Consolidated Financial Statements

Knightscove Media Corp.

December 31, 2010 and 2009 (note 1)

KNIGHTSCOVE MEDIA CORP.
2010 and 2009 Consolidated Financial Statements (note 1)

Contents

	Page
Independent Auditor's Report	1 - 2
Consolidated Balance Sheets	3
Consolidated Statements of Loss and Comprehensive Loss	4
Consolidated Statements of Changes in Shareholders' Equity (Deficiency)	5
Consolidated Statements of Cash Flows	6
Notes to Consolidated Financial Statements	7 - 30

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Independent Auditor's Report

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To the Shareholders of
Knightscove Media Corp.

We have audited the accompanying consolidated financial statements of Knightscove Media Corp., which comprise the consolidated balance sheet as at December 31, 2010, the consolidated statements of loss and comprehensive loss, changes in shareholders' equity (deficiency) and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

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

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

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

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

Opinion
In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of Knightscove Media Corp. as at December 31, 2010, and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

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Emphasis of matter

Without qualifying our opinion, we draw attention to note 1 in the consolidated financial statements which indicates that the Company incurred a net loss of $1,322,876 during the year ended December 31, 2010 and, as of that date, the Company had a working capital deficiency of $2,990,796. These conditions, along with other matters as set forth in note 1, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

Other matter

The consolidated balance sheets as at December 31, 2009 and August 31, 2009 and the consolidated statements of loss and comprehensive loss, shareholders' deficiency, and cash flows for the four months ended December 31, 2009 and the year ended August 31, 2009 were audited by PKF Hill LLP who expressed an unmodified opinion on those statements on April 19, 2010.

Grant Thornton LLP

Chartered Accountants, Licensed Public Accountants
Toronto, Canada
April 29, 2011

KNIGHTSCOVE MEDIA CORP.
Consolidated Balance Sheets

	As at December 31, 2010	As at December 31, 2009 (note 1)	As at August 31, 2009 (note 1)
ASSETS			
Current assets			
Accounts receivable	$ 3,540,161	$ 781,550	$ 454,920
Inventory	361,794	533,264	513,971
Income taxes receivable	-	14,292	21,564
Prepaid expenses	124,526	9,520	8,126
	4,026,481	1,338,626	998,581
License advances	255,684	223,381	190,227
Investment in films (note 4)	1,436,259	393,800	398,405
Distribution rights (note 5)	242,629	418,707	433,098
Equipment (note 7)	128,450	47,224	34,532
Investment in Studio 4 Networks (note 12)	-	-	272,852
Deposit on Ellis Entertainment Corporation (note 3)	537,468	215,000	-
Carriage (note 6)	476,663	598,364	-
Goodwill	792,342	792,342	792,342
	$ 7,895,976	$ 4,027,444	$ 3,120,037
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIENCY)			
Current liabilities			
Bank indebtedness (note 8)	$ 357,148	$ 564,452	$ 545,055
Accounts payable and accrued liabilities	1,994,775	2,158,238	2,035,255
Royalties payable	295,581	612,058	440,242
Notes payable (note 9)	240,000	250,000	250,000
Convertible promissory notes (note 10)	380,200	49,973	49,959
Loans payable (note 11)	3,749,573	1,153,117	742,188
	7,017,277	4,787,838	4,062,699
Non-controlling interest (note 12)	80,804	263,051	-
	7,098,081	5,050,889	4,062,699
Shareholders' equity (deficiency)			
Share capital (note 13(a))	7,081,870	4,256,232	3,986,232
Contributed surplus (notes 10, 13(b) and (c))	804,668	486,090	486,090
Deficit	(7,088,643)	(5,765,767)	(5,414,984)
	797,895	(1,023,445)	(942,662)
	$ 7,895,976	$ 4,027,444	$ 3,120,037

Commitments and contingencies (note 14), subsequent events (note 24)

See accompanying notes

On behalf of the Board:

Rick Ferreira, Director

Michael Levine, Director

KNIGHTSCOVE MEDIA CORP.
Consolidated Statements of Loss and Comprehensive Loss

	Year Ended December 31, 2010	Four Months Ended December 31, 2009 (note 1)	Year Ended August 31, 2009 (note 1)
Revenue	$ 3,296,111	$ 1,199,001	$ 2,458,442
Expenses			
Cost of goods sold	866,702	471,464	1,206,049
General and administrative	2,464,888	779,104	1,820,526
Royalty expense	157,730	153,947	325,907
Amortization			
License advances	83,959	4,101	72,010
Investment in films	291,208	1,448	6,147
Distribution rights	180,078	56,079	176,320
Equipment	27,400	7,374	35,353
Carriage	121,701	10,142	-
Impairment loss on intangible assets (note 15)	246,238	48,293	44,578
Interest	361,330	58,247	135,500
	4,801,234	1,590,199	3,822,390
Loss before non-controlling interest and income taxes	(1,505,123)	(391,198)	(1,363,948)
Non-controlling interest portion of loss (note 12)	182,247	40,415	-
Loss before income taxes	(1,322,876)	(350,783)	(1,363,948)
Income taxes (note 17)	-	-	-
Net loss	$ (1,322,876)	$ (350,783)	$ (1,363,948)
Comprehensive loss	$ (1,322,876)	$ (350,783)	$ (1,363,948)
Loss per share (note 19)			
Subordinate voting shares and multiple voting shares - basic and diluted	(0.03)	(0.01)	(0.06)
Weighted average number of shares outstanding			
Subordinate voting shares - basic and diluted	29,025,859	13,012,605	11,272,372
Multiple voting shares - basic and diluted	10,524,741	10,577,197	10,420,463

See accompanying notes

KNIGHTSCOVE MEDIA CORP.
Consolidated Statements of Changes in Shareholders' Equity (Deficiency)

	Subordinate Voting Shares	Multiple Voting Shares	Share Capital Amount	Contributed Surplus	Deficit	Total Equity
Balance, August 31, 2008	10,646,475	9,747,904	$ 3,760,785	$ 485,800	$ (4,051,036)	$ 195,549
Shares for service (note 13(a)(i))	933,334	-	82,000	-	-	82,000
Shares for service (note 13(a)(i))	-	1,329,293	99,697	-	-	99,697
Shares for service (note 13(a)(ii))	583,333	-	43,750	-	-	43,750
Equity portion of debt	-	-	-	290	-	290
Net loss for the year	-	-	-	-	(1,363,948)	(1,363,948)
Balance, August 31, 2009	12,163,142	11,077,197	3,986,232	486,090	(5,414,984)	(942,662)
Conversion of shares (note 13(a)(iii))	1,000,000	(1,000,000)	-	-	-	-
Issuance of shares (note 13(a)(iv))	850,000	-	42,500	-	-	42,500
Issuance of shares (note 13(a)(v))	1,333,332	-	200,000	-	-	200,000
Shares for service (note 13(a)(vi))	366,667	-	27,500	-	-	27,500
Net loss for the period	-	-	-	-	(350,783)	(350,783)
Balance, December 31, 2009	15,713,141	10,077,197	4,256,232	486,090	(5,765,767)	(1,023,445)
Issuance of shares (note 13(a)(vii))	4,100,000	-	354,804	55,196	-	410,000
Shares for service (note 13(a)(viii))	2,083,888	504,613	378,253	-	-	378,253
Equity portion of debt (note 10)	-	-	-	3,783	-	3,783
Issuance of shares (note 13(a)(ix))	2,150,000	-	189,260	25,740	-	215,000
Issuance of shares (note 13(a)(x))	4,576,063	-	410,298	47,308	-	457,606
Issuance of shares (note 13(a)(xi))	1,706,000	-	150,929	19,671	-	170,600
Shares for service (note 13(a)(xii))	25,000	-	1,289	1,211	-	2,500
Issuance of shares (note 13(a)(xiii))	6,750,000	-	596,897	78,103	-	675,000
Issuance of stock options (note 13(c)(iii))	-	-	-	42,354	-	42,354
Exercise of stock options (note 13(a)(xiv))	100,000	-	15,669	(5,669)	-	10,000
Shares for service (note 13(a)(xv))	75,000	-	9,000	-	-	9,000
Issuance of shares (note 13(a)(xvi))	1,672,000	-	180,285	20,355	-	200,640
Issuance of shares (note 13(a)(xvii))	2,551,500	-	275,654	30,526	-	306,180
Shares for service (note 13(a)(xviii))	2,194,167	-	263,300	-	-	263,300
Net loss for the year	-	-	-	-	(1,322,876)	(1,322,876)
Balance, December 31, 2010	43,696,759	10,581,810	$ 7,081,870	$ 804,668	$ (7,088,643)	$ 797,895

See accompanying notes

KNIGHTSCOVE MEDIA CORP.
Consolidated Statements of Cash Flows

	Year Ended December 31, 2010	Four Months Ended December 31, 2009 (note 1)	Year Ended August 31, 2009 (note 1)
Operating activities			
Net loss	$ (1,322,876)	$ (350,783)	$ (1,363,948)
Items not involving cash			
Non-controlling interest portion of loss	(182,247)	(40,415)	-
Amortization			
License advances	83,959	4,101	72,010
Investment in films	291,208	1,448	6,147
Distribution rights	180,078	56,079	176,320
Equipment	27,400	7,374	35,353
Carriage	121,701	10,142	-
Shares issued for service (included in general and administrative expenses)	695,407	27,500	225,447
Impairment loss on intangible assets	246,238	48,293	44,578
Non-cash interest and financing costs	2,938	3,361	154
	143,806	(232,900)	(803,939)
Net change in non-cash working capital items			
Accounts receivable	(2,758,611)	(326,630)	(197,693)
Inventory	171,470	(19,293)	136,216
Income taxes receivable	14,292	7,272	34,686
Prepaid expenses	(115,006)	(1,394)	29,313
Accounts payable and accrued liabilities	(163,463)	122,983	420,260
Royalties payable	(316,477)	124,782	198,588
Cash flows from operating activities	(3,023,989)	(325,180)	(182,569)
Financing activities			
Bank indebtedness	(207,304)	19,397	228,055
Repayments of notes payable	(10,000)	-	-
Proceeds from loans payable	3,085,028	810,000	16,250
Repayment of loans payable	(157,500)	(402,917)	(16,558)
Proceeds from share and warrant issuances	2,445,026	200,000	-
Cash flows from financing activities	5,155,250	626,480	227,747
Investing activities			
Deposit on Ellis Entertainment Corporation	(322,468)	(215,000)	-
Acquisition of license advances	(327,695)	(85,548)	(184,061)
Acquisition of distribution rights	(4,000)	-	(11,799)
Investment in film library	(1,368,473)	3,157	151,318
Purchase of equipment	(108,625)	(3,909)	(636)
Cash flows from investing activities	(2,131,261)	(301,300)	(45,178)
Net change in cash during the period	-	-	-
Cash, beginning of period	-	-	-
Cash, end of period	$ -	$ -	$ -

See accompanying notes (note 20)

1. Nature of business

Operations

Knightscove Media Corp. (the "Company" or "Knightscove") 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 "Knightscove 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. Knightscove 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 December 31, 2010, there were 43,696,759 (December 31, 2009 - 15,713,141 and August 31, 2009 - 12,163,142) subordinate voting shares and 10,581,810 (December 31, 2009 - 10,077,197 and August 31, 2009 - 11,077,197) multiple voting shares outstanding.

The Company chose to change its fiscal year to December 31, effective December 31, 2009. Accordingly, these financial statements reflect the results of consolidated operations and consolidated changes in cash flows for the year ended December 31, 2010, but the comparative figures reflect the consolidated balance sheets and consolidated results of operations for the four month period ended December 31, 2009, and the year ended August 31, 2009.

Going concern

These consolidated financial statements have been prepared on a going concern basis, which presumes that Knightscove will be able to realize its assets and discharge its liabilities in the normal course of operations for the foreseeable future. At December 31, 2010, the Company had a deficit of $7,088,643 and a working capital deficiency of $2,990,796. The Company's ability to continue as a going concern is dependent upon its ability to generate sufficient operating cash flows and to obtain sufficient financing until it achieves consistently profitable operations.

Management has implemented a number of strategies to achieve these objectives. In September 2009, management prepared a comprehensive business plan and believes that, since then, significant progress has been made in achieving objectives. The investments in Studio 4 Networks and Ellis Entertainment Corporation (note 3) are in accordance with the plan. General and administrative expenses have been and will continue to be reduced in areas which will not interfere with client service. This includes transferring all inventory from third party warehouse facilities to warehouse space managed by the Company, and moving office space to a substantially less expensive location subsequent to year end. In addition, the completion of the film Sophie will provide significant future cash inflows. Total projected revenues from the film are $5,838,000 with $1,187,410 having been recognized during the year. The Company has also recorded estimated film production tax credits receivable of $2,267,353. With Knightscove's continued financing endeavours, the reduction of general and administrative expenses and continuing support of its creditors, the Company believes it will be able to meet its short-term cash flow requirements.

Subsequent to year end, investors have committed to financial support (note 24). The Company is expecting continuing support from its significant creditors who are not expected to demand repayment of their debt in 2011. Based on success with operating and financial objectives, management believes that the use of accounting principles applicable to a going concern is appropriate. Accordingly, 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. Such adjustments could be material.

2. Summary of significant accounting policies

These consolidated financial statements have been prepared 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 which consist of Knightscove Family Films Inc., Sophie Films Inc. (formerly 2096013 Ontario Inc.), Morningstar, Sophie Films 2009 Inc. and its 51% owned subsidiary, KnightTV Inc.

Use of estimates

The preparation of financial statements in accordance with 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: determining any impairment on and the useful lives of license advances, investment in films, distribution rights, carriage, equipment and goodwill; determining the allowance for accounts receivable doubtful accounts; estimating the provision for sales returns; estimating the fair value of stock-based compensation and warrants; and determining the valuation allowance for future income taxes. Actual results could differ from those estimates.

Inventory

Inventory is comprised of completed DVDs in addition to the materials and packaging required to produce individual DVDs. Inventory is valued at the lower of cost and net realizable value, determined on a first-in first-out basis.

In determining net realizable 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 $267,017 (four months ending December 31, 2009 - $28,719 and year ended December 31, 2009 - $Nil) related to obsolete inventory.

License advances

License 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 license agreement. In most cases, the term of the license agreement is five years.

License advances are reviewed on a title-by-title basis for recoverability when an event or change in circumstances indicates that the carrying amounts may not be recoverable on an undiscounted cash flow basis. The fair value of the license advance is determined using management’s future revenue and cost estimates and a discounted cash flow approach. Additional amortization is recorded in the amount by which the unamortized costs exceed the estimated fair value of the license advance should the carrying amounts be determined not recoverable. Estimates of future revenue involve measurement uncertainty and it is therefore possible that reductions in the carrying value of license advances may be required as a consequence of changes in management’s future revenue estimates.

2. Summary of significant accounting policies - continued

Investment in films

Investment in films includes the unamortized costs of completed films which have been produced by the Company or for which the Company has acquired distribution rights, or libraries acquired as part of acquisitions of companies and films in progress and in development.

For films produced by the Company, capitalized costs include all direct production and financing costs, capitalized interest and production overhead. For acquired films these capitalized costs consist of the purchase price to acquire the distribution rights.

Costs of acquiring and producing films and of acquired libraries are capitalized, net of federal and provincial program contributions earned, and amortized using the individual-film-forecast method, whereby these costs are amortized and participations and residual costs are accrued in the proportion that current year's revenue bears to management's estimate of ultimate revenue at the beginning of the current year and expected to be recognized from the exploitation, exhibition or sale of the films. Production financing provided by third parties that acquire substantive equity participation is recorded as a reduction of the cost of the production. Acquired participation costs are recognized initially at the amounts paid or the fair value of amounts due to the counterparty.

Ultimate revenue includes estimates over a period not to exceed ten years following the date of initial release or from the date of delivery. For titles included in acquired libraries, ultimate revenue includes estimates over a period not to exceed twenty years following the date of acquisition.

Investment in films is reviewed on a title-by-title basis for recoverability, when an event or change in circumstances indicates that the carrying amounts may not be recoverable on an undiscounted cash flow basis. The fair value of the film is determined using management's future revenue and cost estimates and a discounted cash flow approach. Additional amortization is recorded in the amount by which the unamortized costs exceed the estimated fair value of the film should the carrying amounts be determined not recoverable. Estimates of future revenue involve measurement uncertainty and it is therefore possible that reductions in the carrying value of investment in films may be required as a consequence of changes in management's future revenue estimates.

Films in development includes the accumulated costs of productions which have not yet been completed. Costs capitalized include production costs and financing costs, capitalized interest and overhead costs incurred on commencement of principal photography. Such costs are capitalized and, upon commencement of production are transferred to films completed. Projects in development are written off at the earlier of the date they are determined not to be recoverable or when abandoned.

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 license period of five years.

Distribution rights are reviewed on a title-by-title basis for recoverabilities when an event or change in circumstance indicates that the carrying amount may not be recoverable on an undiscounted cash flow basis. The fair value of the right is determined using management's future revenue and cost estimates and a discounted cash flow approach. Additional amortization is recorded in the amount by which the unamortized costs exceed the estimated fair value of the right should the carrying amounts be determined not recoverable. Estimates of future revenue involve measurement uncertainty and it is therefore possible that reductions in the carrying value of distribution rights may be required as a consequence of changes in management's future revenue estimates.

2. Summary of significant accounting policies - continued

Carriage

Carriage is the television programming video-on-demand distribution agreements in place with United States ("US") distribution entities. Carriage is amortized on an individual agreement basis over their remaining useful life, in most cases, an agreement period of five years.

Management reviews annually the carrying value of the carriage for impairment by comparing the carrying amount to the estimated undiscounted future net cash flows. The Company writes down the costs associated with carriage to their fair value when the carrying value is determined to be not recoverable on an undiscounted cash flow basis.

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
Websites	5 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.

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 at least 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 unit as at December 31, 2010 and compared this to the carrying amount and determined that no impairment of goodwill existed.

2. Summary of significant accounting policies - continued

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. All financial assets and liabilities are initially recognized at fair value.

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

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

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 including: (i) persuasive evidence of a sale or licensing arrangement with a customer exists; (ii) the film is complete, and in accordance with the terms of the arrangement, has been delivered or is available for immediate and unconditional delivery; (iii) the license period of the arrangement has begun and the customer can begin its exploitation, exhibition, or sale; 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 or earlier when certain conditions are fulfilled 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.

2. Summary of significant accounting policies - continued

Warrants

The Company allocates the proceeds received from the issue of share units to the shares and warrants based on their relative fair values. The fair value of the shares is determined by the closing price on the date of the transaction and the fair value of the warrants are determined using the Black-Scholes model.

Income taxes

The Company follows the liability method of accounting for income taxes. Under this method, future tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between financial statement carrying amounts of assets and liabilities and their respective tax bases and unclaimed losses carried forward measured using the substantively enacted income tax rates and laws expected to apply when these temporary differences reverse. 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 if the effect of including them would be 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.

Convergence to IFRS

The Canadian Institute of Chartered Accountants (“CICA”) 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 December 31, 2011. The 2011 financial statements will include comparative 2010 financial results under IFRS.

3. Deposit on Ellis Entertainment Corporation

In March 2009, Knightscove signed a proposed agreement to acquire 100% of the shares of Ellis Entertainment Corporation. In December 2009, Knightscove paid a $215,000 secured cash deposit against the anticipated purchase price of $2,820,000. During 2010, Knightscove paid a further $138,501 against the anticipated purchase price.

On December 17, 2010, Knightscove filed a notice of intention to purchase the assets of Ellis Entertainment Corporation through the purchase of their senior debt held by the Royal Bank of Canada of $183,967. The transaction closed effective January 13, 2011 and was conducted in accordance with the foreclosure process under Section 65(2) of the *Personal Property Security Act (Ontario)*, such that the assets are free of all encumbrances and claims against Ellis Entertainment Corporation.

4. Investment in films

	December 31, 2010	December 31, 2009	August 31, 2009
Films in development	$ 117,401	$ 207,003	$ 210,160
Films completed			
Cost, net of government and third party assistance and third party participation	1,458,074	-	-
Accumulated amortization	(283,341)	-	-
	1,174,733	-	-
Film library			
Cost	316,885	316,885	316,885
Accumulated amortization	(137,955)	(130,088)	(128,640)
Accumulated impairment in value of certain film library titles	(34,805)	-	-
	144,125	186,797	188,245
	$ 1,436,259	$ 393,800	$ 398,405

5. Distribution rights

	Cost	Accumulated Amortization	Net
December 31, 2010	$ 903,720	$ 661,091	$ 242,629
December 31, 2009	$ 899,720	$ 481,013	$ 418,707
August 31, 2009	$ 821,688	$ 388,590	$ 433,098

6. Carriage

	Cost	Accumulated Amortization	Net
December 31, 2010	$ 608,506	$ 131,843	$ 476,663
December 31, 2009	$ 608,506	$ 10,142	$ 598,364
August 31, 2009	$ -	$ -	$ -

7. Equipment

	December 31, 2010		
	Cost	Accumulated Amortization	Net
Computer equipment	$ 168,809	$ 111,837	$ 56,972
Computer software	110,862	61,181	49,681
Websites	21,084	12,209	8,875
Office furniture	25,965	25,965	-
Leasehold improvements	38,124	25,202	12,922
	$ 364,844	$ 236,394	$ 128,450

	December 31, 2009		
	Cost	Accumulated Amortization	Net
Computer equipment	$ 119,097	$ 102,742	$ 16,355
Computer software	54,012	53,361	651
Websites	22,994	8,620	14,374
Office furniture	25,965	25,965	-
Leasehold improvements	34,150	18,306	15,844
	$ 256,218	$ 208,994	$ 47,224

	August 31, 2009		
	Cost	Accumulated Amortization	Net
Computer equipment	$ 108,310	$ 94,446	$ 13,864
Computer software	54,012	51,464	2,548
Websites	-	-	-
Office furniture	25,965	25,965	-
Leasehold improvements	34,150	16,030	18,120
	$ 222,437	$ 187,905	$ 34,532

8. Bank indebtedness

	December 31, 2010	December 31, 2009	August 31, 2009
Cash and outstanding cheques	$ 14,648	$ 31,960	$ (1,409)
Revolving demand facility (a)	255,000	300,000	260,000
Non-revolving demand facility (b)	87,500	232,492	286,464
	$ 357,148	$ 564,452	$ 545,055

(a) Morningstar has a $300,000 (December 31, 2009 - $300,000 and August 31, 2009 - $300,000) revolving demand facility in place with a major Canadian bank. At December 31, 2010, $255,000 (December 31, 2009 - $300,000 and August 31, 2009 - $260,000) had been utilized. The facility bears interest at prime plus 3.6%.

(b) Morningstar has a $300,000 (December 31, 2009 - $300,000 and August 31, 2009 - $300,000) non-revolving term facility with a major Canadian bank. At December 31, 2010, $87,500 (December 31, 2009 - $232,492 and August 31, 2009 - $286,464) had been utilized. The facility bears interest at prime plus 4.75% and is repayable in full on July 16, 2011.

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 December 31, 2010, December 31, 2009 and August 31, 2009, the Company was in compliance with the required financial covenant.

9. Notes payable

As at December 31, 2010, the Company had outstanding notes payable in respect of the Morningstar acquisition in the aggregate principal amount of $240,000 (December 31, 2009 - $240,000 and August 31, 2009 - $250,000) consisting of two promissory notes to the vendors in the principal amount of $120,000 each (December 31, 2009 - $120,000 each and August 31, 2009 - $125,000 each). The notes yield an interest rate of 6% payable upon payment of the principal (accrued interest is included with accounts payable and accrued liabilities). The holders of the two outstanding notes have deferred repayment until the Company completes a future financing. These notes are secured by substantially all of the assets of Morningstar, behind the bank credit facility (note 8) and loans payable (note 11).

10. Convertible promissory notes

	December 31, 2010	December 31, 2009	August 31, 2009
Two subordinated, convertible promissory notes (a)	$ 49,848	$ 49,973	$ 49,959
Convertible promissory note payable to GC-Global Capital Corp. (b)	230,618	-	-
Convertible debenture payable to a private lender (c)	99,734	-	-
	$ 380,200	$ 49,973	$ 49,959

(a) The convertible promissory notes consist of two subordinated, unsecured, convertible promissory notes payable of $25,000 each. These notes were initially due on March 22, 2008, and were extended to March 22, 2009, then to March 22, 2010 and then to March 22, 2011. The notes were not repaid at that date and extended terms are being negotiated.

10. Convertible promissory notes - continued

In accordance with the terms at March 22, 2010, the notes are unsecured and are convertible at the debt holder's option into subordinate voting shares of the Company at a rate of $.25 per share. Interest at 12% is payable semi-annually.

The difference between the face value of $50,000 and the carrying value of $49,848 (December 31, 2009 - $49,973 and August 31, 2009 - $49,959) represents the net effect of the value of the conversion features credited to contributed surplus and interest expense accreted to the liability. The equity value of the convertible debentures was calculated to be $606 (four months ended December 31, 2009 - $27 and year ended August 31, 2009 - $113) and was applied to contributed surplus. Interest expense of $454 (four months ended December 31, 2009 - $Nil and year ended August 31, 2009 - $Nil) was accreted for the year.

(b) 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 was amended to December 15, 2009. At December 31, 2009, the principal outstanding amount of the loan was $231,145 (note 11(a)).

On April 1, 2010, the principal outstanding of $231,145 was replaced by a convertible promissory note payable. The promissory note payable bears interest at 12% per annum, payable quarterly with a maturity date of April 1, 2011 and management is negotiating an extended due date. At the option of the holder, at any time prior to the maturity date, the promissory note payable may be converted into 1,540,970 subordinate voting shares and 770,485 warrants with each warrant providing the entitlement to acquire one additional subordinate voting share at an exercise price of $0.25. Additionally, as the renewed loan has conversion rights it has been allocated between liabilities and equity based on the estimated fair value of the promissory note payable and the conversion feature. The equity value of the convertible debentures was calculated to be $2,112 and was applied to contributed surplus.

The difference between the face value of $231,145 and the carrying value of $230,618 represents the net effect of the value of the conversion features credited to contributed surplus and interest expense accreted to the liability. Interest expense of $1,585 (four months ended December 31, 2009 - $Nil and year ended August 31, 2009 - $Nil) was accreted for the year.

(c) On April 1, 2010 the principal outstanding of $100,000 of a bridge loan payable (note 11(e)) was replaced by a convertible debenture. The debenture bears interest at 12% per annum, payable quarterly with a maturity date of April 1, 2011 and management is negotiating an extended due date. At the option of the holder, at any time prior to the maturity date, the debentures may be converted into 666,667 subordinate voting shares and 333,334 warrants with each warrant providing the entitlement to acquire one additional subordinate voting share at an exercise price of $0.25. Additionally, as the renewed debenture has conversion rights the value has been allocated between liability and equity based on the estimated fair value of the debenture and the conversion feature. The equity value of the convertible debentures was calculated to be $1,065 and was applied to contributed surplus.

For the year ended December 31, 2010, interest expense of $799 (four months ended December 31, 2009 - $74 and year ended August 31, 2009 - $134) had been accreted to the convertible debenture. Accordingly, the convertible debenture was recorded at $99,734 at December 31, 2010.

10. Convertible promissory notes - continued

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 (a)	0.96%
Risk-free interest rate (b) and (c)	1.29%
Dividend yield	0%
Volatility (a)	98%
Volatility (b) and (c)	93%
Expected life	1.00 year

11. Loans payable

	December 31, 2010	December 31, 2009	August 31, 2009
Loan payable to GC-Global Capital Corp (a)	$ -	$ 231,145	$ 321,145
Loan payable to GC-Global Capital Corp (b)	250,000	-	-
Loan payable to National Bank of Canada (c)	2,109,299	-	-
Loan payable to National Bank of California (d)	475,453	-	-
Bridge loan payable (e)	-	99,926	399,793
Promissory note payable (f)	854,121	803,846	-
Other advances (g)	60,700	18,200	21,250
	$ 3,749,573	$ 1,153,117	$ 742,188

(a) In September 2007, a loan in the principal amount of $600,000 was provided by Global and subsequently 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 was amended to December 15, 2009. At December 31, 2009, the principal outstanding amount of the loan was $231,145 and management was negotiating an extended due date. On April 1, 2010, the principal outstanding of $231,145 was replaced by convertible promissory note payable (note 10(b)).

(b) On June 9, 2010, a loan of $250,000 was provided by Global for the production of the motion picture Sophie. The loan bears interest of 12% per annum payable monthly in arrears with a maturity date of June 9, 2011. A further consideration of 6% of net profits flowing from the exploitation of the production shall be a perpetual entitlement. The fair value of this further consideration was considered by management to be insignificant and accordingly, no value has been assigned to this further consideration in these consolidated financial statements. Any payments as a result of the further consideration will be expensed as paid.

The loan is secured pari passu by a first ranking security interest in the non-consolidated Knightscove 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) On June 18, 2010, the Company entered into an agreement with the National Bank of Canada for a non-revolving special credit in the amount of up to $2,267,000 to assist with the financing of the motion picture Sophie. At December 31, 2010, $2,109,299 had been utilized. The loan bears interest of 2% per annum payable monthly. The loan is to be repaid upon receipt of anticipated refundable federal and provincial film tax credits, but no later than December 31, 2011.

11. Loans payable - continued

The Company also entered into an agreement with the National Bank of Canada for a non-revolving special line of credit in the amount of up to $200,000 to finance the balance to be received from Ontario Media Development Corporation ("OMDC") as part of the project to finance the production of Sophie. At December 31, 2010, none had been utilized. The loan bears interest at 2% per annum payable monthly. The loan is to be repaid upon receipt of the funds from OMDC, but no later than June 30, 2011.

(d) On July 16, 2010, the Company entered into an agreement with the National Bank of California for a principal amount of $731,602 in US funds to be used to pay for costs of production of Sophie. At December 31, 2010, a balance of $475,453 was outstanding. The loan bears interest at an annual rate of 3% plus the prime rate of interest published by The Wall Street Journal, but no less than 8% per annum and is due on July 16, 2011.

(e) On May 23, 2008, the Company secured bridge financing from a private lender in the amount of $400,000, due on May 26, 2009, at 18% per annum. 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. 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 conversion feature. The equity value of the convertible note was calculated to be $208 and was applied to contributed surplus.

During the four month period ended December 31, 2009, $100,000 of principal on the loan was repaid. An additional $200,000 was converted into a portion of the promissory note payable (note 11(a)). Accordingly, the loan was recorded at $99,926 at December 31, 2009.

On April 1, 2010, the principal outstanding of $100,000 on the bridge loan payable was replaced by a convertible debenture (note 10(c)).

(f) On December 17, 2009, a loan in the principal amount of $1,000,000 was provided by Jones, Gable & Company Ltd., Leif Bristow, John Lane and the private lender described in note 11(e). The loan bears interest at 12% per annum, payable quarterly in arrears, beginning March 31, 2010. The loan matures on December 17, 2011 and 25% of any capital raised in excess of $350,000 in one tranche shall be used to repay the principal. In addition, 25% of quarterly earnings before interest, taxes, depreciation and amortization ("EBITDA") is to be used to repay the principal.

As part of the facility, the lenders were issued 1,333,332 subordinate voting shares for a total value of $200,000 (note 13 (a)(v)). The value of the shares issued was included in the loan which is accreted over time at the effective interest rate. $100,275 (four months ended December 31, 2009 - $3,846 and year ended August 31, 2009 - $Nil) was expensed as interest in the current year. In addition, $50,000 contributed by Leif Bristow was repaid during 2010. Accordingly, the loan payable was recorded at $854,121 at December 31, 2010.

(g) Other advances are non-interest bearing, unsecured and due on demand (note 16).

12. Investment - Studio 4 Networks and non-controlling interest

Investment - Studio 4 Networks

In fiscal 2008, management signed a letter of intent to acquire Kidmazing, a division of Studio 4 Networks ("Studio 4"), a Los Angeles-based broadband and video-on-demand ("VOD") broadcaster. A purchase deposit of $272,852 was made at that time.

On November 30, 2009, the Company and Studio 4 incorporated KnightTV Inc. (KnightTV). The Company acquired 51% of the issued common shares of KnightTV, for aggregate consideration of $315,852, consisting of the deposit of $272,852 and 850,000 subordinate voting shares of the Company at an issue price of $.05 per share. Studio 4 subscribed for the remaining 49% of the common shares. On the same date, KnightTV acquired from Studio 4, 100% of the assets of its Kidmazing division. The Company has the option to purchase the remaining 49% of KnightTV for either US$1,000,000 in cash or shares issued to Studio 4.

The summary of the purchase price allocation for the Company's acquired interest and resulting carriage is as follows:

Carriage	$ 608,506
Equipment	16,157
Distribution rights	41,688
Royalties payable	(47,033)
	619,318
Less: non-controlling interest	(303,466)
Total consideration	$ 315,852

Non-controlling interest

Non-controlling interest portion of purchase price equation	$ 303,466
Less: non-controlling interest portion of loss for the four month period ended December 31, 2009	(40,415)
Non-controlling interest as at December 31, 2009	263,051
Less: non-controlling interest portion of loss for the year ended December 31, 2010	(182,247)
Non-controlling interest as at December 31, 2010	$ 80,804

13. Shareholders' equity (deficiency)

(a) Share capital

The Company has authorized an unlimited number of subordinate voting (KC.A) and multiple voting (KC.B) shares. Both classes are fully participating and the multiple voting carry 50 votes per share and the subordinate voting class carries one vote per share. Changes in share capital, starting on September 1, 2008 through to December 31, 2010, are listed in the consolidated statements of changes in shareholders' equity (deficiency).

(i) On February 27, 2009, Knightscove issued 166,667 subordinate voting shares (“SVS”) 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.

(ii) Knightscove issued 283,333 subordinate voting shares in May 2009 to Global for consulting services. In addition, in May 2009, the Company issued 150,000 subordinate voting shares to each of Kai Vogt and Tonclay Capital Inc. as payment for services. In each case, the shares were issued at a price of $0.075 per share. The shares were subject to a four-month hold period.

(iii) On November 2, 2009, a shareholder exercised their option to convert 1,000,000 multiple voting shares to 1,000,000 subordinate voting shares.

(iv) Knightscove issued 850,000 subordinate voting shares on December 8, 2009 to Studio 4 Networks as part consideration for the acquisition of 51% of KnightTV Inc. The shares were issued at a price of $0.05.

(v) On December 15, 2009, Knightscove issued 666,666 subordinate voting shares to Jones, Gable & Company Ltd., 333,333 to John D. Lane and 333,333 to Leif Bristow as part of a collective credit facility of $1,000,000 (note 11(f)). The shares were issued at a price of $0.15 per share.

(vi) On December 22, 2009, 366,667 subordinate voting shares were issued to Global for consulting services. The shares were issued at a price of $0.075 per share.

(vii) On January 1, 2010, the Company issued 4,100,000 subordinate voting shares to subscribers for general working capital purposes. Each share was issued with one half of one warrant attached, convertible into subordinate voting shares at an exercise price of $0.15, for a term of one year from issuance. The value of the warrants was calculated to be $55,196 and was applied to contributed surplus. The shares were issued at a price of $0.10 per share.

(viii) On February 10, 2010, Knightscove issued 2,083,888 subordinate voting shares for consulting services and 504,613 multiple voting shares to Leif Bristow as payment of deferred salary. 250,555 of the shares were issued at a price of $0.11 per share and the remainder at $0.15 per share.

13. Shareholders' equity (deficiency) - continued

(ix) On April 29, 2010, Knightscove issued 2,150,000 subordinate voting shares to subscribers for general working capital purposes. Each share was issued with one half of one warrant attached, convertible into subordinate voting shares at an exercise price of $0.15 for a term of one year from issuance. The value of the warrants was calculated to be $25,740 and was applied to contributed surplus. The shares were issued at a price of $0.10 per share.

(x) On June 16, 2010, Knightscove issued 4,576,063 subordinate voting shares to subscribers for general working capital purposes. Each share was issued with one half of one warrant attached, convertible into subordinate voting shares at an exercise price of $0.15 for a term of one year from issuance. The value of the warrants was calculated to be $47,308 and was applied to contributed surplus. The shares were issued at a price of $0.10 per share.

(xi) On August 6, 2010, Knightscove issued 1,706,000 subordinate voting shares to subscribers for general working capital purposes. Each share was issued with one half of one warrant attached, convertible into subordinate voting shares at an exercise price of $0.15 for a term of one year from issuance. The value of the warrants was calculated to be $19,671 and was applied to contributed surplus. The shares were issued at a price of $0.10 per share.

(xii) On August 24, 2010, Knightscove issued 25,000 subordinate voting shares as payment for consultancy fees. The Company also issued 52,500 warrants, exercisable until June 16, 2011, convertible into subordinate voting shares at an exercise price of $0.15. The value of the warrants was calculated to be $1,211 and was applied to contributed surplus. The shares were issued at a price of $0.10 per share.

(xiii) On September 8, 2010, Knightscove issued 6,750,000 subordinate voting shares to subscribers for general working capital purposes. Each share was issued with one half of one warrant attached, convertible into subordinate voting shares at an exercise price of $0.15 for a term of one year from issuance. The value of the warrants was calculated to be $78,103 and was applied to contributed surplus. The shares were issued at a price of $0.10 per share.

(xiv) On September 16, 2010, a consultant exercised their option to purchase 100,000 subordinate voting shares at a price of $0.10 per share (note 13(c)(iv)).

(xv) On October 4, 2010, Knightscove issued 75,000 subordinate voting shares to a lender as a debt bonus. The shares were issued at a price of $0.12 per share representing fair value at the time of issuance. The $9,000 value of the shares was recorded as interest expense.

(xvi) On October 27, 2010, Knightscove issued 1,672,000 subordinate voting shares to subscribers for general working capital purposes. Each share was issued with one half of one warrant attached, convertible into subordinate voting shares at an exercise price of $0.20 for a term of one year from issuance. The value of the warrants was calculated to be $20,355 and was applied to contributed surplus. The shares were issued at a price of $0.12 per share.

(xvii) On November 23, 2010, Knightscove issued 2,551,500 subordinate voting shares to subscribers for general working capital purposes. Each share was issued with one half of one warrant attached, convertible into subordinate voting shares at an exercise price of $0.20 for a term of one year from issuance. The value of the warrants was calculated to be $30,526 and was applied to contributed surplus. The shares were issued at a price of $0.12 per share.

13. Shareholders' equity (deficiency) - continued

(xviii) On December 21, 2010, Knightscove issued 2,104,167 and 90,000 subordinate voting shares to consultants and employees, respectively. The shares were issued as payment for services and employee bonuses, respectively. The shares were issued at a price of $0.12 per share, representing fair value at the time of issuance. The $263,300 value of the shares was recorded as general and administrative expenses.

(b) Warrants

A summary of the outstanding warrants is presented below:

Description	Issue Date	Expiry Date	Exercise Price	Number of Warrants	Convertible Into SVS
Outstanding at August 31, 2009					
and December 31, 2009 (i)	July 22, 2008	July 22, 2010	$0.50	400,000	400,000
Warrants issued on:					
private placement (ii)	Jan 1, 2010	Jan 1, 2011	$0.15	2,050,000	2,050,000
private placement (iii)	April 29, 2010	April 29, 2011	$0.15	1,075,000	1,075,000
private placement (iv)	June 16, 2010	June 16, 2011	$0.15	2,288,032	2,288,032
expiry (i)	July 22, 2008	July 22, 2010	$0.50	(400,000)	(400,000)
private placement (v)	Aug 6, 2010	Aug 6, 2011	$0.15	853,000	853,000
private placement (vi)	Aug 24, 2010	Aug 24, 2011	$0.15	52,500	52,500
private placement (vii)	Sep 8, 2010	Sep 8, 2011	$0.15	3,375,000	3,375,000
private placement (viii)	Oct 27, 2010	Oct 27, 2011	$0.20	836,000	836,000
private placement (ix)	Nov 23, 2010	Nov 23, 2011	$0.20	1,275,750	1,275,750
Outstanding at December 31, 2010				11,405,282	11,405,282

(i) On July 22, 2008, a private placement investor was issued 400,000 warrants for a two year term, convertible into subordinate voting shares at an exercise price of $0.50. The value of the warrants was calculated to be $22,918 and was applied to contributed surplus. On July 22, 2010, the warrants expired.

(ii) On January 1, 2010, private placement investors were issued 2,050,000 warrants for a one year term, convertible into subordinate voting shares at an exercise price of $0.15 (note 13(a)(vii)). The value of the warrants was calculated to be $55,196 and was applied to contributed surplus.

(iii) On April 29, 2010, private placement investors were issued 1,075,000 warrants for a one year term, convertible into subordinate voting shares at an exercise price of $0.15 (note 13(a)(ix)). The value of the warrants was calculated to be $25,740 and was applied to contributed surplus.

(iv) On June 16, 2010, private placement investors were issued 2,288,032 warrants for a one year term, convertible into subordinate voting shares at an exercise price of $0.15 (note 13(a)(x)). The value of the warrants was calculated to be $47,308 and was applied to contributed surplus.

(v) On August 6, 2010, private placement investors were issued 853,000 warrants for a one year term, convertible into subordinate voting shares at an exercise price of $0.15 (note 13(a)(xi)). The value of the warrants was calculated to be $19,671 and was applied to contributed surplus.

(vi) On August 24, 2010, a private placement investor was issued 52,500 warrants for a one year term, convertible into subordinate voting shares at an exercise price of $0.15 (note 13(a)(xii)). The value of the warrants was calculated to be $1,211 and was applied to contributed surplus.

13. Shareholders' equity (deficiency) - continued

(vii) On September 8, 2010, private placement investors were issued 3,375,000 warrants for a one year term, convertible into subordinate voting shares at an exercise price of $0.15 (note 13(a)(xiii)). The value of the warrants was calculated to be $78,103 and was applied to contributed surplus.

(viii) On October 27, 2010, private placement investors were issued 836,000 warrants for a one year term, convertible into subordinate voting shares at an exercise price of $0.20 (note 13(a)(xvi)). The value of the warrants was calculated to be $20,355 and was applied to contributed surplus.

(ix) On November 23, 2010, private placement investors were issued 1,275,750 warrants for a one year term, convertible into subordinate voting shares at an exercise price of $0.20 (note 13(a)(xvii)). The value of the warrants was calculated to be $30,526 and was applied to contributed surplus.

The Black-Scholes option pricing model was employed using the following assumptions to calculate the fair value of warrants issued:

Risk-free interest rate	0.56 - 1.39%
Dividend yield	0%
Volatility	85 - 101%
Expected life	1 year

(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. All issued and outstanding stock options are for subordinate voting shares.

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

	Number of Options	**Weighted Average Exercise Price**
Outstanding and exercisable at August 31, 2008	925,000	0.27
Retired (i)	(50,000)	0.40
Outstanding and exercisable at August 31, 2009	875,000	0.27
Retired (ii)	(100,000)	0.25
Outstanding and exercisable at December 31, 2009	775,000	0.27
Issued (iii)	600,000	0.12
Exercised (iv)	(100,000)	0.10
Retired (v)	(675,000)	0.25
Outstanding and exercisable at December 31, 2010	600,000	0.16

13. Shareholders' equity (deficiency) - continued

(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.

(ii) In October, 2009, 100,000 stock options held by two directors expired and were retired. No employee or director stock options were granted in the period ended December 31, 2009.

(iii) In September 2010, two consultants were granted 600,000 stock options, 400,000 at an exercise price of $0.10 and 200,000 at an exercise price of $0.15 per share. The value of the stock options was calculated to be $42,354 and was applied to contributed surplus.

(iv) In September 2010, 100,000 stock options were exercised by a consultant at a price of $0.10 per share. The value of the stock options when granted, being $5,669, has been transferred from contributed surplus to share capital.

(v) In December 2010, 675,000 of stock options held by three directors expired and were retired.

At year end, the expiry dates on outstanding options were between August 2011 and September 2011 with exercise prices between $0.10 and $0.40.

No employee or director stock options were granted in the year ended December 31, 2010.

The Black-Scholes option pricing model was employed using the following assumptions to calculate the fair value of stock options issued:

Risk-free interest rate	1.27%
Dividend yield	0%
Volatility	91%
Expected life	1 year

14. Commitments and contingencies

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

2011	$ 169,815
2012	126,550
2013	122,528
2014	16,494
	$ 435,387

15. Impairment loss on intangible assets

	Year Ended December 31, 2010	Four Months Ended December 31, 2009	Year Ended August 31, 2009
Impairment loss on license advances	$ 211,433	$ 48,293	$ 44,578
Impairment loss on investments in films	34,805	-	-
	$ 246,238	$ 48,293	$ 44,578

16. 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 maximum 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 year ended August 31, 2009 (note 13(a)(i)). 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 had accrued a liability of $75,692 to reflect salary owing to Mr. Bristow as at December 31, 2009 (August 31, 2009 - $98,000). This liability has been paid in shares of the Company during the year ended December 31, 2010 (Note 13(a)(viii)). The Company has accrued a liability of $41,395 to reflect salary owing to Mr. Bristow as at December 31, 2010.

Leif Bristow is the holder of one of the two subordinated unsecured convertible promissory notes (note 10(a)) each in the amount of $25,000 which were due to mature on March 22, 2011. Additional unsecured advances were made to the Company by Mr. Bristow in the amount of $Nil (December 31, 2009 and August 31, 2009 - $3,200) (note 11(g)). In addition, Mr. Bristow's wife, Agnes Bristow, provided the Company with unsecured advances totaling $50,700 (note 11(g)). Netted against investment in films are amounts attributable to 1365106 Ontario Ltd. and Mr. Bristow’s daughter in the amount of $80,000 and $50,000 respectively.

At December 31, 2010, one of the directors of the Company is the President and CEO of Global (note 10(b)). John Lane, one of the Company's directors, participated in the promissory note payable (note 11(f)).

17. Income taxes

As at December 31, 2010, 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:

	Year Ended December 31, 2010	Four Months Ended December 31, 2009	Year Ended August 31, 2009
Combined statutory income tax rate	31.00%	33.00%	33.12%
Expected income tax recovery	$ 410,091	$ 129,095	$ 464,168
Decrease in income tax recovery			
Permanent differences	1,000	590	(5,503)
Valuation allowance	(309,817)	(123,822)	(57,496)
Impact of change in rates on tax loss carry forward	(101,274)	(5,863)	(401,169)
	$ -	$ -	$ -

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

	Year Ended December 31, 2010	Four Months Ended December 31, 2009	Year Ended August 31, 2009
Non-capital tax loss carry forward	$ 1,691,920	$ 1,536,322	$ 1,523,640
Financing costs	102,000	111,427	78,492
Cumulative eligible capital	76,000	87,128	26,559
Reserve for sales provision	67,000	66,000	54,325
Investment in films	(566,000)	-	-
Distribution rights	(75,000)	(138,173)	(143,464)
Total future tax assets	1,295,920	1,662,704	1,539,552
Less: valuation allowance	(1,295,920)	(1,662,704)	(1,539,552)
Net future tax assets	$ -	$ -	$ -

As at December 31, 2010, the Company had accumulated non-capital losses for income tax purposes of $5,459,566, which can be carried forward to reduce future Canadian taxable income. The tax effect of these losses is $1,691,920, as presented above.

17. Income taxes - continued

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

2011	$ 507,745
2012	807,626
2025	543,945
2026	630,128
2027	275,111
2028	141,556
2029	1,749,410
2030	804,045
	$ 5,459,566

18. 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 with current maturities. Due to the relatively stable Canadian financial markets, the risk associated with debt is not significant. The Company does not hedge potential exposure to interest rate risk related to this facility.

Foreign currency risk

Although the Company operates primarily in Canada, it purchases some of its DVD licenses from the US or internationally based companies, which gives rise to a risk that its operating earnings may be adversely impacted by fluctuations in foreign exchange conversion rates. In addition, some of the Company's acquisition plans would involve payments in US currency. As at December 31, 2010, 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 DVD sales. The Company mitigates this credit risk through their credit monitoring policies.

Amounts receivable from the Canadian federal government and other government agencies in connection with federal and provincial production tax credits represents 64% of total amounts receivable at December 31, 2010 (December 31, 2009 - Nil and August 31, 2009 - Nil). Certain of these amounts are subject to audit by the government agency. Management believes that these amounts are fully collectible. Management believes that it is standard for the industry for some amounts receivable to take considerable time to collect, for instance, it is normal course for federal and provincial tax credits receivable, to take up to 24 months to proceed through audit and collection. The Company adjusts amounts receivable from Canadian federal government and other government agencies for any known differences arising from internal or external audit of these balances. An allowance against federal and provincial tax credits receivable has been recorded based on the Company's history of collection of these receivables.

18. Financial instruments - continued

Credit risk and customer concentration - continued

The balance of trade accounts receivable are mainly with Canadian broadcasters and large distribution companies. Management believes that the net amounts recorded are fully collectible. The Company has recorded a provision for sales returns of 24% against the gross amounts for certain trade accounts receivable based on historical return rates. Management believes that the net amount of trade accounts receivable is fully collectible.

Liquidity risk

Liquidity risk is the risk that the Company will encounter difficulty in raising funds to meet commitments associated with financial instruments. The Company manages liquidity risk primarily by maintaining sufficient unused capacity within its loan facilities, extension of terms with private lenders and by continuously monitoring forecasted and actual cash flows. The unused capacity at December 31, 2010 was $357,701. Further information with respect to the Company's loan facilities is provided in note 11.

The following table summarizes the Company's financial liabilities and the remaining contractual maturities:

December 31, 2010	Total	Less than 1 year	1-2 years	After 2 years
Contractual obligations				
Bank indebtedness	$ 357,148	$ 357,148	$ -	$ -
Accounts payable and accrued liabilities	1,994,775	1,994,775	-	-
Royalties payable	295,581	295,581	-	-
Notes payable	240,000	240,000	-	-
Convertible promissory notes	380,200	380,200	-	-
Loans payable	3,749,573	3,749,573	-	-
Total contractual obligations	$ 7,017,277	$ 7,017,277	$ -	$ -

December 31, 2009	Total	Less than 1 year	1-2 years	After 2 years
Contractual obligations				
Bank indebtedness	$ 564,452	$ 564,452	$ -	$ -
Accounts payable and accrued liabilities	2,158,238	2,158,238	-	-
Royalties payable	612,058	612,058	-	-
Notes payable	250,000	250,000	-	-
Convertible promissory notes	49,973	49,973	-	-
Loans payable	1,153,117	1,153,117	-	-
Total contractual obligations	$ 4,787,838	$ 4,787,838	$ -	$ -

18. Financial instruments - continued

August 31, 2009	Total	Less than 1 year	1-2 years	After 2 years
Contractual obligations				
Bank indebtedness	$ 545,055	$ -	$ -	$ -
Accounts payable and accrued liabilities	2,035,255	-	-	-
Royalties payable	440,242	-	-	-
Notes payable	250,000	-	-	-
Convertible promissory notes	49,959	-	-	-
Loans payable	742,188	-	-	-
Total contractual obligations	$ 4,062,699	$ -	$ -	$ -

19. Loss per share

Loss per subordinate voting share or multiple voting share is calculated based on the weighted average number of shares outstanding during the year. For the year ended December 31, 2010, the four months ended December 31, 2009, and the year ended August 31, 2009, 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.

20. Consolidated statements of cash flows

Supplemental cash flow information is as follows:

	Year Ended December 31, 2010	Four Months Ended December 31, 2009	Year Ended August 31, 2009
Interest expense paid	$ 85,720	$ 55,172	$ 124,846
Addition to contributed surplus due to loans payable	-	-	208
Addition to contributed surplus due to convertible promissory notes	3,783	-	82
Addition to royalties payable due to acquisition of KnightTV	-	47,034	-
Addition to carriage due to acquisition of KnightTV	-	608,506	-
Addition to distribution rights due to acquisition of KnightTV	-	(41,688)	-
Advances to Studio 4 applied to acquisition of KnightTV	-	272,852	-
Addition to equipment due to acquisition of KnightTV	-	(16,157)	-
Shares issued as part of acquisition of KnightTV	-	42,500	-
Convertible promissory note transferred from loans payable	231,145	-	-
Convertible debenture payable transferred from loans payable	99,926	-	-

21. Capital management

The Company defines its capital as the total of its shareholders' equity (deficiency) and interest bearing debt. The Company's objectives when managing capital are to improve 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, planned requirements and financing opportunities. 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.

There have been no changes to the Company's capital management objectives from the prior periods.

22. Segmented reporting of revenue

The Company markets its services primarily in Canada. In measuring performance, the Company does not distinguish or group its operations on a geographical or any other basis and, accordingly, has a single reportable segment for disclosure purposes and has the following sources of revenue:

	Year Ended December 31, 2010	Four Months Ended December 31, 2009	Year Ended August 31, 2009
Distribution revenue	$ 2,108,701	$ 1,199,001	$ 2,458,442
Production revenue	1,187,410	-	-
	$ 3,296,111	$ 1,199,001	$ 2,458,442

23. Comparative amounts

Certain comparative amounts have been reclassified from those previously presented to conform to the presentation of the 2010 financial statements.

24. Subsequent events

Subsequent to year end, the Company completed the acquisition of Ellis Entertainment Corporation (note 3).

Subsequent to year end, Knightscove arranged commitments for a private placement of share capital of up to $384,000 of which $384,000 has been subscribed for at April 28, 2011.

Subsequent to year end, Morningstar, a wholly-owned subsidiary, changed its name to Knightscove @ Home.