# Deans Knight Income Corporation

Financial Statements
**December 31, 2009**

PRICEWATERHOUSECOOPERS

**PricewaterhouseCoopers LLP**
**Chartered Accountants**
PricewaterhouseCoopers Place
250 Howe Street, Suite 700
Vancouver, British Columbia
Canada V6C 3S7
Telephone +1 604 806 7000
Facsimile +1 604 806 7806

March 4, 2010

## Auditors' Report

**To the Shareholders of**
**Deans Knight Income Corporation**

We have audited the statements of net assets and investments of **Deans Knight Income Corporation** as at December 31, 2009 and the statements of operations, changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2009 and the results of its operations, changes in net assets and cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

**Chartered Accountants**

# Deans Knight Income Corporation

Statement of Net Assets

**As at December 31, 2009**

| | $ |
|---|---|
| **Assets** | |
| **Current assets** | |
| Investments - at fair value (cost - $100,510,397) | 113,245,040 |
| Cash and short-term deposits | 6,042,756 |
| Accrued interest receivable | 1,670,248 |
| Prepaid expenses | 89,840 |
| Future income tax benefits (note 8) | 2,210,000 |
| | 123,257,884 |
| **Non-current** | |
| Future income tax benefits (note 8) | 5,990,000 |
| | 129,247,884 |
| **Liabilities** | |
| **Accounts payable and accrued liabilities** (note 6) | 566,190 |
| **Net assets** | 128,681,694 |
| **Shareholders' Equity** | |
| **Common shares** (note 4) | 99,366,429 |
| **Contributed surplus** (note 4) | 9,904,504 |
| **Retained earnings** (note 5) | 19,410,761 |
| | 128,681,694 |
| **Number of common shares outstanding** (note 4) | 10,537,263 |
| **Net assets per common share** (notes 8 and 12) | 12.21 |

**Contingencies** (notes 2 and 8)

**Commitment** (note 11)

**Approved by the Board of Directors**

______________________ Director ______________________ Director

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

# Deans Knight Income Corporation

Statement of Operations

**For the year ended December 31, 2009**

| | $ |
|---|---|
| **Investment income** | |
| Interest and other | 6,563,633 |
| | |
| **Expenses** | |
| Management fees (note 6) | 1,361,226 |
| Directors' fees and expenses | 133,345 |
| Audit fees | 66,195 |
| Public company reporting costs | 62,681 |
| Foreign exchange loss | 42,714 |
| Custodial fees | 40,439 |
| Legal fees | 15,080 |
| Independent Review Committee fees | 12,000 |
| Transaction costs | 10,050 |
| Accretion on convertible debenture (note 4) | 103,730 |
| Interest on convertible debenture (note 4) | 215,213 |
| | 2,062,673 |
| **Net investment income** | 4,500,960 |
| **Realized and unrealized gains on investments** | |
| Net realized gain on investments sold (note 7) | 5,590,551 |
| Net realized gain on settlement of foreign currency contracts (note 7) | 7,536,754 |
| Change in unrealized appreciation on investments | 12,642,202 |
| Unrealized appreciation on foreign currency contracts | 92,441 |
| **Net gain on investments** | 25,861,948 |
| **Increase in net assets from operations before tax** | 30,362,908 |
| **Recovery of future income tax** (note 8) | 6,507,500 |
| **Increase in net assets from operations** | 36,870,408 |
| **Increase in net assets from operations per weighted average common share** (note 3) | 4.66 |

# Deans Knight Income Corporation
Statement of Changes in Net Assets
**For the year ended December 31, 2009**

| | $ |
|---|---|
| **Increase in net assets from operations** | 36,870,408 |
| **Dividends to common shareholders from net investment income** | (4,300,257) |
| **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 offering costs (note 4) | 95,792,600 |
| | 98,967,813 |
| **Increase in net assets during the year** | 131,537,964 |
| **Net liabilities - Beginning of year** (note 2) | (2,856,270) |
| **Net assets - End of year** | 128,681,694 |

# Deans Knight Income Corporation

Statement of Cash Flows

**For the year ended December 31, 2009**

| | $ |
|---|---|
| **Cash flows from operating activities** | |
| Increase in net assets from operations | 36,870,408 |
| Items not affecting cash | |
| Net realized gain on investments sold | (5,590,551) |
| Net realized gain on settlement of foreign currency contracts | (7,536,754) |
| Change in unrealized appreciation in value of investments | (12,642,202) |
| Unrealized appreciation on foreign exchange contracts | (92,441) |
| Accretion on convertible debenture | 103,730 |
| Interest on convertible debenture | 215,213 |
| Future income tax recovery | (6,507,500) |
| | 4,819,903 |
| Cost of investments purchased | (125,360,814) |
| Proceeds from investments sold | 37,977,722 |
| Net change in non-cash balances related to operations | |
| Accrued interest receivable | (1,670,248) |
| Prepaid expenses | (89,840) |
| Accounts payable and accrued liabilities | 566,190 |
| | (83,757,087) |
| **Cash flows from financing activities** | |
| Dividends paid to common shareholders (note 5) | (4,300,257) |
| Issuance of common shares on initial public offering, net of offering costs (note 4) | 94,100,100 |
| | 89,799,843 |
| **Net increase in cash during the year** | 6,042,756 |
| **Cash and short-term deposits - Beginning of year** | - |
| **Cash and short-term deposits - End of year** | 6,042,756 |
| **Cash and short-term deposits comprise** | |
| Cash | 5,942,803 |
| Short-term deposits | 99,953 |
| | 6,042,756 |

**Supplemental cash flow information** (note 10)

# Deans Knight Income Corporation

Statement of Investments

**For the year ended December 31, 2009**

| | Par value[1] $ | Average cost[2] $ | Fair value[2] $ | Percentage of total fair value[3] % |
|---|---|---|---|---|
| **Fixed Income - Canadian** | | | | |
| *Denominated in Canadian dollars* | | | | |
| Athabasca Oil Sands Corp. 13.0% 07-31-2011 | 7,850,000 | 6,466,688 | 8,321,000 | 7.4 |
| Peak Energy Services Trust 7.5% - 18.0% 03-31-2010 | 1,850,000 | 1,850,000 | 1,850,000 | 1.5 |
| Sherritt International Corp. 7.75% 10-15-2015 | 3,500,000 | 2,718,438 | 3,570,000 | 3.2 |
| Sherritt International Corp. 7.88% 11-26-2012 | 1,200,000 | 903,000 | 1,224,000 | 1.1 |
| | | 11,938,126 | 14,965,000 | 13.2 |
| *Denominated in United States dollars* | | | | |
| Bombardier Inc. 8.00% 11-15-2014 | 5,268,000 | 5,029,913 | 5,730,451 | 5.1 |
| CCS Inc. 11.0% 11-15-2015 | 7,750,000 | 3,879,423 | 5,701,675 | 5.0 |
| CGA Mining Limited 12.0% 11-22-2012 | 2,900,000 | 2,967,677 | 2,895,505 | 2.6 |
| Gibson Energy ULC 11.75% 05-27-2014 | 2,000,000 | 2,220,493 | 2,275,415 | 2.0 |
| Harvest Operations Corp.7.88% 10-15-2011(4) | 5,500,000 | 4,708,549 | 5,845,531 | 5.2 |
| Methanex Corporation 6.0% 08-15-2015 | 1,000,000 | 879,586 | 896,503 | 0.8 |
| Methanex Corporation 8.75% 08-15-2012 | 3,750,000 | 4,098,591 | 4,098,900 | 3.6 |
| Opti Canada Inc. 7.88% 12-15-2014 | 2,000,000 | 1,257,971 | 1,713,130 | 1.5 |
| Paramount Resources Ltd. 8.5% 01-31-2013 | 7,750,000 | 8,242,841 | 8,124,887 | 7.2 |
| Teck Resources Limited 10.75% 05-15-2019 | 5,500,000 | 6,297,137 | 6,864,344 | 6.1 |
| West Fraser Timber Co. Ltd. 5.2% 10-15-2014 | 1,250,000 | 974,216 | 1,169,238 | 1.0 |
| | | 40,556,397 | 45,315,579 | 40.1 |
| Total Canadian fixed income | | 52,494,523 | 60,280,579 | 53.3 |
| **Fixed income - United States** | | | | |
| *Denominated in United States dollars* | | | | |
| Calfrac Holdings LP 7.75% 02-15-2015(4) | 7,140,000 | 6,670,487 | 7,241,495 | 6.4 |
| Calfrac Holdings LP 7.75% 02-15-2015 144A(4) | 500,000 | 500,141 | 507,108 | 0.4 |
| Chesapeake Energy Corp. 7.5% 09-15-2013 | 4,500,000 | 4,987,710 | 4,824,090 | 4.3 |
| Cott Beverages Inc. 8.38% 11-15-2017 | 3,350,000 | 3,546,981 | 3,600,069 | 3.2 |
| Metropcs Wireless Inc. 9.25% 11-01-2014 | 3,900,000 | 4,160,097 | 4,119,395 | 3.6 |
| Metropcs Wireless Inc. 9.25% 11-01-2014 | 1,500,000 | 1,594,520 | 1,596,206 | 1.4 |
| Total United States fixed income | | 21,459,936 | 21,888,363 | 19.3 |
| **Foreign** | | | | |
| *Denominated in United States dollars* | | | | |
| FMG Finance Pty Ltd. 10.63% 09-01-2016 | 1,750,000 | 1,834,705 | 2,013,976 | 1.8 |
| *Denominated Australian dollars* | | | | |
| Western Areas NL 8.0% 07-02-2012 | 3,250,000 | 2,864,931 | 3,061,008 | 2.7 |
| Total foreign fixed income | | 26,159,572 | 26,963,347 | 23.8 |
| Total fixed income | | 78,654,095 | 87,243,926 | 77.1 |

# Deans Knight Income Corporation

Statement of Investments …*continued*

**For the year ended December 31, 2009**

| | Par value[1] $ | Average cost[2] $ | Fair value[2] $ | Percentage of total fair value[3] % |
|---|---|---|---|---|
| **Convertible debentures** | | | | |
| *Denominated in Canadian dollars* | | | | |
| Harvest Energy Trust 7.25% 09-30-2013[(4)] | 5,500,000 | 3,635,076 | 5,596,250 | 5.0 |
| Pacific Rubiales Energy Corporation 8.75% 11-10-2016[(5)] | 2,500,000 | 2,655,612 | 2,772,013 | 2.4 |
| Provident Energy Trust 6.5% 04-30-2011 | 3,000,000 | 2,283,750 | 3,030,000 | 2.7 |
| Trinidad Drilling Ltd. 7.75% 07-31-2012 | 6,941,000 | 5,781,864 | 7,010,410 | 6.2 |
| Whitecap Resources Inc. 8.0% 09-30-2012 | 7,500,000 | 7,500,000 | 7,500,000 | 6.6 |
| | | 21,856,302 | 25,908,673 | 22.9 |
| Investments subtotal | | 100,510,397 | 113,152,599 | 100.0 |
| **Hedges** | | | | |
| *Denominated in United States and Australian dollars* | | | | |
| Foreign currency exchange contracts (note 9) | 72,300,000 | - | 92,441 | |
| | | 100,510,397 | 113,245,040 | 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
[4] These investments share a common director with the Company
[5] Pacific Rubiales Energy Corporation is denominated in United States dollars

## 1 Nature of operations and basis of presentation

Deans Knight Income Corporation (the “Company”), 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 from January 1, 2009 to March 17, 2009, other than in respect of the initial public offering.

The accompanying 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 a newly formed entity (“Forbes”). 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).

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

The following is a summary of significant accounting policies followed by the Company.

**Financial Instruments**

*Investments*

Investments are held for trading and are recorded at fair values 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 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 year 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 investments is detailed in the statement of operations.

*Accrued interest receivable*

Accrued interest is designated as loans and receivables and is accounted for at amortized cost. Due to the immediate and short-term nature carrying value approximates fair value.

*Financial liabilities*

Financial liabilities, consisting of accounts payable and accrued liabilities, are designated as other financial liabilities and are accounted for at amortized costs. Due to the immediate and short-term nature, carrying value approximates fair value.

**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 statement of operations.

**Cash and short-term deposits**

Cash and short-term deposits consists of cash and deposits with maturities at the 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 year. Gains or losses 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.

**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 year 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. The Company accounts for uncertain tax positions using the contingent liability model, whereby a provision is established only where the probability that a payment will be required to be made is considered to be greater than 75%.

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 (note 8).

**Changes in accounting standards**

*Financial Instruments - Disclosures*

Effective January 1, 2009, the Company adopted the new provisions of Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3862, *Financial Instruments - Disclosures*, which requires additional disclosure over the inputs to fair value measurement, including their classification within a prioritized three-level hierarchy based on the relative reliability of the inputs used to estimate the fair values. Level 1 fair values are quoted prices in active markets (unadjusted) for identical assets or liabilities; Level 2 fair values are based on quoted prices for similar assets and liabilities in active markets and inputs that are observable for the asset or liability either directly or indirectly and; Level 3 fair values are based on unobservable market data inputs for the asset or liability. The Company has included these disclosures in note 9.

*Financial Instruments - Recognition and Measurement*

Effective January 1, 2009, the Company adopted the new provisions of Handbook Section 3855, *Financial Instruments - Recognition and Measurement* relating to the accounting for debt instruments held as investments. This section requires the reversal of impairment losses relating to available-for-sale debt instruments when, in a subsequent year, the fair value of the instrument increases and the increase can be objectively related to an event occurring after the loss was recognized. The adoption of this standard did not materially impact the Company's financial statements.

*Financial Instruments - Credit Risk and Fair Value*

Effective January 1, 2009, the Company adopted Emerging Issues Committee ("EIC") Abstract EIC-173, *Credit Risk and the Fair Value of Financial Assets and Liabilities*, which was issued by the Accounting Standards Board ("AcSB"). The abstract clarifies how the credit risk of a counterparty or an entity's own credit risk should be taken into account in the measurement, presentation and disclosure of the fair value of financial assets and liabilities. The adoption of this standard was considered in the valuation of the investment portfolio.

**Use of estimates**

The preparation of financial statements in conformity with Canadian generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, income and expenses. 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.

**Increase in net assets from operations 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 year.

The weighted-average number of shares outstanding during the year ended December 31, 2009 was 8,335,545. 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 year.

## 4 Capital stock

The Company is authorized to issue an unlimited number of voting common shares without par value, and an unlimited number of non-voting common shares without 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 - net of tax | - | (4,576,300) | - | - |
| Balance - December 31, 2009 | 10,191,592 | 96,273,343 | 345,671 | 3,093,086 |
| Total common shares outstanding at December 31, 2009 | | | 10,537,263 | 99,366,429 |

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 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. The net cash proceeds of $94,100,100 were used to invest in a portfolio of debt instruments. As a result of the income tax benefit of $1,692,500 related to offering costs of $6,268,800, the total increase in voting common shares was $95,792,600.

### Contributed surplus

The contributed surplus balance at December 31, 2009 of $9,904,504 did not change during the year, and consists of:

| | $ |
|---|---|
| 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 |
| | 9,904,504 |

## 5 Retained earnings

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

| | $ |
|---|---|
| Deficit - December 31, 2008 | (13,159,390) |
| Increase in net assets from operations | 36,870,408 |
| Dividends paid from net investment income | (4,300,257) |
| Retained earnings - December 31, 2009 | 19,410,761 |

## 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 of 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 year ended December 31, 2009, management fees totalled $1,361,226. Of this amount, $476,700 was included in accounts payable and accrued liabilities in the statement of net assets at December 31, 2009, and is payable immediately.

A director of the Company is a partner at a law firm that provides legal services to the Company. During the year ended December 31, 2009, the Company incurred approximately $355,000 in legal services and disbursements received from this related party, which predominantly related to the Company's IPO. At December 31, 2009, accounts payable and accrued liabilities include $550 to the law firm for legal fees and disbursements.

## 7 Net realized gains on investments sold and foreign currency contracts

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

| | $ |
|---|---|
| Proceeds from sale of investments | 37,977,722 |
| Investments at cost - Beginning of year | - |
| Add: Cost of investments purchased | 125,360,814 |
| Less: Investments at cost - End of year | (100,510,397) |
| Cost of investments sold | 24,850,417 |
| Net realized gains on investments sold | 13,127,305 |

Net realized gains on investments sold consists of:

| | |
|---|---|
| Realized gains on securities sold | 5,590,551 |
| Realized gains on settlement of foreign currency contracts | 7,536,754 |
| | 13,127,305 |

## 8 Taxation

**Uncertainty of deductibility of tax losses**

Prior to the reorganization and change in business as discussed in note 1, the Company has generated significant tax losses and other tax attributes as a result of its prior businesses and research activities. The Company has recorded, as a tax asset, the full amount of the potential tax benefit of such items to the extent of its projected taxable income. There is uncertainty as to whether the tax authorities will allow the Company to deduct some, or all, of the tax losses and other attributes. Should the Company be denied the deductions in full, the recognized amount of the tax assets as well as such amounts claimed to date would be recorded as a charge to income. The total tax assets recognized and tax losses and other attributes claimed to date, which are subject to uncertainty, amount to $15,647,415, representing $1.48 per common share at December 31, 2009.

**Future tax asset**

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.

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 years of operations through to April 30, 2014, the Company concluded that the valuation allowance should be reduced accordingly. The difference between the total value of these tax benefits less the valuation allowance, being $8,200,000, is the amount of the future income tax asset that has been recorded by the Company in the statement of net assets. The valuation allowance is reviewed periodically, based on updated projections of taxable income, and adjusted accordingly by a credit or charge to the statement of operations in that year.

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:

| | $ |
|---|---|
| **Future tax assets** | |
| Non-capital loss carry-forwards | 5,150,041 |
| Research and development expenditures | 8,599,750 |
| Investment tax credits | 5,677,600 |
| Share issuance costs | 1,316,448 |
| Property, plant and equipment and intangible assets | 490,500 |
| Total gross future tax assets | 21,234,339 |
| Valuation allowance | (13,034,339) |
| Net future tax asset | 8,200,000 |
| Less: current portion | (2,210,000) |
| | 5,990,000 |

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 significant components of the future income tax assets 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.

In determining the amount of future income tax assets recognized management assessed the projected taxable income of the Company. Inherent in all forward looking information is uncertainty and actual amounts could differ from these estimates and the difference could be material. In developing the projection, management has assumed full payment of all contractual interest, that investments maturing during the life of the Company will be redeemed for par value and reinvested funds will achieve an 8% yield.

**Tax pools available to offset future tax expense and payable**

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 December 31, 2009, the Company has accumulated scientific research and experimental development expenditures in the amount of $34,399,000 available for carry-forward indefinitely. The Company also has accumulated approximately $7,097,000 of unclaimed federal investment tax credits and accumulated non-capital losses in the amount of $19,351,000. The investment tax credits and non-capital losses for income tax purposes expire as follows:

| | Investment tax credits $ | Non-capital losses $ |
|---|---|---|
| **Year of expiry** | | |
| 2016 | 265,000 | - |
| 2017 | 990,000 | - |
| 2018 | 1,872,000 | - |
| 2019 | 2,483,000 | - |
| 2020 | 298,000 | - |
| 2021 | 187,000 | - |
| 2022 | 496,000 | - |
| 2023 | 506,000 | - |
| 2024 | - | - |
| 2025 | - | - |
| 2026 | - | 7,050,000 |
| 2027 | - | 9,823,000 |
| 2018 | - | 2,478,000 |
| | 7,097,000 | 19,351,000 |

**Reconciliation of income tax expense**

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

| | $ |
|---|---|
| Income before income taxes | 30,362,908 |
| Statutory tax rate | 30% |
| Income tax expense at statutory rates | 9,108,872 |
| Use of prior year losses | (8,763,863) |
| Changes in valuation allowance | (8,200,000) |
| Income tax benefit related to offering cost | 1,692,500 |
| Share issuance costs | (345,009) |
| Income tax recovery | (6,507,500) |

## 9 Financial instruments

The following table illustrates the classification of the Company's financial instruments within the fair value hierarchy as at December 31, 2009:

| | Financial assets at fair value | | | |
|---|---|---|---|---|
| | **Level 1** **$** | **Level 2** **$** | **Level 3** **$** | **Total** **$** |
| Bonds | - | 75,338,513 | 11,616,418 | 86,954,931 |
| Convertible debentures | - | 15,636,660 | 10,561,008 | 26,197,668 |
| Foreign currency forward contract | - | 92,441 | - | 92,441 |
| | - | 91,067,614 | 22,177,426 | 113,245,040 |

All investments remained at their respective levels within the fair value hierarchy during the year.

The following table reconciles the Company's Level 3 fair value measurements from March 18, 2009 (the commencement of operations as an investment company) to December 31, 2009:

| | Fair value measurements of Level 3 inputs | | |
|---|---|---|---|
| | **Bonds** **$** | **Convertible debentures** **$** | **Total** **$** |
| Balance - December 31, 2008 | - | - | - |
| Purchases | 9,671,316 | 10,364,931 | 20,036,247 |
| Unrealized appreciation included in net gain on investments | 1,945,102 | 196,077 | 2,141,179 |
| Balance - December 31, 2009 | 11,616,418 | 10,561,008 | 22,177,426 |

Level 3 fair value measurements have predominantly been valued by considering data inputs such as the last price the security was traded at, most recent bid/ask information, prices of similar securities with available prices, and comparison of yields of comparable investments.

**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, monitoring daily the Company's positions and market events, diversifying the investment portfolio within the constraints of the investment guidelines and periodically using 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 creditworthiness of the debt issuer. The maximum credit exposure of these assets is represented by their carrying amounts. This maximum exposure may be offset to varying degrees in each investment, based on the collateral held, if any. Collateral may include such things as a general security agreement over all assets, or specific security over specific assets. It may also entitle the debt holder to take over the overall business, through restructuring of the investment.

As at December 31, 2009, the Company's credit risk exposure by credit ratings on its investments is listed as follows:

| | **As a % of net assets** |
|---|---|
| **Credit rating** | |
| BB | 18.3 |
| B | 25.1 |
| CCC | 10.3 |
| Not rated* | 34.2 |
| | 87.9 |

* Unrated debt securities consist primarily of convertible debentures and promissory notes 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.

As at December 31, 2009, the Company's credit risk exposure by sector on its investments is as follows:

| | **As a % of net assets** |
|---|---|
| **Sector** | |
| Energy | 56.2 |
| Materials and metals | 16.9 |
| Industrial/manufacturing | 4.5 |
| Technology | 4.4 |
| Consumer goods | 2.8 |
| Precious metals | 2.3 |
| Forestry | 0.8 |
| | 87.9 |

### 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 term to maturity:

| | **Fair value** $ |
|---|---|
| **Maturity** | |
| Less than 1 year | 1,942,441 |
| 1 - 3 years | 42,986,354 |
| 3. 5 years | 35,149,061 |
| Greater than 5 years | 33,167,184 |
| | 113,245,040 |

As at December 31, 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 $3,590,949 (approximately 2.8% 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.

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.

The Company actively reviews its investment portfolio, and the fixed income market, to assess liquidity risk on its holdings.

**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 is 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 currency contracts on the statement of operations.

The table below indicates the foreign currency to which the Company has significant exposure at December 31, 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.

| | **Investments** $ | **Cash and term deposits** $ | **Foreign exchange contracts** $ | **Total** $ | **Impact on net assets** $ |
|---|---|---|---|---|---|
| **Currency** | | | | | |
| United States dollars | 71,989,931 | 1,259,819 | 18,727 | 73,268,477 | 3,373,783 |
| As a % of net assets | 55.9 | 1.0 | 0.0 | 56.9 | 2.6 |
| Australian dollars | 3,061,008 | - | 73,714 | 3,134,722 | 359,776 |
| As a % of net assets | 2.4 | 0.0 | 0.1 | 2.5 | 0.3 |

At December 31, 2009, the Company had outstanding foreign exchange contracts to sell US$69,000,000 and AUS$3,300,000 against future commitments at exchange rates ranging between 1.0411 and 1.05815 for US dollar foreign exchange contracts and 0.96645 for the AUS foreign exchange contract. Those contracts have maturities ranging up to January 28, 2010 and subsequent to their expiry, the Company entered into further foreign currency contracts in accordance with its policy to hedge its foreign currency denominated investments.

## 10 Supplemental cash flow information

| | $ |
|---|---|
| **Non-cash financing transactions** | |
| Non-voting common shares issued on conversion of debentures (note 4) | 2,877,873 |
| Voting common shares issued on conversion of debentures (note 4) | 480,742 |
| Non-voting common shares issued for payment of interest on debentures (note 4) | 215,213 |
| Future income tax benefit from offering costs (note 4) | 1,692,500 |

## 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, making monthly payments of $0.0583 per voting and non-voting common share, or $614,322. This amount has been paid monthly from this date resulting in total dividend payments of $4,300,257 during the year ended December 31, 2009.

The Company is committed to pay a monthly dividend of $0.0583 per voting and non-voting common share for the three months ending March 31, 2010, totalling $1,842,966.

## 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 the net asset value and the net assets.

| | **$** |
|---|---|
| Net asset value per share | 12.23 |
| Canadian GAAP adjustments | (0.02) |
| Net assets per share | 12.21 |