Consolidated Financial Statements

# Intrinsyc Software International, Inc.

August 31, 2006

# MANAGEMENT'S RESPONSIBILITY

The management of Intrinsyc Software International, Inc. is responsible for the preparation of the accompanying consolidated financial statements and the preparation and presentation of information in the Annual Report. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in Canada, and are considered by management to present fairly the financial position and operating results of the Company.

The Company maintains various systems of internal control to provide reasonable assurance that transactions are appropriately authorized and recorded, that assets are safeguarded, and that financial reports are properly maintained to provide accurate reliable financial statements.

The Company's audit committee is comprised entirely of non-management directors and is appointed by the Board of Directors annually. The committee meets periodically with the Company's management and independent auditors to review the consolidated financial statements and the independent auditor's report. The audit committee has approved the consolidated financial statements and reported its findings to the Board of Directors.

The Company's independent auditors, Ernst & Young LLP, have examined the consolidated financial statements and their report follows.

| | |
|---|---|
| **Glenda Dorchak** | **Andrew Morden** |
| Chief Executive Officer | Chief Financial Officer |
| October 16, 2006 | October 16, 2006 |

# AUDITORS' REPORT

To the Shareholders of
**Intrinsyc Software International, Inc.**

We have audited the consolidated balance sheets of **Intrinsyc Software International, Inc.** as at August 31, 2006 and 2005 and the consolidated statements of operations and deficit and cash flows for the years 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 audits.

We conducted our audits 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 consolidated financial statements present fairly, in all material respects, the financial position of the Company as at August 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Ernst & Young LLP

Chartered Accountants
Vancouver, Canada,
October 16, 2006.

**Intrinsyc Software International, Inc.**

# CONSOLIDATED BALANCE SHEETS

As at August 31

| | 2006<br>$ | 2005<br>$ |
|---|---|---|
| **ASSETS** | | |
| **Current** | | |
| Cash and cash equivalents *[note 3 and 4]* | **22,487,076** | 7,318,210 |
| Accounts receivable *[notes 5 and 17]* | **3,789,743** | 3,909,596 |
| Inventory | **110,996** | 134,318 |
| Prepaid expenses - current | **385,816** | 306,089 |
| **Total current assets** | **26,773,631** | 11,668,213 |
| Prepaid expenses | **61,769** | 39,673 |
| Equipment *[notes 6 and 17]* | **1,360,832** | 980,580 |
| Goodwill *[note 7[a]]* | **14,189,478** | 14,189,478 |
| Intangible assets *[note 7[b]]* | **556,120** | 1,212,577 |
| Deferred financing costs *[note 9]* | **516,599** | -- |
| **Total assets** | **43,458,429** | 28,090,521 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| **Current** | | |
| Accounts payable and accrued liabilities | **4,010,542** | 2,790,071 |
| Taxes payable | **218,912** | 263,382 |
| Deferred revenue | **542,515** | 836,660 |
| **Total current liabilities** | **4,771,969** | 3,890,113 |
| Debentures *[note 9]* | **7,617,946** | -- |
| Future income taxes *[note 12]* | **229,655** | 261,425 |
| **Total liabilities** | **12,619,570** | 4,151,538 |
| Commitments and contingencies *[notes 13 and 14]* | | |
| **Shareholders' equity** | | |
| Share capital *[note 10]* | **74,623,739** | 57,452,141 |
| Warrants and underwriters' options *[notes 9 and 10]* | **5,229,997** | 163,500 |
| Contributed surplus *[note 11]* | **2,951,875** | 1,896,760 |
| Cumulative translation adjustment | **(27,792)** | (27,792) |
| Deficit | **(51,938,960)** | (35,545,626) |
| **Total shareholders' equity** | **30,838,859** | 23,938,983 |
| **Total liabilities and shareholders' equity** | **43,458,429** | 28,090,521 |

*See accompanying notes to consolidated financial statements*

On behalf of the Board:

Director　　　　　　　　Director

**Intrinsyc Software International, Inc.**

# CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT

Years ended August 31

| | 2006<br>$ | 2005<br>$ |
|---|---|---|
| **Revenues** *[note 17]* | **18,657,717** | 17,539,105 |
| Cost of sales | **11,318,054** | 9,080,999 |
| | **7,339,663** | 8,458,106 |
| **Expenses** | | |
| Administration | **5,407,944** | 4,185,208 |
| Marketing and sales | **3,456,723** | 3,008,441 |
| Research and development | **10,969,692** | 4,042,779 |
| Amortization | **1,061,174** | 825,150 |
| Stock-based compensation *[note 11]* | **915,115** | 816,214 |
| Technology Partnerships Canada Funding Investment *[note 13]* | **260,905** | 214,652 |
| | **22,071,553** | 13,092,444 |
| Loss before other (earnings) expense and income taxes | **14,731,890** | 4,634,338 |
| Other expense (earnings) | | |
| Foreign exchange loss *[note 16]* | **428,220** | 482,657 |
| Loss on disposal of equipment | **671** | -- |
| Interest income | **(551,785)** | (119,830) |
| Accretion and amortization – long term debt *[note 9]* | **744,098** | -- |
| Interest expense – long term debt *[note 9]* | **909,590** | -- |
| | **1,530,794** | 362,827 |
| Loss before income taxes | **16,262,684** | 4,997,165 |
| Income tax expense (recovery) *[note 12]* | | |
| Current | **202,929** | 77,424 |
| Future | **(72,279)** | (94,608) |
| | **130,650** | (17,184) |
| **Loss for the year** | **16,393,334** | 4,979,981 |
| Deficit, beginning of year | **35,545,626** | 30,565,645 |
| **Deficit, end of year** | **51,938,960** | 35,545,626 |
| **Loss per share (basic and diluted)** | **0.24** | 0.09 |
| **Weighted average number of shares outstanding** | **67,618,153** | 54,477,377 |

*See accompanying notes to consolidated financial statements*

## Intrinsyc Software International, Inc.

# CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended August 31

| | 2006 $ | 2005 $ |
|---|---|---|
| **OPERATING ACTIVITIES** | | |
| Loss for the year | **(16,393,334)** | (4,979,981) |
| Items not involving cash | | |
| Amortization | **1,061,174** | 825,150 |
| Future income taxes | **(31,770)** | (94,608) |
| Stock-based compensation *[note 11]* | **915,115** | 816,214 |
| Accretion and amortization – long term debt | **744,098** | -- |
| Changes in non-cash operating working capital | | |
| Income taxes payable | **(44,470)** | 133,640 |
| Accounts receivable | **119,852** | (528,325) |
| Other receivable | **--** | 947,374 |
| Inventory | **23,323** | 143,522 |
| Prepaid expenses | **(101,823)** | (10,982) |
| Accounts payable and accrued liabilities | **1,220,468** | 888,033 |
| Deferred revenue | **(294,145)** | 190,840 |
| **Cash used in operating activities** | **(12,781,512)** | (1,669,123) |
| **INVESTING ACTIVITIES** | | |
| Acquisition of intangible assets | **--** | (184,875) |
| Purchase of equipment | **(784,969)** | (552,316) |
| **Cash used in investing activities** | **(784,969)** | (737,191) |
| **FINANCING ACTIVITIES** | | |
| Issuance of common shares and warrants *[note 10]* | **24,123,936** | 5,632,671 |
| Share issuance costs *[note 10]* | **(2,344,984)** | (508,607) |
| Debentures *[note 9]* | **8,000,000** | -- |
| Debentures issuance costs *[note 9]* | **(1,043,605)** | -- |
| **Cash provided by financing activities** | **28,735,347** | 5,124,064 |
| **Increase in cash and cash equivalents** | **15,168,866** | 2,717,750 |
| Cash and cash equivalents, beginning of year | **7,318,210** | 4,600,460 |
| **Cash and cash equivalents, end of year** | **22,487,076** | 7,318,210 |
| **Supplementary information** | | |
| Interest paid | **903,749** | 14,203 |
| Interest received | **503,329** | 132,035 |
| Income taxes paid (recovered) | **117,630** | (11,007) |

*See accompanying notes to consolidated financial statements*

**Intrinsyc Software International, Inc.**

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

August 31, 2006 & 2005

## 1. ORGANIZATION

The Company was incorporated on August 31, 1992 under the laws of Alberta and continued under the Company Act (British Columbia) on July 19, 1995. Articles of Continuance were filed under the Canada Business Corporations Act on May 1, 2003 to continue the Company federally and change the name of the Company from Intrinsyc Software, Inc. to Intrinsyc Software International, Inc. The Company is a mobility software and services company that specializes in providing smartphone and feature phone software licensing and supporting systems integration services to handset manufacturers and their partners. The Company's technologies and services make it possible for customers to identify, create and deliver mobile devices and solutions.

## 2. SIGNIFICANT ACCOUNTING POLICIES

These consolidated financial statements are presented in Canadian dollars and have been prepared by management in accordance with Canadian generally accepted accounting principles.

### Principles of consolidation

The accompanying consolidated financial statements include the accounts of Intrinsyc Software International, Inc. (the "Company") and its wholly-owned subsidiaries, Intrinsyc Software (USA) Inc., Linar Limited, Intrinsyc Europe Limited, NMI Electronics Limited and Intrinsyc Software (Barbados), Inc. The Company has eliminated all significant inter-company balances and transactions. These consolidated financial statements are stated in Canadian dollars and have been prepared in accordance with Canadian generally accepted accounting principles.

### Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates used in the preparation of the financial statements.

### Cash equivalents

Cash equivalents include short-term deposits, which are all deposits rated R1, term deposits, savings investment deposits, guaranteed investment certificate deposits or banker's acceptances, with a term to maturity of three months or less when acquired and are valued at cost plus interest earned.

## 2. SIGNIFICANT ACCOUNTING POLICIES (cont'd.)

### Inventory

Inventory is valued at the lower of cost and estimated net realizable value with cost being determined on a first-in-first-out basis.

### Allowance for doubtful accounts

The Company records an allowance for doubtful accounts related to accounts receivable that are considered to be uncollectible. The allowance is based on the Company's knowledge of the financial condition of its customers, the aging of the receivables, the current business environment and historical experience. A change to these factors could impact the estimated allowance and the provision for bad debts.

### Research and development

The Company expenses research and development costs as they are incurred.

### Equipment

Equipment is initially recorded at cost. Amortization is subsequently provided on the following basis:

| | |
|---|---|
| Computers and equipment | 30% declining-balance |
| Computer software | 3 years straight-line |
| Furniture and fixtures | 20% declining-balance |

Leasehold improvements are amortized on a straight-line basis over the shorter of the initial lease term or their expected useful life.

### Leases

Leases are classified as either capital or operating. Those leases, which transfer substantially all the benefits and risks of ownership of the property to the Company are accounted for as capital leases. Capital lease obligations reflect the present value of future lease payments, discounted at the appropriate interest rate.

All other leases are accounted for as operating leases wherein rental payments are charged to income as incurred.

## 2. SIGNIFICANT ACCOUNTING POLICIES (cont'd.)

### Intellectual property and other intangible assets

Intangible assets acquired either individually or with a group of other assets are initially recognized and measured at cost. The cost of a group of intangible assets acquired in a transaction, including those acquired in a business combination that meet the specified criteria for recognition apart from goodwill, is allocated to the individual assets acquired based on their relative fair values.

Intangible assets with finite useful lives are amortized over their estimated useful lives. The amortization methods and estimated useful lives of intangible assets are reviewed annually.

Intangible assets with indefinite useful lives are not amortized and are tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test compares the carrying amount of the intangible asset with its fair value, and an impairment loss is recognized in income for the excess, if any.

Intellectual property is recorded at cost. Intellectual property related to software is amortized on a straight-line basis over six years.

### Goodwill

Goodwill is the residual amount that results when the purchase price of an acquired business exceeds the sum of the amounts allocated to the identifiable assets acquired less the liabilities assumed based on their fair values. Goodwill is allocated as of the date of the business combination to the Company's reporting unit's that are expected to benefit from the synergies of the business combination.

Goodwill is not amortized and is annually tested for impairment or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test is carried out in two steps. The first step is to compare the carrying amount of the reporting unit to its fair value. When the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not to be impaired and the second step of the impairment test is unnecessary. Management has completed the first step of the goodwill impairment test as of August 31, 2005 and August 31, 2006.

The second step has not been required, but would be carried out if the carrying amount of a reporting unit exceeds its fair value, in which case the implied fair value of the reporting unit's goodwill is compared with its carrying amount to measure the amount of the impairment loss, if any. The implied fair value of the reporting unit's goodwill is determined in the same manner as

## 2. SIGNIFICANT ACCOUNTING POLICIES (cont'd.)

the value of goodwill is determined in a business combination described in the first paragraph, using the fair value of the reporting unit as if it was the purchase price. When the carrying amount of a reporting unit's goodwill exceeds the implied fair value of the goodwill, an impairment loss is recognized in an amount equal to the excess and is presented as a separate line item in the consolidated statement of operations before extraordinary items and discontinued operations.

### Revenue recognition

The Company recognizes revenue from the sale of product and software licences upon transfer of title, which generally occurs on shipment, unless there are significant post-delivery obligations or collection is not considered probable at the time of sale. When significant post-delivery obligations exist, revenue is deferred until such obligations are fulfilled. Revenue from support obligations is deferred and recognized ratably over the period of the obligation. Revenue from consulting and other services is recorded as the services are performed if there is reasonable certainty as to collectibility.

Revenues from contracts with milestone payments are recognized using the percentage of completion method based on costs incurred relative to total estimated costs to complete. Changes of contract price, total estimated costs, or estimated losses, if any, are included in the determination of estimated cumulative revenues and expenses in the period the change is determined by management.

### Unbilled revenue

Unbilled revenue is revenue that has been recognized using the percentage of completion method of accounting less amounts billed to the customer in accordance with the milestone terms of the contract. Unbilled revenue is reduced when customers are invoiced and the respective accounts receivable are recorded.

### Derivative financial instruments

Derivative financial instruments are utilized by the Company in the management of its foreign currency exposure to reduce its exposure to fluctuations in foreign exchange on certain committed and anticipated transactions. The Company formally documents the relationships between derivative financial instruments and hedged items, as well as the risk management objective and strategy. The Company assesses, on an ongoing basis, whether the derivative financial instruments continue to be effective in offsetting changes in fair values or cash flows of the hedged transactions.

## 2. SIGNIFICANT ACCOUNTING POLICIES (cont'd.)

Foreign exchange translation gains and losses on foreign currency denominated derivative financial instruments used to hedge anticipated or committed foreign currency exposures are recognized as an adjustment to the related operating costs, revenue or capital expenditures when the hedged transaction is recorded. Derivatives that are not subject to hedge accounting are recorded on the consolidated balance sheet with the changes in fair value being recorded in the consolidated statement of operations each period. For the year ended August 31, 2006, all derivative financial instruments met the criteria for hedge accounting.

### Warranty costs

The Company accrues warranty costs based on management's best estimate, with reference to past experience.

### Share issue costs

The Company reduces the value of consideration assigned to shares issued by the costs, net of income tax recoveries, of issuing the shares.

### Impairment of equipment

The Company monitors the recoverability of equipment, based on factors such as future utilization, business climate and the future undiscounted cash flows expected to result from the use of the related assets. The Company's policy is to record an impairment loss in the period when the Company determines that the carrying amount of the asset will not be recoverable. At that time, the carrying amount is written down to the undiscounted future cash flows. As at August 31, 2006, the Company has not recorded any such impairment losses.

### Translation of foreign currencies

Foreign operations that are considered integrated (financially and operationally dependent on the parent) are translated to Canadian dollars using current rates of exchange for monetary assets and liabilities. Historical rates of exchange are used for non-monetary assets and liabilities and average rates for the period are used for revenues and expenses except for amortization, which is translated at exchange rates used in the translation of the related asset accounts. Gains or losses resulting from these translation adjustments are included in income.

Foreign operations that are considered self-sustaining (financially and operationally independent of the parent) are translated to Canadian dollars using the current rates of exchange for assets and

## 2. SIGNIFICANT ACCOUNTING POLICIES (cont'd.)

liabilities and using average rates for the year for revenues and expenses. Gains or losses resulting from these translation adjustments are deferred in a separate component of shareholders' equity ("Cumulative translation adjustment") until there is a realized reduction in the parent's net investment in the foreign operation.

Transactions completed in foreign currencies are recorded in Canadian dollars at the rates prevailing at the time of the transactions. Monetary assets and liabilities denominated in foreign currencies are recorded in the consolidated financial statements in equivalent Canadian dollars at the rate of exchange prevailing at the balance sheet date.

### Loss per share

The loss per share is calculated by using the weighted average number of common shares outstanding during the period. If in a reporting period the Company has outstanding dilutive equity instruments, the diluted loss per share is calculated using the treasury stock method. Diluted per share amounts have not been disclosed as the effect of outstanding options and warrants is anti-dilutive for all periods presented.

### Income taxes

The Company follows the liability method of accounting for income taxes. Under this method, future income taxes are recognized for the future income tax consequences attributable to differences between the financial statement carrying values of existing assets and liabilities and their respective income tax bases (temporary differences). Changes in the net future tax asset or liability are included in income. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is included in income in the period that includes the substantive enactment date. Future income tax assets are evaluated and if their realization is not considered "more likely than not", a valuation allowance is provided.

## 3. OPERATING LINE OF CREDIT

In Canada, the Company has an operating line of credit for borrowings up to $1,000,000, bearing interest at prime rate. Prime rate was 6.00% at August 31, 2006 [2005 - 4.50%]. The line is collateralized by a $1,050,000 Guaranteed Investment Certificate of Deposit. There were no borrowings outstanding against the operating line of credit as at August 31, 2006 and 2005. The Company also has a US chequing account with an overdraft limit that is collateralized by restricted cash in the amount of $13,800 ($12,500 USD). There were no borrowings outstanding against the overdraft as at August 31, 2006.

## 4. CASH AND CASH EQUIVALENTS

| | **2006**<br>$ | **2005**<br>$ |
|---|---|---|
| Cash | **22,487,076** | 2,309,178 |
| Short-term deposit | **--** | 5,009,032 |
| | **22,487,076** | **7,318,210** |

## 5. ACCOUNTS RECEIVABLE

| | **2006**<br>$ | **2005**<br>$ |
|---|---|---|
| Trade and miscellaneous receivables | **3,129,351** | 3,465,144 |
| Unbilled revenue | **660,392** | 444,452 |
| | **3,789,743** | 3,909,596 |

## 6. EQUIPMENT

| | Cost<br>$ | Accumulated amortization<br>$ | Net book value<br>$ |
|---|---|---|---|
| **2006** | | | |
| Computers and equipment | 2,358,083 | 1,583,442 | 774,641 |
| Computer software | 939,813 | 838,112 | 101,701 |
| Furniture and fixtures | 835,280 | 674,817 | 160,463 |
| Leasehold improvements | 654,419 | 330,392 | 324,027 |
| | 4,787,595 | 3,426,763 | 1,360,832 |
| **2005** | | | |
| Computers and equipment | 1,984,900 | 1,359,523 | 625,377 |
| Computer software | 893,746 | 766,846 | 126,900 |
| Furniture and fixtures | 826,758 | 626,296 | 200,462 |
| Leasehold improvements | 332,244 | 304,403 | 27,841 |
| | 4,037,648 | 3,057,068 | 980,580 |

The aggregate amortization expense for the year ended August 31, 2006 was $404,717 [2005 - $410,004].

## 7. GOODWILL AND OTHER INTANGIBLE ASSETS

[a] There were no changes to the goodwill balance during the years ended August 31, 2006 and August 31, 2005.

[b] Other intangible assets as at August 31, 2006 and 2005 were as follows:

| | Gross carrying amount $ | Accumulated amortization $ | Total $ |
|---|---|---|---|
| **2006** | | | |
| Intellectual property | 3,336,679 | 2,780,559 | 556,120 |
| Other intangible assets | 274,080 | 274,080 | -- |
| | 3,610,759 | 3,054,639 | 556,120 |
| **2005** | | | |
| Intellectual property | 3,336,679 | 2,198,550 | 1,138,129 |
| Other intangible assets | 274,080 | 199,632 | 74,448 |
| | 3,610,759 | 2,398,182 | 1,212,577 |

The aggregate amortization expense for the year ended August 31, 2006 was $656,457 [2005 - $415,146] including the amortization of $196,000 of Intellectual Property costs in the year ended August 31, 2006 related to intellectual property that has been deemed to have no future benefit to the Company.

## 8. EMPLOYEE PENSION CONTRIBUTIONS

| | **2006** $ | **2005** $ |
|---|---|---|
| Benefit costs | **548,579** | 339,477 |

The Company matches employees' pension contributions to registered pension plans each year as part of the employee benefits plan. The funds are transferred to the individual employees' pension plans once a year. The expense is accrued throughout the year.

## 9. DEBENTURES

On October 3, 2005, the Company closed an $8.0 million debenture financing (the “Debenture Financing”) with Wellington Financial Fund II ("Wellington Financial"). The financing was by way of secured Debentures (the “Debentures”) maturing on October 3, 2007, at which time the $8.0 million will become due and payable. The maturity date may be extended by one year by the Company if the Company meets certain pre-determined financial targets and may also accelerate in certain circumstances including a default by the Company or in the event of a change of control of the Company. The Company has the right to repay the Debentures in whole or in part at any time following such date which is six months from the date following the closing date (April 3, 2006), and subject to certain restrictions. The Debentures have an annual interest rate of 12.5% with monthly payments of interest only until maturity, and are collateralized by a charge over all of the assets of the Company and its subsidiaries. Under the terms of the debentures, the Company must maintain a minimum cash balance of $2 million and tangible net assets in excess of $500,000.

Concurrent with the financing, the Company has issued to Wellington Financial an aggregate of 3,870,968 warrants of the Company (the “Warrants”). Each warrant entitles the holder to purchase one common share of the Company at an exercise price of $0.62 per share at any time prior to October 3, 2010.

The gross proceeds for the Debentures were allocated to the Debentures and the Warrants based on the relative fair value of each security at the time of issuance. Accordingly, $7,310,973 was allocated to the Debentures and $689,027 was allocated to the Warrants. The fair value of the Debentures was determined by discounting the expected future cash flows of the principal and interest payments using a discount rate of 19%, which, in management's opinion, approximates the market rate of interest for similar instruments, at the time of issue, without attached warrants. The carrying value of the Debentures will be accreted to their face value over their life to maturity (October 3, 2007). For the year ended August 31, 2006, the Company recorded $306,973 [2005 – nil] as accretion expenses. The fair value of the Warrants recorded in shareholders’ equity was determined using the Black-Scholes option pricing model.

There were a total of $1,043,605 of legal, professional and transaction fees associated with the Debenture Financing. Of this amount, $953,721 was recorded as deferred financing costs and $89,884 was offset against the warrants in shareholders' equity on a proportionate basis based on the relative fair value of the Debentures and the Warrants resulting in a net valuation of the warrants of $599,143. Deferred financing costs are being amortized over the twenty-four month life to maturity of the Debentures. During the year ended August 31, 2006, the Company recorded $437,125 [2005 – nil] of amortization on the deferred financing costs.

## 9. DEBENTURES (cont'd.)

A summary of the Company's expenses related to the long-term debt financing are as follows:

| | 2006<br>$ | 2005<br>$ |
|---|---|---|
| Non-cash accretion of debentures from carrying value to face value | **306,973** | -- |
| Non-cash amortization of debt financing charges | **437,125** | -- |
| Total accretion and amortization | **744,098** | -- |
| Cash interest expense | **909,590** | -- |
| | **1,653,688** | -- |

## 10. SHARE CAPITAL

### Authorized

Unlimited number of common shares without par value; and
Unlimited number of preference shares without par value.

### Issued

| | Number of common shares | Amount<br>$ |
|---|---|---|
| Outstanding, August 31, 2004 | 44,986,975 | 52,328,077 |
| Shares issued in connection with October 2004 rights offering | 11,246,743 | 5,124,064 |
| **Outstanding, August 31, 2005** | 56,233,718 | 57,452,141 |
| Warrants exercised | -- | 23,500 |
| Shares issued in connection with stock options exercised | 13,250 | 7,175 |
| Shares issued in connection with public offering | 26,796,401 | 17,140,923 |
| **Outstanding, August 31, 2006** | 83,043,369 | 74,623,739 |

The Company completed a rights offering for common shares on October 28, 2004 which was fully subscribed. The rights were exercised, resulting in the issuance of a total of 11,246,743 common shares on October 28, 2004, with gross proceeds amounting to $5,632,671 at $0.50 per common share. Net proceeds amounted to $5,124,064.

## 10. SHARE CAPITAL (cont'd.)

On March 2, 2006, the Company announced that it had entered into an agreement with a group of underwriters in connection with a public offering of units comprised of common shares and warrants to purchase common shares in the Company. The offering closed on March 30, 2006, and
a total of 26,796,401 units were sold at an offering price of $0.90 per unit for gross proceeds of approximately $24,116,761 with approximately $2,344,984 of cash underwriters' fees and expenses resulting in net cash proceeds of $21,771,777.

The units were divided into their constituent common shares and warrants upon closing, and as a result, an additional 26,796,401 common shares and 13,398,201 common share purchase warrants were issued by the Company on March 30, 2006. Each whole warrant entitles the holder thereof to purchase one common share at a price of $1.05 for a period of four years following the closing of the offering. The warrants were valued at $4,084,584.

The underwriters received 1,607,784 compensation options ("underwriters" options). This equates to 6% of the aggregate number of units sold under the offering. Each compensation option is exercisable to purchase one unit at the offering price for a period of two years following the closing date of March 30, 2006. The underwriters' options were valued at $546,270.

The fair values of the warrants and underwriters' options recorded in shareholders' equity were determined using the Black-Scholes Option Pricing Model.

Net proceeds from the offering will be used to fund sales, marketing and research and development related to the Company's new Soleus mobile phone software platform, as well as for general corporate purposes.

## Share option plan

Under the terms of the Company's employee share option plan, the Board of Directors may grant options to employees, officers and directors. The plan provides for the granting of options at the closing price of the Company's stock prior to the grant date. Options granted on or after May 11, 1999 and before April 5, 2001 generally vest over three years with the first 1/3 vesting at the first anniversary date of the grant and the balance vesting in equal amounts at the end of each quarter thereafter. The Company determines the term of each option at the time it is granted, with options generally having a five year term. The Company has reserved 11,095,774 options for issuance under its employee share option plan, a total of 4,109,024 options have been exercised to date leaving a total of 6,986,750 options available for issuance of which 6,374,413 have been granted and are outstanding as at August 31, 2006.

### 10. SHARE CAPITAL (cont'd.)

A summary of the Company's share option activity for the years ended August 31, 2006 and 2005 is as follows:

| | Outstanding options | |
|---|---|---|
| | **Number of common shares** | **Weighted average exercise price $** |
| Outstanding, August 31, 2004 | 4,694,906 | 1.57 |
| Options granted | 2,008,860 | 0.68 |
| Options cancelled/expired | (1,970,793) | 1.99 |
| **Outstanding, August 31, 2005** | 4,732,973 | 1.02 |
| Options granted | 2,913,030 | 0.93 |
| Options exercised | (13,250) | 0.54 |
| Options cancelled/expired | (1,258,340) | 1.29 |
| **Outstanding, August 31, 2006** | 6,374,413 | 0.97 |

The following table summarizes the share options outstanding at August 31, 2006:

| Options outstanding | | | | Options exercisable | |
|---|---|---|---|---|---|
| **Range of exercise price $** | **Number of shares** | **Weighted average remaining contractual life** | **Weighted average exercise price $** | **Number exercisable** | **Weighted average exercise price $** |
| 0.49 - 0.80 | 2,026,288 | 3.34 | 0.63 | 1,075,932 | 0.59 |
| 0.81 – 1.00 | 1,823,975 | 4.44 | 0.86 | 124,315 | 0.90 |
| 1.00 - 1.50 | 2,151,525 | 2.78 | 1.18 | 1,313,823 | 1.14 |
| 1.51 - 3.21 | 372,625 | 0.13 | 2.17 | 372,625 | 2.17 |
| | 6,374,413 | 3.27 | 0.97 | 2,886,695 | 1.06 |

The fair value of each stock option granted was estimated on the date of grant using the Black-Scholes Option Pricing Model with the following weighted average assumptions:

| | Years ended August 31, | |
|---|---|---|
| | **2006** | **2005** |
| Expected life (in years) | **4.0** | 2.91 |
| Risk-free interest rate | **4.13%** | 2.99% |
| Volatility | **52.2%** | 171.7% |
| Dividend yield | **0.00%** | 0.00% |

### 10. SHARE CAPITAL (cont'd.)

### Warrants & Underwriters' Options

A summary of the Company's share purchase warrants and underwriters' options for the years ended August 31, 2006 and 2005 are as follows:

| | | Outstanding warrants | |
|---|---|---|---|
| | **Number of Warrants and Underwriters' Options** | **Weighted average exercise price** $ | **Amount** $ |
| Outstanding, August 31, 2004 and 2005 | 100,000 | 3.20 | 163,500 |
| Warrants *[note 9]* | 3,870,968 | 0.62 | 599,143 |
| Share capital reallocation | | 0.94 | (23,500) |
| Warrants expired | (100,000) | 3.20 | (140,000) |
| Warrants | 13,398,201 | 1.05 | 4,084,584 |
| Underwriters' compensation options | 1,607,784 | 0.90 | 391,711 |
| Underwriters' compensation warrants | 803,892 | 1.05 | 154,559 |
| Outstanding, August 31, 2006 | 19,680,845 | 0.95 | 5,229,997 |

On January 26, 2006, 100,000 share purchase warrants valued at $140,000 expired and the value of the warrants was recorded as contributed surplus. The value of $23,500 relating to 25,000 share purchase warrants exercised in March 2004 has been recorded as an addition to share capital.

### 11. CONTRIBUTED SURPLUS

| | **2006** $ | **2005** $ |
|---|---|---|
| Contributed surplus – beginning of year | **1,896,760** | 1,080,546 |
| Warrants expired | **140,000** | -- |
| Stock-based compensation expense | **915,115** | 816,214 |
| Contributed surplus – end of year | **2,951,875** | 1,896,760 |

## 12. INCOME TAXES

Income tax expense differs from the amount that would be computed by applying the federal and provincial statutory income tax rates of 34.1% [2005 - 35.6%] to loss before income taxes due to the following:

| | **2006**<br>$ | **2005**<br>$ |
|---|---|---|
| Combined Canadian federal and provincial income taxes at expected rate | **(5,545,575)** | (1,778,423) |
| Change in valuation allowance | **4,261,000** | (4,134,217) |
| Permanent and other differences | **1,030,983** | 582,751 |
| Income recognized for tax, not for accounting purposes | **(2,528,000)** | 5,400,534 |
| Foreign income taxed at other rates | **2,958,389** | 93,171 |
| Costs of issuing equity | **(830,000)** | (181,000) |
| Adjustment to future income tax assets and liabilities for enacted changes in tax laws and rates | **783,853** | - |
| | **130,650** | (17,184) |

The composition of the Company's future tax assets and liabilities as at August 31, 2006 and 2005 is as follows:

| | **2006**<br>$ | **2005**<br>$ |
|---|---|---|
| Future income tax assets: | | |
| Equipment | **1,049,000** | 888,000 |
| Loss carry forwards | **6,387,000** | 2,830,000 |
| Share issue costs | **775,000** | 204,000 |
| SR&ED pool | **1,134,000** | 744,000 |
| Other | **579,000** | 997,000 |
| | **9,924,000** | 5,663,000 |
| Valuation allowance | **(9,924,000)** | (5,663,000) |
| Future income tax liability: | | |
| Equipment | **(62,655)** | - |
| Intellectual property | **(167,000)** | (261,425) |
| Net future income tax liability | **229,655** | 261,425 |

### 12. INCOME TAXES (cont'd.)

The future income tax assets have not been recognized in these consolidated financial statements, as management does not consider it more likely than not that such assets will be realized in the carry forward period.

As at August 31, 2006, the Company has non-capital loss carry forwards for Canadian purposes aggregating approximately $18,592,000 available to reduce taxable income otherwise calculated in future years. These losses expire as follows:

| | $ |
|---|---|
| 2007 | 2,213,000 |
| 2008 | 1,184,000 |
| 2009 | 3,683,000 |
| 2010 | 5,756,000 |
| 2014 | 1,114,000 |
| 2026 | 4,642,000 |
| | 18,592,000 |

The Company also has approximately $3,658,000 of scientific research and experimental development expenditures that may be carried forward indefinitely to be deducted against future Canadian taxable income, and federal investment tax credits of approximately $1,532,000 available to offset future Canadian federal income taxes payable as well as provincial investment tax credits of $849,000. The investment tax credits expire commencing in 2007 until 2015. The benefit of the investment tax credits has not been recognized as the realization is not reasonably assured.

At August 31, 2006, the Company also has non-capital loss carry forwards for UK income tax purposes totalling approximately $1,285,000 that may be carried forward indefinitely to reduce taxable income otherwise calculated in future years.

The Company estimates that is has non capital loss carry forwards in Barbados of approximately $9,700,000 that may be carried forward to reduce future taxable income. These losses are expected to expire in 2015.

## 13. GOVERNMENT ASSISTANCE

Under agreements with the Government of Canada's Technology Partnerships Canada ("TPC") program, the Company was eligible to receive conditionally repayable research and development funding amounting up to $5,415,648 to support the development of embedded devices and wireless internet-enabled network connectivity.

In December 2004, payments totalling $985,063, representing $947,374 previously withheld and applied against the receivable outstanding as at August 31, 2004 and an additional $37,689, were received of which $947,374 was applied against the associated fiscal 2005 other receivable balance. The additional $37,689 of funds received was recorded as Technology Partnerships Canada Funding Investment in the accompanying consolidated statements of operations.

During the year ended August 31, 2005, the Company determined that it had received an overpayment from TPC of $22,063 and accordingly recorded a liability for this amount. In addition, the Company paid royalties of $226,173 during the year ended August 31, 2006 [2005 - $5,278] and accrued a further $260,905 in royalties.

The Technology Partnerships Canada Funding Investment reflected in the accompanying consolidated statements of operations comprises the following:

| | **2006**<br>$ | **2005**<br>$ |
|---|---|---|
| Payment received from the Government of Canada, under the TPC program | **-** | (37,689) |
| Overpayment received and payable to the Government of Canada, under the TPC program | **-** | 22,063 |
| Royalties paid to the Government of Canada, under the TPC program | **-** | 5,278 |
| Accrued royalties payable to the Government of Canada, under the TPC program | **260,905** | 225,000 |
| | **260,905** | 214,652 |

All Government of Canada audits of the Company's compliance with the TPC agreements that were in process in prior periods are complete and the Company is currently reviewing the results of the audits and negotiating an extension of its TPC agreement, which expired in March 2004. If the

## 13. GOVERNMENT ASSISTANCE (cont'd)

extension is granted by TPC and the Company accepts the extension, the Company will be required to pay approximately $387,000 and the original terms and conditions will be amended. If the Company does not accept the extension, the Company is not obligated to pay this $387,000. The outcome of these negotiations is not known or determinable at this time. Accordingly no provision has been made as at August 31, 2006. If the Company is found to be in default of its agreement with TPC, TPC can suspend or terminate any obligation and it can demand repayment of all or part of the contributions disbursed to the Company. To date the Company has received approximately $3.8 million in contributions from TPC and paid and accrued approximately $491,183 to TPC in royalties.

## 14. COMMITMENTS AND CONTINGENCIES

[a] The Company has lease commitments for office premises and equipment with remaining terms of up to four years. In addition, the Company has a commitment to pay a royalty of $15 USD per $100 USD of licenses sold of certain software. In the event the cumulative royalty is less than $150,000 USD, the Company must pay the difference between the cumulative amount paid and the $150,000 USD on November 30, 2008. The royalty and minimum lease payments in each of the next six years are approximately as follows:

| | $ |
|---|---:|
| 2007 | 1,169,953 |
| 2008 | 1,227,518 |
| 2009 | 1,306,096 |
| 2010 | 1,183,438 |
| 2011 | 538,532 |
| 2012 | 409,487 |
| | 5,835,024 |

[b] The Company warrants that its software and hardware products will operate substantially in conformity with product documentation and that the physical media will be free from defect. The specific terms and conditions of the warranties are generally ninety days. The Company accrues for known warranty issues if a loss is probable and can be reasonably estimated, and accrues for estimated incurred but unidentified warranty issues based on historical activity. To date, the Company has had no material warranty claims.

## 15. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

### Fair values

The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate fair values due to their short maturities.

### Credit and foreign currency risk

The Company maintains substantially all of its cash and cash equivalents with major financial institutions in Canada. Deposits held with banks may exceed the amount of insurance provided on such deposits. However, as the Company can generally redeem these deposits upon demand, the Company bears minimal risk.

Financial instruments that potentially subject the Company to concentrations of credit risk are primarily accounts receivable. Management is of the opinion that any risk of accounting loss is significantly reduced due to the financial strength of the Company's major customers. The Company performs ongoing credit evaluations of its customers' financial condition and requires letters of credit or other guarantees whenever deemed necessary.

Although substantially all of the Company's revenues are received in US dollars, the Company incurs operating costs and has outstanding indebtedness that is denominated in Canadian dollars. The Company incurs certain research and development expenses in the U.S. Fluctuations in the exchange rates between these currencies could have a material effect on the business, financial condition and results of operations. The Company attempts to mitigate this risk by denominating many of its payment obligations in US dollars.

## 16. DERIVATIVE FINANCIAL INSTRUMENTS/FOREIGN EXCHANGE CONTRACTS

The Company enters into transactions denominated in US dollars and British pounds. As such its revenues, expenses, monetary assets and liabilities will be affected by fluctuations in the US dollar and the British pound relative to its functional currency, the Canadian dollar.

The Company purchased foreign exchange forward contracts to hedge sales to customers and expenditures expected to occur in the near future denominated in US dollars. The purpose of the Company's hedging activities is to reduce the level of exposure to exchange rate movements. As at August 31, 2006, the Company had no foreign exchange contracts maturing in the ensuing year. During fiscal 2006, the Company entered into foreign exchange contracts which matured throughout the year. For fiscal 2006 the Company has recorded an approximate foreign exchange loss of $6,800 [2005 - $21,000] related to these contracts.

## 17. SEGMENTED INFORMATION

### Operating segments

The Company operates in the sale and service of embedded hardware and software solutions and all sales of the Company's products and services are made in this segment. Management makes decisions about allocating resources based on the one operating segment.

### Geographic information

Substantially all of the Company's goodwill is located in Canada. The Company's equipment is located as follows:

| | 2006<br>$ | 2005<br>$ |
|---|---|---|
| United States | **280,828** | 165,902 |
| Canada | **963,623** | 705,443 |
| Europe | **116,381** | 109,235 |
| | **1,360,832** | 980,580 |

The Company earned revenues attributed to the following countries based on the location of the customer:

| | 2006<br>$ | 2005<br>$ |
|---|---|---|
| United States | **9,656,845** | 6,912,925 |
| Canada | **746,597** | 542,438 |
| Europe | **7,721,924** | 9,033,080 |
| Other | **532,351** | 1,050,662 |
| | **18,657,717** | 17,539,105 |

## 17. SEGMENTED INFORMATION (cont'd.)

The Company earned revenue in the following groups:

| | 2006<br>$ | 2005<br>$ |
|---|---|---|
| Hardware | **1,887,058** | 1,944,910 |
| Software | **1,832,281** | 2,670,154 |
| Services | **14,938,378** | 12,924,041 |
| | **18,657,717** | 17,539,105 |

## Significant customers

Two customers accounted for more than 10% of sales for the year ended August 31, 2006. Three customers accounted for more than 10% of sales for the year ended August 31, 2005.

| | % of Sales | | % of Accounts Receivable |
|---|---|---|---|
| | **2006** | **2005** | **2006** |
| Customer 1 | **17%** | 18% | 17% |
| Customer 2 | **11%** | 11% | 13% |
| Customer 3 | **1%** | 14% | -- |
| | **29%** | 43% | 30% |

## 18. COMPARATIVE FIGURES

The Company has reclassified certain of the figures presented for comparative purposes to conform to the consolidated financial statement presentation adopted in the current year.