

Deans Knight Income Corporation

Financial Statements
December 31, 2012



March 11, 2013

Independent Auditor's Report

To the Shareholders of Deans Knight Income Corporation

We have audited the accompanying financial statements of Deans Knight Income Corporation which comprise the statements of net assets as at December 31, 2012 and 2011, the statements of operations, changes in net assets and cash flows for the years then ended, the statement of investments as at December 31, 2012, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of Deans Knight Income Corporation as at December 31, 2012 and 2011 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants

PricewaterhouseCoopers LLP
PricewaterhouseCoopers Place, 250 Howe Street, Suite 700, Vancouver, British Columbia, Canada V6C 3S7
T: +1 604 806 7000, F: +1 604 806 7806, www.pwc.com/ca

PwC refers to PricewaterhouseCoopers LLP, an Ontario limited liability partnership.

Deans Knight Income Corporation

Statements of Net Assets

As at December 31, 2012 and 2011

	2012 \$	2011 \$
Assets		
Investments - at fair value (cost - \$117,207,284 ; 2011 - \$125,475,983)	118,788,753	129,918,543
Cash and cash equivalents	20,091,125	4,997,715
Accrued interest receivable	1,662,373	2,339,751
Prepaid expenses	56,460	73,151
Future income tax benefits (note 7)	2,390,000	4,920,000
	<u>142,988,711</u>	<u>142,249,160</u>
Liabilities		
Accounts payable and accrued liabilities (note 5)	<u>713,711</u>	<u>709,240</u>
Net assets	<u>142,275,000</u>	<u>141,539,920</u>
Shareholders' equity		
Common shares (note 3)	99,366,429	99,366,429
Contributed surplus (note 3)	9,904,504	9,904,504
Retained earnings (note 4)	<u>33,004,067</u>	<u>32,268,987</u>
	<u>142,275,000</u>	<u>141,539,920</u>
Number of common shares outstanding (note 3)	<u>10,537,263</u>	<u>10,537,263</u>
Net assets per common share (notes 7 and 10)	<u>13.50</u>	<u>13.43</u>
Contingencies (notes 1 and 7)		
Commitments (notes 1 and 9)		
Subsequent events (note 11)		

Approved by the Board of Directors

(signed) Wayne Deans Director

(signed) Craig Langdon Director

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

Deans Knight Income Corporation

Statements of Operations

For the years ended December 31, 2012 and 2011

	2012 \$	2011 \$
Investment income		
Interest and other	<u>11,547,744</u>	<u>11,607,293</u>
Expenses		
Management fees (note 5)	2,311,289	2,283,158
Directors' fees and expenses	148,727	157,681
Public company reporting costs	127,384	141,111
Audit, accounting and tax fees	82,024	87,003
Custodial fees	50,651	51,354
Legal fees (note 5)	14,014	37,336
Independent Review Committee fees	12,180	12,000
Transaction costs	<u>11,318</u>	<u>-</u>
	<u>2,757,587</u>	<u>2,769,643</u>
Net investment income	<u>8,790,157</u>	<u>8,837,650</u>
Realized and unrealized gains (losses) on investments		
Net realized gain on investments sold (note 6)	2,548,818	4,695,889
Net realized gain (loss) on settlement of foreign currency contracts (note 6)	2,159,065	(892,178)
Change in unrealized appreciation on investments	(2,564,496)	(5,832,280)
Unrealized (depreciation) appreciation on foreign currency contracts	<u>(296,595)</u>	<u>389,347</u>
Net gain (loss) on investments	<u>1,846,792</u>	<u>(1,639,222)</u>
Increase in net assets from operations before tax	10,636,949	7,198,428
Provision for future income tax (note 7)	<u>(2,530,000)</u>	<u>(1,630,000)</u>
Increase in net assets from operations	<u>8,106,949</u>	<u>5,568,428</u>
Increase in net assets from operations per weighted average common share (note 2)	<u>0.77</u>	<u>0.53</u>

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

Deans Knight Income Corporation

Statements of Changes in Net Assets

For the years ended December 31, 2012 and 2011

	2012 \$	2011 \$
Increase in net assets from operations	<u>8,106,949</u>	<u>5,568,428</u>
Dividends to common shareholders (notes 4 and 9)	<u>(7,371,869)</u>	<u>(7,371,869)</u>
Increase (decrease) in net assets during the year	735,080	(1,803,441)
Net assets – Beginning of year	<u>141,539,920</u>	<u>143,343,361</u>
Net assets – End of year	<u>142,275,000</u>	<u>141,539,920</u>

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

Deans Knight Income Corporation

Statements of Cash Flows

For the years ended December 31, 2012 and 2011

	2012 \$	2011 \$
Cash flows from operating activities		
Increase in net assets from operations	8,106,949	5,568,428
Items not affecting cash		
Net realized gain on investments sold	(2,548,818)	(4,695,889)
Net realized (gain) loss on settlement of foreign currency contracts	(2,159,065)	892,178
Change in unrealized appreciation on investments	2,564,496	5,832,280
Unrealized depreciation (appreciation) on foreign currency contracts	296,595	(389,347)
Future income tax provision	2,530,000	1,630,000
	<u>8,790,157</u>	<u>8,837,650</u>
Cost of investments purchased (note 6)	(18,898,699)	(62,743,948)
Proceeds from investments sold (note 6)	31,875,281	59,635,633
Net change in non-cash balances related to operations		
Accrued interest receivable	677,378	(530,995)
Prepaid expenses	16,691	16,511
Accounts payable and accrued liabilities	4,471	16,766
	<u>22,465,279</u>	<u>5,231,617</u>
Cash flows from financing activities		
Dividends paid to common shareholders (notes 4 and 9)	<u>(7,371,869)</u>	<u>(7,371,869)</u>
Net increase (decrease) in cash and cash equivalents during the year	15,093,410	(2,140,252)
Cash and cash equivalents – Beginning of year	<u>4,997,715</u>	<u>7,137,967</u>
Cash and cash equivalents – End of year	<u>20,091,125</u>	<u>4,997,715</u>
Cash and cash equivalents comprise		
Cash	9,110,875	2,402,631
Short-term deposits	10,980,250	2,595,084
	<u>20,091,125</u>	<u>4,997,715</u>

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

Deans Knight Income Corporation

Statement of Investments

As at December 31, 2012

	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 Corp 7.5% 11-19-2017	1,500,000	1,500,000	1,500,000	1.3
Black Press Group 10.00% 02-04-2014 ⁴	2,750,000	2,750,000	2,746,563	2.3
Cara Operations Ltd. 9.13% 12-01-2015	3,500,000	3,500,000	3,622,500	3.0
Conifex Timber Inc. 12.00% 12-31-2013 ⁴	3,000,000	3,000,000	3,000,000	2.5
Garda World Security 9.75% 03-15-2017	3,250,000	3,237,105	3,380,000	2.8
Gateway Casinos 8.88% 11-15-2017	2,750,000	2,816,875	2,894,375	2.4
North American Energy Partners Inc. 9.13% 04-07-2017	8,750,000	8,793,125	7,743,750	6.5
Paramount Resources Ltd. 8.25% 12-13-2017	9,250,000	9,250,000	9,596,875	8.1
Perpetual Energy Inc. 8.75% 03-15-2018	5,000,000	5,000,000	4,775,000	4.0
Petroamerica Oil Corp. 11.50% 04-19-2015 ⁴	4,000,000	4,000,000	4,000,000	3.4
Sherritt International Corp. 7.75% 10-15-2015	196,000	152,233	208,740	0.2
Sherritt International Corp. 8.00% 11-15-2018	3,750,000	3,750,000	3,937,500	3.3
Sherritt International Corp. 7.50% 09-24-2020	2,000,000	2,000,000	2,045,000	1.7
Skylink Aviation Inc. 12.25% 03-15-2016	5,450,000	5,357,250	1,635,000	1.3
Sure Energy Inc. 6.25% 01-21-2014 ⁴	2,500,000	2,500,000	2,500,000	2.1
Western Energy Services Corp. 7.88% 01-30-2019	2,250,000	2,250,000	2,317,500	2.0
		59,856,588	55,902,803	46.9
<i>Denominated in United States dollars</i>				
CCS Inc. 11.00% 11-15-2015	4,500,000	2,252,568	4,465,856	3.8
Mirabela Nickel Ltd. 8.75% 04-15-2018	10,050,000	9,138,320	8,498,933	7.2
Pacific Rubiales Energy Corp. 7.25% 12-12-2021	2,300,000	2,365,780	2,628,650	2.2
Southern Pacific Resources Libor+8.5% 01-01-2016	5,880,000	5,808,758	5,908,513	5.0
Tembec Industries 11.25% 12-15-2018	4,250,000	4,494,779	4,503,166	3.8
		24,060,205	26,005,118	22.0
Total Canadian fixed income		83,916,793	81,907,921	68.9

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 represent loans receivable

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

Deans Knight Income Corporation

Statement of Investments...continued

As at December 31, 2012

	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>				
99 Cents Only Stores 11.00% 12-15-2019	1,850,000	1,926,584	2,079,838	1.8
AbitibiBowater Inc. 10.25% 10-15-2018	1,185,000	1,221,735	1,349,905	1.1
Beazer Homes USA, Inc. 9.13% 06-15-2018	3,250,000	3,327,056	3,370,846	2.8
Calfrac Holdings LP 7.5% 12-01-2020	6,000,000	6,130,329	5,894,783	5.0
Stone Energy Corp. 8.63% 02-01-2017	7,750,000	7,813,451	8,211,656	6.9
Total United States fixed income		20,419,155	20,907,028	17.6
Fixed income - International				
<i>Denominated in United States dollars</i>				
Northland Resources 13.0% 03-16-2017	4,750,000	4,678,275	4,820,291	4.1
Total fixed income		109,014,223	107,635,240	90.6
Convertible debentures - Canada				
<i>Denominated in Canadian dollars</i>				
Niko Resources Ltd. 7.00% 12-13-2017	2,000,000	2,000,000	2,200,000	1.9
Equities – Canada				
<i>Conifex Timber Inc.- purchase warrants</i>				
\$9.38 strike, 12-31-2014	81,250	-	16,102	0.0
<i>Petroamerica Oil Corp. - purchase warrants</i>				
\$0.20 strike, 04-19-2015	400	-	661,311	0.6
<i>Sure Energy Inc.- purchase warrants</i>				
\$1.80 strike, 12-21-2013	625,000	-	-	0.0
Whitecap Resources Inc.- common shares	1,005,367	6,193,061	8,696,425	7.3
Total equities		6,193,061	9,373,838	7.9
Royalties – Canada				
<i>Denominated in Euro</i>				
RapidEye Canada Royalty		-	1,238,770	1.0
Provision for investments		-	(1,362,500)	(1.1)
Investments subtotal		117,207,284	119,085,348	100.3
Foreign Currency Contracts (note 8)				
<i>Denominated in United States dollars</i>				
Payable 01-08-2013 at 0.99310	25,000,000	-	(47,949)	(0.1)
Payable 01-08-2013 at 0.99356	3,000,000	-	(4,356)	(0.0)
Payable 02-12-2013 at 0.98698	28,000,000	-	(244,290)	(0.2)
Total foreign currency contracts		-	(296,595)	(0.3)
		117,207,284	118,788,753	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 represent loans receivable

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

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

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 its reorganization in May 2008, 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. 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 as an investment company.

As per the Company’s Articles of Incorporation, the common shares of the Company are to be redeemed on, or around, April 30, 2014, for a cash amount equal to 100% of the net asset value per common share.

The accompanying financial statements are prepared in accordance with Part V of the Canadian Institute of Chartered Accountants Handbook, Pre-changeover Accounting Standards (GAAP). All amounts are presented in Canadian dollars, unless otherwise noted.

2 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:

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.

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

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.

Foreign currency contracts

Foreign currency contracts are recorded at fair value. The proceeds (payments) on contracts settled during the year are included in the net realized gain (loss) on settlement of foreign currency contracts (note 6). The Company's policy is to hedge 95% - 105% 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 Company'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.

Warrants

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

The impact of changes in fair value of 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.

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

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, the 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 during the year. Royalty income is recognized on an accrual basis as earned. Gains or losses on the sale of investments, including foreign exchange gain or loss on such investments, are calculated on an average cost basis.

Foreign currency contracts

Foreign currency contracts (note 8) 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 on 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.

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 that it is more likely than not 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 taxable income and an interpretation of the various income tax laws and

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

regulations. It is possible, due to the complexity inherent in estimating income taxes, that the tax provision and future tax balances could change (note 7), 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 are computed by dividing the net assets of the Company by the total number of common shares outstanding on the statements of net assets 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, 2012 was 10,537,263 (2011 - 10,537,263). This weighted average includes both the voting common shares and non-voting common shares of the Company.

3 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 were no changes in the number of voting and non-voting common shares for the years ended December 31, 2011 and 2012.

The total shares outstanding at December 31 are summarized as follows:

	2012		2011	
	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	345,671	3,093,086	345,671	3,093,086
Total common shares outstanding	<u>10,537,263</u>	<u>99,366,429</u>	<u>10,537,263</u>	<u>99,366,429</u>

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

Contributed surplus

Contributed surplus consists of:

	2012 \$	2011 \$
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>

4 Retained earnings

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

	2012 \$	2011 \$
Retained earnings – opening balance	32,268,987	34,072,428
Increase in net assets from operations	8,106,949	5,568,428
Dividends paid from net investment income	<u>(7,371,869)</u>	<u>(7,371,869)</u>
Retained earnings – closing balance	<u>33,004,067</u>	<u>32,268,987</u>

5 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, 2012, management fees (including applicable taxes) totalled \$2,311,289 (2011- \$2,283,158). At December 31, 2012, \$589,251 (2011 - \$575,224) 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 year ended December 31, 2012, the Company incurred \$14,014 (2011 - \$ 42,750) in legal services and disbursements received from this related party. At December 31, 2012, accounts payable and accrued liabilities include \$226 (2011 - \$4,185) due to the law firm for legal fees and disbursements.

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

6 Net realized gains on investments sold and foreign currency contracts

The net realized gain on investments sold and foreign currency contracts for the year ended December 31 was as follows:

	2012 \$	2011 \$
Proceeds from sale of investments	31,875,281	59,635,633
Investments at cost – Beginning of year	125,475,983	118,563,957
Add: Cost of investments purchased	18,898,699	62,743,948
	144,374,682	181,307,905
Less: Investments at cost – End of year	(117,207,284)	(125,475,983)
Cost of investments sold	27,167,398	55,831,922
Net realized gain on investments sold	4,707,883	3,803,711

Net realized gain on investments sold and foreign currency contracts consists of:

	2012 \$	2011 \$
Realized gain on investments sold	2,548,818	4,695,889
Realized gain (loss) on settlement of foreign currency contracts	2,159,065	(892,178)
	4,707,883	3,803,711

7 Taxation

Uncertainty of deductibility of tax losses

Prior to the reorganization and change in business as discussed in note 1, 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 December 31, 2012, which are subject to uncertainty, amount to \$21,154,044 (2011 - \$21,024,806), representing \$2.01 per common share at December 31, 2012 (2011 - \$2.00 per common share).

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

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.

As the Company's investments in debt securities are generating interest income, but are not expected to generate sufficient taxable income in order to fully utilize the available tax credits during the years of operations through to April 30, 2014, the Company has recorded a valuation allowance. The difference between the total value of these tax benefits less the valuation allowance, being \$2,390,000 (2011 - \$4,920,000), 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, based on updated projections of taxable income, and adjusted accordingly by a credit or charge to the statement of operations.

The tax effects of temporary differences and tax credits that give rise to significant components of the future income tax assets, at the statutory enacted rates when such benefits are expected to be realized, are as follows:

	2012 \$	2011 \$
Future tax assets		
Research and development expenditures	4,533,250	6,879,250
Investment tax credits	5,322,750	5,322,750
Share issuance costs	313,440	626,880
	<hr/>	<hr/>
Total gross future tax assets	10,169,440	12,828,880
Valuation allowance	(7,779,440)	(7,908,880)
	<hr/>	<hr/>
Net future tax asset	2,390,000	4,920,000
	<hr/>	<hr/>

Future tax assets expected to be realized in:

	2012 \$	2011 \$
Less than 12 months	1,930,000	2,180,000
Greater than 12 months	460,000	2,740,000
	<hr/>	<hr/>
Net future tax asset	2,390,000	4,920,000
	<hr/>	<hr/>

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

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 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, 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 December 31, 2012, the Company has accumulated scientific research and experimental development expenditures in the amount of \$18,133,000 available for carry-forward indefinitely. The Company also has accumulated approximately \$7,097,000 of unclaimed federal investment tax credits, which expire as follows:

	Investment tax credits \$
Year of expiry	
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
	<hr/>

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

Reconciliation of income tax expense

The reconciliation of income tax computed at the statutory tax rate to income tax expense, using a 25.0% statutory tax rate (2011 - 26.5%), is:

	2012 \$	2011 \$
Increase in net assets from operations before tax	10,636,949	7,198,428
Statutory tax rate	25.0%	26.5%
Income tax expense at statutory rates	2,659,238	1,907,583
Use of scientific research and experimental development expenditures	(2,345,798)	(1,575,337)
Reduction of future tax asset	2,530,000	1,630,000
Current tax deductions for offering costs	(313,440)	(332,246)
Provision for future income tax	<u>2,530,000</u>	<u>1,630,000</u>

8 Financial instruments

Fair value measurement

Financial instruments are classified in a hierarchy that prioritizes the inputs to fair value measurement. Each level is based on the transparency of the inputs used to measure the fair values of assets and liabilities. The three levels of the fair value hierarchy are:

Level 1 – inputs that reflect unadjusted quoted prices in active markets for identical assets or liabilities;

Level 2 – inputs that reflect other than quoted prices that are observable for the assets or liabilities either directly or indirectly;

Level 3 – inputs that are not based on observable market data.

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

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

Financial assets at fair value – 2012

	Level 1	Level 2	Level 3	Total
	\$	\$	\$	\$
Corporate debt	-	93,669,383	13,965,857	107,635,240
Convertible debentures	-	2,200,000	-	2,200,000
Equity	8,696,425	-	677,413	9,373,838
Royalty	-	-	1,238,770	1,238,770
Other	-	(1,362,500)	-	(1,362,500)
Foreign currency contracts	-	(296,595)	-	(296,595)
	8,696,425	94,210,288	15,882,040	118,788,753

Financial assets at fair value – 2011

	Level 1	Level 2	Level 3	Total
	\$	\$	\$	\$
Corporate debt	-	94,406,534	22,965,956	117,372,490
Convertible debentures	-	-	1,554,218	1,554,218
Equity	10,397,044	-	205,444	10,602,488
Foreign currency contracts	-	389,347	-	389,347
	10,397,044	94,795,881	24,725,618	129,918,543

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

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

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

Fair value measurements of Level 3 inputs

	Corporate debt \$	Convertible debentures \$	Equities \$	Royalty \$	Total \$
Balance – December 31, 2010	14,475,875	3,617,677	400,000	-	18,493,552
Purchases	14,812,500	-	-	-	14,812,500
Sales	(7,031,250)	(2,148,120)	-	-	(9,179,370)
Unrealized appreciation (depreciation) included in net gain on investments	708,831	84,661	(194,556)	-	598,936
Balance – December 31, 2011	22,965,956	1,554,218	205,444	-	24,725,618
Purchases	4,000,000	-	-	-	4,000,000
Sales	(13,081,762)	(1,558,378)	-	-	(14,640,140)
Unrealized appreciation (depreciation) included in net gain on investments	81,663	4,160	471,969	1,238,770	1,796,562
Balance – December 31, 2012	13,965,857	-	677,413	1,238,770	15,882,040

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. Accordingly, in the absence of any reasonably possible alternative assumptions, and except as noted below, it is not practicable to provide a sensitivity analysis.

For certain Level 3 investments measured on a discounted cash flow basis the value is imputed through forecasted cash flows and discount rates. The following summarizes the affect a change in assumptions would have on total net assets at December 31, 2012:

	Increase by 5%	Decrease by 5%
Cash flow growth rate	198,972	(189,288)
Discount rate	(219,021)	279,418

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

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 advisor, 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 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. Due to the predominantly fixed income nature of the investment portfolio, the Company has minimal direct price risk. A 10% change in the value of the Company's equity investments (excluding warrants) would have a \$869,643 impact on net assets, on an after tax basis.

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.

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

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

Credit rating	As a % of net assets	
	2012	2011
BB+	4.4	-
BB	1.8	1.7
BB-	0.9	-
B+	8.3	-
B	6.0	37.3
B-	10.6	-
CCC+	30.3	-
CCC	3.1	23.0
CCC-	2.4	-
Not rated*	15.7	29.3
	<hr/>	<hr/>
	83.5	91.3

* Unrated debt securities consist primarily of loans receivable.

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	
	2012	2011
Consumer goods	8.4	7.5
Energy	49.8	50.4
Financial services	-	2.9
Forestry	6.2	6.9
Industrial/manufacturing	4.3	3.5
Materials and metals	13.7	12.2
Services	0.2	4.2
Technology	0.9	3.7
	<hr/>	<hr/>
	83.5	91.3

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

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	
	2012	2011
	\$	\$
Maturity		
Less than 1 year	-	1,943,565
1 – 3 years	20,543,660	20,139,165
3 – 5 years	46,527,959	27,120,250
Greater than 5 years	42,639,891	70,113,075
	<hr/>	<hr/>
	109,711,510	119,316,055
	<hr/>	<hr/>

As at December 31, 2012, 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 \$4,000,000, or approximately 2.8% of net assets (December 31, 2011 - \$5,000,000, or approximately 3.5% 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.

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

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 translation of the underlying investments. The unrealized gains or losses are reflected in unrealized appreciation/depreciation on foreign currency contracts on the statement of operations. The potential impact to net assets of a 5% change in foreign currency rates against the Canadian dollar, assuming all other variables remain constant, would be \$16,000 (2011 - \$160,000).

9 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 3.

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 investment income annually. Net investment income, 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. During the year ended December 31, 2012, the Company made dividend payments of \$7,371,869 (December 31, 2011 - \$7,371,869).

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 March 31, 2013, totalling \$1,842,966 (note 11).

Deans Knight Income Corporation

Notes to Financial Statements

December 31, 2012

10 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.

	2012	2011
	\$	\$
Net asset value per share	13.58	13.49
Canadian GAAP adjustments	(0.08)	(0.06)
Net assets per share	13.50	13.43

11 Subsequent events

On January 4, 2013, the Company announced a monthly dividend of \$614,322, or \$0.0583 per common share, payable on each of January 31, 2013, February 28, 2013 and March 29, 2013.