shares related to the Convertible Debenture and the related interest owed, the 59,095,785 voting common shares and the 132,046,161 non-voting common shares outstanding were consolidated on a 382 to 1 basis, into 154,702 voting common shares and the 345,671 non-voting common shares.

The Company then issued 10,036,890 voting common shares at a price of \$10.00 per share, for gross proceeds of \$100,368,900 (\$94,161,178 net of issue costs). The proceeds of these funds were used to invest in a portfolio of debt securities.

Contributed surplus

The contributed surplus balance at June 30, 2009 of \$9,904,504 did not change during the period, and consists of:

	2009
	\$
Surplus related to stock compensation, warrants and options associated with common shares	8,030,295
Surplus relating to warrants associated with previously issued preferred shares	1,874,209
	<hr/>
	9,904,504

5 Retained earnings

The changes in retained earnings for the period were as follows:

	2009
	\$
Deficit – December 31, 2008	(13,159,390)
Increase in net assets from operations	25,305,746
Dividends paid from net investment income	(614,322)
	<hr/>
Retained earnings – June 30, 2009	11,532,034

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Notes to Financial Statements . . . *continued*

June 30, 2009

(Unaudited)

6 Related party transactions and balances

Management fees are paid quarterly to Deans Knight Capital Management Ltd. (the Investment Advisor), a corporation with certain common directors and officers as the Company, for services received in connection with the management of the investment portfolio and financial accounts, among other services provided. Management fees are computed quarterly at an annual rate of 1.5% of Net Asset Value, adjusted for certain non-investment related assets. For the period ended June 30, 2009, management fees totalled \$424,864. This amount was included in accounts payable and accrued liabilities in the statement of net assets at June 30, 2009.

A director of the Company is a partner at a law firm that provides legal services to the Corporation. During the period ended June 30, 2009, the Corporation incurred approximately \$330,000 in legal services and disbursements received from this related party, which predominantly related to the Company's IPO. At June 30, 2009, accounts payable and accrued liabilities include \$10,000 to the law firm for legal fees and disbursements, which have not been billed.

7 Net realized gains on investments sold

The following summarizes the net realized gains on investments sold during the period:

	2009 \$
Proceeds from sale of investments	<u>11,971,122</u>
Investments at cost – beginning of period	-
Add: Cost of investments purchased	<u>85,827,511</u>
	85,827,511
Less: Investments at cost – end of period	<u>(78,746,455)</u>
Cost of investments sold	<u>7,081,056</u>
Net realized gains on investments sold	<u>4,890,066</u>

Net realized gains on investments sold consists of:

Realized gains on securities sold	953,429
Realized gains on settlement of foreign currency contracts	<u>3,936,637</u>
	<u>4,890,066</u>

8 Taxation

Canadian GAAP requires a valuation allowance to be recognized against any future tax asset to the extent that it is more likely than not that the future income tax asset will not be realized. This is also the Company's stated accounting policy.

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Notes to Financial Statements . . . *continued*

June 30, 2009

(Unaudited)

Prior to commencing operations as an investment corporation in March 2009, the Company had determined that it had not met this test. As such, the Company recorded a full valuation allowance against the potential value of all of its tax losses and deductions available to be taken against future years' taxable income.

As the Company's investments in debt securities are now generating interest income, and are expected to continue to generate income during the period of operations through to April 30, 2014, the Company concluded that the valuation allowance be reduced accordingly. The difference between the total value of these tax benefits less the valuation allowance, being \$11,065,000, is the amount of the future income tax asset that has been recorded by the Company in the statement of net assets. This amount is recorded as a benefit in the statement of operations. The valuation allowance is reviewed periodically based on updated projections of taxable income and adjusted accordingly by a credit or change to the statement of operations in that period.

The tax effects of temporary differences that give rise to significant components of the future income tax assets at the statutory enacted rates are as follows:

	2009
	\$
Future tax assets:	
Non-capital loss carry-forwards	13,413,000
Research and development expenditures	8,943,000
Share issuance costs	1,649,000
Property plant and equipment and intangible assets	<u>510,000</u>
Total gross future tax assets	24,515,000
Valuation allowance	<u>(13,450,000)</u>
Net future tax asset	11,065,000
Less: current portion	<u>(2,000,000)</u>
	<u>9,065,000</u>

The tax balances and income tax expense recognized by the Company are based on management's interpretation of the tax laws. Due to the complexity inherent in tax interpretations, regulations and legislation, there are significant estimates required to compute income tax balances. It is possible that some or all of the Company's non-capital losses may not be deductible for tax purposes and, accordingly, the amount of future income taxes and provision for (recovery of) income taxes recorded in the financial statements could change by a material amount.

The operations of the Company and related tax interpretations, regulations and legislation are continually changing. As a result, there are significant estimates required to compute income tax balances. As at June 30, 2009, the Company has accumulated scientific research and experimental development expenditures in the amount of \$34,398,700 available for carry-forward indefinitely. The Company also has accumulated approximately \$7,096,900 of unclaimed federal investment tax credits. The Company also has accumulated

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Notes to Financial Statements . . . *continued*

June 30, 2009

(Unaudited)

non-capital losses in the amount of \$48,423,600. The investment tax credits and Canadian non-capital losses for income tax purposes expire as follows:

Year of expiry	Investment tax credits	Non-capital losses
	\$	\$
2009	-	1,687,000
2010	-	3,106,000
2014	-	4,475,800
2015	-	11,005,100
2016	264,800	-
2017	989,800	-
2018	1,872,300	-
2019	2,483,000	-
2020	297,500	-
2021	186,800	-
2022	496,200	-
2023	506,500	-
2024	-	-
2025	-	-
2026	-	15,884,700
2027	-	9,822,900
2028	-	2,478,000
	<u>7,096,900</u>	<u>48,423,600</u>

The reconciliation of income tax computed at the statutory tax rate to income tax expense, using a 30% statutory tax rate is:

	2009
	\$
Income before income taxes	14,240,746
Statutory tax rate	<u>30%</u>
Income tax expense at statutory rates	4,272,224
Use of prior years losses	(1,019,221)
Changes in valuation allowance	(11,065,000)
Effect of unrealized appreciation on investments	(2,540,937)
Permanent differences	(702,391)
Effect of foreign exchange gain	<u>(9,675)</u>
Income tax recovery	<u>(11,065,000)</u>

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Notes to Financial Statements . . . *continued*

June 30, 2009

(Unaudited)

9 Financial instruments

Fair values

The carrying value of cash and short-term deposits, accrued interest receivable and accounts payable and accrued liabilities approximates fair value due to the immediate or short-term maturity of these financial instruments. The fair value of the Company's publicly traded investments is determined by quoted bid prices at the balance sheet date. Unlisted or non-exchange traded investments, or investments where a last bid, sale or close price is unavailable or investments for which market quotations are, in the Company's opinion, inaccurate, unreliable, or not reflective of all available material information, are valued at their fair value as determined by the Company using appropriate and accepted industry valuation techniques.

Management of financial risks

In the normal course of business, the Company is exposed to various financial risks, including credit risk, liquidity risk and market risk (consisting of interest rate risk, currency risk and other price risk). The Company's overall risk management program seeks to minimize potentially adverse effects of these risks on the Company's financial performance by employing a professional, experienced portfolio adviser, by monitoring daily the Company's positions and market events, by diversifying the investment portfolio within the constraints of the investment guidelines and periodically may use derivatives to hedge certain risk exposures. Further, the Company monitors the portfolio to ensure compliance with its investment strategy, investment guidelines and securities regulations.

Fair value risk

The Company's investments are exposed to market price risk and this risk affects the fair value of the investments. All investments in fixed income investments have an inherent risk of loss of capital. The maximum risk resulting from investments is determined by their fair value. The Company seeks to manage valuation risks by careful selection of fixed income investments prior to making an investment and by regular ongoing monitoring of the investment performance of the individual investee companies.

Credit risk

Credit risk is the risk that a counterparty to a financial instrument will fail to discharge an obligation or commitment that it has entered into with the Company.

All transactions executed by the Company in listed securities are settled/paid for upon delivery using approved brokers. The risk of this settlement not occurring is considered minimal, as delivery of securities sold is only made once the broker has received payment. Payment is made on a purchase once the securities have been received by the broker. The trade will fail if either party fails to meet its obligation. Since the Company invests in high-yield debt instruments and derivatives, this represents the main concentration of credit risk. The fair value of debt securities includes consideration of the credit worthiness of the debt issuer. The maximum credit exposure of these assets is represented by their carrying amounts.

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Notes to Financial Statements . . . *continued*

June 30, 2009

(Unaudited)

As at June 30, 2009, the Company's credit risk exposure by credit ratings is listed as follows:

Credit rating	As a % of net assets
BB	22.1
B	9.7
CCC	22.3
Not rated*	21.2
	<u>75.3</u>

*Unrated debt securities consist primarily of convertible debentures and a promissory note in publicly traded companies

Credit ratings are obtained from Standard & Poor's and/or Moody's. Where one or more rating is obtained for a security, the lowest rating has been used.

Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or fair values of financial instruments.

The Company invests in interest-bearing financial instruments. As such, the Company is exposed to the risk that the value of such financial instruments will fluctuate due to changes in the prevailing levels of market interest rates. The table below summarizes the Company's exposure to interest rate risk by remaining term to maturity.

Bonds	Fair value \$
Less than 1 year	-
1 -3 years	31,370,464
3 -5 years	30,330,103
Greater than 5 years	27,988,969

As at June 30, 2009, if the prevailing interest rates had been raised or lowered by 1%, assuming a parallel shift in the yield curve, with all other factors remaining constant, net assets could possibly have decreased or increased, respectively by approximately \$2,581,261 (approximately 2.4% of total net assets).

Liquidity risk

As the Company is a publicly traded, closed-end investment company with a fixed number of common shares outstanding, unlike an open-ended mutual fund, it is not exposed to the liquidity risk associated with daily cash redemptions of securities.

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Notes to Financial Statements . . . *continued*

June 30, 2009

(Unaudited)

Investments in fixed income investments may not be able to be liquidated quickly at an amount close to their fair value to respond to specific events such as deterioration in the creditworthiness of any particular issuer. Fixed income investments purchased by the Company may be subject to resale restrictions such as hold periods. The resulting values for fixed income investments may differ from values that would be realized had a ready market existed.

Currency risk

Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. The Company invests a portion of its assets in securities that are denominated in a currency other than the Canadian dollar, which represents the functional currency of the Company. Consequently, the Company is exposed to currency risk as the value of the portfolio securities denominated in currencies other than the Canadian dollar will vary due to changes in foreign currency exchange rates.

The Company enters into foreign currency contracts with financial institutions to hedge the value of foreign currency denominated investments. The fair value of these contracts is reflected in investments. Gains or losses arising from these contracts offset the gains or losses from the underlying investments. The unrealized gains or losses are reflected in unrealized appreciation/depreciation on foreign exchange contracts on the Statement of Operations.

The table below indicates the foreign currency to which the Company has significant exposure at June 30, 2009 in Canadian dollar terms. The table also illustrates the potential impact to the Company's net assets, all other variables held constant, as a result of a 5% change in this currency relative to the Canadian dollar.

Currency	Investments \$	Cash and term deposits \$	Foreign exchange contracts \$	Total \$	Impact on net assets \$
United States Dollars	61,741,843	642,057	(62,775,000)	(391,000)	(16,822)
As a % of net assets	(57.6%)	(0.6%)	(58.5%)	(0.3%)	(0.2%)

At June 30, 2009, the Company had outstanding foreign exchange contracts to sell US\$54,000,000 against future commitments at exchange rates ranging between 1.0834 and 1.1277 with maturities ranging up to July 16, 2009.

10 Supplemental cash flow information

Non-cash financing transactions

Non-voting common shares issued on conversion of debenture	2,877,873
Voting common shares issued on conversion of debenture	480,742
Non-voting common shares issued for payment of interest on debenture	215,213

Deans Knight Income Corporation

(formerly 3887685 Canada Inc.)

Notes to Financial Statements . . . *continued*

June 30, 2009

(Unaudited)

11 Capital management

The capital of the Company is divided in voting and non-voting common shares, each having an unlimited authorized amount. The number of voting and non-voting shares outstanding, and changes thereto, are outlined in note 4.

The Company manages its capital in accordance with the Company's investment objectives. The Company's investment objectives are to: (i) maximize the total return for common shareholders, consisting of dividend income and capital appreciation; and (ii) provide Shareholders with monthly dividends targeted to payout a minimum of 75% of net earnings annually. Net earnings in reference to the Company's dividend payments to Shareholders excludes any realized and unrealized capital gains and losses from debt securities in the Portfolio and any income or loss not derived from debt securities in the Portfolio. The Company commenced its dividend payments on June 30, 2009, with a payment of \$0.0583 per voting and non-voting common share, or \$614,322.

12 Comparison of net asset value per share and net assets per share

In accordance with Section 3.6(1) of National Instrument 81-106, the Company's net asset value per share, the net assets per share calculated in accordance with Canadian GAAP for financial reporting purposes, and an explanation of the differences between such amounts, are required disclosures in the notes to the financial statements. For investments that are traded in an active market, Canadian GAAP requires that bid prices be used in the fair value of instruments, rather than the use of the last traded price, as currently used for the purpose of determining net asset value. This change accounts for the difference between net asset value and net assets.

	June 30 2009
	\$
Net asset value per share	11.34
Canadian GAAP adjustments	(0.03)
Net assets per share	11.31