Digifonica International Inc.

Consolidated Financial Statements

Years ended December 31, 2010 and 2009

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Years ended December 31, 2010 and 2009

Contents

Management's Responsibility

To the Shareholders of Digifonica International Inc.:

Management is responsible for the preparation and presentation of the accompanying financial statements, including responsibility for significant accounting judgments and estimates in accordance with Canadian generally accepted accounting principles and ensuring that all information in the annual report is consistent with the statements. This responsibility includes selecting appropriate accounting principles and methods, and making decisions affecting the measurement of transactions in which objective judgment is required.

In discharging its responsibilities for the integrity and fairness of the financial statements, management designs and maintains the necessary accounting systems and related internal controls to provide reasonable assurance that transactions are authorized, assets are safeguarded and financial records are properly maintained to provide reliable information for the preparation of financial statements.

The Board of Directors and the Audit Committee is composed primarily of Directors who are neither management nor employees of Digifonica International Inc. The Board is responsible for overseeing management in the performance of its financial reporting responsibilities, and for approving the financial information included in the annual report. The Board fulfills these responsibilities by reviewing the financial information prepared by management and discussing relevant matters with management and external auditors. The Audit Committee has the responsibility of meeting with management and external auditors to discuss the internal controls over the financial reporting process, auditing matters and financial reporting issues. The Committee is also responsible for recommending the appointment of Digifonica International Inc.'s external auditors.

Meyers Norris Penny LLP, an independent firm of Chartered Accountants, is appointed by the shareholders to audit the financial statements and report directly to them; their report follows. The external auditors have full and free access to, and meet periodically and separately with, both the Audit Committee and management to discuss their audit findings.

May 2, 2011

Chief Executive Officer

MEYERS NORRIS PENNY LIMITED

Independent Auditors' Report

To the Shareholders of Digifonica International Inc.:

We have audited the consolidated financial statements of Digifonica International Inc. and its subsidiaries which comprise the balance sheets as at December 31, 2010 and 2009, and the statements of operations, comprehensive loss, deficit and cash flows for the years then ended, and 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 consolidated 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 consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 consolidated financial statements.

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Digifonica International Inc. and its subsidiaries as at December 31, 2010 and 2009, and their financial performance and cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Emphasis of Matter

Without qualifying our opinion, we draw attention to Note 1 to these financial statements, which states that Digifonica International Inc. and its subsidiaries incurred significant losses from operations, negative cash flows from operating activities and has an accumulated deficit. This indicates the existence of a material uncertainty which may cast doubt about the ability of Digifonica International Inc. to continue as a going concern.

Meyers Norris Penny LLP

Vancouver, British Columbia

May 2, 2011

Chartered Accountants

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DIGIFONICA INTERNATIONAL INC.
(A Development Stage Company)
Consolidated Balance Sheets

		December 31, 2010		December 31, 2009
Assets				
Current assets:				
Cash and cash equivalents	$	238	$	4,327
Other receivable		2,998		3,548
Prepaid expenses		-		3,242
Total current assets		3,236		11,117
Patents (Note 6)		1		381,179
Total Assets	$	3,237	$	392,296
Liabilities and Shareholders' Equity				
Current liabilities:				
Accounts payable(Note 12)	$	653,875	$	601,826
Note payable in default (Note 7)		78,998		82,884
Accrued expenses(Note 13)		1,020,720		958,201
Convertible promissory notes (Note 8)		75,000		150,000
Subscriptions payable (Note 9)		134,822		124,822
Loan from shareholders(Note 12)		202,691		151,182
Total current liabilities		2,166,106		2,068,915
Shareholders' equity:				
Share capital (Note 10)		11,778,565		11,622,658
Contributed surplus		560,372		560,372
Deficit accumulated during the development stage		(14,501,806)		(13,859,649)
Total shareholders' equity		(2,162,869)		(1,676,619)
Total Liabilities and Shareholders' Equity	$	3,237	$	392,296

Nature of operations (Note 1)		-		
Subsequent events (Note 15)				

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

Approved on behalf of the Board of Directors:

"Colin Tucker" — Director

"Emil Malak" — Director

DIGIFONICA INTERNATIONAL INC.
(A Development Stage Company)
Consolidated Statements of Operations, Comprehensive Loss and Deficit

	Year ended December 31, 2010	Year ended December 31, 2009	Inception (Sep 9, 2004) to Dec 31, 2010
Sales	$ -	$ -	$ -
Cost of sales	-	-	-
	-	-	-
Expenses (recoveries):			
Accounting and audit	(9,693)	43,347	554,332
Amortization	-	128,033	1,108,923
Bad debt	3,660	-	3,660
Consulting fees (Note 12)	52,862	226,500	457,390
General and administrative	62,362	113,934	3,127,027
Foreign currency gain	(42,588)	(48,143)	(473,778)
Interest expense	75,300	36,730	344,192
Interest income	-	(330)	(5,906)
Legal	2,700	6,704	874,009
Rent	-	25,343	430,737
Research and development	-	-	284,073
Salaries, wages, and commissions	14,095	70,689	3,134,326
Sales and marketing	-	-	2,095,071
Travel	-	-	460,324
	158,698	602,807	12,394,380
Loss from continuing operations before other income (expense) and income taxes	(158,698)	(602,807)	(12,394,380)
Other income (expense):			
Loss from disposition of property and equipment	-	(339,669)	(367,769)
Write-off of deferred development costs (Note 5)	-	(3,117,605)	(3,117,605)
Gain on sale of subsidiary	-	-	805,133
Loss on settlement of liabilities (Note 8)	(69,304)	-	986,970
Impairment loss on patents (Note 6)	(414,155)	-	(414,155)
	(483,459)	(3,457,274)	(2,107,426)
Loss from continuing operations before income taxes	(642,157)	(4,060,081)	(14,501,806)
Income tax expense	-	-	-
Net loss and comprehensive loss	(642,157)	(4,060,081)	(14,501,806)
Deficit, beginning of period	(13,859,649)	(9,799,568)	-
Deficit, end of period	$ (14,501,806)	$ (13,859,649)	$ (14,501,806)
Loss per share - basic and diluted	$ (0.02)	$ (0.12)	$ (0.66)
Weighted average number of common shares Basic and diluted	38,689,175	32,609,317	21,825,169

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

DIGIFONICA INTERNATIONAL INC.
(A Development Stage Company)
Consolidated Statements of Cash Flows

	Year ended December 31, 2010	Year ended December 31, 2009	Inception (Sep 9, 2004) to Dec 31, 2010
Cash provided by (used in):			
Operations:			
Loss from operations	$ (642,157)	$ (4,060,081)	$ (14,501,806)
Items not involving cash:			
Amortization	-	128,033	1,108,923
Common shares issued for services rendered	-	139,247	145,268
Stock-based compensation expense	-	-	56,746
Loss on disposal of property and equipment	-	339,669	367,769
Write-off of deferred development costs	-	3,117,605	3,117,605
Flat fee on shareholders' loan	-	3,084	98,842
Gain on sale of subsidiary	-	-	(805,133)
Bad debt	3,660	-	3,660
Impairment loss on patents	414,155	-	414,155
Loss on settlement of liabilities	69,304	-	(986,970)
Changes in non-cash operating working capital (Note 13)	122,416	(18,212)	2,559,280
	(32,622)	(350,655)	(8,421,661)
Investments:			
Purchase of property and equipment	-	-	(1,477,387)
Proceeds from disposition of property and equipment	-	-	695
Payable from purchase of property and equipment	-	-	28,210
Expenditures on deferred development costs	-	(100,741)	(3,117,605)
Payable from deferred development costs	-	8,519	155,216
Expenditures on patents	(32,976)	(238,170)	(414,155)
Sale (Purchase) of short term investments	-	-	-
	(32,976)	(330,392)	(4,825,026)
Financing:			
Issuance of shares, net of issue costs	-	751,030	11,362,716
Subscription proceeds received in advance	10,000	-	360,000
Proceeds from shareholder loans	51,509	61,684	4,008,299
Proceeds from convertible promissory notes	-	-	150,000
Proceeds from subscriptions payable	-	-	124,822
(Decrease) Increase in bank overdraft	-	(46,595)	-
Repayment of loan	-	(123,691)	(2,758,912)
	61,509	642,428	13,246,925
Increase (decrease) in cash and cash equivalents	(4,089)	(38,619)	238
Cash and cash equivalents, beginning of period	4,327	42,946	-
Cash and cash equivalents, end of period	$ 238	$ 4,327	$ 238

Supplementary cash flow information (Note 14)

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

1. Nature of operations and going concern

Digifonica International Inc., formerly Initial Capital Inc., ("Digifonica" or the "Company") was incorporated under the Alberta Business Corporations Act on November 23, 2004 and was listed as a Capital Pool Company on the TSX Venture Exchange (the "Exchange") effective May 9, 2005. The Company completed its Qualifying Transaction by acquiring a 50.02% controlling interest in Digifonica International Corp. ("DIC") on May 8, 2007. The Company completed the acquisition of a further 49.5% of the issued and outstanding shares of DIC on September 10, 2007. The Company currently trades on the Exchange under the symbol "DIL".

In 2007, the Company completed an internal group reorganization with ownership by DIC in Digifonica (International) Limited (organized in Gibraltar on September 9, 2004) , Digifonica Intellectual Properties Limited (organized in Gibraltar on September 25, 2003) , Digifonica Canada Limited (organized in Canada on July 29, 2004), Digifonica Enterprises Limited (organized in England and Wales on April 26, 2006) and Shenzhen Sino-Can Inter-Communication Technology Limited (a joint venture company in China) being transferred directly to the Company. Previously ownership by the Company was held indirectly through DIC. Subsequent to the internal group reorganization DIC was sold to an arm's length third party for proceeds of $1,000.

These consolidated financial statements have been prepared assuming the Company will continue as a going concern, which contemplates the realization of assets and satisfaction of liabilities in the normal course of business. The Company has accumulated operating losses of $14,501,806 since its inception and had a working capital deficiency of $2,162,869 at December 31, 2010 (December 31, 2009: $2,057,798). The Company is in default of covenants and repayment schedules with certain creditors. The continuation of the Company is dependent upon the continuing support of creditors and stockholders, long-term financing and achieving profitability. These consolidated financial statements do not give effect to any adjustments to the amounts and classifications of assets and liabilities which might be necessary should the Company be unable to continue its operations as a going concern.

During the year the Company ceased operations due to a lack of financing. The main activities in the Company during the year was maintaining its public listing and keeping the patents applications current.

2. Basis of presentation

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"). All dollar amounts presented are in Canadian dollars.

These consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries, Digifonica (International) Limited, Digifonica Intellectual Properties Limited, Digifonica Canada Limited and Digifonica Enterprises Limited and its 49% interest in Shenzhen Sino-Can Inter-Communication Technology Limited. All of the Company's subsidiaries are inactive. All significant inter-company transactions have been eliminated.

3. Significant accounting policies

The Company's significant accounting policies are as follow:

a) Cash and cash equivalents

The Company considers all highly liquid investments with maturity of three months or less at the time of purchase to be cash equivalents. These cash equivalents primarily consist of funds on deposit under various terms.

3. Significant accounting policies (continued)

b) Use of estimates

The preparation of the financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods may be significant. Key areas of estimation, where management has made difficult, complex or subjective judgments, often as a result of matters that are inherently uncertain, include certain accrued liabilities, useful lives of depreciable assets and intangible assets with finite useful lives, estimates of volatility and forfeiture rates for stock based compensation and the determination of the debt and equity components for convertible debt instruments, recoverability of patent, calculation and recoverability of future tax assets and liabilities. For business combinations, key areas of estimation and judgment include the allocation of the purchase price.

c) Foreign currency translation

The Company's subsidiaries are considered fully integrated and are translated into Canadian dollars using the temporal method. Under this method, monetary assets and liabilities denominated in a foreign currency have been translated into Canadian dollars at rates of exchange in effect at the balance sheet date. Non-monetary assets, liabilities, revenue and expense items are translated at rates prevailing when they were acquired or incurred. Exchange gains and losses arising on translation of assets and liabilities are included in operations.
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d) Patents

The Company capitalizes patent application costs and amortizes on a straight-line basis over the estimated useful life of the patent. The unamortized balance is charged to its operations if the Company does not obtain approval or the patent is abandoned.

e) Impairment of long-lived assets

Long-lived assets are tested for recoverability whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. An impairment loss is recognized when the carrying amount of the asset exceeds the sum of the undiscounted cash flows resulting from its use and eventual disposition. The impairment loss is measured as the amount by which the carrying amount of the asset exceeds its fair value.

f) Convertible Promissory note

The Company's Convertible Promissory notes are considered to be a compound financial instrument that contains both a debt and equity component. On issuance, the fair value of the debt component is determined by discounting the expected future cash flows over the expected life using a market rate of interest for a nonconvertible debt instrument with similar terms. The value is carried as debt on an amortized cost basis until extinguished on conversion or redemption. The remainder of the proceeds is allocated as a separate component of shareholders' equity. Transaction costs are apportioned between the debt and equity components based on their respective carrying amount when the instrument was issued.

3. Significant accounting policies (continued)

g) Financial instruments

Fair value

CICA Handbook Section 3855, *Financial instruments – recognition and measurement*, establishes standards for recognizing and measuring financial assets, financial liabilities and derivatives, including derivatives embedded in non-financial contracts. It requires financial assets and financial liabilities, including derivatives, be measured at fair value on initial recognition and recorded on the balance sheet. Measurement in subsequent periods is dependent on the classification of the financial instrument:

- held for trading – measured at fair value with changes in those fair values recognized in income
- available for sale – measured at fair value with unrealized gains and losses recognized in other comprehensive income; instruments that do not have a quoted market price in an active market are measured at cost
- held to maturity, loans and receivables, other financial liabilities – measured at amortized cost using the effective interest method of amortization

The Company's financial instruments include cash and cash equivalents, other receivable, accounts payable, accrued liabilities, accrued expenses, notes payable in default, convertible promissory notes, loans from shareholders and subscriptions payable. Management believes that the fair values of these financial instruments approximate their carrying values due to their short term natures.

The Company has classified all of its financial assets and liabilities as follows:

Financial Asset / Liability Classification / Subsequent Measurement

Cash and cash equivalents / Held for trading / Fair value
Other receivable / Loans and receivables / Amortized cost
Accounts payable and accrued expenses / Other liabilities / Amortized cost
Notes payable in default / Other liabilities / Amortized cost
Loans from shareholders / Other liabilities / Amortized cost
Convertible Promissory notes / Other liabilities / Amortized cost
Subscriptions payable / Other liabilities / Amortized cost

Held for trading financial assets and liabilities, including derivative financial instruments, are recorded at fair value as determined by active market prices and valuation models, as appropriate. Valuation models require the use of assumptions concerning the amount and timing of estimated future cash flows and discount rates. In determining these assumptions, the Company uses readily observable market inputs. Changes in fair value of held for trading financial instruments are recorded in net earnings. Loans and receivables and other financial liabilities are recorded initially at fair value, net of transaction costs incurred, and subsequently at amortized cost using the effective interest method.

3. Significant accounting policies (continued)

h) Income taxes

The Company follows the asset and liability method of accounting for income taxes. Under this method future income tax assets and liabilities are determined based on differences between financial reporting and income tax bases of assets and liabilities, and are measured using substantively enacted income tax rates and laws that will be in effect when the differences are expected to reverse. The effect on future income tax assets and liabilities of a change in income tax rates is recognized in operations in the period in which the change is substantively enacted. A valuation allowance is recorded against any future income tax assets to the extent that there is uncertainty regarding utilization of future tax assets.

l) Loss per share

The treasury stock method of calculating diluted per share amounts is used whereby any proceeds from the exercise of in-the-money stock options or warrants are assumed to be used to purchase, for cancellation, common shares of the Company at the average market price during the period. Basic loss per share is computed by dividing net losses by the weighted average number of common shares outstanding during the period. Diluted per share amounts reflect the potential dilution that could occur if stock options or warrants to purchase common shares were exercised and converted to common shares. Anti-dilutive options and warrants are not included in the calculation.

i) Stock based compensation

Under the Company's stock option plan described in Note 11 (c), options to purchase common shares are granted to directors, officers, employees and consultants at current market prices. Stock-based compensation expense is recorded in the statement of loss and deficit for all options granted with a corresponding increase recorded as contributed surplus. Compensation expense is based on the estimated fair values at the time of the grant and the expense is recognized over the estimated vesting period. Upon the exercise of the stock options, consideration paid together with the amount previously recognized in contributed surplus is recorded as an increase in share capital. In the event that vested options expire, previously recognized compensation expense associated with such stock options is not reversed. In the event that vested options are cancelled, previously recognized compensation expense associated with such stock options is reduced.

o) Comprehensive income

CICA Handbook Section 1530, *Comprehensive income*, introduces comprehensive income, which consists of net income and other comprehensive income. Other comprehensive income represents changes in shareholders' equity during a period arising from unrealized foreign currency translation gains or losses of self sustaining foreign operations, unrealized gains and losses on financial assets classified as available for sale, and changes in the fair value of the effective portion of cash flow hedging instruments. The components of comprehensive income are disclosed in the consolidated statement of comprehensive income. The Company does not have any items that should be included in other comprehensive income.

p) Hedges

CICA Handbook Section 3865, *hedges*, specifies the criteria that must be satisfied for the application of hedge accounting. The Company does not engage in hedging practices.

4. Recent accounting announcement

Transition to International Financial Reporting Standards ("IFRS")

In 2006, Canada's Accounting Standards Board (AcSB) ratified a strategic plan that will significantly affect financial reporting requirements for Canadian companies. The AcSB strategic plan outlines the convergence of Canadian GAAP with IFRS over an expected five year transitional period. In February 2008, the AcSB announced that January 1, 2011 is the changeover date for publicly-traded companies to use IFRS, replacing Canada's own GAAP. The date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The transition date of January 1, 2011 will require the restatement for comparative purposes of amounts reported by the Company for the year ended December 31, 2010. While the Company has begun assessing the adoption of IFRS for 2011, the financial reporting impact of the transition to IFRS cannot be reasonably estimated at this time.

5. Deferred development costs

The Company has capitalized the cost of development related to wages, contractor fees and other related costs for software design and application products of the Company's VoIP system and applications. As at December 31, 2009 the Company determined that the deferred development costs were no longer recoverable and the balance of $3,117,605 was written off to the income statement.

The amount of deferred development costs for the year ended December 31, 2010 and 2009 were $nil and $100,741 respectively. No amortization expense was taken in either year.

6. Patents

The Corporation has several patent applications pending approval that relate directly to the process and technology that run the Company's current business platform. The carrying amounts are representative of actual costs incurred to date in pursuing patent applications. $32,976 of patent application costs and legal fees have been capitalized during the year ended December 31, 2010 (December 31, 2009: $238,170). Patents will be amortized over the remaining life of the patent commencing when the patents have been granted. To date, none of the patents have been granted and therefore no amortization has been recorded.
The patents of the company with the capitalized value of $414,155 have been written down to $1 as at December 31, 2010.

7. Note payable in default

Due to inactivity and a lack of financing, the Company has one note payable in default for $78,998 as at December 31, 2010 (December 31, 2009: $82,884). At December 31, 2010 and 2009 the one note in default is an unsecured promissory note dated July 23, 2008 which was entered into by the Company with a supplier. The promissory note bears interest at 12% per annum on the unpaid principal.

8. Convertible promissory notes

On July 14, 2008, the Company issued $150,000 in convertible promissory notes to three shareholders and one arms-length party. The notes bear interest at a rate of 10% per annum. The notes are convertible into common shares of the Company at the election of the holder, at a price of $0.36 per Unit. Each Unit consists of one common share of the Company and one non-transferable common share purchase warrant of the Company. Each common share purchase warrant shall entitle the holder thereof to acquire one common share of the Company at a price of $0.50 per common share on or before the day that is eighteen months from the date of the note agreements. The notes are repayable at a date which is not more than ten days from the date of closing a private placement offering by the Company where the Company raises funds, net of expenses of the offering, in excess of $1,000,000 (the "Private Placement"); or where the Private Placement has not closed by September 30, 2008, within five business days of demand at anytime thereafter, unless otherwise converted at the terms outlined above. The notes are secured by a general security agreement.

The Company has allocated $140,965 of the $150,000 proceeds to current liabilities based on the fair value of similar debt instruments without an associated conversion option. The fair value of the conversion option was estimated at approximately $9,035. This is reflected as an adjustment to Contributed surplus. An accretion expense of $NIL (December 31, 2009: $2,582) was recognized in the year ended December 31, 2010.

On February 4, 2010, the Company issued 866,031 common shares at a deemed price of $0.10 per common share to settle $86,603 in convertible promissory notes and its accrued interest ($ 75,000 convertible notes plus 11,603 interest). TSX Venture Exchange approval was obtained. Shares were issued with a fair value of $155,907, resulting in a loss on debt settlement of $69,304 which has been recognized in the income statement.

9. Subscriptions payable

In December, 2008, the Company received an advance of $124,822 from an arm's length party. The terms of the subscription agreement are yet to be finalized.

In 2010 the company received $10,000 subscription in advance, but shares were not issued.

10. Share capital

a) Authorized

Unlimited number of common shares without nominal or par value.
Unlimited number of preferred shares issuable in series.

b) Common shares issued and fully paid

	Number		Amount
Balance – December 31, 2008	29,003,179	$	10,745,975
Shares issued pursuant to private placement (Note 10 (b) (I))	7,510,300		751,030
Fair value of warrants issued allocated to contributed surplus (Note 10 (b) (II))	-		(13,594)
Shares for debt (Note 10 (b) (III)	1,392,465		139,247
Balance – December 31, 2009	37,905,944	$	11,622,658
Shares issued for debt (Note 10 (b) (IV))	866,031		155,907
Balance – December 31, 2010	38,771,975	$	11,778,565

10. Share capital (continued)

b) Common shares issued and fully paid (continued)

i. On July 24, 2009 the Company closed a non-brokered Private Placement of units (“Units”). The Company issued an aggregate of 7,510,300 Units at a price of $0.10 per Unit for gross proceeds of $751,030. Each Unit consists of one common share (a "Common Share") of the Company and one-half of one non-transferable common share purchase warrant (a "Warrant"), with each whole Warrant entitling the holder thereof to acquire one Common Share at a price of $0.15 per Common Share for a period of 12 months from the date of issuance and thereafter at a price of $0.25 per Common Share until the date that is 24 months from the date of issuance.

The fair value of the warrants issued as part of each Unit was determined using the Black-Scholes Option Pricing Model and resulted in a value of $13,594 based on the following assumptions: risk-free interest rate of 1.29%, expected term of 2 years, weighted average stock volatility of 35%, and expected future dividends of nil per share.

ii. On September 22, 2009, the Company issued 350,000 common shares to the President of the Company to settle $35,000 of debt owed in respect of consultancy services provided to the Company.

iii. On October 19, 2009, the Company issued 1,042,465 common shares at $0.10 per share to seven creditors to settle $104,246 of payables.

iv. In the year ended December 31, 2010, 866,031 shares at a fair value of $0.18 per share were issued in settlement of debt (note 9).

c) Stock options

The Company has a stock option plan, administered by the Board of Directors, in which up to 10% of the issued and outstanding common shares are reserved for issuance. Under the plan, the options vest immediately and expire three years from date of grant.

The fair value of the stock options granted to Directors was determined using the Black-Scholes Option Pricing Model and resulted in a value of $17,562 based on the following assumptions: risk-free interest rate of 2.89%, expected term of 3 years, weighted average stock volatility of 35%, and expected future dividends of nil per share. The fair value of the stock options granted to officers, consultants and employees was determined using the Black-Scholes Option Pricing Model and resulted in a value of $40,368 based on the following assumptions: risk-free interest rate of 2.89%, expected term of 3 years, weighted average stock volatility of 35%, and expected future dividends of nil per share.

10. Share capital (continued)

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c) Stock options (continued)

The following table presents the changes in the number of options outstanding for the stock option plan:

	December 31, 2010			December 31, 2009		
	Number		Weighted average exercise price	Number		Weighted average exercise price
Balance, beginning of period	690,000	$	1.06	981,000	$	1.04
Options granted	-		-			
Options exercised	-		-			
Options expired				(291,000)		1.00
Balance, end of period	690,000	$	1.06	690,000	$	1.06

	Options outstanding and exercisable			
Exercise Price	Number of options	Weighted average remaining contractual life		Weighted average exercise price
$1.00	290,000	2.42	$	1.00
$1.10	400,000	2.42		1.10
	690,000	2.42	$	1.06

At December 31, 2010, the weighted average remaining contractual life of the options was 2.42 years (December 31, 2009: 3.42 years).

d) Escrowed shares

The Company has 7,340,500 shares subject to a six year escrow period starting September 10, 2007 (4,404,300 common shares remaining in escrow as at December 31, 2010). The Company has 9,342,731 shares subject to a three year escrow period starting May 8, 2007 (4,658,403 common shares remaining in escrow as at December 31, 2010).

e) Share purchase warrants

The exercise price and expiry date of the common share purchase warrants as at December 31, 2010 are as follows:

Number	Exercise Price	Expiry Date
3,755,150	$0.15 to 7/24/10, $0.25 to 7/24/11	July 24, 2011

During the year ended December 31, 2010, 653,500 (December 31, 2009: 1,007,172) share purchase warrants expired unexercised.

11. Income taxes

The Company's effective tax rate differs from the amount that would be computed by applying federal and provincial statutory rate of 28.5% (2009 – 30%) to the pre-tax net loss for the year. The differences result from the following items:

		2010		2009
Loss before income taxes	$	(642,157)	$	(4,060,081)
Expected income tax (recovery) at statutory rate	$	(183,015)	$	(1,218,024)
Impact of lower statutory rates on foreign subsidiaries		-		1,123
Non deductible expenses		156,158		3,174
Effect of rate change		414,668		281,489
Expired non-capital losses		-		5,771
Change in valuation allowance		(387,811)		926,467
Total income tax recovery	$	-	$	-

Future income tax assets

The company's future income tax assets are as follows:

		2010		2009
Non capital losses	$	1,850,365	$	2,051,218
Share issuance cost		33,651		69,703
Tax value of equipment in excess of book value		1,077,895		1,228,801
		2,961,911		3,349,722
Valuation allowance		(2,961,911)		(3,349,722)
Future income tax asset	$	-	$	-

Estimate taxable income for the period is $nil. Based on the level of historic taxable income, it cannot be reasonably estimated at this time if it is more likely than not that the Company will realize the benefits from future income tax assets. The estimated taxable temporary difference valuation allowance will be adjusted in the period it is determined that it is more likely than not that some portion or all of the future tax assets will be realized.

Losses carried forward

As at December 31, 2010, the Company has non-capital losses of approximately $7,401,458 (2009 - $7,197,254) which may be carried forward to apply against future year's income for Canadian income tax purposes, subject to final determination by taxation authorities and expiring as follows:

2014	78,938
2015	1,185,480
2026	1,697,140
2027	1,960,042
2028	1,764,027
2029	511,627
2030	204,204
	$ 7,401,458

11. Income taxes (continued)

The future potential savings associated with these items have not been recognized in these financial statements.

12. Related party transactions

The following related party transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

a) During the year ended December 31, 2010, the Company paid consulting fees in the amount of $48,362 to directors and officers, and companies owned by directors and officers of the Company (2009- $224,000).

b) During the year ended December 31, 2010, the Company issued nil shares to officers (December 31,2009: 350,000) shares to an officer at a deemed price of $0.10 per share to in settlement of consulting fees owing to him in the amount of $35,000).

Included in accounts payable is $70,752 (2009- $35,210) payable to directors and officers of the Company. The amounts are non-interest bearing with no specific terms of repayment.

Included in accrued expenses is $173,490 payable to a director of the Company (2009 - $150,435). This amount is non-interest bearing and due on demand.

Included in loans from shareholders is $139,356 payable to a director of the Company (2009 - $88,183 payable to directors or their related companies). This amount is due on demand and is non-interest bearing. A flat 5% fee was paid to the director in the amount of nil in 2010 (2009: $3,084).

13. Supplementary cash flow information

	Year ended December 31, 2010	Year ended December 31, 2009	Inception (Sep 9, 2004) to Dec 31, 2010
Changes in non-cash operating working capital:			
Other receivable	$ 132	$ 9,342	$ 1,121,759
Inventory	-	-	-
Prepaid and other current assets	-	66,997	261,559
Accounts payable	52,021	(251,965)	393,963
Accrued expenses	74,149	168,528	749,652
Note payable in default	(3,886)	(13,696)	52,117
Convertible promissory notes	-	2,582	(72,418)
Due to other parties	-	-	(65,500)
	$ 122,416	$ (18,212)	2,476,339
Cash paid during the period for:			
Interest	$ -	$ 2,199	$ 21,225
Non-cash investing and financing activities:			
Liabilities assumed, reverse merger	$ -	-	$ 886,273
Common shares issued for services rendered	-	-	6,021
Shareholders' loan converted to common shares	-	-	1,231,768
Common shares issued for debt settlement	155,907	-	-

14. Comparative figures

Certain prior period amounts have been reclassified to conform to the presentation adopted in the current period.

15. Subsequent events

On February 25, 2011, the Company announced the consolidation of 38,771,975 issued and outstanding shares on 10:1 basis. This event was approved by TSX on the same date. Each approved shareholder will receive 1 common share consolidated for each 10 pre-consolidated common shares of the Company. The number of issued and outstanding shares after the consolidation will be 3,877,397.

16. Capital management

The Company's objectives when managing its capital are:

I. to maintain a flexible capital structure which optimizes the cost of capital at acceptable risk while providing an appropriate return to its shareholders;
II. to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business;
III. to safeguard the Company's ability to obtain financing should the need arise; and
IV. to maintain financial flexibility in order to benefit from potential opportunities as they arise.

The Company manages its capital structure and makes adjustments to it in accordance with the objectives stated above, as well as responds to changes in economic conditions and the risk characteristics of the underlying assets. The Company monitors the return on capital, which is defined as total shareholders' equity. There were no changes in the Company's approach to capital management during the year ended December 31, 2010 and 2009. Neither the Company nor any of its subsidiaries are subject to externally imposed capital requirements.

17. Financial instruments and financial risk management

The Company is exposed to risks of varying degrees of significance which could affect its ability to achieve its strategic objectives for growth and shareholder returns. The Company's risk management policies are established to identify and analyze the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks and adherence to market conditions and the Company's activities.

This note presents information about the Company's exposure to significant financial risks and the Company's objectives, policies and processes for measuring and managing these risks. Further quantitative disclosures are included throughout these financial statements. The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board has implemented and monitors compliance with risk management policies.

The principal financial risks to which the Company is exposed are described below

Credit risk

A significant portion of the Company's cash is held at one institution and as a result the Company is exposed to the risks of that institution. The carrying amount of cash and short-term investment held for trading represents the Company's maximum credit exposure. The Company minimizes its risk by ensuring that funds are deposited with credit worthy financial institutions.

Liquidity risk

Liquidity risk is the risk that the Company is not able to meet its financial obligations as they become due or can do so only at excessive cost. The Company manages its liquidity risk by continuously monitoring forecasted and actual cash flows, as well as anticipated investing and financing activities.

17. Financial instruments and financial risk management (continued)

Foreign exchange risk

The Company conducts its business in foreign currencies and as a result it is exposed to fluctuations in foreign exchange rates. The Company's current foreign currency risk is primarily with the U.S. dollar and Great Britain pound ('GBP'). Accounts exposed to foreign exchange risk as of December 31, 2010 are:

FOREIGN EXCHANGE RISK

		US$ Balance		GBP Balance
Cash and cash equivalents	$	-	$	(420)
Accounts payable		(44,676)		(282,680)
Accrued expenses		(15,997)		(221,014)
Notes payable in default		(78,998)		-
Total	$	(139,671)	$	(504,114)

The Company does not actively hedge its foreign denominated financial instruments.

Foreign currency exchange risk sensitivity analysis

The following table details the Company's sensitivity analysis to a 10% strengthening in the US Dollar and Great Britain Pound on foreign currency denominated monetary items and adjusts their translation at the balance sheet date for a 10% change in foreign currency rates. For a 10% weakening of the US Dollar against the Canadian Dollar, there would be an equal and opposite impact on net loss for the period.

Change in foreign exchange gain/(loss) resulting from currency fluctuations at December 31, 2010:

FOREIGN EXCHANGE RISK

		US$ Balance		GBP Balance
Cash and cash equivalents	$		$	(42)
Accounts payable		(4,468)		(28,268)
Accrued expenses		(1,600)		(22,101)
Notes payable in default		(7,900)		-
Total	$	(13,967)	$	(50,411)

17. Financial instruments and financial risk management (continued)

Fair value of financial instruments

The Company classifies its financial instruments measured at fair value at one of three levels according to the relative reliability of the inputs used to estimate the fair value:

2010	**Level 1**	**Level 2**	**Level 3**	**Total**
Cash	$ 238	$ -	$ -	$ 238
Other receivable	2,998			2,998

2009	**Level 1**	**Level 2**	**Level 3**	**Total**
Cash	$ 4,327	$ -	$ -	$ 4,327
Other receivable	3,548			3,548

Level 1 – quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 – inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e., as prices) or indirectly (i.e., derived from prices); and

Level 3 – Inputs for the asset or liability that are not based on observable market data (unobservable inputs).