

**KNIGHTSCOVE MEDIA CORP.**

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**2009 Consolidated Financial Statements**

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## **Auditors' Report**

### **To the Shareholders of Knightscope Media Corp.**

We have audited the consolidated balance sheets of Knightscope Media Corp. as at August 31, 2009 and 2008 and the consolidated statements of loss and comprehensive loss, changes in shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at August 31, 2009 and 2008 and the results of its operations and its cash flows for the years then ended, in accordance with Canadian generally accepted accounting principles.

PKF Hill LLP

Chartered Accountants, Licensed Public Accountants  
December 11, 2009

**KNIGHTSCOVE MEDIA CORP.**  
**Consolidated Balance Sheets**  
**As at August 31**

	<b>2009</b>	<b>2008</b>
<b>ASSETS</b>		
Current assets		
Accounts receivable	\$ 454,920	\$ 257,227
Inventory	513,971	650,187
Income taxes receivable	21,564	56,250
Prepaid expenses	8,126	37,439
	998,581	1,001,103
Licence advances	190,227	122,754
Films in development	210,160	349,679
Film library (note 5)	188,245	194,392
Development costs - video products (note 6(a))	309,821	347,347
Distribution rights (note 6(b))	433,098	609,418
Equipment (note 7)	34,532	69,249
Investment - Studio 4 Networks (note 4)	272,852	272,852
Goodwill	792,342	792,342
	\$ 3,429,858	\$ 3,759,136
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities		
Bank indebtedness (note 8)	\$ 545,055	\$ 317,000
Accounts payable and accrued liabilities	2,035,255	1,614,995
Royalties payable	440,242	241,654
Notes payable (note 9)	250,000	250,000
Convertible promissory notes (note 10)	49,959	49,887
Loans payable (note 11)	742,188	742,704
	4,062,699	3,216,240
Commitments and contingencies (note 13)		
Shareholders' equity		
Share capital (note 12(a))	3,986,232	3,760,785
Contributed surplus (notes 10, 12(b) and (c))	486,090	485,800
Deficit	(5,105,163)	(3,703,689)
	(632,841)	542,896
	\$ 3,429,858	\$ 3,759,136

**See accompanying notes**

**On behalf of the Board:**

**Rick Ferreira, Director**

**Michael Levine, Director**

**KNIGHTSCOVE MEDIA CORP.**  
**Consolidated Statements of Loss and Comprehensive Loss**  
**Years ended August 31, 2009 and 2008**

	<b>2009</b>	<b>2008</b>
Revenue	\$ 2,458,442	\$ 4,248,372
Expenses		
Cost of goods sold	1,151,423	1,187,400
Royalty expense	325,907	433,468
Amortization		
Licence advances	72,010	36,999
Film library	6,147	103,479
Development costs - video products	92,152	93,347
Distribution rights	176,320	152,355
Equipment	35,353	42,579
General and administrative	1,820,526	2,408,327
Impairment loss on licence advances	44,578	-
Interest	135,500	99,051
	<u>3,859,916</u>	<u>4,557,005</u>
Loss before income taxes	(1,401,474)	(308,633)
Income taxes (note 15)	-	-
Net loss	<u>\$ (1,401,474)</u>	<u>\$ (308,633)</u>
Comprehensive loss	<u>\$ (1,401,474)</u>	<u>\$ (308,633)</u>
Loss per share (note 17)		
Basic and diluted	(0.06)	(0.02)
Weighted average number of shares outstanding		
Basic and diluted	21,692,835	19,506,946

**See accompanying notes**

**KNIGHTSCOVE MEDIA CORP.**  
**Consolidated Statements of Changes in Shareholder Equity**  
**Years ended August 31, 2009 and 2008**

	<b>Common Shares</b>	<b>Share Capital Amount</b>	<b>Contributed Surplus</b>	<b>Deficit</b>	<b>Total Equity</b>
Balance, August 31, 2007	19,295,808	\$ 3,493,603	\$ 462,655	\$ (3,395,056)	\$ 561,202
Shares issued for service (note 12(a)(i))	200,000	60,000	-	-	60,000
Cancel common shares (note 12(a)(ii))	(19,495,808)	-	-	-	-
Balance, March 5, 2008	-	\$ 3,553,603	\$ 462,655	\$ (3,395,056)	\$ 621,202

  

	<b>Subordinate- Voting Shares</b>	<b>Multiple- Voting Shares</b>	<b>Share Capital Amount</b>	<b>Contributed Surplus</b>	<b>Deficit</b>	<b>Total Equity</b>
Balance, March 5, 2008	-	-	\$ 3,553,603	\$ 462,655	\$ (3,395,056)	\$ 621,202
Issuance of shares (note 12(a)(ii))	9,747,904	-	-	-	-	-
Issuance of shares (note 12(a)(ii))	-	9,747,904	-	-	-	-
Equity portion of debt (note 10)	-	-	-	227	-	227
Shares for service (note 12(a)(iii))	370,000	-	85,100	-	-	85,100
Shares for service (note 12(a)(iii))	128,571	-	45,000	-	-	45,000
Private placement (note 12(a)(iv))	400,000	-	100,000	-	-	100,000
Issuance of warrants (note 12(b)(i))	-	-	(22,918)	22,918	-	-
Net loss	-	-	-	-	(308,633)	(308,633)
Balance, August 31, 2008	10,646,475	9,747,904	3,760,785	485,800	(3,703,689)	542,896
Shares for service (note 12(a)(v))	933,334	-	82,000	-	-	82,000
Shares for service (note 12(a)(v))	-	1,329,293	99,697	-	-	99,697
Shares for service (note 12(a)(vi))	583,333	-	43,750	-	-	43,750
Equity portion of debt (notes 10 and 11(b))	-	-	-	290	-	290
Net loss for the year	-	-	-	-	(1,401,474)	(1,401,474)
Balance, August 31, 2009	12,163,142	11,077,197	\$ 3,986,232	\$ 486,090	\$ (5,105,163)	\$ (632,841)

**See accompanying notes**

**KNIGHTSCOVE MEDIA CORP.**  
**Consolidated Statements of Cash Flows**  
**Years ended August 31, 2009 and 2008**

	<b>2009</b>	<b>2008</b>
Operating activities		
Net loss	\$ (1,401,474)	\$ (308,633)
Items not involving cash		
Amortization		
Licence advances	72,010	36,999
Film library	6,147	103,479
Development costs - video products	92,152	93,347
Distribution rights	176,320	152,355
Equipment	35,353	42,579
Shares issued for service (included in general and administrative expenses)	225,447	190,100
Impairment loss on licence advances	44,578	-
Non-cash interest and financing costs	154	2,161
	(749,313)	312,387
Net change in non-cash working capital items		
Accounts receivable	(197,693)	259,364
Inventory	136,216	33,094
Income taxes receivable	34,686	-
Prepaid expenses	29,313	(30,512)
Accounts payable and accrued liabilities	420,260	(369,284)
Royalties payable	198,588	94,076
Cash flows from operating activities	(127,943)	299,125
Financing activities		
Bank indebtedness	228,055	(3,874)
Repayments of notes payable	-	(368,117)
Proceeds from loans payable	16,250	1,100,000
Repayment of loans payable	(16,558)	(357,296)
Proceeds from share and warrant issuances	-	100,000
Funding received for films in development	151,318	28,063
Cash flows from financing activities	379,065	498,776
Investing activities		
Advances to Studio 4 Networks	-	(272,852)
Acquisition of licence advances	(184,061)	(147,445)
Investment in films in development - net	(11,799)	(105,172)
Investment in development costs - video products	(54,626)	(243,409)
Purchase of equipment	(636)	(33,468)
Cash flows from investing activities	(251,122)	(802,346)
Net change in cash during the year	-	(4,445)
Cash, beginning of year	-	4,445
Cash, end of year	\$ -	\$ -

See accompanying notes (note 19)

**KNIGHTSCOPE MEDIA CORP.**  
**Notes to Consolidated Financial Statements**  
**Years ended August 31, 2009 and 2008**

**1. Nature of business**

Operations

Knightscope Media Corp. (the "Company" or "Knightscope") is a Canadian entertainment company specializing in the distribution, acquisition and creation of live action feature films and television productions for the whole family under its brand "Knightscope Family Films". Through its family brand and wholly owned subsidiary, Morningstar Entertainment Inc. ("Morningstar"), the Company acquires, develops and distributes family oriented films in the television and Digital Video Disc ("DVD") markets. Knightscope is an issuer listed on the TSX Venture Exchange ["TSXV"] under the ticker symbols KC.A (subordinate voting shares) and KC.B (multiple voting shares). As of August 31, 2009, there were 12,163,142 subordinate voting shares and 11,077,197 multiple voting shares outstanding.

Going concern

These consolidated financial statements have been prepared on a going concern basis, which presumes that Knightscope will be able to realize its assets and discharge its liabilities in the normal course of operations for the foreseeable future. At August 31, 2009, the Company had an accumulated deficit of approximately \$5,100,000 and a working capital deficit of approximately \$3,000,000. The Company's ability to continue as a going concern is dependent upon its ability to generate sufficient future cash flows and obtain sufficient financing to fund its business until it achieves consistently profitable operations.

The Corporation's ability to continue as a going concern is dependent on its ability to raise additional capital and ultimately to develop profitable operations. Investors have committed to sufficient financial support (note 21). With Knightscope's continued financing endeavours, the Company believes it will be able to meet its short-term cash flow requirements. However, the success of obtaining additional financing is not objectively assessable.

Management is implementing a business development strategy which has focused the Company on achieving economies of scale and increased revenue with their acquisition of Ellis Entertainment Inc. (note 21). Additionally, Knightscope anticipates continuing its program of reducing corporate overhead costs.

Accordingly, management believes that the use of accounting principles applicable to a going concern is appropriate.

Based on the above, these consolidated financial statements do not include any adjustments to the amounts and classification of assets and liabilities that might be necessary should the Company be unable to continue as a going concern and, therefore, be required to realize its assets and discharge its liabilities in other than the normal course of business and at amounts different from those reflected in the accompanying consolidated financial statements.

**2. Summary of significant accounting policies**

These consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles ("GAAP"). The significant accounting policies are summarized as follows:

Basis of consolidation

The consolidated financial statements include the assets, liabilities, and operating results of the Company and its wholly owned subsidiaries; Knightscope Family Films Inc., Sophie Films Inc. (formerly 2096013 Ontario Inc.) and Morningstar.

**KNIGHTSCOVE MEDIA CORP.**  
**Notes to Consolidated Financial Statements**  
**Years ended August 31, 2009 and 2008**

**2. Summary of significant accounting policies - continued**

Use of estimates

The preparation of financial statements in accordance with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the consolidated balance sheet date and the reported amounts of revenue and expenses during the reporting period. The most significant assumptions made by management in the preparation of the Company's consolidated financial statements include the determination of any impairment and the useful lives of licence advances, films in development, film library, development costs - video products, distribution rights, equipment and goodwill, determining the allowance for accounts receivable, estimating the provision for sales returns, estimation of the fair value of stock-based compensation and warrants and the determination of valuation allowance for income taxes. Actual results could differ from those estimates.

Inventory

Inventory is comprised of completed DVDs as well as the materials and packaging required to produce individual DVDs. Inventory is valued at the lower of cost and market value, determined on a first-in first-out basis. Market value for materials used in the production of a DVD is its replacement cost and for finished DVD units, it is net realizable value.

In determining market value, the Company considers factors such as shrinkage, the aging and the demand for inventory, past experience with specific customers and the ability to redistribute inventory through other distribution channels.

Inventory expensed during the year is recorded in cost of goods sold. Included in cost of goods sold are write-downs of \$Nil (2008 - \$Nil) related to obsolete inventory.

Licence advances

Licence advances are prepayments made to producers to secure the right to distribute specific DVD titles. These prepayments are capitalized and amortized on a straight-line basis over the life of the licence agreement. In most cases, the term of the licence agreement is five years.

Films in development

Investment in film properties represents the amortized costs of film productions developed, produced and exploited by the Company and participation in properties produced and exploited by third parties. Costs capitalized include production costs and financing costs, capitalized interest and overhead costs incurred on commencement of principal photography.

Costs of developing and producing films are capitalized and amortized using the individual film-forecast-computation method, whereby capitalized costs and estimated total costs of participations and residuals are charged to amortization expense on a program-by-program basis in the ratio that current period's revenue bears to management's estimate of ultimate revenue expected to be recognized from the exploitation, exhibition or sale of programs. Ultimate revenue is projected for periods not exceeding 10 years from the date of delivery.

Properties are stated at the lower of amortized cost and estimated net realizable value as determined on an individual basis. Net realizable values of the films are determined using management's future revenue estimates. Revenue estimates will be reviewed periodically and should an event or change in circumstance indicate that the fair value of the film is less than its amortized cost, an adjustment would be made to reflect that change. These adjustments could have a material effect on results of operations in future periods.

**KNIGHTSCOVE MEDIA CORP.**  
**Notes to Consolidated Financial Statements**  
**Years ended August 31, 2009 and 2008**

**2. Summary of significant accounting policies - continued**

Films in development - continued

Estimates of future revenue involve measurement uncertainty and it is therefore possible that reductions in the carrying value of films in development may be required as a consequence of changes in management's estimates of future revenue streams.

Film library

The capitalized costs of the acquisition of the Company's film library include the purchase price and other acquisition costs. Amortization is calculated using the individual film-forecast-computation method.

Development costs - video products

Development costs relate to the design and development of video products including authoring (the production of a DVD master), design, artwork and film translation. The Company capitalizes development costs that meet specific criteria related to the technical, market and financial feasibility. Once the product is ready for production and distribution, the costs are amortized on a straight-line basis over the estimated useful life of the product. The current estimated useful life of capitalized development costs is five years. The Company writes down the carrying value of development costs to their fair value when the value is determined to be impaired.

Distribution rights

The value of acquired distribution rights to licensed films is estimated using discounted future cash flows for individual titles at the Company's weighted average cost of capital. Distribution rights are amortized over their remaining useful life, in most cases, a licence period of five years.

Management periodically reviews the carrying value of the distribution rights whenever events or changes in circumstances indicate that the carrying amount of the distribution rights may not be recoverable which is determined by comparing the carrying amount to the estimated undiscounted future net cash flows. The Company writes down the costs associated with distribution rights to their fair value when the value is determined to be impaired.

Equipment

Equipment is recorded at cost less accumulated amortization. Amortization is calculated on a straight-line basis over the estimated useful lives of the assets as follows:

Computer equipment	5 years
Computer software	2 years
Office furniture	5 years
Leasehold improvements	5 years

The Company reviews the recoverability of equipment annually or more frequently, if events or circumstances indicate that the carrying amount may not be recoverable. Recoverability is measured by comparing the carrying amounts of a group of assets to future undiscounted cash flows expected to be generated by that group of assets. When an asset is not recoverable, the impairment loss recognized is measured as the amount by which the carrying amount of the asset exceeds its fair value.

Investment - Studio 4 Networks

The Company accounts for its investment in Studio 4 Networks using the cost method of accounting (note 21).

**KNIGHTSCOPE MEDIA CORP.**  
**Notes to Consolidated Financial Statements**  
**Years ended August 31, 2009 and 2008**

**2. Summary of significant accounting policies - continued**

Goodwill

Goodwill represents the excess of the purchase consideration over the fair value of the net tangible and intangible assets acquired at the date of acquisition.

Goodwill is not amortized and is tested for impairment annually. The impairment test is carried out in two steps. In the first step, the carrying amount of the reporting unit is compared with its fair value. When the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not to be impaired and the second step of the impairment test is not required. The fair value of the reporting unit is principally based on management's estimates of future discounted cash flows.

The second step is carried out when the carrying amount of a reporting unit exceeds its fair value, in which case the implied fair value of the reporting unit's goodwill is compared with its carrying amount to measure the amount of the impairment loss, if any. When the carrying amount of a reporting unit's goodwill exceeds the implied fair value of the goodwill, an impairment loss is recognized in an amount equal to the excess.

The Company is also required to evaluate goodwill for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Certain indicators of potential impairment that could impact the Company's reporting unit include, but are not limited to, the following: (a) a significant long-term adverse change in the North American home entertainment industry that is expected to cause a substantial decline in DVD sales and/or gross margins and (b) a significant technological change that results in a substantially more cost-effective method of distribution of films.

The Company has calculated the fair value of its reporting units as at August 31, 2009 and compared this to the carrying amount and determined that no impairment of goodwill existed.

Financial instruments

The Company is required to classify financial assets and liabilities according to their characteristics and management's intentions for the purposes of ongoing measurement.

Classification for financial assets include:

- (a) held for trading - measured at fair value with changes in fair value recorded in net loss;
- (b) held to maturity - recorded at amortized cost using the effective interest rate method, with gains and losses recognized in net loss in the period that the asset is de-recognized or impaired;
- (c) available for sale - measured at fair value with changes in fair value recognized in other comprehensive loss for the current period until realized through de-recognition or impairment; and
- (d) loans and receivables - recorded at amortized cost using the effective interest rate method, with gains and losses recognized in net loss in the period that the asset is de-recognized or impaired.

Classification for financial liabilities include:

- (a) held for trading - measured at fair value with changes in fair value recorded in net loss; and
- (b) other - measured at amortized cost using the effective interest rate method, with gains and losses recognized in net loss in the period that the liability is de-recognized.

**KNIGHTSCOVE MEDIA CORP.**  
**Notes to Consolidated Financial Statements**  
**Years ended August 31, 2009 and 2008**

**2. Summary of significant accounting policies - continued**

Financial instruments - continued

The Company's financial assets and liabilities are generally classified and measured as follows:

Cash	Held for trading	Fair value
Accounts receivable	Loans and receivables	Amortized cost
Bank indebtedness	Other liabilities	Amortized cost
Accounts payable	Other liabilities	Amortized cost
Loans payable	Other liabilities	Amortized cost
Notes payable	Other liabilities	Amortized cost
Convertible promissory notes	Other liabilities	Amortized cost
Royalties payable	Other liabilities	Amortized cost

Other consolidated balance sheet accounts, are not within the scope of the financial instrument accounting standards as they are not financial instruments. The carrying values of cash, accounts receivable, accounts payable, loans payable, royalties payable, notes payable, and convertible promissory notes approximates fair values due to their short-term maturities. Loans payable are recorded at amortized cost using the effective interest rate method at the rates disclosed in note 11.

Revenue recognition

The Company earns revenue from the production of film and television products and from the sales of home entertainment products.

Revenue from theatrical, DVD, video, pay and specialty television licensing is recognized on meeting all recognition requirements of American Institute of Certified Public Accountants ("AICPA") Statement of Position 00-2 "Accounting by producers or distributors of films" ("SOP 00-2"). The conditions are as follows: (i) persuasive evidence of a sale or licensing arrangement with a customer exists; (ii) the film is complete and is available for delivery; (iii) the licence period of the arrangement has begun; and (iv) the arrangement fee is fixed or determinable. Cash received in advance of the film being available for delivery is recorded as deferred revenue until all the foregoing conditions of revenue recognition have been met.

Revenue from royalties, distribution fees and government incentives is recognized on receipt or evidence that collection is reasonably assured.

Revenue for home entertainment products, net of an allowance for estimated DVD returns, is recorded when the products are shipped to customers and collectability is reasonably assured.

Stock-based compensation

All stock-based awards granted to employees and non-employees are measured using a fair value based method. The fair value of stock options granted is recognized on a straight-line basis over the applicable stock option vesting period as compensation expense included in the consolidated statements of loss and comprehensive loss and contributed surplus within shareholders' equity on the consolidated balance sheets. On the exercise of stock options, the total of the consideration received and the related accumulated contributed surplus is credited to share capital. The Company has estimated the fair value of the stock options using the Black-Scholes option pricing model.

**KNIGHTSCOVE MEDIA CORP.**  
**Notes to Consolidated Financial Statements**  
**Years ended August 31, 2009 and 2008**

**2. Summary of significant accounting policies - continued**

Income taxes

The Company follows the asset and liability method of accounting for income taxes. Under this method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between financial statement carrying amounts of assets and liabilities and their respective tax bases. The Company provides a valuation allowance to reduce future tax assets when it does not appear more likely than not that the asset will be realized.

Loss per share

Basic loss per share is calculated by dividing net loss by the weighted average number of common shares outstanding during the period. All dilutive instruments such as stock options were excluded from the calculation of diluted loss per share as the effect of including them would have been anti-dilutive. Generally, diluted loss per share would be calculated by dividing net loss by the weighted average number of common shares outstanding during the period after giving effect to potentially dilutive financial instruments. The dilutive effect of stock options is determined using the treasury stock method.

Future accounting changes

The Canadian Institute of Chartered Accountants ("CICA") has recently issued three new accounting standards that could impact the Company, as follows:

Section 1582, Business Combinations, the term "business" will be more broadly defined than in the existing standard. Most assets acquired and liabilities assumed will be measured at fair value and any prior owned interest will be remeasured at fair value at the new acquisition date. A bargain purchase option will result in recognition of a gain and acquisition costs must be expensed.

Section 1601, Consolidated Financial Statements, effective for fiscal years beginning on or after January 1, 2011, replaces the former standard on consolidated financial statements and it is the Canadian equivalent to the respective International Financial Reporting Standard.

Section 3064, Goodwill and Intangibles, establishes standards for identifying, recognizing and measuring intangible assets (including internally generated intangibles such as research and development). It clarifies which expenditures should be recognized as an expense, unless certain recognition criteria are met. Subsequent measurement of intangibles and goodwill has not changed. This standard now incorporates guidance on research and development, which was previously included in Section 3450.

The Accounting Standards Board requires all Canadian publically accountable enterprises to adopt International Financial Reporting Standards ("IFRS") for years beginning on or after January 1, 2011. The Company will adopt IFRS for its fiscal year ended August 31, 2012. The fiscal 2012 financial statements will include comparative 2011 financial results under IFRS.

The impact of the adoption of these new standards on the consolidated financial statements is not expected to be material. The impact of the transition to IFRS on the Company's statements has not yet been determined.

**KNIGHTSCOPE MEDIA CORP.**  
**Notes to Consolidated Financial Statements**  
**Years ended August 31, 2009 and 2008**

**3. Changes in accounting policies**

On September 1, 2008, the Company adopted CICA Handbook Section 1400, Going Concern, Section 1535, Capital Disclosures, Section 3031, Inventories, Section 3862, Financial Instruments - Disclosures, and Section 3863, Financial Instruments - Presentation, with no restatement of prior periods.

Section 1400 - Going Concern requires management to make an assessment of the Company's ability to continue as a going concern. This assessment is disclosed in note 1.

Section 1535 - Capital Disclosures establishes standards for disclosing information about an entity's objectives, policies and processes for managing capital and whether the Company has complied with externally imposed capital requirements. The required disclosures are included in note 20.

Section 3031 - Inventories' enhanced disclosures with respect to accounting policies used, carrying amounts and amounts recognized in cost of goods sold are included in note 2.

Section 3862 - Financial Instruments - Disclosures places increased emphasis on risk disclosures. Entities are required to provide both qualitative and quantitative information about exposures to risks arising from financial instruments, including credit, interest rate, currency and other price risks. This section also requires disclosure of pledging of collateral, details on any defaults in the terms or covenants of loans payable, and methods for determining fair values of financial instruments. See note 16 - Financial instruments for disclosures made under this Section.

Section 3863 - Financial Instruments - Presentation establishes standards for classification of financial instruments. The requirements of this section are consistent with those of the previously issued section and therefore, had no impact on the Company's consolidated financial statements.

There was no impact to the Company as a result of adopting these new standards other than enhanced disclosures in the notes to the consolidated financial statements.

**4. Investments and acquisition**

Investment - Studio 4 Networks

In fiscal 2008, a letter of intent was entered into to acquire Studio 4 Networks ("Studio 4"), a Los Angeles-based broadband and video-on-demand ("VOD") broadcaster. Offering its programming across multiple platforms including cable, satellite and broadband, Studio 4 operates three cable VOD channels (Studio 4 Learning, Fitness and Kids) and two internet video sites ([www.studio4kids.tv](http://www.studio4kids.tv) and [www.studio4fitness.tv](http://www.studio4fitness.tv)), which provide family friendly programming complementary to Knightscope's core product.

Additionally, Studio 4 has entered into strategic partnerships with print publishers such as Parenting, Babytalk and Self magazines to create multi-platform advertising packages in the magazine print pages and on their respective web priorities. Studio 4's revenues are derived from advertising, subscription, sponsorship, pay per view and other fees. Studio 4's content library of over 400 hours of licensed and original productions is focused on the kids' entertainment, adult education and fitness categories.

The initial letter of intent has expired. Knightscope and Studio 4 have subsequently agreed that the Knightscope advances would be on account of an investment in common shares. To date, cash advances totaling \$272,852 have been made to Studio 4 in respect of this agreement.

Subsequent to year end, the Company acquired 51% of the common share capital of Studio 4 (note 21).

**KNIGHTSCOPE MEDIA CORP.**  
**Notes to Consolidated Financial Statements**  
**Years ended August 31, 2009 and 2008**

**5. Film library**

	<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Net</b>
2009	\$ 316,885	\$ 128,640	\$ 188,245
2008	\$ 316,885	\$ 122,494	\$ 194,391

**6. Developments costs - video products and distribution rights**

(a) Development costs - video products

	<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Net</b>
2009	\$ 481,828	\$ 172,007	\$ 309,821
2008	\$ 427,202	\$ 79,855	\$ 347,347

(b) Distribution rights

	<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Net</b>
2009	\$ 821,688	\$ 388,590	\$ 433,098
2008	\$ 821,688	\$ 212,270	\$ 609,418

**7. Equipment**

	<b>2009</b>			<b>2008</b>		
	<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Net</b>	<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Net</b>
Computer equipment	\$ 108,310	\$ 94,446	\$ 13,864	\$ 108,309	\$ 75,911	\$ 32,398
Computer software	54,012	51,464	2,548	53,377	41,841	11,536
Office furniture	25,965	25,965	-	25,965	24,513	1,452
Leasehold improvements	34,150	16,030	18,120	34,150	10,287	23,863
	\$ 222,437	\$ 187,905	\$ 34,532	\$ 221,801	\$ 152,552	\$ 69,249

**KNIGHTSCOVE MEDIA CORP.**  
**Notes to Consolidated Financial Statements**  
**Years ended August 31, 2009 and 2008**

**8. Bank indebtedness**

	<b>2009</b>	<b>2008</b>
Cash and outstanding cheques	\$ (1,409)	\$ 42,000
Revolving demand facility (a)	260,000	-
Non-revolving demand facility (b)	286,464	-
Demand operating facility (c)	-	275,000
	<hr/>	<hr/>
	\$ 545,055	\$ 317,000

- (a) Morningstar has a \$300,000 (2008 - \$Nil) revolving demand facility in place with a major Canadian bank. At August 31, 2009, \$260,000 (2008 - \$Nil) had been utilized. The facility bears interest at prime plus 3.6%.
- (b) Morningstar has a \$300,000 (2008 - \$Nil) non-revolving term facility with a major Canadian bank. At August 31, 2009, \$286,464 (2008 - \$Nil) had been utilized. The facility bears interest at prime plus 4.75% and is repayable in full on July 16, 2011.
- (c) At August 31, 2008, Morningstar had a \$300,000 demand operating facility in place, with a major Canadian bank (\$275,000 utilized on August 31, 2008) which incurred interest at prime plus 1.5%.

Substantially, all of the assets of Morningstar are pledged as collateral against the above credit facilities.

The Company is subject to a financial covenant relating to its bank indebtedness which consists of a minimum debt-service ratio. At August 31, 2009 the Company is in compliance with the required financial covenant.

**9. Notes payable**

As at August 31, 2008 and 2009, the Company had outstanding notes payable in respect of the Morningstar acquisition in the aggregate principal amount of \$250,000 consisting of two promissory notes to the vendors in the principal amount of \$125,000 each. The notes yield an interest rate of 6% payable upon payment of the principal. The holders of the two outstanding notes have deferred repayment until the Company completes a future financing. These notes are secured in third position by substantially all of the assets of Morningstar behind the bank credit facility (note 8).

**10. Convertible promissory notes**

As at August 31, 2008, the Company had outstanding convertible promissory notes in the aggregate principal amount of \$50,000 consisting of two subordinated unsecured convertible promissory notes each in the principal amount of \$25,000. The notes were issued for cash. They had a term of two years which ended on March 22, 2008, and yielded an interest rate of 13%, payable semi-annually, payable in March and September. At the debt-holder's option, the debt was convertible into subordinate voting shares of the Company at a rate of \$0.30 per share in the year ending March 22, 2008. The convertible promissory notes were secured by assets of the Company.

The face value of the convertible debentures had been allocated between liability and equity based on the estimated fair value of the loan payable and the conversion feature.

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**10. Convertible promissory notes - continued**

On March 22, 2008, the convertible promissory notes were refinanced. The new debt became due on March 22, 2009, with interest at 12%, payable semi-annually in March and September. The notes are unsecured. At the debt-holder's option, the debt is convertible into subordinate voting shares of the Company at a rate of \$0.25 per share (in the year ending March 22, 2009). The equity value of the convertible notes was calculated to be \$227 and was applied to contributed surplus. At August 31, 2008, interest expense of \$114 had been accreted to these convertible promissory notes. Accordingly, the convertible promissory notes were recorded at \$49,887 at August 31, 2008.

On March 22, 2009, the convertible promissory notes were refinanced. The new debt is due on March 22, 2010. All other terms remain unchanged. The face value of the convertible debentures had been allocated between liability and equity based on the estimated fair value of the loan payable and the conversion feature. The equity value of the convertible notes was calculated to be \$82 and was applied to contributed surplus. At August 31, 2009, interest expense of \$41 had been accreted to these convertible promissory notes. The remaining \$113 of interest accretion from the March 22, 2008 convertible promissory note extension was also expensed in fiscal 2009. Accordingly, the convertible promissory notes were recorded at \$49,959 at August, 31, 2009.

The Black-Scholes option pricing model was employed using the following assumptions to calculate the fair value of the equity portion of the convertible promissory notes:

Risk-free interest rate	0.58%
Dividend yield	0%
Volatility	150%
Expected life	1 year

**11. Loans payable**

	<b>2009</b>	<b>2008</b>
Loan payable to GC-Global Capital Corp (a)	\$ 321,145	\$ 337,704
Bridge loan payable (b)	399,793	400,000
Other advances (c)	21,250	5,000
	<b>\$ 742,188</b>	<b>\$ 742,704</b>

(a) During September 2007, a loan in the principal amount of \$600,000 was provided by GC-Global Capital Corp. ("Global") and during November and December of 2007, an additional loan of \$100,000 was provided by Global. The loan bears interest at 12% per annum, payable monthly, with a structuring fee of 2% at closing. The loan was initially repayable on March 15, 2009 and has been amended to December 15, 2009. At August 31, 2009, the principal outstanding amount of the loan was \$321,145.

(b) On May 23, 2008, the Company secured additional bridge financing from a private lender in the amount of \$400,000, due on May 26, 2009, at 18% per annum, of which \$300,000 was used to repay existing loans provided by Global (note 11(a)) and the remainder was used for general corporate purposes.

On May 22, 2009, the maturity date of the loan was amended to March 23, 2010 and the interest reduced to 12.5% per annum. At August 31, 2009, the principal outstanding amount of the loan is \$399,793. Additionally, the renewed loan has conversion rights and as a result the loan has been allocated between liability and equity based on the estimated fair value of the loan payable and the conversion feature. The equity value of the convertible notes was calculated to be \$208 and was applied to contributed surplus. The Black-Scholes option pricing model was employed using the following assumptions to calculate the fair value of the equity portion of the loans payable:

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**11. Loans payable - continued**

Risk-free interest rate	0.45%
Dividend yield	0%
Volatility	150%
Expected life	0.836 year

The loans in (a) and (b) are secured pari passu by a first ranking security interest in the non-consolidated Knightscope Media Corp.'s assets including all rights to the film library and a second ranking security interest in Morningstar's assets including rights to its DVD library.

- (c) Other advances are non-interest bearing, unsecured and due on demand (note 14).

**12. Shareholders' equity**

- (a) Share capital

The Company has authorized an unlimited number of subordinate voting (KC.A) and multiple voting (KC.B) shares with no par value. Changes in share capital starting on September 1, 2007 through to August 31, 2009 are listed in the consolidated statements of changes in shareholders' equity.

- (i) During September 2007, the Company issued 200,000 common shares to satisfy a loan financing fee totalling \$60,000 to Global, related to the initial \$600,000 bridge loan provided (note 11(a)). As consideration for Global's agreement to provide the loan, the Company issued 200,000 common shares of Knightscope, at a deemed price of \$0.30 per share. The shares issued were subject to a four-month hold period to January 27, 2008.
- (ii) On March 5, 2008, Knightscope completed a capital reorganization to exchange each issued and outstanding common share of the Company for one-half of a Multiple Voting Share and one-half of a Subordinate Voting Share. Both classes commenced trading on the TSX Venture Exchange at the opening on March 5, 2008, and the common shares of the Company were de-listed on the same date. An unlimited number of Multiple Voting Shares and an unlimited number of Subordinate Voting Shares have been authorized with no par value of which 9,747,904 shares of each class are issued and outstanding as of March 5, 2008. The stock symbols for the Subordinate and Multiple Voting Shares are 'KC.A' and 'KC.B' respectively. Both classes are fully participating and the Multiple Voting carry 50 votes per share and the Subordinate Voting class carries one vote per share.
- (iii) On June 11, 2008, the Company issued 370,000 subordinate voting shares to satisfy a consulting fee totalling \$85,100 to Global at a deemed value of \$0.23 per share. The Company additionally issued 128,571 subordinate voting shares at a deemed value of \$0.35 per share to Lane Capital Markets to satisfy a consulting fee of \$45,000. The shares issued were subject to a four-month hold period.
- (iv) On July 22, 2008, the Company completed a private placement with an accredited investor by issuing 400,000 subordinate voting shares at a deemed value of \$0.25 per share for net proceeds of \$100,000 to Knightscope. Each share was issued with one full warrant attached, convertible into subordinate voting shares at an exercise price of C\$0.50 for a term of two years. The value of the warrants was calculated to be \$22,918 and was applied to contributed surplus.

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**12. Shareholders' equity - continued**

(a) Share capital - continued

- (v) On February 27, 2009, Knightscope issued 166,667 subordinate voting shares to each of the four independent directors sitting on its Board in reference to director fees of \$12,500 each. The Chairman of the Board received an additional 66,666 subordinate voting shares valued at \$5,000 for acting as the Chairman. Additionally, the Company issued 200,000 subordinate voting shares to an outside consultant in reference to consulting fees of \$27,000. The shares issued to the consultant were at a price of \$0.135 per share. Leif Bristow, President and Chief Executive Officer ("CEO"), received 1,329,293 multiple voting shares as payment of deferred salary due in the amount of \$99,697. In each case the shares were issued at a price of \$0.075 per share.
- (vi) Knightscope issued 283,333 subordinate voting shares ("S'S") in May 2009 to GC-Global Capital Inc. for consulting services. In addition, in May 2009, the Company issued 150,000 subordinate voting shares to each of Kai Vogt and Tinkle Capital Inc as shares for service. In each case, the shares were issued at a price of \$0.075 per share. The shares are subject to a four-month hold period.

(b) Warrants

As at August 31, 2009, the Company had outstanding warrants as described below:

Description	Issue date	Expiry date	Exercise price	Number of warrants	Convertible into S'S
Warrants issued on private placement (i)	July 22, 2008	July 22, 2010	C\$0.50	400,000	400,000
				400,000	400,000

- (i) On July 22, 2008, the private placement investor was issued 400,000 warrants for a two year term, convertible into subordinate voting shares at an exercise price of C\$0.50. The value of the warrants was calculated to be \$22,918 and was applied to contributed surplus.

No warrants were issued during the year ended August 31, 2009. The Black-Scholes option pricing model was employed using the following assumptions to calculate the fair value of warrants issued during the fiscal year 2008:

Risk-free interest rate	3.05%
Dividend yield	0%
Volatility	75%
Expected life	2 years

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**12. Shareholders' equity - continued**

(c) Stock options

The Company has adopted an incentive stock option plan for the benefit of its directors, officers and technical consultants, whereby a maximum of 10% of the issued and outstanding shares of the Company are reserved for issuance pursuant to the exercise of stock options to be granted to directors, officers and technical consultants.

The number of shares reserved for issuance to any individual director or officer will not exceed 5% of the issued and outstanding shares and the number of shares reserved for issuance to all technical consultants will not exceed 2% of the issued and outstanding shares.

Options issued prior to December 2006 and convertible into common shares have been amended to be convertible into one half of one subordinate voting share and one half of one multiple voting share.

A summary of the options outstanding under the plan is presented below.

	<b>Number of options</b>	<b>Weighted average exercise price</b>
Outstanding and exercisable at August 31, 2007 and 2008	925,000	0.27
Retired (i)	(50,000)	0.40
Outstanding and exercisable at August 31, 2009	875,000	0.27

(i) In December 2008, 50,000 stock options held by a director that did not stand for re-election, expired and were retired. No employee or director stock options were granted in the year ended August 31, 2009.

**13. Commitments and contingencies**

Knightscope is party to a number of future financial commitments including an operating lease for equipment, a lease of office premises and future licence commitments. All lease and future licence costs are expensed as incurred. Net payments under these leases are as follows:

2010	\$ 467,102
2011	90,080
2012	5,104
2013	5,104
	\$ 567,390

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**14. Related party transactions**

The Company has contracted with 1365106 Ontario Ltd. for the services of Mr. Leif Bristow, its President and CEO. The remuneration is for writing, directing and producing the Company's proprietary products, together with daily management of the Company. A formal employment contract was approved by the Compensation Committee of the Board of Directors, which has set Mr. Bristow's remuneration (including a base salary of \$180,000 with a producing fee bonus for each proprietary production up to a maximum compensation of \$450,000 per annum, plus a monthly gas allowance of \$650 to a cap of \$6,500 for the year).

The Company had accrued a liability of \$53,333 and \$46,364 to reflect salary owing to Mr. Bristow for fiscal 2007 and 2008 respectively. These liabilities have both been paid in shares of the Company during the quarter ended May 31, 2009 (note 12(a)(v)). Mr. Bristow is also a shareholder and director of the Company. Mr. Bristow receives the benefit of a \$1,000,000 life insurance policy for which the annual premium of \$3,600 is paid by the Company. The Company has accrued a liability of \$98,000 to reflect salary owing to Mr. Bristow for fiscal 2009. Sophie Films 2009 Inc. (a corporation controlled by Mr. Bristow) has paid Mr. Bristow a \$80,000 creative fee which pursuant to the terms of his contract has been applied against the base salary owing by the Company.

Leif Bristow, the President and CEO, is the holder of one of the two unsecured convertible promissory notes (note 10) each in the amount of \$25,000 which mature on March 22, 2010. Additional unsecured advances were made to the Company by Mr. Bristow in the amount of \$3,200 (note 11(c)). In addition, Mr. Bristow's wife, Agnes Bristow, provided the Company with unsecured advances totaling \$18,050 (note 11(c)).

At August 31, 2009, the Company had two outstanding notes payable in respect of the Morningstar acquisition in the principal amount of \$125,000 each (note 9). These notes are held by a former owner of Morningstar, currently an executive of the Company, and his spouse. One of the directors is the President and CEO of GC-Global Capital (note 11(a)). One of the Company's directors is founding partner of Lane Capital Markets (note 12 (a) (iii)).

**15. Income taxes**

As at August 31, 2009, the income tax recovery differs from the amount obtained by applying the combined federal and provincial income tax rates to loss before income taxes. The difference relates to the following items:

	<b>2009</b>	<b>2008</b>
Combined statutory income tax rate	33.12%	34.37%
Expected income tax recovery	\$ (464,168)	\$ (106,077)
Decrease in income tax recovery resulting from:		
Permanent differences	5,503	4,125
Valuation allowance	401,169	44,963
Impact of change in rates on tax loss carry forward	57,496	56,989
	\$ -	\$ -

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**15. Income taxes - continued**

The tax effects of temporary differences and net operating losses that give rise to future tax assets are as follows:

	<b>2009</b>	<b>2008</b>
Non-capital tax loss carry forward	\$ 1,523,640	\$ 1,067,472
Financing costs	78,492	76,145
Cumulative eligible capital	26,599	24,220
Reserve for sales provision	54,325	88,331
Distribution rights	(143,464)	(158,449)
<b>Total future tax assets</b>	<b>1,539,592</b>	<b>1,097,719</b>
Less: valuation allowance	(1,539,592)	(1,097,719)
<b>Net future tax assets</b>	<b>\$ -</b>	<b>\$ -</b>

As at August 31, 2009, the Company's deductible temporary differences for which no related future tax assets have been recognized include accumulated non-capital losses for income tax purposes of \$4,599,670, which can be carried forward to reduce future Canadian taxable income. Since it is not more likely than not that the Company will be able to realize the benefit of the unused tax losses, a valuation allowance in respect of all future income tax assets has been provided.

The non-capital losses which cannot be carried forward indefinitely expire as follows:

2011	\$ 675,813
2012	738,626
2026	704,838
2027	1,174,871
2028	-
2029	1,305,522
	<b>\$ 4,599,670</b>

**16. Financial instruments**

Interest rate risk

The Company has minimal exposure to interest rate risk as the Company is primarily funded by fixed rate debt obligations and equity. The risk associated with debt that is not at a fixed rate of interest is not significant. The Company does not hedge potential exposure to interest rate risk related to this facility.

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**16. Financial instruments - continued**

Foreign currency risk

Although the Company operates primarily in Canada, it purchases some of its DVD licences from the United States of America or internationally based companies, which gives rise to a risk that its earnings may be adversely impacted by fluctuations in foreign exchange conversion rates. As at August 31, 2009 and 2008, the Company had no contractual obligations to buy or sell fixed amounts of foreign currency.

Credit risk and customer concentration

Concentration of credit risk arises when a group of customers has a similar characteristic, such that their ability to meet their obligations is expected to be affected similarly by changes in economic or other conditions. For the Company, significant concentrations of credit risk are related to the retail markets. Two customers each represent greater than 10% of total sales. The Company mitigates this credit risk through their credit monitoring policies.

**17. Loss per share**

Loss per share is calculated based on the weighted average number of shares outstanding during the period. For the years ended August 31, 2009 and 2008, all dilutive instruments such as stock options, convertible promissory notes and warrants were excluded from the calculation of diluted loss per share, as the effect of including them would have been anti-dilutive.

**18. Segmented reporting of revenue**

Whereas the Company has two operating divisions (note 1), management considers that the Company operates in one business segment, which is the production, licensing and distribution of family-friendly films and videos. The Company markets its services primarily in Canada.

**19. Consolidated statement of cash flows**

Supplemental cash flow information is as follows:

	<b>2009</b>	<b>2008</b>
Interest expense paid	\$ 124,846	\$ 96,880
Addition to contributed surplus due to loans payable	208	-
Addition to contributed surplus due to convertible promissory notes	82	227

**20. Capital management**

The Company defines its capital as the total of its shareholders' deficiency and interest bearing debt. The Company's objectives when managing capital are to build liquidity and shareholders' equity to ensure that strategic objectives are met.

Capital structure is managed within guidelines approved by the Board of Directors. The Company makes adjustments to its capital structure based on changes in economic conditions and planned requirements. The Company has the ability to adjust its capital structure by issuing new equity or debt, selling assets to reduce debt, controlling the amount it distributes to shareholders, and making adjustments to its capital expenditure program.

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**21. Subsequent events**

Agnes Bristow provided additional security on the Global loan in the form of \$100,000 mortgage on her principle residence.

In December 2009, Knightscope acquired a 51% holding in Studio 4. The purchase price is the \$272,852 previously advanced to Studio 4 (note 4) and the issuance of 850,000 subordinate voting shares which have been approved for issue as consideration for the acquisition of Studio 4. The Company has the option to purchase the remaining 49% for either US \$1,000,000 in cash or common shares.

Subsequent to year end, Knightscope arranged for long-term debt of approximately \$1,000,000 primarily to finance the acquisition of Ellis Entertainment Corporation, a Canadian based producer and distributor of television product, and provide general working capital. This is anticipated to close by the end of December, 2009.

**22. Comparative amounts**

Certain comparative amounts have been reclassified from those previously presented to conform to the presentation of the 2009 financial statements.