

XS Financial Inc.

Consolidated Financial Statements

For the years ended December 31, 2022 and 2021

(Expressed in United States Dollars)

XS Financial Inc.

Table of Contents

	Page(s)
INDEPENDENT AUDITOR'S REPORT	1-3
FINANCIAL STATEMENTS:	
Consolidated Statements of Loss and Comprehensive Loss	4
Consolidated Statements of Financial Position	5
Consolidated Statements of Changes in Equity	6
Consolidated Statements of Cash Flows	7-8
Notes to Consolidated Financial Statements	9-46

Independent Auditor's Report

To the Shareholders of XS Financial Inc.

Opinion

We have audited the consolidated financial statements of XS Financial Inc. and its subsidiaries (the "Company"), which comprise the consolidated statement of financial position as at December 31, 2022 and 2021, and the consolidated statements of loss and comprehensive loss, changes in equity and cash flows for the years then ended, and the related notes to the consolidated financial statements, including a summary of significant accounting policies (the "financial statements").

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2022 and 2021, and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards (IFRSs) as issued by the International Accounting Standards Board.

Basis for Opinion

We conducted our audit in accordance with Canadian generally accepted auditing standards (Canadian GAAS). Our responsibilities under those standards are further described in the 'Auditor's Responsibilities for the Audit of the Financial Statements' section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements for the year ended December 31, 2022. These matters were addressed in the context of the audit of the consolidated financial statements as a whole, and in forming the auditor's opinion thereon, and we do not provide a separate opinion on these matters.

Financing Receivables (Note 7) and Related Revenue (Note 4)

During the year ended December 31, 2022, the Company entered into financing leases with multiple customers resulting in financing income on financing leases of \$7,480,996 for the year ended December 31, 2022. The carrying value of financing receivables on the Company's consolidated financial statements was \$87,091,945 as of December 31, 2022.

We consider this a key audit matter due to the magnitude of the balance and the judgment made by management in determining the net value of such receivables, which in turn led to increased audit effort in performing audit procedures.

How the Audit Matter was Addressed in the Audit

We reviewed the underlying contracts and recalculated the balances of financing receivables and related revenue for a sample of leases. We additionally sent out confirmations, and also vouched subsequent receipts on a sample of financing receivables. Additionally, we evaluated the financing receivables for any potential impairment and the appropriateness of the method of valuation.

Other Information

Management is responsible for the other information. The other information comprises:

- The information, other than the consolidated financial statements and our auditor's report thereon, included in the Annual Report, and
- The information included in the Management's Discussion and Analysis for the year ended December 31, 2022. Our opinion on the consolidated financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements, or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

We obtained the Management's Discussion and Analysis and the Annual Report prior to the date of this auditor's report. If, based on the work we have performed on this other information, we conclude that there is a material misstatement of this other information, we are required to report that fact in this auditor's report. We have nothing to report in this regard.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with IFRS as issued by the International Accounting Standards Board; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not a guarantee that an audit conducted in accordance with Canadian GAAS will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with Canadian GAAS, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the entity to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Company to express an opinion on the financial statements. We are responsible for the direction, supervision and performance of the audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

The engagement partner on the audit resulting in this independent auditor's report is Shaji Varghese.



Melville, New York
April 25, 2023

XS Financial Inc.
Consolidated statements of loss and comprehensive loss
For the years ended December 31, 2022 and 2021
(Expressed in United States dollars)

	<u>Note</u>	<u>Year ended December 31,</u>	
		<u>2022</u>	<u>2021</u>
Revenue	4	\$ 7,567,473	\$ 3,158,562
Operating expenses			
Administrative expenses	5	5,220,520	3,837,830
Sales and marketing expenses	5	409,636	250,103
Gain (loss) from operations		1,937,317	(929,371)
Financing expense, net	12	4,866,565	1,453,741
Accretion expense	12	3,881,943	867,285
Realized loss on sale of investments	6	-	98,857
Unrealized loss in fair value change of investments	6	84,491	44,719
Change in fair value of derivative liabilities	12,13	(3,406,236)	(1,048,781)
Other expense	5	2,816,042	640,229
Loss before income tax		(6,305,488)	(2,985,421)
Income tax	15	-	-
Net loss		<u>\$ (6,305,488)</u>	<u>\$ (2,985,421)</u>
Other comprehensive loss			
Items that will subsequently be reclassified to operations:			
Unrealized gain on foreign currency translation		2,487,495	716,334
Comprehensive loss		<u>\$ (3,817,993)</u>	<u>\$ (2,269,087)</u>
Loss per share - basic and diluted		<u>\$ (0.06)</u>	<u>\$ (0.03)</u>
Weighted average shares outstanding:			
Basic and diluted		<u>103,885,041</u>	<u>95,509,221</u>

Approved on behalf of the Board:

Gary Herman, Director

Andrew Mitchell, Director

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

XS Financial Inc.
Consolidated statements of financial position
As of December 31, 2022 and 2021
(Expressed in United States dollars)

	Note	December 31,	
		2022	2021
Assets			
<i>Current assets</i>			
Cash		\$ 1,040,932	\$ 17,119,026
Investments	6	1,281	85,772
Financing receivables, short-term	7	22,763,720	9,484,979
Prepaid and other current assets	8	196,796	115,097
Total current assets		24,002,729	26,804,874
<i>Non-current assets</i>			
Servicing and property equipment	9	20,376	27,386
Financing receivables, long-term	7	64,328,225	25,474,255
Total non-current assets		64,348,601	25,501,641
Total assets		\$ 88,351,330	\$ 52,306,515
Shareholders' equity and liabilities			
<i>Current liabilities</i>			
Loans and borrowings, short-term	12	\$ 66,323,801	\$ 1,287,143
Trade and other payables	10	2,468,341	1,420,604
Accrued expenses	11	6,369,637	2,968,651
Warrant derivative liabilities	13	346,207	1,805,665
Embedded derivative liabilities	12	518,000	-
Total current liabilities		76,025,986	7,482,063
<i>Non-current liabilities</i>			
Loans and borrowings, long-term	12	4,759,733	34,334,201
Embedded derivative liabilities	12	-	1,072,722
Total non-current liabilities		4,759,733	35,406,923
Total liabilities		80,785,719	42,888,986
<i>Shareholders' equity</i>			
Share capital	14	21,158,842	21,158,842
Reserves		10,245,884	8,279,809
Conversion feature - debentures		930,697	930,697
Accumulated other comprehensive income		3,161,040	673,545
Accumulated deficit		(27,930,852)	(21,625,364)
Total shareholders' equity		7,565,611	9,417,529
Total shareholders' equity and liabilities		\$ 88,351,330	\$ 52,306,515

Nature of operations and background information (Note 1)
Contingencies (Notes 12 and 18)
Subsequent events (Note 21)

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

XS Financial Inc.
Consolidated statements of changes in shareholders' equity
For the years ended December 31, 2022 and 2021
(Expressed in United States dollars)

	Note	Number of Common Shares	Number of Proportionate Common Shares	Share Capital	Reserves	Conversion feature for debentures	Accumulated other comprehensive income	Accumulated deficit	Total
Balance at January 1, 2021		32,337,724	23,107	\$ 14,688,043	\$ 3,589,233	\$ 939,534	\$ (42,789)	\$ (18,639,943)	\$ 534,078
Conversion of Sub Receipt debentures to common shares and warrants	12,13	31,818	-	13,533	9,660	(8,837)	-	-	14,356
Issuance of common shares to consultants and related parties	14	2,447,170	-	575,006	-	-	-	-	575,006
Common shares, proportionate voting shares and warrants issued in connection with private placement, net of issuance costs of \$1,504,308	13,14	40,709,731	5,251	5,882,260	3,992,871	-	-	-	9,875,131
Share-based incentive compensation	16	-	-	-	688,045	-	-	-	688,045
Net loss and comprehensive loss		-	-	-	-	-	716,334	(2,985,421)	(2,269,087)
Balance at December 31, 2021		<u>75,526,443</u>	<u>28,358</u>	<u>\$ 21,158,842</u>	<u>\$ 8,279,809</u>	<u>\$ 930,697</u>	<u>\$ 673,545</u>	<u>\$ (21,625,364)</u>	<u>\$ 9,417,529</u>
Share-based incentive compensation	16	-	-	-	1,966,075	-	-	-	1,966,075
Net loss and comprehensive loss		-	-	-	-	-	2,487,495	(6,305,488)	(3,817,993)
Balance at December 31, 2022		<u>75,526,443</u>	<u>28,358</u>	<u>\$ 21,158,842</u>	<u>\$ 10,245,884</u>	<u>\$ 930,697</u>	<u>\$ 3,161,040</u>	<u>\$ (27,930,852)</u>	<u>\$ 7,565,611</u>

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

XS Financial Inc.
Consolidated statements of cash flows
For the years ended December 31, 2022 and 2021
(Expressed in United States dollars)

	Note	Year ended December 31,	
		2022	2021
Cash flows from operating activities			
Net loss for the year		\$ (6,305,488)	\$ (2,985,421)
Adjustments to reconcile loss to net cash flows:			
Depreciation and amortization	9	17,131	17,498
Unrealized loss on investments	6	84,491	44,719
Change in fair value of derivative liabilities	12,13	(3,406,236)	(1,048,781)
Loss on debt extinguishment	12	134,350	-
Loss on investment	6	-	98,857
Gain on lease termination	7	(40,559)	(67,357)
Gain on loan forgiveness	12	-	(55,762)
Share-based incentive compensation expense	16	1,966,075	688,045
Common shares issued for services	14	-	254,001
Interest expense paid in kind	12	723,516	117,250
Accretion expense	12	3,881,943	867,285
		(2,944,777)	(2,069,666)
Change in working capital items:			
Financing receivables	7	(52,092,152)	(28,584,181)
Prepaid and other current assets	8	(81,699)	(35,864)
Trade and other payables	10	1,047,737	(843,535)
Accrued expenses	11	3,400,951	1,883,528
Net cash flows used in operating activities		(50,669,940)	(29,649,718)
Cash flows from investing activities			
Proceeds from the sale of investments	6	-	86,845
Purchases of servicing and property equipment	9	(10,121)	-
Net cash flows provided by (used in) by investing activities		(10,121)	86,845
Cash flows from financing activities			
Proceeds from issuance of private placement, net of issuance costs	14	-	9,875,131
Proceeds from the issuance of convertible notes	12	10,000,000	33,500,000
Proceeds from loans and borrowings	12	42,042,955	14,965,000
Repayment of loans and borrowings	12	(19,100,333)	(10,595,380)
Payment of debt financing and issuance costs	12	(828,185)	(2,325,176)
Net cash flows provided by financing activities		32,114,437	45,419,575
Effect of exchange rate changes on cash		2,487,530	716,334
Net increase (decrease) in cash		(16,078,094)	16,573,036
Cash at beginning of the the year		17,119,026	545,990
Cash at end of the year		\$ 1,040,932	\$ 17,119,026

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

XS Financial Inc.
Consolidated statements of cash flows
For the years ended December 31, 2022 and 2021
(Expressed in United States dollars)

Supplemental disclosure of cash flow information:

Cash paid for interest		<u>\$ 4,078,705</u>	<u>\$ 1,332,888</u>
------------------------	--	---------------------	---------------------

Non-cash investing and financing activities

Issuance of common shares to consultants, board members and related parties	14	-	575,006
Conversion of Sub Receipt convertible debt to common stock and warrants	12	-	14,355
Private placement issuance costs - warrants issued	13,14	-	442,508
Issuance of units in connection with the payment of a finance fee related to the private placement	14	-	341,659
Issuance of warrant derivative liabilities	13	161,056	1,966,775
Issuance of embedded derivative liabilities	12	1,231,000	1,960,393

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

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

(1) Nature of operations and background information

XS Financial Inc. ("XSF", or "the Company"), which changed its name from Xtraction Services Holdings Corp. on June 26, 2020 and formerly known as Caracara Silver Inc. ("Caracara") was incorporated under the laws of the Province of British Columbia on December 3, 2009 and is listed on the Canadian Securities Exchange ("CSE") under the symbol "XSF".

XSF, inclusive of its wholly-owned subsidiary Xtraction Services, Inc ("XSI"), is a specialty finance company that provides equipment leasing solutions in the United States to owner/operators of cannabis and hemp companies including cultivators, oil processors, manufacturers, testing laboratories, among others and operates in one business segment in one geographic area. Its registered office is located at 301 - 1665 Ellis Street, Kelowna, British Columbia, V1Y 2B3 and its operations address is 1901 Avenue of The Stars, Suite 120, Los Angeles, California 90067, USA.

On July 7, 2021, the Company established XSF SPC, LLC ("XSF SPC"), a Delaware limited liability company wholly owned by XSF, and utilized as a special purpose vehicle for the purpose of funding new leases under a \$15,000,000 credit facility entered into in September of 2021. In August 2022 the credit facility was terminated in conjunction with the Company entering into a new into a senior secured revolving credit facility (Note 12).

The accompanying consolidated financial statements have been approved by the Company's board of directors and are authorized for issuance as of April 25, 2023.

Basis of presentation

Statement of compliance

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards and International Accounting Standards and Interpretations (collectively IFRSs) as issued by the International Accounting Standards Board (IASB).

Basis of consolidation

Subsidiaries are entities over which the Company has control, where control is defined to exist when the Company is exposed to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Subsidiaries are consolidated from the date control is transferred to the Company and are de-consolidated from the date control ceases.

The consolidated financial statements incorporate the financial statements of the Company and its wholly owned subsidiaries, Xtraction Services, Inc. incorporated in Delaware, United States, CA Licensed Lenders LLC incorporated in California, United States, XSF SPC, LLC incorporated in Delaware, United States and CSI Princessa Inc. incorporated in Ontario, Canada. The results of subsidiaries acquired or disposed of during the year are included in the consolidated financial

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

statements of loss and comprehensive income (loss) from the effective date of acquisition up to the effective date of disposal, as appropriate.

All intercompany transactions, balances, income and expenses are eliminated upon consolidation.

Functional and presentation currency

The consolidated financial statements of the Company are presented in U.S. dollars (USD). The functional currency of the Company and CSI Princessa Inc., its Canadian subsidiary, is the Canadian dollar. The functional currency of Xtraction Services, Inc., CA Licensed Lenders LLC and XSF SPC, LLC is the U.S. dollar.

Basis of measurement

The consolidated financial statements have been prepared on the going concern and historical cost bases, except for derivative financial instruments and hybrid financial liabilities designated at fair value through net income or loss, which have been measured at fair value. Historical cost is generally based on the fair value of the consideration given in exchange for goods and services. In addition, these consolidated financial statements have been prepared using the accrual basis of accounting.

Use of estimates and judgement

The preparation of financial statements in compliance with adopted IFRS requires the use of certain critical accounting estimates. It also requires the management of the Company to exercise judgment in applying the Company's accounting policies. The areas where significant judgments and estimates have been made in preparing the consolidated financial statements and their effect are disclosed in Note 3 below.

(2) Significant accounting policies

Cash

The Company's cash consists of immediately available fund balances and is maintained at recognized US and Canadian banks. Funds maintained at US banks are insured through the FDIC. The Company maintained no cash equivalents as of December 31, 2022, and 2021.

Investments

Investments consist of marketable securities received in exchange for proportionate voting shares related to a strategic partnership and cooperation agreement (Note 6). The investments were initially recognized at fair value and are subsequently remeasured at fair value with any changes recorded as an unrealized gain or loss in the consolidated statements of loss and comprehensive loss. Any gain or loss on the disposal of investments is recorded as a realized gain or loss in the consolidated statements of loss and comprehensive loss.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

Financing receivables

Financing receivables are measured at amortized cost net of allowance for uncollectible amounts. The Company determines its expected credit loss based on a number of factors, including length of time an account is past due, the customer's previous loss history, and the ability of the customer to pay its obligation to the Company. The Company writes off receivables when they become uncollectible. Expected credit losses are included in general and administration expenses within the consolidated statements of loss and comprehensive loss. As of December 31, 2022, and 2021 the Company had no allowances for expected credit losses.

Servicing and property equipment

Servicing and property equipment is stated at the aggregate cost incurred to acquire and place the assets in service. Expenditures for routine maintenance and repairs are charged to expense as incurred and costs of improvements and renewals are capitalized.

Depreciation is provided over the estimated useful lives of the assets using the straight-line method when the assets are available for use. Depreciation of servicing and property equipment is included in administrative expenses in the consolidated statements of loss and comprehensive loss. Estimated useful lives have been determined as follows:

	<u>Estimated useful lives</u>
Computers	3 years
Machinery and equipment	5 years
Servicing equipment	5 years

Long-lived assets

Long-lived assets, such as servicing and property equipment, are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. If circumstances require a long-lived asset or asset group be tested for possible impairment, the Company estimates its recoverable amount. An impairment loss is recognized to the extent the carrying value exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value, less costs of disposal and value in use. For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows, or cash –generating units. Fair value is determined using various valuation techniques, including discounted cash flow models, quoted market values, and third-party independent appraisals, as considered necessary.

Revenue recognition

The Company's revenue is derived from providing financing for equipment and other qualified capital expenditures to cannabis companies, including cultivators, processors, manufacturers and testing laboratories. The products and services offered by the Company include the financing for the lease of equipment and processes.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

The Company recognizes revenue using the following five step model to analyze revenue transactions:

- Identify the contract(s) with a customer
- Identify the performance obligations in the contract
- Determine the transaction price
- Allocate the transaction price to the performance obligations in the contract
- Recognize revenue when (or as) the entity satisfies a performance obligation

Leasing arrangements

Interest revenue on finance leases and loans is recognized using the effective interest rate method. Ancillary finance and other fee income is recognized when earned. Each lease is classified as either a financing lease or operating lease. If a lease meets one or more of the criteria listed below and both the collectability of the minimum lease payments is reasonably predictable and there are no material uncertainties surrounding the amount of un-reimbursable costs yet to be incurred, the lease is classified as a financing lease; otherwise, it is classified as an operating lease:

- The lease transfers ownership of the asset to the customer by the end of the lease term.
- The customer has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception date that the option will be exercised.
- The lease term is for the major part of the economic life of the asset even if title is not transferred.
- At the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the asset.
- The asset is of such a specialized nature that only the customer can use it without major modifications.

The Company recognizes a finance lease when it transfers substantially all the risks and rewards incidental to ownership of the underlying servicing equipment to the customer. Financing income is separated from the contract, computed at the customer's incremental borrowing rate for equipment. When contracts contain non-lease components such as maintenance, professional services and or other deliverables, the Company separates and allocates transaction price to those individual components.

A lease in which the Company purchases assets from a customer that are controlled by the customer prior to entering into a lease agreement with the Company and which contains a bargain purchase option for the customer is determined to be a failed sale-leaseback. Similar to a finance lease the financing income is separated from the contract, computed at the customer's incremental borrowing rate for equipment. The Company completed 10 and nil failed sale-leaseback transactions in the years ended December 31, 2022, and 2021, respectively, which totaled approximately \$21,422,000 and \$nil of the financing receivables as of December 31, 2022, and 2021, respectively.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

A lease that does not transfer substantially all the risks and rewards incidental to the ownership of the asset, is determined to be an operating lease.

Financial instruments

Financial assets and liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantially all risks and rewards of ownership. Financial assets and liabilities are offset, and the net amount is reported in the statements of financial position when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis or realize the asset and settle the liability simultaneously.

At initial recognition, the Company classifies its financial instruments in the following categories depending on the purpose for which the instruments were acquired:

- a) Financial assets and liabilities at fair value through profit or loss (“FVTPL”): A financial asset or liability is classified in this category if acquired principally for the purpose of selling or repurchasing in the short term. Financial instruments in this category are recognized initially and subsequently at fair value. Transaction costs are expensed in the consolidated statements of loss and comprehensive loss. Gains and losses arising from changes in fair value are presented in the consolidated statements of loss and comprehensive loss in the year in which they arise. The Company has investments classified as FVTPL.
- b) Receivables: Receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. The Company's receivables comprise financing and other receivables and financing receivables and are initially recognized at fair value. Subsequently, receivables are measured at amortized cost using the effective interest method less a provision for impairment.

The effective interest method is a method of calculating the amortized cost of a financial liability and of allocating interest expense over the relevant period. The effective interest rate is the rate that exactly discounts the estimated future cash payments (including all fees and points paid or received that form and integral part of the effective interest rate, transaction costs and other premiums or discounts) through the expected life of the financial liability, or (where appropriate) a shorter period, to the net carrying amount on initial recognition.

- c) Financial liabilities at amortized cost: Financial liabilities at amortized cost include trade and other payables, accrued expenses, amounts due to related parties and loans and borrowings, which include the term loans and the underlying debenture component of the convertible debentures. Financial liabilities are initially recognized at fair value, net of directly attributable transaction costs.
- d) Compound financial instruments are initially measured at fair value less transaction costs directly attributable to its issue.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

The liability component of compound financial instruments is initially recognized at the fair value of a similar liability that does not have an equity component such as a conversion option. The equity component is initially recognized as the difference between the fair value of the compound financial instrument as a whole and the fair value of the liability component. Any directly attributable transaction costs are allocated to the liability and equity components in proportion to their initial carrying amounts. Subsequent to initial recognition financial liabilities are measured at amortized cost using the effective interest method. The equity component of a compound financial instrument is not remeasured.

Where the currency of the conversion price of a conversion option is different than the functional currency of the legal entity in which they were issued and when the conversion price of convertible debt is not fixed, the conversion option component is accounted for as a derivative liability. For the Company's conversion options denominated in Canadian dollars where the Company's functional currency was in U.S. dollars and for the Company's conversion options for convertible debt in which the conversion price is not fixed, the conversion option component is accounted for as a derivative liability, which is measured at fair value using the Black-Scholes and Binomial Lattice valuation models, respectively. In these cases, the liability component of a compound financial instrument is recognized at the difference between the fair value of the compound financial instrument as a whole and the fair value of the conversion option component. Any directly attributable transaction costs are allocated to the liability and conversion option components in proportion to their initial carrying amounts. Costs allocated to the derivative liability conversion feature are expensed on initial recognition.

Subsequent to initial recognition, the liability component of a compound financial instrument is measured at amortized cost using the effective interest method. The conversion option component classified as a derivative liability is subsequently revalued every reporting period using market-based valuation techniques. Gains and losses from changes in fair value are recorded in the consolidated statements of loss and comprehensive loss.

Interest related to the convertible debentures is recognized in the consolidated statements of loss and comprehensive loss. On conversion at maturity, the financial liability is reclassified to equity and no gain or loss is recognized.

Derivative liabilities

Derivative liabilities are initially recognized at fair value on the date entered into and are subsequently remeasured to their fair value at the end of each reporting period. Changes in the fair value of any derivative instrument are recognized immediately as a component of other expense in the consolidated statements of loss and comprehensive loss.

Fair value of financial instruments

The Company categorizes its financial assets and liabilities measured and reported at fair value in the consolidated financial statements on a recurring basis based upon the level of judgments associated with the inputs used to measure their fair value. Hierarchical levels, which are directly

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

related to the amount of subjectivity associated with the inputs used to determine the fair value of financial assets and liabilities, are as follows:

- *Level 1*: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities
- *Level 2*: Quoted prices in markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liabilities
- *Level 3*: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity)

Each major category of financial assets and liabilities measured at fair value on a recurring basis is categorized based upon the lowest level of significant input to the valuations. The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

Company's management assessed that cash, financing and other receivables, trade and other payables, accrued expenses, and amounts due to related parties approximate their carrying amounts largely due to the short-term maturities of these instruments. There is no organized market for the finance receivables. The carrying value is the amortized cost using the effective interest rate method which approximates fair value because contractual interest rates approximate current market rates.

The warrant derivative liabilities were valued at fair value using a Black-Scholes model (Note 13). The embedded derivative liabilities were valued using a Binomial Lattice Model analysis that probability weighted various expected conversion prices (Note 12). The estimated fair value of the warrant derivative and embedded derivative liabilities would increase or decrease if the expected volatility and conversion price was higher or lower.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

The following fair value hierarchy table presents information about each major category of the Company's financial assets and liabilities measured at fair value on a recurring basis:

	<u>Fair Value Measurement at Reporting Date Using</u>			
	<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>	<u>Total</u>
As of December 31, 2022:				
Assets:				
Investments (Note 6)	\$ 1,281	\$ -	\$ -	\$ 1,281
Liabilities:				
Warrant derivative liabilities (Note 13)	\$ -	\$ -	\$ 346,207	\$ 346,207
Embedded derivative liabilities (Note 12)	\$ -	\$ -	\$ 518,000	\$ 518,000
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 864,207</u>	<u>\$ 864,207</u>
As of December 31, 2021:				
Assets:				
Investments (Note 6)	\$ 85,772	\$ -	\$ -	\$ 85,772
Liabilities:				
Warrant derivative liabilities (Note 13)	\$ -	\$ -	\$ 1,805,665	\$ 1,805,665
Embedded derivative liabilities (Note 12)	\$ -	\$ -	\$ 1,072,722	\$ 1,072,722
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,878,387</u>	<u>\$ 2,878,387</u>

The estimated fair value of the warrant derivative and embedded derivative liabilities would increase or decrease if the expected volatility and conversion price was higher or lower. The following table shows a reconciliation during the years ended December 31, 2022 and 2021 for Level 3 fair values:

	<u>Warrant derivative liabilities</u>	<u>Embedded derivative liabilities</u>	<u>Total</u>
Balance at December 31, 2020	\$ -	\$ -	\$ -
Convertible notes conversion option (Note 12)	-	1,960,393	1,960,393
Warrants issued in connection with convertible notes (Note 13)	1,966,775	-	1,966,775
Net change in unrealized fair value	<u>(161,110)</u>	<u>(887,671)</u>	<u>(1,048,781)</u>
Balance at December 31, 2021	\$ 1,805,665	\$ 1,072,722	\$ 2,878,387
Convertible notes conversion option (Note 12)	-	1,231,000	1,231,000
Warrants issued in connection with convertible notes (Note 13)	161,056	-	161,056
Net change in unrealized fair value	<u>(1,620,514)</u>	<u>(1,785,722)</u>	<u>(3,406,236)</u>
Balance at December 31, 2022	<u>\$ 346,207</u>	<u>\$ 518,000</u>	<u>\$ 864,207</u>

Transfers between levels are considered to occur on the date that the fair valuation methodology changes. There were no transfers between levels during the current or comparative periods.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

Share-based incentive compensation

The Company accounts for share-based awards in accordance with provisions of *IFRS 2, Share Based Payments*, under which the Company recognizes the grant-date fair value of incentive-based awards issued to employees, consultants and advisors as compensation expense on a graded vesting basis over the vesting period of the award. The Company uses the Black-Scholes option pricing model to determine the grant-date fair value of restricted awards.

Equity-settled share-based payment transactions with parties other than employees are measured at the fair value of the goods or services received, except where that fair value cannot be estimated reliably, in which case they are measured at the fair value of the equity instruments granted, measured at the date the entity obtains the goods or the counterparty renders the service.

Leases

The Company as Lessor

Refer to the revenue recognition policy note.

Foreign currency translation

The functional currency accounts are translated into the presentation currency by translating assets and liabilities at exchange rates in effect at the reporting date. Equity accounts are translated at historical exchange rates. Revenues and expenses are translated at the average exchange rate for the period, if this is considered a reasonable approximate to actual rates, or at the rate on the date of the transaction. Any resulting gain or loss is recorded as a component of other comprehensive loss.

Transactions in currencies other than the functional currency are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities denominated in foreign currencies at the period-end exchange rates are recognized in profit or loss. Non-monetary items that are measured in terms of historical cost in a foreign currency are not re-translated.

Income taxes

The Company uses the asset and liability method to account for income taxes. Deferred income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the carrying amounts of existing assets and liabilities for accounting purposes, and their respective tax bases.

Deferred income tax assets and liabilities are measured using tax rates that have been enacted or substantively enacted and applied to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred income tax assets and liabilities of a change in statutory tax rates is recognized in profit or loss in the year of change.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

Deferred tax assets are recognized only if it is probable that future taxable amounts will be available to utilize those temporary differences and losses.

The Company had no uncertain tax positions for the years ended December 31, 2022 and 2021.

Earnings per share

Basic loss per share is computed by dividing the loss by the weighted average number of shares / units outstanding during the period. Diluted loss per share is computed by dividing the loss by the weighted average number of shares / units and other dilutive units outstanding during the period. For the periods presented, the effect of the dilutive instruments on loss per share / units would be anti-dilutive, therefore, basic loss per share / units equals diluted loss per share / units.

New standards and interpretations recently adopted

Effective January 1, 2022 the Company adopted the amended IAS 37 – *Provisions, Contingent Liabilities, and Contingent Assets* (“IAS 37”). The amendments clarify that when assessing if a contract is onerous, the cost of fulfilling the contract includes all costs that relate directly to the contract – i.e. a full-cost approach. Such costs include both the incremental costs of the contract (i.e. costs a company would avoid if it did not have the contract) and an allocation of other direct costs incurred on activities required to fulfill the contract – e.g. contract management and supervision, or depreciation of equipment used in fulfilling the contract. The Company has concluded there was no impact on its financial statements and related disclosures upon the adoption of the amended standard for IAS37.

New standards and interpretations not yet adopted

Certain pronouncements were issued by the IASB or the IFRIC that are mandatory for accounting periods commencing on or after January 1, 2022. Many are not applicable or do not have a significant impact to the Company and have been excluded. The following have not yet been adopted and are being evaluated to determine their impact on the Company.

IAS 1 – Presentation of Financial Statements (“IAS 1”) was amended in January 2020 to provide a more general approach to the classification of liabilities under *IAS 1* based on the contractual arrangements in place at the reporting date. The amendments clarify that the classification of liabilities as current or noncurrent is based solely on a company’s right to defer settlement at the reporting date. The right needs to be unconditional and must have substance. The amendments also clarify that the transfer of a company’s own equity instruments is regarded as settlement of a liability, unless it results from the exercise of a conversion option meeting the definition of an equity instrument. The amendments are effective for annual periods beginning on January 1, 2023. Earlier adoption is permitted. The Company will adopt these amendments as of their effective date, and is currently assessing the impacts on adoption.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

(3) Critical accounting estimates and judgements

In the application of the Company's accounting policies, which are described in Note 2 above, the Company's management are required to make judgments, estimates and assumptions about the carrying amounts of assets and liabilities that are not readily apparent from other sources. The estimates and associated assumptions are based on historical experience and other factors that are considered to be relevant. Actual results may differ from these assumptions.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods. Significant judgments, estimates and assumptions that have the most significant effect on the amounts recognized in the consolidated financial statements are described below.

Depreciation of Servicing and Property Equipment and Estimate of Useful Lives

Depreciation of servicing and property equipment is dependent upon estimates of useful lives. The Company estimates the useful lives of these assets based on the period over which the assets are expected to be available for use. The estimated useful lives are reviewed periodically and are updated if expectations differ from previous estimates due to physical wear and tear, technical or commercial obsolescence and legal or other limits on the use of the relevant assets.

Long-Lived Assets and Impairment

Long-lived assets, such as servicing and property equipment, are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. If circumstances require a long-lived asset or asset group be tested for possible impairment, the Company estimates its recoverable amount. An impairment loss is recognized to the extent the carrying value exceeds its recoverable amount. Fair value is determined using various valuation techniques, including discounted cash flow models, quoted market values, and third-party independent appraisals, as considered necessary.

Share-based Incentive Compensation

The Company determines costs for share-based payments using market-based valuation techniques. The fair value of the market-based and performance-based share awards are determined at the date of grant using generally accepted valuation techniques. Assumptions are made and judgment used in applying valuation techniques. These assumptions and judgments include estimating the future volatility of the stock price, expected dividend yield, future employee turnover rates and future employee stock option exercise behaviors and corporate performance. Such judgments and assumptions are inherently uncertain. Changes in these assumptions affect the fair value estimates. The assumptions and models used for estimating fair value for share-based payment transactions is disclosed in Note 16. The expected volatility assumptions for the Company's option and warrant grants are based on both the Company's and comparable companies' volatility.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

Derivative Liabilities

Derivative liabilities are initially recognized at fair value on the date entered and are subsequently remeasured to their fair value at the end of each reporting period. Changes in the fair value of any derivative instrument are recognized immediately as a component of the change in fair value of derivative liabilities line item in the consolidated statements of loss and comprehensive loss. The fair value of the derivative liabilities is subject to measurement uncertainty due to the assumptions made for the inputs in the valuation models. See Notes 12 and 13.

Compound Financial Instruments

The initial recognition of the compound financial instruments requires that the liability component and the conversion feature are recognized separately. Judgement is required to determine whether the conversion feature meets the definition of equity or a derivative liability. The fair values at initial recognition are subject to measurement uncertainty. See Note 12.

Functional Currency Determination

The functional currency for the Company and its subsidiaries is the currency of the primary economic environment in which the entity operates.

Determination of functional currency is conducted through an analysis of the consideration factors identified in IAS 21. The Effects of Changes in Foreign Exchange Rates may involve certain judgments to determine the primary economic environment. The Company reconsiders the functional currency of its entities if there is a change in events and conditions which determine the primary economic environment. Significant changes to those underlying factors could cause a change to the functional currency.

Determination of Discount Rates

Determination of the discount rate for term loans and convertible debentures is based on comparison to similar interest-bearing debt instruments of a group of comparative companies.

Determination of Financing Lease or Operating Lease

In making the determination of whether an arrangement should be accounted for as a financing lease or an operating lease, the Company makes certain assumptions including, the interest implicit in the lease and the residual value of the equipment at the end of the lease.

Expected Credit Losses

The Company measures loss allowances based on an expected credit loss ("ECL") impairment model for all financial instruments except those measured at FVTPL. Application of the model depends on the following credit stages of the financial assets:

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

- (i) Stage 1 - for new leases recognized and for existing leases that have not experienced a significant increase in credit risk since initial recognition, a loss allowance is recognized equal to the credit losses expected to result from defaults occurring in the next 12 months;
- (ii) Stage 2 - for those leases that have experienced a significant increase in credit risk since initial recognition, a loss allowance is recognized equal to the credit losses expected over the remaining life of the lease; and
- (iii) Stage 3 - for leases that are considered to be credit-impaired, a loss allowance equal to full lifetime ECLs is recognized.

Thus, the evaluation of the allowance for credit losses is performed on a lease-by-lease basis. Definitions of default have been selected to eliminate the judgement that may otherwise be necessary, given the diversity within the finance receivable portfolio, the lack of individual drivers of changes in credit risk across assets and over time, and the resulting inability to assess which specific assets will be rectified. For the purposes of measuring ECL, a default is defined as leases and loans that have missed one payment and are not subsequently rectified within 60 days.

The Company is entitled to repossess financed equipment if the borrower defaults on their lease obligations. Any amounts recovered from the sale of repossessed equipment are credited to the allowance for credit losses when received.

The process of estimating ECLs uses the following inputs and assumptions to reflect information about past events, current conditions and forecasts of future conditions that are not already captured in the inputs:

- Recoveries of amounts previously written off in the last 12 months, as an estimate of recoveries for the next 12 months;
- An estimate of the effects of natural disasters and economic shocks that have occurred on credit losses in the next 12 months;
- The stage of the business cycle for the industry, which considers: the competitive environment, Gross Domestic Product growth, prevailing interest rates and expectations of future rates, fiscal policy and inflation rates; and
- Current delinquency trends of non-accrual and greater than 30 days delinquency rates.

Determining the inputs listed and ECLs requires significant estimation uncertainty. The estimation and application of forward-looking information requires significant judgement.

Definition of a Business

Determination of whether a set of assets acquired, and liabilities assumed constitute a business under IFRS 3 requires the Company to make certain judgments, taking into account all facts and circumstances.

Contingencies

See Note 12 and 18.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

Income, Value Added, Withholding and Other Taxes

The Company is subject to income, value added, withholding and other taxes. Significant judgment is required in determining the Company's provisions for taxes. There are many transactions and calculations for which the ultimate tax determination is uncertain during the ordinary course of business. The Company recognizes liabilities for anticipated tax audit issues based on estimates of whether additional taxes will be due. The determination of the Company's income, value added, withholding and other tax liabilities requires interpretation of complex laws and regulations. The Company is also subject to tax regulations as they relate to flow-through financing arrangements. The Company's interpretation of taxation law as applied to transactions and activities may not coincide with the interpretation of the tax authorities. All tax related filings are subject to government audit and potential reassessment subsequent to the financial statement reporting period. Where the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the tax related accruals and deferred income tax provisions in the period in which such determination is made.

(4) Revenue

The following table presents a disaggregation of revenue by source:

	Year ended December 31,	
	2022	2021
Revenue source:		
Financing income on financing leases (Note 7)	\$ 7,480,996	\$ 3,143,562
Other revenue	86,477	15,000
	<u>\$ 7,567,473</u>	<u>\$ 3,158,562</u>

Revenue concentration

All of the Company's revenue is derived from customers in the United States with three customers representing 38%, 23%, and 17% for the year ended December 31, 2022, and 35%, 25% and 24% of the Company's recognized revenue for the year ended December 31, 2021.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

(5) Expenses by nature

The following tables presents an analysis of expense by nature:

	Year ended December 31,	
	2022	2021
Administrative expenses:		
Compensation and benefits	\$ 1,678,815	\$ 1,072,324
Share-based incentive compensation	1,966,075	688,045
Contractors and outside services	368,731	534,173
Management fee	-	171,001
Professional fees	628,998	982,358
Office rent, utilities and expenses	-	2,400
Travel, meals and entertainment	56,957	41,483
Insurance	176,548	188,672
Depreciation expense	17,131	17,498
Other expenses	327,265	139,876
	<u>5,220,520</u>	<u>\$ 3,837,830</u>
Sales and marketing expenses:		
Compensation and benefits	\$ 366,144	\$ 131,847
Contractors and outside services	-	54,700
Advertising and marketing	43,277	57,970
Other expenses	215	5,586
	<u>\$ 409,636</u>	<u>\$ 250,103</u>
Other expense (income)		
Loss on foreign currency translation	\$ 2,494,212	\$ 763,605
Loss on debt extinguishment	370,111	-
Gain on lease termination	-	(67,358)
Other income	(48,281)	(56,018)
	<u>\$ 2,816,042</u>	<u>\$ 640,229</u>

(6) Investments

The Company owns shares of Greenlane Holdings, Inc. (“Greenlane”), a NASDAQ publicly listed company. The shares are recorded as investments on the consolidated statement of financial position. Investments are classified at FVTPL. In July 2021, the Company sold an aggregate of 294,981 shares for net proceeds of \$86,845 and recorded a realized loss of \$98,857 at FVPL in the consolidated statements of loss and comprehensive loss for the year ended December 31, 2021. At December 31, 2022, and 2021 the remaining investment in Greenlane was re-valued at \$1,281 and \$85,772, respectively. The Company recorded an unrealized change in fair value,

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

resulting in losses of \$84,491 and \$44,719 in the consolidated statements of loss and comprehensive loss for the years ended December 31, 2022, and 2021, respectively.

(7) Financing receivables

The following table presents financing receivables:

	December 31,	
	2022	2021
Financing receivables, short-term	\$ 22,763,720	\$ 9,484,979
Financing receivables, long-term	64,328,225	25,474,255
	<u>\$ 87,091,945</u>	<u>\$ 34,959,234</u>

The Company has entered lease arrangements as a lessor that are considered to be finance leases. All the risks and rewards of ownership of the service equipment assets underlying the finance leases are substantially transferred to the lessee.

The following table presents a maturity analysis of financing receivables, including the undiscounted lease payments to be received as of December 31, 2022:

2023	\$ 32,479,765
2024	30,910,852
2025	21,262,762
2026	13,716,011
2027	4,681,643
Thereafter	<u>8,356,193</u>
Total undiscounted lease payments receivable	111,407,226
Unearned finance income	<u>(24,315,281)</u>
Net investment in lease	<u>\$ 87,091,945</u>

Allowance for credit losses

The Company measures loss allowances based on an expected credit loss ("ECL") impairment model for all financial instruments except those measured at FVTPL. As of December 31, 2022, there are no finance receivables past due or impaired and the Company has not recognized and loss allowance for expected credit losses on financing receivables.

Financing receivable concentration

The Company has 38%, 13%, 13% and 11% of its financing receivables with four customers as of December 31, 2022, and 37%, 33% and 18% of its financing receivables with three customers as of December 31, 2021.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

(8) Prepaid and other current assets

The following table presents prepaid and other current assets:

	December 31,	
	2022	2021
Prepaid insurance	\$ 93,227	\$ 42,369
Prepaid software costs	50,000	-
Vendor receivable	3,333	37,462
Canada tax receivable	18,036	16,550
Other	32,200	18,716
	<u>\$ 196,796</u>	<u>\$ 115,097</u>

(9) Servicing and property equipment

The following table below presents the change in carrying value of the Company's servicing and property equipment during the years ended December 31, 2022, and 2021:

	<u>Computers</u>	<u>Machinery and equipment</u>	<u>Servicing equipment</u>	<u>Total</u>
Cost:				
Balance at December 31, 2020	\$ 13,621	\$ 3,490	\$ 64,825	\$ 81,936
Additions	-	-	-	-
Balance at December 31, 2021	\$ 13,621	\$ 3,490	\$ 64,825	\$ 81,936
Additions	10,121	-	-	10,121
Balance at December 31, 2022	<u>\$ 23,742</u>	<u>\$ 3,490</u>	<u>\$ 64,825</u>	<u>\$ 92,057</u>
Accumulated Depreciation:				
Balance at December 31, 2020	\$ (7,237)	\$ (1,687)	\$ (28,128)	\$ (37,052)
Depreciation	(3,786)	(698)	(13,014)	(17,498)
Balance at December 31, 2021	\$ (11,023)	\$ (2,385)	\$ (41,142)	\$ (54,550)
Depreciation	(3,421)	(698)	(13,012)	(17,131)
Balance at December 31, 2022	<u>\$ (14,444)</u>	<u>\$ (3,083)</u>	<u>\$ (54,154)</u>	<u>\$ (71,681)</u>
Net book value:				
Balance at December 31, 2021	\$ 2,598	\$ 1,105	\$ 23,683	\$ 27,386
Balance at December 31, 2022	\$ 9,298	\$ 407	\$ 10,671	\$ 20,376

All of the servicing and property equipment is located in the United States.

Depreciation expense related to servicing and property equipment is included in administrative expenses within the consolidated statements of loss and comprehensive loss.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

(10) Trade and other payables

The following table presents trade and other payables:

	December 31,	
	2022	2021
Trade payables	\$ 2,453,664	\$ 1,416,746
Other payables	14,677	3,858
	<u>\$ 2,468,341</u>	<u>\$ 1,420,604</u>

Trade payables primarily comprise equipment purchases satisfying financing agreements with the Company's customers.

(11) Accrued expenses

The following table presents accrued expenses:

	December 31,	
	2022	2021
Accrued servicing equipment purchases	\$ 6,007,434	\$ 2,630,511
Accrued interest	58,096	-
Accrued professional fees	105,456	82,850
Accrued compensation, commissions, benefits and related taxes	52,879	224,164
Accrued sales tax	55,680	11,777
Accrued other	41,206	1,849
Unearned revenue	48,886	17,500
	<u>\$ 6,369,637</u>	<u>\$ 2,968,651</u>

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

(12) Loans and borrowings

The following table presents loans and borrowings outstanding:

Description	Maturity date	Interest rate	December 31,	
			2022	2021
Line of credits:				
Revolving credit facility	August, 2024	8.50%	\$ 24,442,955	\$ -
Term loans:				
Syndication notes	April, 2024 - July, 2025	12.00%	3,619,287	5,119,620
Convertible debentures:				
Broker debentures	March, 2024	10.00%	218,869	218,869
Sub Receipt debentures	September, 2024	10.00%	4,059,242	4,059,242
Convertible notes	October, 2023	9.50%	44,340,765	33,617,249
			<u>76,681,118</u>	<u>43,014,980</u>
Less:				
Unamortized discounts, debt issuance costs, financing costs and prepaid offering costs ⁽¹⁾			(5,597,584)	(7,393,636)
			<u>\$ 71,083,534</u>	<u>\$ 35,621,344</u>
Non-current			\$ 4,759,733	\$ 34,334,201
Current			\$ 66,323,801	\$ 1,287,143

Note to the table:

- (1) The carrying value of the broker debentures, and Sub Receipt debentures issued in 2019 were adjusted using a discount rate of 25% to reflect the prevailing borrowing rates associated with debt acquired by companies with a similar credit risk profile as the Company. The carrying value of the convertible notes issued in 2021 and 2022 are netted against discounts related to the recognition of derivative liabilities and cash issuance costs. The debt discounts are accreted over the life of the respective debt instruments using the effective interest method.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

The following table below shows the change in carrying value of the Company's loans and borrowings From January 1, 2022, through December 31, 2022:

	<u>Line of credits</u>	<u>Term loans</u>	<u>Convertible debentures</u>	<u>Debt discounts, issuance costs and deferred financing costs</u>	<u>Total</u>
Balance at December 31, 2020	\$ 750,000	\$ 55,762	\$ 4,304,720	\$ (2,020,831) ⁽¹⁾	\$ 3,089,651
Borrowings	9,200,000	5,765,000	-	-	14,965,000
Repayments	(9,950,000)	(645,380)	-	-	(10,595,380)
Issuance of convertible notes	-	-	33,500,000	(5,998,995) ⁽²⁾	27,501,005
Issuance of additional convertible notes as payment for PIK Interest	-	-	117,250	-	117,250
Conversion of Sub Receipt convertible debenture	-	-	(26,610)	12,255	(14,355)
Loan forgiveness	-	(55,762)	-	-	(55,762)
Deferred financing costs	-	-	-	(253,350) ⁽³⁾	(253,350)
Amortization and accretion of debt discounts, financing costs and debt issuance costs	-	-	-	867,285	867,285
Balance at December 31, 2021	\$ -	\$ 5,119,620	\$ 37,895,360	\$ (7,393,636)	\$ 35,621,344
Borrowings	42,042,955	-	-	-	42,042,955
Repayments	(17,600,000)	(1,500,333)	-	-	(19,100,333)
Issuance of convertible notes	-	-	10,000,000	(1,892,056) ⁽⁴⁾	8,107,944
Issuance of additional convertible notes as payment for PIK Interest	-	-	723,516	-	723,516
Deferred financing costs	-	-	-	(328,185) ⁽³⁾	(328,185)
Loss on debt extinguishment	-	-	-	134,350 ⁽⁵⁾	134,350
Amortization and accretion of debt discounts, financing costs and debt issuance costs	-	-	-	3,881,943	3,881,943
Balance at December 31, 2022	<u>\$ 24,442,955</u>	<u>\$ 3,619,287</u>	<u>\$ 48,618,876</u>	<u>\$ (5,597,584)</u>	<u>\$ 71,083,534</u>

Notes to the table:

- (1) Represents debt discounts on loan borrowing proceeds and convertible debt issuances, and debt issuance costs netted against the gross proceeds of the Sub Receipt debenture issuance in 2019.
- (2) Represents debt discounts of \$3,927,168 on the convertible notes issuance in 2021 of which \$1,960,393 is allocated to embedded derivative liabilities, and \$1,966,775 is allocated to warrant derivative liabilities, and \$2,071,827 of debt issuance costs netted against the gross proceeds of the convertible notes.
- (3) Represents deferred financing costs related to the Company's line of credit borrowings.
- (4) Represents debt discounts of \$1,392,056 on the convertible notes issuance in 2022 of which \$1,231,000 is allocated to embedded derivative liabilities, and \$161,056 is allocated to warrant derivative liabilities, and \$500,000 of debt issuance costs netted against the gross proceeds of the convertible notes.
- (5) Represents unamortized deferred financing costs written off as the result of the payoff of a line of credit and reflected as a loss on debt extinguishment within the other expense line item in the consolidated statements of loss and comprehensive loss for the year ended December 31, 2022.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

Loans and borrowings (excluding interest), assuming no prepayments are scheduled to be repaid as follows:

<u>As of December 31,</u>	
2023	\$ 70,469,116
2024	5,839,009
2025	<u>372,993</u>
	<u>\$ 76,681,118</u>

Convertible debentures

In October 2021, the Company completed a private placement of unsecured convertible debenture notes (“convertible notes”) in the aggregate principal amount of \$43,500,000, of which \$33,500,000 million was funded at closing with an additional \$10,000,000 available on a delayed draw on the same terms until June 30, 2022. In June 2022, the Company extended the terms on the delayed draw until December 31, 2022, and in October 2022, the Company drew down on the additional \$10,000,000 netting gross proceeds of \$9,500,000. The convertible notes mature in October 2023 subject to a one-year extension at the option of the Company upon providing at least 30 days prior notice and issuing additional convertible notes to the holders on a pro-rata basis in an aggregate principal amount equal to 1% of the aggregate principal amount of the convertible notes outstanding as of the date of the extension notice. Additionally, as part of the transaction, one purchaser was entitled to a seat on the Company’s board of directors. The convertible notes are subject to a quarterly total leverage ratio financial covenant, which the Company was not in compliance with as of December 31, 2022. The Company has received a waiver for the noncompliance.

The principal amount outstanding under the convertible notes may be converted by the holders at any time prior to the third business day prior to maturity into Shares at a conversion price equal to the lesser of: (i) CAD\$0.35 per Share; or (ii)(a) the last offering price per security (the “Qualified Offering Price”) in one or more prospectus offerings of Shares completed by the Company within 12 months of the closing of the Offering to raise aggregate gross proceeds of at least US\$5,000,000 (a “Qualified Offering”) if the date of conversion is prior to the commencement of marketing of such Qualified Offering; or (b) 125% of the Qualified Offering Price if the date of conversion is after the commencement of marketing of such Qualified Offering, all in accordance with the terms and conditions of the notes.

Interest on the convertible notes accrue at the rate of (i) 9.50% per annum, of which 7.50% shall be payable in cash and the remaining 2.00% shall be payable in kind by the issuance of additional convertible notes (“PIK Interest”) and (ii) in the event of the Shares commence trading on a market tier of the Nasdaq Stock Market LLC (a “NASDAQ Listing”), interest shall accrue at a rate of 8.00% per annum, of which 6.00% shall be payable in cash, and the remaining 2.00% shall be payable as PIK Interest.

In the event of a change of control of the Company, XSF shall be required to redeem the convertible notes at a repurchase price equal to the greater of (i) 101% of the principal amount thereof, plus accrued and unpaid interest; and (ii) the product of (x) the number of Shares issuable

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

upon conversion of the convertible notes to be redeemed and (y) the “transaction price” of such change of control, payable in the same form and amount as would be payable on the underlying Shares, all in accordance with the terms and conditions of the notes.

The Company also issued an aggregate of 21,750,000 share purchase warrants being one warrant for each US\$2.00 principal amount of convertible notes (Note 13). The warrants to be received have an exercise price of a \$0.45CAD (\$0.33 - \$0.36) and have a three-year term.

The principal amount of the convertible notes issued in October 2022 of \$10,000,000 and October 2021 of \$33,500,000 was estimated at fair values of \$8,769,000 and \$31,539,607 at issuance with the differences of \$1,231,000 and \$1,960,393 reflected as an embedded derivative liability for the conversion feature and offset against the convertible notes carrying value as a discount. The discounts will be amortized to interest expense over the life of the convertible notes under the effective interest rate method. Additionally, the Company incurred debt issuance costs, netted against the gross proceeds of the issuance, of \$2,571,826 in connection with the issuance of the convertible notes. The debt issuance costs were recorded as a discount on the convertible notes carrying value and are being amortized to interest expense over the life of the convertible notes under the effective interest rate method.

In July 2021, an investor exercised their conversion feature on \$35,000CAD (\$26,611) of the Sub Receipt debentures and received 31,818 common shares and warrants, respectively.

In March and April 2019, the Company issued \$294,000CAD (\$218,869) of convertible debentures to investment advisors and brokers for services rendered in raising debt subscriptions (“broker debentures”). The broker debentures mature after 5 years and bear interest at a rate of 10% per annum payable in cash in equal quarterly installments. The broker debentures convert into common shares and warrants at a conversion price of \$1.10CAD (\$0.82) at the holders’ option prior to maturity or upon a change of control. The warrants to be received have an exercise price of a \$1.50CAD (\$1.12) and have a five-year term. Upon a change in control, the Company is required to purchase the broker debentures at a price of 105% of the principal balance plus accrued, unpaid interest. The Company has accounted for the fair value of the convertible debt at issuance of \$218,869 as debt issuance costs, within the consolidated statements of financial position and is being amortized to interest expense over the term of the Sub Receipt debentures under the effective interest rate method within the consolidated statements of loss and comprehensive loss. The debt discount of \$160,499 is being amortized to interest expense over the term of the broker debentures under the effective interest rate method within the consolidated statements of loss and comprehensive loss. As of September 11, 2019, with the completion of the reverse acquisition, the broker debentures were re-issued through the legal parent entity and the underlying functional currency change triggered a reclassification of the debenture liability to equity. The fair value of the debenture liability as at September 11, 2019 immediately prior to the reclassification was \$145,989.

In March and April 2019, the Company completed a private placement of 5,882 subscription receipts for aggregate gross proceeds of approximately \$5,882,000CAD (\$4,500,000) and closing costs of approximately \$560,000 CAD (\$426,000). The subscription receipts were held in escrow, until satisfaction of the escrow release conditions, at which time each subscription receipt would be convertible into one 10% unsecured convertible debenture of the Company in the principal

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

amount of \$1,000CAD (“Sub Receipt debenture”). On September 11, 2019, the escrow conditions were met, and the Company issued \$5,882,000CAD (\$4,472,085) of convertible debentures (“Sub Receipt debentures”) to various investors. The Sub Receipt debentures mature after 5 years and bear interest at a rate of 10% per annum payable in cash in equal quarterly installments. The Sub Receipt debentures convert into common shares and warrants at a conversion price of \$1.10CAD (\$0.82) at the holders’ option prior to maturity or upon a change of control. The warrants to be received have an exercise price of a \$1.50CAD (\$1.12) and have a five-year term. Upon a change in control the Company is required to purchase the Sub Receipt debentures at a price of 105% of the principal balance plus accrued, unpaid interest.

The principal amount of the debenture was estimated at its fair value of \$2,630,804 based on a discount rate of 25%. The Company incurred debt issuance costs, netted against the gross proceeds of the issuance, of \$1,398,268CAD (\$1,060,821) in connection with the issuance of the Sub Receipt debentures, of which \$821,332CAD (\$623,112) was allocated to the debenture liability. The debt issuance costs were recorded as a discount on the Sub Receipt debentures carrying value and are being amortized to interest expense over the life of the sub receipts convertible debentures under the effective interest rate method. The residual value of the debenture of \$1,841,281 was allocated to the conversion feature and recorded as a component of equity, net of issuance costs of \$437,709 and deferred tax impact of \$384,000.

Line of credits

In August 2022, the Company entered into a senior secured revolving credit facility (“revolving credit facility”) with two FDIC insured banks and a maximum borrowing base of \$24,000,000. In December of 2022 the revolving credit facility was amended to increase the maximum borrowing base to \$39,000,000. The revolving credit facility has a term of two years, expiring in August 2024, and bears interest at an annual rate equal to the greater of (i) 6.0% per annum or (ii) Wall Street Journal Prime plus 1.0% and may be prepaid with no penalty at any time. The revolving credit facility is subject to a quarterly minimum interest expense ratio financial covenant, which are waived for compliance until the first quarter of 2023. The revolving credit facility is secured by substantially all of the assets of the Company. The Company incurred fees and financing costs of \$333,588, which were recorded net of the revolving credit facility carrying value and are being amortized to interest expense over the life of the revolving credit facility under the effective interest rate method.

In September 2021, the Company entered into a secured term loan credit facility (“credit facility”), with a maximum borrowing base of \$15,000,000 and required monthly interest payments with all unpaid principal and interest due in September 2023. In August 2022, in conjunction with the Company entering its revolving credit facility the Company repaid and terminated the credit facility arrangement. The credit facility bore interest at an annual rate equal to the Wall Street Journal Prime plus 8.5% with a prime rate floor of no less than 3.25%. The credit facility was subject to monthly financial covenants such as maintaining a minimum tangible net worth, EBITDA and default rates such as defined in the agreement.

Under the credit facility, the Company sold financing arrangements (“finance receivables”) to XSF SPC, LLC (“SPC”), a wholly-owned limited liability company of XSF. In turn, SPC grants, without recourse, a senior undivided interest in the financed receivables and the underlying

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

equipment to the lender in exchange for cash while maintaining a subordinated undivided interest, in the form of over-collateralization, in the leased receivables. The Company agreed to continue servicing the receivables for SPC at market rates; accordingly, no servicing asset or liability has been recorded. Although SPC is a wholly-owned consolidated subsidiary of the Company, SPC is legally separate from the Company and its subsidiaries. Upon and after the sale or contribution of the lease receivables to SPC, such lease receivables are legally assets of SPC, and as such are not available to creditors of other subsidiaries or the parent company.

The Company was subject to certain fees under the credit facility including an origination fee equal to the greater of \$25,000 or 1% of the Company's first borrowing and 1% of each loan borrowing thereafter with a minimum fee of \$75,000 in the first year of the credit facility. Additionally, the Company was subject to an anniversary fee due equal to the greater of \$37,500 or 0.50% of the outstanding credit facility balance on each anniversary of the credit facility agreement. The Company incurred fees and financing costs of \$231,029, which were recorded net of the credit facility carrying value and were being amortized to interest expense over the life of the credit facility under the effective interest rate method. In August 2022 the remaining unamortized financing costs of \$134,350 were written off, and the Company incurred early termination fees of \$224,754 related to the termination of the credit facility arrangement. The Company recorded a total of \$359,104 as a loss on debt extinguishment within the other expense line item in the consolidated statements of loss and comprehensive loss for the year ended December 31, 2022.

In November 2020, the Company entered into a senior secured revolving credit facility ("line of credit"), with a maximum borrowing base of \$2,000,000 and required monthly interest payments with all principal and unpaid interest payments due in November 2022. In July 2021, the Company increased the maximum borrowing base to \$4,000,000. In August 2022, in conjunction with the Company entering its revolving credit facility the Company repaid and terminated the line of credit arrangement. The line of credit bore interest at an annual rate equal to the greater of (i) 8.0% per annum or (ii) the Wall Street Journal Prime plus 4.0% and may be prepaid with no penalty at any time. The line of credit was subject to monthly financial covenants such as maintaining a maximum total leverage ratio and tangible net worth, such as defined in the agreement. The line of credit was secured by substantially all of the assets of the Company. The Company incurred financing costs of \$22,321 related to the increase in the line of credit borrowing base. The financing costs were recorded net of the line of credit carrying value and were being amortized to interest expense over the life of the line of credit under the effective interest rate method. The Company incurred unused facility fees of \$11,005 related to the termination of the line of credit arrangement, which was reflected as a loss on debt extinguishment within the other expense line item in the consolidated statements of loss and comprehensive loss for the year ended December 31, 2022.

Term loans

In February 2021, the Company launched its syndication platform by way of entering into promissory note agreements ("syndication notes") with third-party lenders totaling \$5,765,000 with maturity dates ranging from April 2024 to July 2025. The syndication notes bear interest at rates between 10.25% and 12% per annum, payable monthly. Each syndication note is secured by

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

the lease payment streams and the underlying equipment of certain finance leases the Company has entered into with customers.

Summary of financing expense, net

The following table below details financing expense, net:

	Year ended December 31,	
	2022	2021
Financing expense:		
Convertible debentures	\$ 3,869,813	\$ 1,007,778
Term loans	520,496	264,796
Line of credits	476,256	177,565
Other	-	3,602
	<u>\$ 4,866,565</u>	<u>\$ 1,453,741</u>

Embedded derivative liabilities

The conversion feature of the convertible notes was considered an embedded derivative liability as the conversion price is not fixed. The Company performed a Binomial Lattice Model analysis that probability weighted various expected conversion prices, resulting in fair values at issuance of \$2,420,179CAD (\$1,960,393) for the October 2021 issuance, and \$1,692,050CAD (\$1,231,000) for the October 2022 issuance. The embedded derivative liabilities are reflected as a short-term liability within the consolidated statements of financial position.

At December 31, 2022 and 2021 the embedded derivative liabilities were re-valued at \$702,897CAD (\$518,000) and \$1,355,971CAD (\$1,072,722) with changes in fair value of \$(1,884,074)CAD (\$1,785,722) and \$(1,064,208)CAD (\$887,671) reflected in the consolidated statements of loss and comprehensive loss for the years ended December 31, 2022 and 2021, respectively.

The fair value of the embedded derivative liabilities was determined using a Binomial Lattice Model with the following assumptions as of December 31, 2022, and 2021 and at issuance

	December 31,		At issuance	
	2022	2021	October 6, 2022	October 28, 2021
Expected dividend yield	-	-	-	-
Expected volatility	147.5% - 150.1%	100.0%	153.0%	100.0%
Risk-free interest rate	4.5%	0.7%	4.2%	0.5%
Expected term	0.8 years	1.8 years	1 year	2 years
Conversion / share price	\$ Various	\$ Various	Various	Various

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

(13) Warrants

The following table summarizes warrant activity for the years ended December 31, 2022, and 2021:

	<u>Number of warrants</u>	<u>Weighted average exercise price per share</u>
Outstanding at December 31, 2020	7,375,077	\$ 1.06
Granted	59,850,200	\$ 0.39
Expired	<u>(586,818)</u>	<u>\$ 0.82</u>
Outstanding at December 31, 2021	66,638,459	\$ 0.46
Granted	<u>5,000,000</u>	<u>\$ 0.33</u>
Outstanding at December 31, 2022	<u>71,638,459</u>	<u>\$ 0.45</u>

Warrant issuances

In October 2022, in connection with the issuance of additional unsecured convertible notes related to the Company's October 2021 private placement of unsecured convertible notes (Note 12), the Company issued 5,000,000 of common share warrants. The warrants have a term of three years and an exercise price of \$0.45CAD (\$0.33) per share. The warrants had a value of \$0.07CAD (\$0.05) on the date of issue based on the allocation of the total carrying value of the convertible notes using the Black-Scholes option pricing model. The Company recorded \$220,049CAD (\$161,056) as a derivative liability as the exercise price is not fixed with an offset reflected as a discount to carrying value of the convertible notes within the consolidated statements of financial position.

In October 2021, in connection with the private placement of unsecured convertible notes (Note 12), the Company issued 16,750,000 of common share warrants. The warrants have a term of three years and an exercise price of \$0.45CAD (\$0.36) per share. The warrants had a value of \$0.15CAD (\$0.13) on the date of issue based on the allocation of the total carrying value of the convertible notes using the Black-Scholes option pricing model. The Company recorded \$2,395,079CAD (\$1,966,775) as a derivative liability as the exercise price is not fixed with an offset reflected as a discount to carrying value of the convertible notes within the consolidated statements of financial position.

At December 31, 2022 and 2021, the warrant derivative liabilities were re-valued using the Black-Scholes option pricing model at \$468,472CAD (\$346,207), and \$2,250,527CAD (\$1,805,665), respectively, with the change in fair value of \$(2,002,104)CAD (\$(1,620,514)) and \$(144,552)CAD (\$(161,110)) reflected in the consolidated statements of loss and comprehensive loss for the years ended December 31, 2022 and 2021, respectively.

In July 2021, the Company issued 31,818 of warrants related to the conversion of Sub Receipt debentures (Note 12). The warrants have a term of five years and exercise price of \$1.50CAD (\$1.20) per share. The warrants had a value of \$9,660 on the date of issue based on the allocation

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

of the total carrying value of the debenture liability and conversion feature using the Black-Scholes option pricing model.

In March 2021, the Company issued 40,709,731 common share warrants, of which 1,450,000 of the warrants were satisfaction for a corporate financing fee, and 5,251 proportionate voting share warrants related to a private placement equity issuance (Note 14). The warrants have a term of two years and exercise prices of \$0.45CAD (\$0.36) per share for the common share warrants and \$450CAD (\$360) per share for the proportionate voting share warrants. The non-corporate financing fee warrants had a value of \$5,377,706CAD (\$4,267,007) on the date of issue using the Black-Scholes option pricing model and were recorded as a component of equity within the consolidated statements of financial position. The corporate financing fee warrants had a value of \$175,194CAD (\$137,595) on the date of issue using the Black-Scholes option pricing model and were recorded as a component of equity as non-cash equity issuance costs within the consolidated statements of financial position.

In connection with the private placement the Company issued an additional 2,353,400 common share warrants to brokers and agents for services rendered in the private placement equity issuance. The warrants entitle the holder to acquire one unit at a price of \$0.30CAD (\$0.24) for a period of two years from the date of issuance. Each unit consists of one common share and one warrant. The warrants to be received have an exercise price of a \$0.45CAD (\$0.36) and have a two-year term. The warrants had a value of \$561,809CAD (\$442,508) on the date of issue using the Black-Scholes option pricing model and were recorded as a component of equity as non-cash equity issuance costs within the consolidated statements of financial position.

The grant date fair value of the warrants was determined using the Black-Scholes option pricing model with the following assumptions as of December 31, 2022, and 2021 and at issuance:

	Expected dividend yield	Expected volatility	Risk-free interest rate	Expected term	Conversion / share price
Convertible debenture issuances:					
Common share warrants at December 31, 2022	-	145.4%	3.8%	1.8 years	\$ 0.33 - 0.36
Common share warrants issued in 2022	-	145.3%	3.8%	2 years	\$ 0.33
Common share warrants at December 31, 2021	-	145.7%	0.1%	2.8 years	\$ 0.36
Common share warrants issued in 2021	-	147.4%	0.1%	3 years	\$ 0.36
Equity issuances:					
Common share warrants issued in 2021	-	156.3%	0.1%	2 years	\$ 0.36
Proportionate voting share warrants issued in 2021	-	156.3%	0.1%	2 years	\$ 360.00
Broker warrants issued in 2021	-	156.3%	0.1%	2 years	\$ 0.24
Sub receipt debenture conversion:					
Common share warrants issued in 2021	-	150.1%	1.0%	5 years	\$ 1.20

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

The following table presents warrants outstanding at December 31, 2022:

<u>Expiration date</u>	<u>Term (years)</u>	<u>Number of warrants outstanding</u>	<u>Number of warrants exercisable</u>	<u>Exercise price US \$</u>	<u>Exercise price CAD \$</u>
Common share warrants:					
3-Mar-23	2	40,709,731	40,709,731	\$ 0.36	\$ 0.45
3-Mar-23	2	2,353,400	2,353,400	\$ 0.36	\$ 0.45
12-Apr-24	5	500,000	500,000	\$ 0.82	\$ 1.10
11-Sep-24	5	374,308	374,308	\$ 0.82	\$ 1.10
11-Sep-24	5	5,452,134	5,452,134	\$ 1.12	\$ 1.50
11-Sep-24	5	363,636	363,636	\$ 1.13	\$ 1.50
11-Sep-24	5	50,000	50,000	\$ 1.14	\$ 1.50
11-Sep-24	5	22,727	22,727	\$ 1.16	\$ 1.50
11-Sep-24	5	25,454	25,454	\$ 1.05	\$ 1.50
11-Sep-24	5	31,818	31,818	\$ 1.20	\$ 1.50
28-Oct-24	3	16,750,000	16,750,000	\$ 0.36	\$ 0.45
28-Oct-24	2	5,000,000	5,000,000	\$ 0.33	\$ 0.45
Proportionate voting share warrants:					
3-Mar-23	2	5,251	5,251	\$ 355.55	\$ 450.00
Total		<u>71,638,459</u>	<u>71,638,459</u>		

The weighted average remaining term for outstanding warrants is 0.8 years, and the weighted average exercise price is \$0.58CAD (\$0.45) as at December 31, 2022.

(14) Share capital

As at December 31, 2022 and December 31, 2021, the Company has an unlimited number of authorized common and proportionate voting shares with no par value. Proportionate voting shares can be converted into common shares at the option of the holders at a ratio of 1,000 to 1 upon approval of the Company's Resulting Issuer Board and satisfaction of the condition that greater than 40% of common and proportionate shareholders are US residents. On all voting matters, common shareholders are entitled to one vote and proportionate voting shareholders are entitled to 1,000 votes per proportionate voting share. Generally, in all other matters the proportionate voting shareholders have the same rights as the common shareholders and will be treated as if they were one class of shares. At December 31, 2022 and December 31, 2021, the Company had 75,526,443 issued and outstanding common shares and 28,358 issued and outstanding proportionate voting shares, respectively.

Share issuances

In July 2021, the Company issued 31,818 common shares, respectively, on the conversion of Sub Receipt debentures (Note 12). Total shareholders' equity increased \$14,356 as a result of this conversion.

In March and June 2021, the Company issued 2,447,170 common shares at share prices ranging between \$0.22CAD (\$0.19) and \$0.37CAD (\$0.30), based on the value of the services provided,

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

to consultants and a related party (Archytas) (Note 18), as consideration for services performed. The Company recorded \$404,563CAD (\$321,005) for 1,348,542 of the common shares issued as a reduction to accrued expenses for previously accrued bonuses, within the consolidated statements of financial position, and \$102,654CAD (\$85,000) and \$314,293CAD (\$254,001) for the remaining 1,098,628 of common shares issued as general and administrative expense, within the consolidated statements of loss and comprehensive loss for the year ended December 31, 2021.

In February and March 2021, the Company received gross proceeds of \$13,353,219CAD (\$10,595,270), including \$1,575,300 CAD (\$1,249,940) from a related party Archytas (Note 18), net of cash issuance costs of \$914,667CAD (\$720,141), from the issuance of 39,259,731 units at a price \$0.30CAD (\$0.24) and 5,251 proportionate voting units at a price \$300CAD (\$238). Each unit consists of one common share and one warrant. The warrants to be received have an exercise price of a \$0.45CAD (\$0.36) and \$450CAD (\$360) for the units and proportionate voting units, respectively, and have a two-year term (Note 13). The Company recorded \$7,975,513CAD (\$6,328,263) of the unit value as share capital with the residual value of \$5,377,706CAD (\$4,267,007) allocated to warrants (Note 13) and recorded as a component of equity within the consolidated statements of financial position.

In connection with the private placement in February and March 2021, the Company issued an additional 2,353,400 warrants to brokers and agents which entitled the holder to acquire one unit at a price of \$0.30CAD (\$0.24) for a period of two years from the date of issuance (Note 13), and an aggregate of 1,450,000 units in satisfaction of a corporate finance fee. Each unit consists of one common share and one warrant. The warrants to be received have an exercise price of a \$0.45CAD (\$0.36) and have a two-year term. The corporate financing fee common shares had a value of \$259,824CAD (\$204,064) on the date of issue using the Black-Scholes option pricing model and were recorded as a component of equity as non-cash equity issuance costs within the consolidated statements of financial position.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

(15) Income taxes

Provision for income taxes

Major items causing the Company's effective income tax rate to differ from the combined Canadian federal and provincial statutory rate of 29.0% (2021 – US federal and state statutory rate of 21.0%) were as follows:

	<u>Year ended December 31,</u>	
	<u>2022</u>	<u>2021</u>
(Loss) before income taxes	\$ (6,305,488)	\$ (2,985,421)
Expected income tax recovery based on statutory rate	(1,324,000)	(627,000)
Adjustment to expected income tax benefit:		
Permanent differences	417,000	141,000
Other	245,000	51,000
State taxes	(854,000)	-
Change in benefit of tax assets not recognized	<u>1,516,000</u>	<u>435,000</u>
Deferred income tax recovery	<u>\$ -</u>	<u>\$ -</u>

Deferred income tax

The nature of deferred tax assets that have not been recognized because it is not probable that future taxable profit will be available against which the Company can use the benefits therefrom is summarized as follows:

	<u>December 31,</u>	
	<u>2022</u>	<u>2021</u>
Unrecognized Deferred Tax Assets		
Deferred income tax assets have not been recognized in respect of the following deductible temporary differences:		
Non-capital loss carry-forwards	\$ 27,003,000	\$ 17,092,000
Share issue costs	110,000	331,000
Other temporary differences	<u>(1,777,000)</u>	<u>(1,381,000)</u>
Total	<u>\$ 25,336,000</u>	<u>\$ 16,042,000</u>

As at December 31, 2022, the Company had Canadian non-capital losses of approximately \$3,546,000 CAD (\$4,613,000) (2021 - \$5,113,000) that expire from 2031 to 2040. As at December 31, 2022, the Company had United States net operating losses of approximately \$11,962,000 (2021 - \$11,967,000) that can be carried forward indefinitely, and state operating losses of approximately \$10,428,000 that will begin to expire in 2028.

Deferred tax assets have not been recognized in respect of these items because it is not probable that future taxable profit will be available against which the Company can use the benefits.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

(16) Share-based compensation

In September 2019, the Company established the Omnibus Incentive Plan (“Incentive Plan”) which replaced and governs all options under the Company’s previously issued 2018 Stock Option Plan. The Omnibus plan was revised in August 2021 and 2022. The Incentive Plan provides for the granting of up to 15% of outstanding shares and is not to exceed a maximum of 75,000,000 share-based equity incentive compensation awards such as stock options and restricted stock awards to directors, officers, employees, contractors, and advisors, as determined by the Company’s board of directors.

In January, June and October 2022, the Company granted a total of 15,743,035 options to employees, directors and consultants of the Company with exercise prices ranging between \$0.13CAD (\$0.09) and \$0.18CAD (\$0.14). The options have terms of five years, with vesting terms either immediately or over three years. A total of 10,813,040 stock options were granted to directors and officers.

In March, April, June and September 2021, the Company granted a total of 13,648,840 options to employees, directors and consultants of the Company with exercise prices ranging between \$0.20CAD (\$0.16) and \$0.33CAD (\$0.27). The options have terms of five years, with vesting terms either immediately or over three years. A total of 8,686,946 stock options were granted to directors and officers.

In February 2022 the Company and a related party mutually cancelled 50,000 issued options, and the Company and an unrelated party mutually cancelled 427,500 issued options. Throughout the year ended December 31, 2021 the Company cancelled 450,875 issued options as a result of the resignation of certain employees.

The per-share grant date weighted average fair value of stock options was estimated at \$0.12 and \$0.18 on the date of grant for years ended December 31, 2022 and 2021, respectively, using the Black-Scholes option pricing model with the following weighted average assumptions:

	Year ended December 31,	
	2022	2021
Expected dividend yield	-	-
Expected volatility	146.0% - 159.6%	148.3% - 156.5%
Risk-free interest rate	1.6% - 4.2%	0.1%
Expected term	3.5 - 5.0 years	3.5 years
Share price	\$ 0.09 - 0.14	\$ 0.16 - 0.27

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

The following table summarizes stock option activity under the Option Plan for the years ended December 31, 2022, and 2021:

	Number of shares	Weighted average exercise price per share	Weighted average remaining contractual term (years)
Outstanding at December 31, 2020	4,685,583	\$ 0.30	4.9
Granted	13,648,840	\$ 0.18	
Cancelled / forfeited	<u>(450,875)</u>	\$ 0.21	
Outstanding at December 31, 2021	17,883,548	\$ 0.21	4.5
Granted	15,743,035	\$ 0.14	
Cancelled / forfeited	<u>(477,500)</u>	\$ 0.60	
Outstanding at December 31, 2022	<u>33,149,083</u>	\$ 0.17	3.7
Exercisable and vested at December 31, 2022	<u>18,526,701</u>	\$ 0.18	3.6

As of December 31, 2022, there was approximately \$931,000 of unrecognized compensation expense related to unvested stock options, which is expected to be recognized over a weighted average period of 1.6 years.

The Company recorded compensation expense for stock options of \$1,966,075 and \$688,045 for the years ended December 31, 2022, and 2021, respectively.

The following table summarizes the stock options outstanding as at December 31, 2022:

Expiry Date	Exercise Price US \$	Exercise Price CAD \$	Weighted Average Remaining Contractual Life (years)	Number of Options Outstanding	Number of Options Vested
July 2028	\$ 0.60	\$ 0.78	5.55	539,194	539,194
November 2024	\$ 0.26	\$ 0.34	1.90	1,730,000	1,730,000
April 2025	\$ 0.16	\$ 0.22	2.30	1,471,449	1,471,449
December 2025	\$ 0.18	\$ 0.23	2.95	16,565	16,565
March 2026	\$ 0.26	\$ 0.33	3.23	1,880,180	1,005,180
April 2026	\$ 0.27	\$ 0.33	3.32	360,000	360,000
June 2026	\$ 0.25	\$ 0.30	3.44	148,660	148,660
September 2026	\$ 0.16	\$ 0.20	3.69	11,260,000	5,630,000
January 2027	\$ 0.14	\$ 0.18	4.08	14,917,080	7,147,767
June 2027	\$ 0.14	\$ 0.18	4.42	327,229	327,229
October 2027	<u>\$ 0.09</u>	<u>\$ 0.13</u>	<u>4.78</u>	<u>498,726</u>	<u>150,657</u>
	<u>\$ 0.17</u>	<u>\$ 0.22</u>	<u>3.73</u>	<u>33,149,083</u>	<u>18,526,701</u>

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

(17) Retirement plan

The Company sponsors a defined contribution 401(k) retirement plan (“401(k) Plan”) that allows eligible employees to contribute a portion of their compensation through payroll deductions. The retirement plan is a deferred salary arrangement under Section 401(k) of the Internal Revenue Code. Under the 401(k) Plan, participating U.S. employees may defer a portion of their pre-tax earnings, up to the U.S. Internal Revenue Service annual contribution limit (\$20,500 for calendar year 2022). Participants are eligible to receive a matching contribution from the Company of 100% of the first 4% of contributions. The Company contributed \$38,540 and \$nil to the plan for the years ended December 31, 2022 and 2021, respectively.

(18) Related party transactions

The following presents balances and transactions between the Company and other related parties as of December 31, 2022 and 2021, and for the years ended December 31, 2022 and 2021, respectively.

Key management personnel

Key employees include executive management with the authority and responsibility for planning, directing and controlling the activities of the Company. The following table presents compensation and benefit expenses of key employees:

	Year ended December 31,	
	2022	2021
Salaries, contractor costs, management fees and benefits	\$ 975,521	\$ 1,021,075
Incentive compensation (non-cash)	1,011,317	367,741
	<u>\$ 1,986,838</u>	<u>\$ 1,388,816</u>

See also Notes 14 and 16.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

Related party transactions and amounts due to related parties

The following table presents expenses incurred and paid on behalf of the Company from related parties for the years ended December 31, 2022 and 2021:

	<u>Archytas</u> ⁽¹⁾
Amounts due to related parties at December 31, 2020	\$ 256,486
Management fee	171,001
Operating expenses	1,849
Less payment through issuance of common shares	(426,001)
Less payments to related parties	<u>(1,486)</u>
Amounts due to related parties at December 31, 2021	\$ 1,849 ⁽²⁾
Operating expenses	21,242
Less payments to related parties	<u>(17,277)</u>
Amounts due to related parties at December 31, 2022	<u>\$ 5,814</u> ⁽²⁾

Notes to table:

(1) Archytas is a shareholder of the Company, having been involved in the initial formation of XSI.

(2) Reflected as a component of accrued expenses within the consolidated statements of financial position.

In March 2021, the Company received gross proceeds of \$1,249,940 from Archytas related to the issuance of 5.251 proportionate voting shares to Archytas (Note 14).

In January 2019, the Company entered into a management services agreement with Archytas at a monthly rate of \$28,667 and a term of five years, with one-year automatic renewals, whereby Archytas will provide day-to-day executive management and support to the Company. In March and June 2021, the Company authorized the issuance of 1,890,824 common shares to Archytas as payment for a 2020 management fee bonus and the 2021 first and second quarter management fees (Note 14). The Company recorded \$255,000 as a reduction to accrued expenses for previously accrued bonuses, within the consolidated statements of financial position, and \$nil and \$171,001 as management fee expense, within the consolidated statements of loss and comprehensive loss for the year ended December 31, 2021.

In July 2021, the Company and Archytas mutually agreed to terminate the management services agreement and the Company entered into employment agreements with the Company's CEO, COO and VP of Corporate Development all of whom previously provided services to the Company under the management services agreement. The Company is party to certain management contracts. These contracts may require payments upon the occurrence of termination on change in control of the Company, as defined by each officer's respective consulting agreement. As a triggering event has not taken place, the contingent payments have not been reflected in these consolidated financial statements.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

Related party loans and borrowings

In August and November 2021, the Company entered into syndication term loans (Note 12) with certain officers and directors of the Company with borrowings totaling \$550,000 and repayments totaling \$141,780 and \$36,561 resulting in a balance outstanding of \$371,659 and \$513,439 as of December 31, 2022, and 2021, respectively.

(19) Financial instrument risk exposures

Financial risk management

The Company is exposed in varying degrees to a variety of financial instrument related risks. The Board mitigates these risks by assessing, monitoring and approving the Company's risk management processes:

Credit risk

Credit risk is the risk of a potential loss to the Company if a customer or third party to a financial instrument fails to meet its contractual obligations. The maximum credit exposure is the carrying amount of cash, financing and other receivables. The Company does not have significant credit risk with respect to customers as all payments are direct debited from customer accounts and all customers go through initial and periodic qualitative and quantitative credit analysis to evaluate and mitigate credit risk. All cash is placed with recognized U.S. and Canadian financial institutions. The Company provides credit to its customers in the normal course of business and has established credit evaluation and monitoring processes to mitigate credit risk. The Company has not recognized any loss allowance for expected credit losses on financing receivables as of December 31, 2022. See also Note 7.

The Company is entitled to repossess financed equipment if the lessee defaults on their contract in order to minimize any credit losses.

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations associated with financial liabilities. The Company manages liquidity risk through the management of its capital structure. The Company's approach to managing liquidity is to ensure that it will have sufficient liquidity to settle obligations and liabilities when due.

At December 31, 2022, the Company had current assets of \$24,002,729 and current liabilities of \$76,025,986. All current liabilities are classified as due within one year.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

At December 31, 2022, the Company also has the following obligations due:

	<u>Less than 6 months</u>	<u>6 months to 1 years</u>	<u>1 to 3 years</u>	<u>Total</u>
Trade and other payables	\$ 2,468,341	\$ -	\$ -	\$ 2,468,341
Accrued expenses	6,369,637	-	-	6,369,637
Loans and borrowings ⁽¹⁾	25,261,175	45,207,941	6,212,002	76,681,118
Balance at December 31, 2022	<u>\$ 34,099,153</u>	<u>\$ 45,207,941</u>	<u>\$ 6,212,002</u>	<u>\$ 85,519,096</u>

Note to the table:

(1) Represents undiscounted loans and borrowings.

Market risk

Currency risk

The Company has determined its functional currency to be the Canadian dollar for its Canada subsidiary and U.S. dollar for U.S. subsidiaries. The operating results and financial position of the Company are reported in U.S. dollars. The Company has minimal financial transactions denominated in currencies other than the Canadian and U.S. dollar. The Company has no hedging agreements in place with respect to foreign exchange rates. The following table presents financial instruments in CAD currency subject to currency risk:

	<u>December 31,</u>	
	<u>2022</u>	<u>2021</u>
Tax receivable	\$ 18,036	\$ 20,920
Trade payable	\$ 11,926	\$ 47,021
Loans and borrowings ⁽¹⁾	\$ 5,633,000	\$ 5,633,000

Note to the table:

(1) Represents broker debentures and sub receipt convertible debentures (Note 12).

Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Company's lines of credit are subject to fluctuations in interest rates and therefore exposes the Company to interest rate fair value risk. The remainder of the Company's financial debt and lease receivables have fixed rates of interest resulting in limited interest rate fair value risk for the Company. Beginning in 2022, the Company began indexing a portion of new lease originations based on short-term rates plus a spread. That spread is determined by the perceived credit risk of the customer as of origination date and subject to approval of the Company's Investment Committee.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

Price risk

Price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices, other than those arising from interest rate risk or foreign currency risk. The Company is exposed to equity price risk associated with changes in the market value of its investments. The Company closely monitors equity prices to determine the appropriate course of action to be taken. A 10% change in the quoted market of investments would result in a change of approximately \$100 in the consolidated statements of loss and comprehensive loss for the year ended December 31, 2022.

(20) Business segments

The Company has one reportable business segment, which is engaged in the business of providing leasing solutions to owners/operators of cannabis and hemp companies including cultivators, oil processors, manufacturers, and testing laboratories, among others.

(21) Subsequent events

Lease Originations

In the months of January through April 2023, the Company completed 24 lease transactions with publicly-traded and private cannabis companies including Aeriz, Ayr Wellness, Green Dragon / Eaze, Jushi, and PharmaCann, amongst others. During this period, the Company originated over \$7,200,000 million of leases.

Stock Option Activity

In February 2023, the Company granted a total of 6,187,391 common share options and 28,335 proportionate common share options to employees, directors, and consultants of the Company with an exercise price of \$0.07CAD (\$0.05). The options have a term of ten years, with 25% vesting immediately and the remainder vesting evenly over three years. A total of 24,480 proportionate common share options were granted to directors and officers. Additionally, in March 2023 the Company cancelled 25,023,888 options of which 19,700,737 were options of directors, officers and a related party (Archytas).

Financing Receivable

In March 2023, the Company was notified that all the assets of one its customers were put in receivership as result of ongoing debt dispute with a lender of the customer. As of December 31, 2022, the Company had approximately \$4,493,000 and \$1,373,000 of outstanding undiscounted lease receivables and unearned finance income, respectively, for this customer. As of the date of this report the customer has not missed any payments and the Company has confirmed that the customer plans to continue to use and pay for the Company's leased equipment in due course. Therefore, the Company has concluded that an allowance for an expected credit loss is not warranted as of December 31, 2022.

XS Financial Inc.

Notes to Consolidated Financial Statements

Years Ended December 31, 2022, and 2021

(Expressed in United States Dollars)

Management and Board Changes

In March 2023, the Company announced that Justin Vuong has been named Chief Financial Officer (“CFO”) effective June 1, 2023. Mr. Vuong succeeds the Company’s current CFO Stephen Christoffersen, who will remain active as a member of the Company’s Board of Directors, Investment Committee, and has been appointed as Audit Chair.