

Deans Knight Income Corporation

Financial Statements

June 30, 2011

(Unaudited)

Deans Knight Income Corporation

Statement of Net Assets

As at June 30, 2011 (Unaudited)

	June 30, 2011 \$	December 31, 2010 \$
Assets		
Current		
Investments - at fair value (cost – June 30, 2011 - \$127,518,870; December 31, 2010 - \$118,563,957)	133,558,796	128,449,450
Cash and cash equivalents	2,618,721	7,137,967
Accrued interest receivable	1,888,705	1,808,756
Prepaid expenses	158,159	89,662
Future income tax benefits (note 8)	2,250,000	2,150,000
	<hr/>	<hr/>
	140,474,381	139,635,835
Non-current		
Future income tax benefits (note 8)	3,620,000	4,400,000
	<hr/>	<hr/>
	144,094,381	144,035,835
Liabilities		
Accounts payable and accrued liabilities (note 6)	665,723	692,474
	<hr/>	<hr/>
Net Assets	143,428,658	143,343,361
	<hr/>	<hr/>
Shareholders' Equity		
Common shares (note 4)	99,366,429	99,366,429
Contributed surplus (note 4)	9,904,504	9,904,504
Retained earnings (note 5)	34,157,725	34,072,428
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	143,428,658	143,343,361
	<hr/>	<hr/>
Number of common shares outstanding (note 4)	10,537,263	10,537,263
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Net assets per common share (notes 8 and 11)	13.61	13.60
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Contingencies (notes 2 and 8)		
Commitment (note 10)		
Subsequent events (note 12)		

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

Deans Knight Income Corporation

Statement of Operations

Six-month period ended June 30, 2011 (Unaudited)

	2011 \$	2010 \$
Investment income		
Interest and other	5,459,044	5,036,042
	<hr/>	<hr/>
Expenses		
Management fees (note 6)	1,165,607	980,755
Public company reporting costs	93,067	72,699
Directors' fees and expenses	87,086	84,535
Audit, accounting and tax fees	37,043	53,384
Custodial fees	24,607	15,408
Legal fees	17,895	17,409
Independent Review Committee fees	4,500	4,500
	<hr/>	<hr/>
	1,429,805	1,228,690
	<hr/>	<hr/>
Net investment income	4,029,239	3,807,352
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Realized and unrealized gains (losses) on investments		
Net realized gain on securities sold (note 7)	2,064,001	2,572,267
Net realized gain on settlement of foreign currency contracts (note 7)	2,203,559	444,042
Change in unrealized (depreciation) appreciation on investments	(4,457,177)	5,246,375
Unrealized appreciation (depreciation) on foreign currency contracts	611,610	(1,438,353)
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Net gain on investments	421,993	6,824,331
	<hr/>	<hr/>
Increase in net assets from operations before tax	4,451,232	10,631,683
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Provision for future income tax (note 8)	(680,000)	(2,190,000)
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Increase in net assets from operations	3,771,232	8,441,683
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Increase in net assets from operations per weighted average common share (note 3)	0.36	0.80
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The accompanying notes are an integral part of these financial statements.

Deans Knight Income Corporation

Statement of Changes in Net Assets

Six-month period ended June 30, 2011 (Unaudited)

	2011 \$	2010 \$
Increase in net assets from operations	3,771,232	8,441,683
Dividends to common shareholders (notes 5 and 10)	<u>(3,685,935)</u>	<u>(3,685,935)</u>
Increase in net assets during the period	85,297	4,755,748
Net assets – Beginning of period	<u>143,343,361</u>	<u>128,681,694</u>
Net assets – End of period	<u>143,428,658</u>	<u>133,437,442</u>

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

Deans Knight Income Corporation

Statement of Cash Flows

Six-month period ended June 30, 2011 (Unaudited)

	2011 \$	2010 \$
Cash flows from operating activities		
Increase in net assets from operations	3,771,232	8,441,683
Items not affecting cash		
Net realized gain on securities sold	(2,064,001)	(2,572,267)
Net realized gain on settlement of foreign currency contracts	(2,203,559)	(444,042)
Change in unrealized depreciation (appreciation) on investments	4,457,177	(5,246,375)
Unrealized (appreciation) depreciation on foreign exchange contracts	(611,610)	1,438,353
Future income tax provision	680,000	2,190,000
	<u>4,029,239</u>	<u>3,807,352</u>
Cost of investments purchased (note 7)	(40,887,826)	(26,584,338)
Proceeds from investments sold (note 7)	36,200,473	24,049,707
Net change in non-cash balances related to operations		
Accrued interest receivable	(79,949)	(1,070,412)
Prepaid expenses	(68,497)	(77,779)
Accounts payable and accrued liabilities	(26,751)	116,628
	<u>(833,311)</u>	<u>241,158</u>
Cash flows from financing activities		
Dividends paid to common shareholders (note 5)	(3,685,935)	(3,685,935)
	<u>(3,685,935)</u>	<u>(3,685,935)</u>
Net decrease in cash during the period	(4,519,246)	(3,444,777)
Cash and cash equivalents – Beginning of period	<u>7,137,967</u>	<u>6,042,756</u>
Cash and cash equivalents – End of period	<u><u>2,618,721</u></u>	<u><u>2,597,979</u></u>
Cash and cash equivalents comprise		
Cash	2,618,721	2,597,979
Short-term deposits	-	-
	<u><u>2,618,721</u></u>	<u><u>2,597,979</u></u>

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

Deans Knight Income Corporation

Statement of Investments

As at June 30, 2011 (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>				
Air Canada 10.13% 08-01-2015	1,500,000	1,485,690	1,545,000	1.2
Black Press Group 10% 02-04-2014	2,750,000	2,750,000	2,750,000	2.1
Cara Operations Ltd. 9.13% 12-01-2015	3,750,000	3,750,000	3,890,625	2.9
Flint Energy Services 7.5% 06-15-2019	1,750,000	1,732,500	1,723,750	1.3
Garda World Security 9.75% 03-15-2017	2,500,000	2,472,105	2,643,750	2.0
Gateway Casinos 8.88% 11-15-2017	2,750,000	2,816,875	2,860,000	2.1
Mercator Minerals Ltd. 6.50% 01-03-2013	4,500,000	4,500,000	4,500,000	3.4
Newalta Corp. 7.63% 11-23-2017	2,250,000	2,250,000	2,345,625	1.8
North American Energy Partners Inc. ⁴ 9.13% 04-07-2017	8,750,000	8,793,125	8,815,625	6.6
Paramount Resources 8.25% 12-13-2017	9,250,000	9,250,000	9,458,125	7.1
Perpetual Energy Inc. 8.75% 03-15-2018	5,000,000	5,000,000	4,975,000	3.7
Sherritt International Corp. 7.75% 10-15-2015	1,500,000	1,165,045	1,606,875	1.2
Skylink Aviation Inc. 12.25% 03-15-2016	4,750,000	4,750,000	4,666,875	3.5
Sure Energy 6.25% 01-21-2014	2,500,000	2,500,000	2,500,000	1.9
Trident Exploration Corp. 8.25% 04-13-2018	1,650,000	1,650,000	1,596,375	1.2
Vermilion Energy Inc. 6.50% 02-10-2016	1,750,000	1,750,000	1,780,625	1.3
		56,615,340	57,658,250	43.3
<i>Denominated in United States dollars</i>				
CCS Inc. 11.00% 11-15-2015	7,750,000	3,879,423	7,809,625	5.8
CHC Helicopter 9.25% 10-15-2020	250,000	253,623	218,776	0.2
Harvest Operations Corp. 6.88% 10-01-2017	1,750,000	1,783,273	1,742,370	1.3
Mirabela Nickel Ltd. 8.8% 04-15-2018	6,000,000	5,811,649	5,727,942	4.3
National Money Mart 10.38% 12-15-2016	4,000,000	4,363,855	4,233,277	3.2
Pacific Rubiales Energy Corp. 8.75% 11-10-2016	2,500,000	2,655,612	2,726,558	2.0
Southern Pacific Resource Corp. LIBOR+8.5% 01-07-2016	5,970,000	5,897,667	5,814,440	4.4
Tembec Industries 11.25% 12-15-2018	3,750,000	4,015,216	3,787,891	2.8
Trinidad Drilling 7.88% 01-15-2019	3,500,000	3,507,651	3,493,177	2.6
		32,167,969	35,554,056	26.6
Total Canadian fixed income		88,783,309	93,212,306	69.9

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

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

Deans Knight Income Corporation

Statement of Investments...continued

As at June 30, 2011 (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>				
ABI Escrow Corp. 10.25% 10-15-2018	1,585,910	1,635,073	1,659,283	1.2
Beazer Homes USA, Inc. 9.13% 06-15-2018	3,250,000	3,327,056	2,710,888	2.0
Calfrac Holdings LP 7.5% 12-01-2020	6,000,000	6,130,329	5,858,123	4.4
Cott Beverages Inc. 8.38% 11-15-2017	4,350,000	4,622,109	4,404,440	3.3
McMoRan Exploration Co. 11.88% 11-15-2014	2,000,000	2,114,471	2,073,245	1.6
Stone Energy Corp. 8.63% 2-01-2017	8,750,000	8,821,638	8,564,189	6.4
Total United States fixed income		26,650,676	25,270,168	18.9
Total fixed income		115,433,985	118,482,474	88.8
Convertible debentures - Canadian				
<i>Denominated in Canadian dollars</i>				
Harvest Energy 7.25% 09-30-2013	4,595,000	3,036,941	4,721,363	3.5
Convertible debentures - Australian				
<i>Denominated Australian dollars</i>				
Western Areas NL 8.0% 07-02-2012	1,500,000	1,322,276	1,587,125	1.2
		4,359,217	6,308,488	4.7
Equity				
Sure Energy Inc.- purchase warrants	625,000	-	292,599	0.2
Whitecap Resources Inc.- common shares	1,254,167	7,725,668	7,863,625	5.9
		7,725,668	8,156,224	6.1
Investments subtotal		127,518,870	132,947,186	99.6
Hedges				
<i>Denominated in United States and Australian dollars</i>				
Foreign currency exchange contracts (note 9)	67,600,000	-	611,610	0.4
		127,518,870	133,558,796	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

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

Deans Knight Income Corporation

Notes to Financial Statements

As at June 30, 2011 (Unaudited)

1 Nature of operations and basis of presentation

Deans Knight Income Corporation (the “Company”) 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 and began operating its new business of investing in corporate debt.

The common shares of the Company will be redeemed on, or around, April 30, 2014, for a cash amount equal to 100% of the net asset value per share.

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

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. Forbes Medi-Tech Inc (“Forbes”), who now carries on the prior business of the Company, has 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.

3 Summary of significant accounting policies

The following is a summary of significant accounting policies followed by the Company, and these policies are consistent with the most recent annual financial statements. These statements should be read in conjunction with the most recent annual financial statements.

Deans Knight Income Corporation

Notes to Financial Statements

June 30, 2011 (Unaudited)

Financial instruments

Investments

Investments are held for trading and are recorded at fair values determined as follows:

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 certain 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, and the difference could be significant.

Forward currency contracts

Forward currency contracts are recorded at fair value. The proceeds (payments) on contracts settled during the six month period are included in the net realized gain on settlement of foreign currency contracts (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.

Public company equities

Publicly traded equities are recorded at bid prices as quoted on recognized stock exchanges.

The amounts at which the Fund's publicly-traded investments could be disposed of currently may differ from carrying value based on market quotes, as the value at which significant ownership positions are sold is often different than the quoted market price due to a variety of factors such as premiums paid for large blocks or discounts due to illiquidity.

Deans Knight Income Corporation

Notes to Financial Statements

As at June 30, 2011 (Unaudited)

Warrants

Warrants are recorded at their estimated fair value, using appropriate and accepted industry valuation techniques.

The impact of changes in fair value on net income of the Company arising from changes in estimated fair value for investments is recorded in the statement of operations.

Cash and cash equivalents

Cash and cash equivalents are accounted for at amortized cost. They consist of cash and deposits with maturities, at the time of purchase, of three months or less and are held with a Canadian chartered bank.

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 cost. 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.

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. 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.

Deans Knight Income Corporation

Notes to Financial Statements

As at June 30, 2011 (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.

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 it is likely that a payment will be required to be made.

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), and the change could be significant.

Use of estimates

The preparation of financial statements in conformity with 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 investments and future income tax assets.

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 balance sheet 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 period.

The weighted average number of shares outstanding during the six month period ended June 30, 2011 was 10,537,263 (June 30, 2010 - 10,537,263). This weighted average includes both the voting common shares and non-voting common shares of the Company.

Comparative figures

Certain of the comparative figures have been reclassified to conform with the current period presentation.

Deans Knight Income Corporation

Notes to Financial Statements

As at June 30, 2011 (Unaudited)

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.

There have been no changes in the number of voting and non-voting common shares for the periods ended June 30, 2010 and June 30, 2011.

The total shares outstanding at June 30 are summarized as follows:

	June 30, 2011		December 31, 2010	
	Number of Shares	Amount \$	Number of Shares	Amount \$
Voting common shares	10,191,592	96,273,343	10,191,592	96,273,343
Non-voting common shares	<u>345,671</u>	<u>3,093,086</u>	<u>345,671</u>	<u>3,093,086</u>
Total common shares outstanding	<u>10,537,263</u>	<u>99,366,429</u>	<u>10,537,263</u>	<u>99,366,429</u>

Contributed surplus

The contributed surplus balance did not change during the six month period, and consists of:

	June 30, 2011 \$	December 31, 2010 \$
Surplus related to stock compensation, warrants and options associated with common shares	8,030,295	8,030,295
Surplus relating to warrants associated with previously issued preferred shares	<u>1,874,209</u>	<u>1,874,209</u>
	<u>9,904,504</u>	<u>9,904,504</u>

Deans Knight Income Corporation

Notes to Financial Statements

June 30, 2011 (Unaudited)

5 Retained earnings

The changes in retained earnings for the six month period ended June 30 were as follows:

	2011	2010
	\$	\$
Retained earnings – Opening balance	34,072,428	19,410,761
Increase in net assets from operations	3,771,232	8,441,683
Dividends paid from net investment income	<u>(3,685,935)</u>	<u>(3,685,935)</u>
Retained earnings – closing balance	<u>34,157,725</u>	<u>24,166,509</u>

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 six month period ended June 30, 2011, management fees totalled \$1,165,607 (June 30, 2010 - \$980,755). At June 30, 2011, \$576,164 (December 31, 2010 - \$599,474) was owed to the Investment Advisor, which was included in accounts payable and accrued liabilities in the statement of net assets 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 six month period ended June 30, 2011, the Company incurred \$17,895 (June 30, 2010 - \$17,409) in legal services and disbursements received from this related party. At June 30, 2011, accounts payable and accrued liabilities include \$1,532 (December 31, 2010 - \$1,355) due to the law firm for legal fees and disbursements.

Deans Knight Income Corporation

Notes to Financial Statements

June 30, 2011 (Unaudited)

7 Net realized gains on investments sold and foreign currency contracts

The net realized gain on sale of investments for the six-month period ended June 30 was as follows:

	2011 \$	2010 \$
Proceeds from sale of investments	36,200,473	24,049,707
Investments at cost – Beginning of period	118,563,957	100,510,397
Add: Cost of investments purchased	40,887,826	26,584,338
	159,451,783	127,094,735
Less: Investments at cost – End of period	(127,518,870)	(106,061,337)
Cost of investments sold	31,932,037	21,033,398
Net realized gains on investments sold	4,267,560	3,016,309

Net realized gains on investments sold consist of:

	2011 \$	2010 \$
Realized gains on securities sold	2,064,001	2,572,267
Realized gains on settlement of foreign currency contracts	2,203,559	444,042
	4,267,560	3,016,309

8 Taxation

Uncertainty of deductibility of tax losses

Prior to the reorganization and change in business as discussed in notes 1 and 2, the Company had 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 no guarantee that 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, 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 \$21,247,000 (December 31, 2010 - \$20,747,249), representing \$2.02 per common share at June 30, 2011 (December 31, 2010 - \$1.97 per common share).

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Notes to Financial Statements

June 30, 2011 (Unaudited)

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 \$5,870,000 (December 31, 2010 - \$6,550,000), 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 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:

	June 30, 2011	December 31, 2010
	\$	\$
Future tax assets		
Research and development expenditures	7,630,000	8,467,000
Investment tax credits	6,032,450	6,032,450
Share issuance costs	629,900	959,100
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Total gross future tax assets	14,292,350	15,458,550
Valuation allowance	(8,422,350)	(8,908,550)
	<hr/>	<hr/>
Net future tax asset	5,870,000	6,550,000
Less: current portion	(2,250,000)	(2,150,000)
	<hr/>	<hr/>
	3,620,000	4,400,000

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,

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Notes to Financial Statements

June 30, 2011 (Unaudited)

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 prior to April 30, 2014 will be redeemed for par value, that reinvested funds will achieve an 8% yield, and that investments maturing after April 30, 2014 will be sold at their current value.

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, significant estimates are required to compute income tax balances. As at June 30, 2011, the Company has accumulated scientific research and experimental development expenditures in the amount of \$30,264,000 available for carry-forward indefinitely. The Company also has accumulated approximately \$7,097,000 of unclaimed federal investment tax credits, which expire as follows:

Year of expiry	Investment tax credits \$
2018	265,000
2019	990,000
2020	1,872,000
2021	2,483,000
2022	298,000
2023	187,000
2024	496,000
2025	506,000
	<hr/>
	7,097,000
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Deans Knight Income Corporation

Notes to Financial Statements

June 30, 2011 (Unaudited)

Reconciliation of income tax expense

The reconciliation of income tax computed at the statutory tax rate to income tax expense at June 30, using a 26.5 % statutory tax rate (2010 – 28.5%), is:

	2011 \$	2010 \$
Increase in net assets from operations before taxes	4,451,232	10,631,683
Statutory tax rate	<u>26.5%</u>	<u>28.5%</u>
Income tax expense at statutory rates	1,179,576	3,030,030
Use of prior year losses	-	(2,672,708)
Use of scientific research and experimental development expenditures	(847,330)	-
Changes in valuation allowance	680,000	2,190,000
Current tax deductions for offering costs	<u>(332,246)</u>	<u>(357,322)</u>
Income tax provision	<u>680,000</u>	<u>2,190,000</u>

9 Financial instruments

The following tables illustrate the classification of the Company's financial instruments within the fair value hierarchy:

	Financial assets at fair value – June 30, 2011			
	Level 1 \$	Level 2 \$	Level 3 \$	Total \$
Corporate debt	-	102,085,725	16,396,749	118,482,474
Convertible debentures	-	6,308,488	-	6,308,488
Equity	7,863,625	-	292,599	8,156,224
Foreign currency forward contracts	-	611,610	-	611,610
	<u>7,863,625</u>	<u>109,005,823</u>	<u>16,689,348</u>	<u>133,558,796</u>

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Financial assets at fair value – December 31, 2010

	Level 1 \$	Level 2 \$	Level 3 \$	Total \$
Corporate debt	-	91,969,703	14,475,875	106,445,578
Convertible debentures	-	9,334,369	3,617,677	12,952,046
Equity	7,826,002	-	400,000	8,226,002
Foreign currency forward contracts	-	825,824	-	825,824
	7,826,002	102,129,896	18,493,552	128,449,450

All investments remained at their respective levels within the fair value hierarchy during the six month period.

The following table reconciles the Company's Level 3 fair value measurements:

	Corporate debt \$	Convertible debentures \$	Equity \$	Total \$
Balance – December 31, 2009	11,616,418	10,561,008	-	22,177,426
Purchases	7,500,000	1,879,862	-	9,379,862
Sales	(6,061,608)	(17,921,531)	-	(23,983,139)
Unrealized appreciation included in net gain on investments	1,421,065	9,098,338	400,000	10,919,403
Balance – December 31, 2010	14,475,875	3,617,677	400,000	18,493,552
Purchases	4,500,000	-	-	4,500,000
Sales	(5,000,000)	(2,148,120)	-	(7,148,120)
Unrealized appreciation included in net gain on investments	833,749	117,568	(107,401)	843,916
Balance – June 30, 2011	14,809,624	1,587,125	292,599	16,689,348

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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 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.

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The Company's credit risk exposure by credit ratings on its investments is listed as follows:

Credit rating	As a % of net assets	
	June 30, 2011	December 31, 2010
BB	5.5	10.7
B	50.9	36.0
CCC	21.3	21.3
CC	-	1.0
Not rated*	15.0	20.0
	<hr/>	<hr/>
	92.7	89.0

* Unrated debt securities consist primarily of equity securities, convertible debentures and promissory notes in publicly traded companies.

Credit ratings are obtained from various credit rating agencies and sources. Where one or more rating is obtained for a security, the lowest rating has been used.

The Company's credit risk exposure by sector on its investments is as follows:

Sector	As a % of net assets	
	June 30, 2011	December 31, 2010
Energy	57.0	57.1
Consumer goods	9.6	9.4
Materials and metals	9.4	6.0
Services	6.1	3.6
Industrial/manufacturing	3.8	2.2
Forestry	3.8	4.3
Financial services	3.0	3.0
Chemicals	-	3.4
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	92.7	89.0

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Notes to Financial Statements

June 30, 2011 (Unaudited)

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 primarily 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	
	June 30, 2011 \$	December 31, 2010 \$
Maturity		
Less than 1 year	611,610	5,825,824
1 – 3 years	16,058,487	16,154,645
3 – 5 years	29,187,309	27,443,442
Greater than 5 years	79,545,166	70,799,537
	<hr/>	<hr/>
	125,402,572	120,223,448

As at June 30, 2011, 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 \$5,150,000, or approximately 3.6% of net assets (December 31, 2010 - \$4,900,000, or approximately 3.4% of 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.

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June 30, 2011 (Unaudited)

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 currency contracts on the statement of operations.

The tables below indicate the foreign currency to which the Company had significant exposure in Canadian dollar terms. The tables also illustrate 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, assuming the forward currency contracts in place did not offset the foreign currency risk.

				As at June 30, 2011	
	Investments	Cash and cash equivalents	Foreign exchange contracts	Total	Impact on net assets
	\$	\$	\$	\$	\$
Currency					
United States dollars	60,824,223	1,165,454	611,458	61,378,239	3,068,912
As a % of net assets	42.4	0.8	0.4	42.8	2.1
Australian dollars	1,587,125	-	173	1,586,952	79,348
As a % of net assets	1.1	-	-	1.1	0.1

				As at December 31, 2010	
	Investments	Cash and cash equivalents	Foreign exchange contracts	Total	Impact on net assets
	\$	\$	\$	\$	\$
Currency					
United States dollars	61,640,143	5,024,395	916,045	67,580,583	3,379,029
As a % of net assets	43.1	3.5	0.6	47.3	2.4
Australian dollars	3,617,677	-	(90,221)	3,527,456	176,373
As a % of net assets	2.5	0.0	-0.1	2.5	0.1

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At June 30, 2011, the Company had outstanding foreign exchange contracts to sell US\$66,000,000 and AUS\$1,600,000 against future commitments at exchange rates ranging between 0.9736 and 0.97436 for US dollar foreign exchange contracts and 1.0320 for the AUS dollar foreign exchange contract. Those contracts have maturities ranging up to July 28, 2011 and are with AAA rated Canadian bank counterparties.

10 Capital management

The capital of the Company is divided into 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 exclude 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. During the six month period ended June 30, 2011, the Company made dividend payments of \$3,685,935 (June 30, 2010 - \$3,685,935).

The Company is committed to continue paying a monthly dividend of \$0.0583 per voting and non-voting common share for the three months ending September 30, 2011, totalling \$1,842,966.

11 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.

	June 30, 2011	December 31, 2010
	\$	\$
Net asset value per share	13.63	13.65
Canadian GAAP adjustments	0.02	(0.05)
Net assets per share	13.61	13.60

Deans Knight Income Corporation

Notes to Financial Statements

June 30, 2011 (Unaudited)

12 Subsequent events

The Company announced a monthly dividend of \$614,322, or \$0.0583 per common share, payable on each of July 29, 2011, August 31, 2011 and September 30, 2011.