



*Consolidated Financial Statements of*

**Route1 Inc.**

*December 31, 2008 and 2007*



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## Auditors' Report

To the Shareholders of  
Route1 Inc.

We have audited the consolidated balance sheets of Route1 Inc. as at December 31, 2008 and 2007 and the consolidated statements of operations, comprehensive loss and deficit and of cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*Deloitte & Touche LLP*

Chartered Accountants  
Licensed Public Accountants

Toronto, Ontario  
March 20, 2009

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December 31, 2008 and 2007

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## CONSOLIDATED BALANCE SHEETS

### Route1 Inc.

As at December 31

	2008	2007
<b>ASSETS</b>		
Current		
Cash	\$ 2,120,333	\$ 6,303,351
Accounts receivable	115,620	585,545
Other receivables	18,873	19,399
Notes receivable (note 5)	198,220	163,833
Inventory	1,333,427	607,796
Prepaid expenses	228,469	174,633
	<b>4,014,942</b>	<b>7,854,557</b>
Investments (note 6)	4	4
Capital assets (note 7)	206,464	470,761
	<b>\$ 4,221,410</b>	<b>\$ 8,325,322</b>
<b>LIABILITIES</b>		
Current		
Accounts payable and accrued liabilities	\$ 920,541	\$ 1,193,872
Deferred revenue	1,658,691	376,239
Current portion of obligations under capital lease (note 8)	2,700	88,169
	<b>2,581,932</b>	<b>1,658,280</b>
Non current		
Deferred revenue	48,302	12,098
Obligations under capital lease (note 8)	-	2,700
	<b>2,630,234</b>	<b>1,673,078</b>
Commitments and contingencies (note 14)		
<b>SHAREHOLDERS' EQUITY</b>		
Common shares (note 9)	24,038,562	23,905,243
Warrants (note 9)	3,203,207	6,527,888
Contributed surplus (note 9)	5,149,384	1,572,409
Deficit	(30,799,977)	(25,353,296)
	<b>1,591,176</b>	<b>6,652,244</b>
	<b>\$ 4,221,410</b>	<b>\$ 8,325,322</b>

Approved by the Board of Directors:

Director:

Director:

<Signed> \_\_\_\_\_

<Signed> \_\_\_\_\_

Michael F. Doolan

K. Andrew White

**CONSOLIDATED STATEMENTS OF OPERATIONS, COMPREHENSIVE LOSS AND DEFICIT**

**Route1 Inc.**

**Years ended December 31**

	<b>2008</b>	<b>2007</b>
<b>Revenues</b>		
Devices	\$ 444,110	\$ 633,329
Services	725,352	373,871
	<b>1,169,462</b>	<b>1,007,200</b>
<b>Cost of revenues</b>	<b>811,467</b>	<b>1,292,587</b>
<b>Gross margin (loss)</b>	<b>357,995</b>	<b>(285,387)</b>
<b>Expenses</b>		
General administration	2,386,826	2,334,188
Research and development	1,946,968	2,244,611
Selling and marketing	1,338,306	2,308,331
Amortization	213,796	284,592
	<b>5,885,896</b>	<b>7,171,722</b>
<b>Loss before the following items</b>	<b>(5,527,901)</b>	<b>(7,457,109)</b>
<b>Interest income</b>	<b>81,220</b>	<b>67,687</b>
<b>Loss from operations</b>	<b>(5,446,681)</b>	<b>(7,389,422)</b>
<b>Write-down of Hypernet (note 6)</b>	<b>-</b>	<b>(74,999)</b>
<b>Net loss and comprehensive loss for the year</b>	<b>(5,446,681)</b>	<b>(7,464,421)</b>
<b>Deficit, beginning of year</b>	<b>(25,353,296)</b>	<b>(17,888,875)</b>
<b>Deficit, end of year</b>	<b>\$ (30,799,977)</b>	<b>\$ (25,353,296)</b>
<b>Loss per share (note 13)</b>	<b>\$ (0.02)</b>	<b>\$ (0.03)</b>
<b>Weighted average number of common shares outstanding</b>	<b>349,864,827</b>	<b>286,651,757</b>

## CONSOLIDATED STATEMENTS OF CASH FLOW

### Route1 Inc.

#### Years ended December 31

	2008	2007
<b>Net cash inflow (outflow) related to the following activities</b>		
<b>Operating activities</b>		
Loss from operations	\$ (5,446,681)	\$ (7,389,422)
Items not affecting cash		
Amortization	329,583	538,138
Stock based compensation	291,329	258,677
	<b>(4,825,769)</b>	<b>(6,592,607)</b>
Net changes in working capital balances		
Accounts receivable	469,925	(39,301)
Other receivables	526	(1,075)
Inventory	(725,631)	(99,749)
Prepaid expenses	(53,836)	(57,091)
Accounts payable and accrued liabilities	(273,331)	(137,818)
Deferred revenue	1,318,656	208,106
	<b>(4,089,460)</b>	<b>(6,719,535)</b>
<b>Investing activities</b>		
Acquisition of capital assets	(65,286)	(257,417)
Notes receivable	(34,387)	(77,376)
	<b>(99,673)</b>	<b>(334,793)</b>
<b>Financing activities</b>		
Repayment of obligations under capital lease	(88,169)	(218,447)
Issuance of share capital – net of issuance costs	94,284	12,089,762
	<b>6,115</b>	<b>11,871,315</b>
<b>Net cash inflow (outflow)</b>	<b>(4,183,018)</b>	<b>4,816,987</b>
<b>Cash, beginning of year</b>	<b>6,303,351</b>	<b>1,486,364</b>
<b>Cash, end of year</b>	<b>\$ 2,120,333</b>	<b>\$ 6,303,351</b>
<b>Supplementary information</b>		
Interest paid	\$ 4,077	\$ 10,864

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

**December 31, 2008 and 2007**

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#### 1. BASIS OF PRESENTATION

Route1 Inc. (“Route1” or “the Company”) is a publicly traded company on the TSX Venture Exchange. The Company is incorporated under the laws of the Province of Ontario by articles of amendment dated October 14, 2004 followed by articles of continuance dated November 10, 2004.

Route1 delivers award-winning security and identity management solutions to customers worldwide. These solutions provide universal, secure access to all digital resources and sensitive data. At the heart of Route1’s solutions is MobiNET, a communications and service delivery platform focused on identity management and entitlement-based access to resources. Route1’s patent-pending solutions are based on FIPS-140-2 cryptographic modules, and simplify the process of meeting increasingly stringent regulatory requirements around privacy and security.

The Company participates in the high-technology industry and management believes that changes in any of the following areas could have a material adverse effect on the Company's future financial position, results of operations or cash flows: advances and trends in new technologies and industry standards, competitive pressures in the form of new products and services or price reductions on current products and services, changes in the overall demand for products and services offered by the Company, market acceptance of the Company's products and services, development of sales channels, changes in certain strategic relationships or customer relationships, litigation or claims against the Company based on intellectual property, patent, product, regulatory or other factors, and the Company's ability to attract and retain necessary employees to support its growth.

#### *Going concern assumption*

While the accompanying consolidated financial statements have been prepared on a going concern basis which assumes that the Company will realize its assets and discharge its liabilities and commitments in the normal course of business, several conditions such as raising sufficient capital or generating enough cash flow from operations will need to be met to support the validity of this assumption.

For the years ended December 31, 2008 and 2007, the Company incurred losses of \$5,446,681 and \$7,464,421 respectively, and has an accumulated deficit of \$30,799,977 as at December 31, 2008. The Company’s continued existence is dependent upon its ability to obtain additional financing and ultimately achieve profitable operations. However there can be no assurance that the Company will be able to achieve profitable operations, nor that financing efforts will continue to be successful.

If the going concern assumption were not appropriate to these financial statements, then adjustments would be necessary in the carrying values of assets and liabilities, the reported net loss and the balance sheet classifications used.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2008 and 2007

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#### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”) for going concern entities and reflect the following significant accounting policies:

##### *Principles of consolidation*

These consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary companies, Route1 Technologies Inc., Route1 Security Corporation, Prospectus Group Inc. and The Clones Society Inc.

##### *Foreign currency translation*

Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at the exchange rate in effect at the balance sheet date; non-monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at historical exchange rates; revenues and expenses denominated in foreign currencies are translated into Canadian dollars at the average exchange rate for the period. Foreign exchange gains and losses on translation are included in the consolidated statement of operations in the period in which they occur.

##### *Cash*

Cash consist of cash balances with banks.

##### *Allowance for Doubtful Accounts*

The allowance for doubtful accounts receivable is determined based on management’s assessment of the collectability of specific customer balances, considering general and industry economic and market conditions as well as other credit information available for the customer. Recoveries of the allowances are recorded when payment is received.

##### *Inventory*

Inventory is valued at the lower of cost and net realizable value with cost being calculated on a weighted average basis as per guidelines of the Canadian Institute of Chartered Accountants (“CICA”) Handbook Section 3031 “Inventories”.

##### *Investments*

Investments are classified as “Available-for-sale”. They are carried at fair value with changes to fair value recorded in other comprehensive income (loss). If a decline in fair value is determined to be other-than temporary, the cumulative loss included in accumulated other comprehensive income (loss) is removed and recognized as net income (loss). Gains and losses realized on disposal of available-for-sale securities are recognized in other income.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2008 and 2007

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#### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

##### *Capital assets*

Capital assets are recorded at cost. Amortization is provided over the estimated useful life of the assets as follows:

Furniture and equipment	-	straight-line over 36 months
Computer equipment	-	straight-line over 36 months
Computer software	-	straight-line over 12 months
Leasehold improvements	-	straight-line over 60 months or the term of the lease (whichever is shorter)

##### *Revenue recognition*

The Company recognizes revenue when it is realized and earned. The Company considers revenue realized or realizable and earned when the product has been delivered or the services have been provided to the customer, the sales price is fixed or determinable and collectability is reasonably assured. In addition to this general policy, the following paragraphs describe the specific revenue recognition policies for each major category of revenue.

##### *Devices*

Revenues from the sale of MobiKEY devices are recognized when title is transferred to the customer and all significant contractual obligations that affect the customer's final acceptance have been fulfilled.

##### *Service*

Revenue from service is recognized rateably on a monthly basis when the service is provided. In instances where the Company bills the customer prior to performing the service, the prepayment amount is recorded as deferred revenue.

##### *Multiple-element arrangements*

The Company enters into transactions that represent multiple-element arrangements which may include any combination of device and service. These multiple-element arrangements are assessed to determine whether they can be separated into more than one unit of accounting or element for the purpose of revenue recognition. When the appropriate criteria for separating revenue into more than one unit of accounting is met and there is vendor specific objective evidence of fair value for all units of accounting or elements in an arrangement, the arrangement consideration is allocated to the separate units of accounting or elements based on each unit's relative fair value. This vendor specific objective evidence of fair value is established through prices charged for each revenue element when that element is sold separately. The revenue recognition policies described above are then applied to each unit of accounting.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2008 and 2007

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#### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

##### *Research and development*

Currently, research and development expenditures are charged as an operating expense of the Company as incurred. Expenditures for research and development equipment are capitalized and deferred and amortized when the criteria for deferral are met, or otherwise, are expensed as incurred. To date, no development expenditures have been deferred.

##### *Earnings (loss) per share*

Basic earnings (loss) per share is computed by dividing the net income (loss) by the weighted average shares outstanding during the reported period.

The Company uses the treasury stock method of calculating the dilutive effect of options and warrants on earnings (loss) per share. Diluted earnings (loss) per share is computed similarly to basic earnings (loss) per share, except the weighted average shares outstanding are increased to include additional shares from the assumed exercise of stock options and warrants, if dilutive. The number of additional shares is calculated by assuming that outstanding stock options and warrants were exercised and that the proceeds from such exercises were used to acquire shares of common stock at the average market price during the reporting period.

##### *Income taxes*

The Company follows the liability method of accounting for income taxes. Under this method future income tax assets and liabilities are determined based on differences between the financial reporting and tax basis of assets and liabilities, and measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are established when necessary to reduce future income tax assets to the amount expected to be realized.

##### *Use of estimates/measurement uncertainty*

In preparing the Company's consolidated financial statements in accordance with Canadian generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amount of assets, liabilities, and the disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates used in the Company's consolidated financial statements and such differences could be material. Examples of significant estimates include:

- the allowance for doubtful accounts;
- the allowance for inventory obsolescence;
- the estimated useful lives of capital assets;
- the recoverability of investments;
- the valuation of future tax assets; and
- the calculation of stock option compensation expense.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2008 and 2007

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#### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

##### *Stock compensation*

The Company has a stock-based compensation plan, which is described in note 9. The Company adopted the recommendation of the Canadian Institute of Chartered Accountants (“CICA”) with respect to stock-based compensation issued to employees. The fair value of stock options granted under the stock option plan is determined using the Black-Scholes Option Pricing Model and is amortized to income on a straight-line basis over the vesting period and a corresponding increase to contributed surplus. Any consideration paid by the employees or non-employees on exercise of the options is credited to share capital, and the contributed surplus balance is reduced as stock options are exercised and credit to share capital.

#### 3. ADOPTION OF NEW ACCOUNTING STANDARDS

On January 1, 2008, the Company adopted the following new accounting standards; CICA Handbook Section 1535 “Capital Disclosures”, Section 3031 “Inventories”, Section 3862 “Financial Instruments - Disclosures” and Section 3863 “Financial Instruments – Presentation”. These standards have been adopted prospectively and comparative amounts for the prior year have not been restated.

##### *Capital Disclosures*

In November 2006, the Canadian Institute of Chartered Accountants (“CICA”) issued the new handbook Section 1535 “Capital Disclosures”. This section requires an entity disclose information that enables users of its financial statements to evaluate an entity’s objectives, policies and processes for managing capital. The new standard applies to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007, specifically January 1, 2008 for the Company. This new standard does not have a material effect on the Company’s financial statements.

##### *Inventories*

In June 2007, the Canadian Institute of Chartered Accountants (“CICA”) issued the new handbook Section 3031 “Inventories” replacing Section 3030 “Inventories”. The new Section is applicable to financial statements relating to fiscal years beginning on or after January 1, 2008. Accordingly, the Company adopted the new standard for its fiscal year beginning January 1, 2008. The new standard requires inventories to be measured at the lower of cost and net realizable value. This new standard does not have a material effect on the Company’s financial statements.

##### *Financial Instruments*

Effective January 1, 2008, the Company adopted two new standards issued by the Canadian Institute of Chartered Accountants (“CICA”), Section 3862 “Financial Instruments – Disclosure,” and Section 3863 “Financial Instruments - Presentation,” which replaced Section 3861 “Financial Instruments – Disclosures and Presentation”. This new presentation standard carries forward the former presentation requirements and increases the emphasis on the disclosure of risks associated with both recognized and unrecognized financial instruments and how those risks are managed. This new standard does not have a material effect on the Company’s financial statements.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2008 and 2007

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#### 4. FUTURE ACCOUNTING PRONOUNCEMENTS

##### *International Financial Reporting Standards*

On February 13, 2008, the Canadian Accounting Standards Board (“AcSB”) confirmed the mandatory International Financial Reporting Standards (“IFRS”) changeover date for Canadian profit-oriented publicly accountable entities (“PAEs”). This means that PAEs will be required to prepare financial statements in accordance with IFRS for interim and annual financial statements for fiscal years beginning on or after January 1, 2011. The transition date of January 1, 2011 will require restatement for comparative purposes of amounts reported by the Company for annual and interim periods for the year ended December 31, 2010.

Canadian generally accepted accounting principles will be converged with IFRS through a combination of two methods: as current joint-convergence projects of the United States Financial Accounting Standards Board and the International Accounting Standards Board are agreed upon, they will be adopted by the AcSB and may be introduced in Canada before the completed changeover to IFRS; and standards not subject to a joint-convergence project will be exposed in an omnibus manner for introduction at the time of the complete changeover to IFRS.

As the International Accounting Standards Board currently, and expectedly, has projects underway that should result in new pronouncements that continue to evolve IFRS; this Canadian convergence initiative is in its infancy. The Company anticipates that it will not adopt IFRS for annual and interim reporting periods before our fiscal year beginning January 1, 2011. By the end of fiscal 2009, we will have completed an analysis of accounting policies and standards under IFRS. The analysis will include those policies we are required to use, as well as those we expect to apply where choices are permitted in preparing IFRS financial statements.

##### *Goodwill and Intangible Assets*

In February 2008, the CICA issued Handbook Section 3064, Goodwill and Intangible Assets which establishes revised standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets. CICA Handbook Section 1000, Financial Statement Concepts, was also amended to provide consistency with this new standard. The new and amended standards are effective for the Company beginning January 1, 2009.

The Company is currently assessing the impact of these standards on its consolidated financial statements.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2008 and 2007

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#### 5. NOTES RECEIVABLE

Notes receivable consist of the following:

	<u>2008</u>	<u>2007</u>
Due from an officer of the Company, secured and repayable no later than December 15, 2009 with interest at 6%	\$ 90,100	\$ -
Due from an officer of the Company, secured and due on demand with interest at 6%	55,120	52,000
Due from an employee of the Company, secured and due on demand with interest at 6%	53,000	50,000
Due from an officer of the Company, unsecured and due on demand with interest at 6%	-	60,000
Due from an employee of the Company, secured, due on demand and non-interest bearing	-	1,000
Due from an employee of the Company, secured and repayable no later than January 15, 2008 with interest at 6%	-	833
	<u>\$ 198,220</u>	<u>\$ 163,833</u>

#### 6. INVESTMENTS

Investments in companies not subject to significant influence are as follows:

	<u>2008</u>	<u>2007</u>
Hypernet Inc.	\$ 1	\$ 1
Other	3	3
	<u>\$ 4</u>	<u>\$ 4</u>

The Company holds first preferred shares in Hypernet Inc. ("Hypernet"), which Hypernet shall redeem all or a portion of the first preferred shares based on a percentage Hypernet revenues exceeding a certain level. During 2007, a write-down of \$74,999 was recorded to reflect impairment in the carrying value of Hypernet.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2008 and 2007

#### 7. CAPITAL ASSETS

	December 31, 2008		
	Cost	Accumulated Amortization	Net Book Value
Furniture and equipment	\$ 235,950	\$ 230,551	\$ 5,399
Computer equipment	1,335,154	1,159,013	176,141
Computer software	607,691	601,926	5,765
Leasehold improvements	69,769	50,610	19,159
	<u>\$ 2,248,564</u>	<u>\$ 2,042,100</u>	<u>\$ 206,464</u>

	December 31, 2007		
	Cost	Accumulated Amortization	Net Book Value
Furniture and equipment	\$ 235,950	\$ 193,001	\$ 42,949
Computer equipment	1,269,868	885,227	384,641
Computer software	607,691	597,632	10,059
Leasehold improvements	69,769	36,657	33,112
	<u>\$ 2,183,278</u>	<u>\$ 1,712,517</u>	<u>\$ 470,761</u>

Included in computer equipment are assets held under finance leases with a cost of \$657,847 (December 31, 2007 - \$657,847), accumulated amortization of \$652,995 (December 31, 2007 - \$548,671) and net book value of \$4,852 (December 31, 2007 - \$109,176).

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2008 and 2007

#### 8. OBLIGATIONS UNDER CAPITAL LEASE

The Company has obligations under capital lease as follows:

	2008	2007
Computer equipment lease agreement in the amount of \$32,400, repayable in quarterly instalments of \$2,700 including interest calculated at 8.3%, with a bargain purchase option at maturity on March 1, 2009	\$ 2,700	\$ 13,500
Computer equipment lease agreement in the amount of \$26,920, repayable in monthly instalments of \$862 including interest calculated at 5.4%, with a bargain purchase option at maturity on July 26, 2008	-	5,137
Computer equipment lease agreement in the amount of \$214,097, repayable in monthly instalments of \$6,082 including interest calculated at 5.4%, with a bargain purchase option at maturity on June 30, 2008	-	36,492
Computer equipment lease agreement in the amount of \$274,270, repayable in monthly instalments of \$8,249 including interest calculated at 5.4%, with a bargain purchase option at maturity on April 30, 2008	-	32,250
Computer equipment lease agreement in the amount of \$86,960, repayable in monthly instalments of \$2,471 including interest calculated at 5.4%, with a bargain purchase option at maturity on March 31, 2008	-	7,094
Total amount of future minimum lease payments	<b>2,700</b>	94,473
Executory costs and interest included in instalments	-	3,604
	<b>2,700</b>	90,869
Current portion	<b>2,700</b>	88,169
	<b>\$ -</b>	<b>\$ 2,700</b>

Future minimum lease payments under the capital leases are as follows:

2009	<b>\$ 2,700</b>
	<b>\$ 2,700</b>

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

#### December 31, 2008 and 2007

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#### 9. SHARE CAPITAL, WARRANTS AND CONTRIBUTED SURPLUS

The Company's authorized share capital consists of the following:

Unlimited number of common shares with voting rights.

Unlimited number of non-cumulative, non-voting first preferred shares with no fixed dividend rate, issuable in series.

Unlimited number of non-cumulative, non-voting second preferred shares with no fixed dividend rate, issuable in series.

Unlimited number of non-cumulative, non-voting Series A first preferred shares with no fixed dividend rate, issuable in series and convertible into common shares at the option of the holder on a one-for-one basis at any time after October 31, 2000.

The following is a summary of the issued and outstanding common shares of the Company:

	<u>Number of Shares</u>	<u>Share Capital</u>
Balance, January 1, 2007	241,707,617	\$13,065,386
Shares issued on exercise of warrants (a)	42,959,832	7,086,064
Shares issued on private placement (b)	64,720,666	3,781,593
Other	-	(27,800)
Balance, December 31, 2007	<u>349,388,115</u>	<u>23,905,243</u>
Shares issued on exercise of warrants (c)	1,000,000	139,035
Other	-	(5,716)
Balance, December 31, 2008	<u>350,388,115</u>	<u>\$24,038,562</u>

During the year ended December 31, 2007, the following share transactions took place:

- a. 15,214,159 warrants were exercised at \$0.155 per share for total proceeds of \$2,358,195 and 27,745,673 warrants were exercised at \$0.10 per share for total proceeds of \$2,774,567. Included in the stated share capital amount is \$1,953,302 reallocated from contributed surplus as related to the valuation of the warrants exercised under the Black-Scholes option pricing model.
- b. On November 6, 2007, the Company issued through a private placement 64,720,666 units at a price of \$0.12 per unit for total net proceeds of \$6,984,800. Each unit consisted of one common share and one-half common share purchase warrant which is exercisable into one common share at a price of \$0.155 per share for a period of 2 years. \$3,781,593 of these proceeds has been recorded as common shares and \$3,203,207 has been recorded as warrants. In addition, 3,883,240 common share purchase warrants have been issued as Broker Warrants exercisable into one common share at a price of \$0.155 per share for a period of 2 years. The value of the warrants was derived under the Black-Scholes pricing model using the following assumptions: a risk free interest rate of 4.75%, an expected life of 2.0 years, an expected volatility of 100% and a dividend yield of nil.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

#### December 31, 2008 and 2007

#### 9. SHARE CAPITAL, WARRANTS AND CONTRIBUTED SURPLUS (continued)

During the year ended December 31, 2008, the following share transactions took place:

- c. 1,000,000 warrants were exercised at \$0.10 per share for total proceeds of \$100,000. Included in the stated share capital amount is \$39,035 reallocated from contributed surplus as related to the valuation of the warrants exercised under the Black-Scholes option pricing model.

##### *Escrow requirements*

As at December 31, 2008, approximately 22,570,000 (2007 – 33,825,000) common shares of the Company were held in an Exchange escrow agreement dated October 14, 2004. These shares are to be released over a period of seventy two (72) months at six (6) month intervals in accordance with the requirements of the TSX Venture Exchange.

##### *Stock options*

The Company has a Stock Option Plan (the “Plan”) that was created in 1997 to attract, retain and motivate officers, salaried employees and directors who are in a position to make important contributions toward the success of the Company. Under the Plan, options may be granted to directors, officers, employees, and consultants of the Company at an exercise price determined by the Board of Directors provided that such exercise price should not be less than permitted under the rules of any stock exchange where the shares are listed. The period during which an option may be exercised (the “Option Period”) is determined by the Board at the time the option is granted, subject to any vesting limitations which may be imposed by the Board in its sole unfettered discretion at the time such option is granted. Options are exercisable as determined by the Board at the date of the grant. Shares covered by options granted with respect to any year may not exceed 10% of the issued and outstanding shares of the Company, calculated on a non-diluted basis.

The following tables reflect the movement and status of the stock options:

	Year ended December 31, 2008		Year ended December 31, 2007	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Options Outstanding				
Balance, beginning of the year	10,598,660	\$ 0.26	9,201,500	\$ 0.30
Options granted during the year	1,125,000	0.08	5,390,160	0.17
Options expired during the year	(2,837,000)	0.44	-	-
Options forfeited during the year	(2,937,000)	0.18	(3,993,000)	0.23
Balance, end of the year	<u>5,949,660</u>	<u>\$ 0.18</u>	<u>10,598,660</u>	<u>\$ 0.26</u>

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

#### December 31, 2008 and 2007

#### 9. SHARE CAPITAL, WARRANTS AND CONTRIBUTED SURPLUS (continued)

Exercise Price	Options Outstanding December 31, 2008		Options Exercisable December 31, 2008	
	Number of Options	Weighted Average Life (Years)	Number of Options	Weighted Average Life (Years)
\$ 0.08	1,125,000	4.2	-	-
\$ 0.125	950,000	2.3	-	-
\$ 0.20	1,185,000	1.0	-	-
\$ 0.205	1,790,160	3.5	596,720	3.5
\$ 0.30	899,500	2.3	599,666	2.3
	<u>5,949,660</u>	<u>2.8</u>	<u>1,196,386</u>	<u>2.9</u>

  

Exercise Price	Options Outstanding December 31, 2007		Options Exercisable December 31, 2007	
	Number of Options	Weighted Average Life (Years)	Number of Options	Weighted Average Life (Years)
\$ 0.125	2,300,000	3.3	-	-
\$ 0.20	2,685,000	2.0	-	-
\$ 0.205	1,790,160	4.5	-	-
\$ 0.30	986,500	3.3	328,833	3.3
\$ 0.40	1,693,500	0.3	1,411,250	0.3
\$ 0.50	1,143,500	0.3	952,917	0.3
	<u>10,598,660</u>	<u>2.4</u>	<u>2,693,000</u>	<u>1.1</u>

During 2008, the Company recorded stock-based compensation expense of \$291,329 (2007 - \$258,677), as derived using the Black-Scholes option valuation model. The table below shows the assumptions used in determining stock based compensation expense, as derived under the Black-Scholes option pricing model:

	2008	2007
Risk free interest rate	4.25%	4.5% to 4.75%
Expected life (years)	5	3 to 5
Expected volatility	100%	100%
Dividend yield	Nil	nil
Weighted average fair value of options granted	<u>\$ 0.09</u>	<u>\$ 0.11</u>

The Black-Scholes option valuation model used by the Company to determine fair values was developed for use in estimating the fair value of freely traded options, which are fully transferable and have no vesting restrictions. The Company's stock options are not transferable and cannot be traded and are subject to vesting restrictions and exercise restrictions under the Company's black-

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2008 and 2007

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#### 9. SHARE CAPITAL, WARRANTS AND CONTRIBUTED SURPLUS (continued)

out policy which would tend to reduce the fair value of the Company's stock options. Changes to subjective input assumptions used in the model can cause a significant variation in the estimate of the fair value of the options.

##### *Contributed surplus*

Contributed surplus represents the fair value of stock options granted under the stock option plan, determined using the Black-Scholes Option Pricing Model and is amortized to income on a straight-line basis over the vesting period and also a corresponding increase to contributed surplus. Any consideration paid by the employees or non-employees on the exercise of stock options is reflected as an increase to share capital, with a reduction in contributed surplus. On March 9, 2008, 29,369,174 warrants issued as part of a private placement on March 9, 2006 expired with a value of \$1,679,917 which was reallocated to contributed surplus from warrants. On September 20, 2008, 41,135,618 warrants issued as part of a private placement on September 20, 2006 expired with a value of \$1,605,729 which was reallocated to contributed surplus from warrants.

##### *Warrants*

The following is a summary of the issued and outstanding warrants of the Company:

	<b>Number of warrants</b>	<b>Weighted average exercise price</b>
Balance, January 1, 2007	114,464,624	\$0.121
Warrants issued (a)	36,243,573	0.155
Warrants exercised	(42,959,832)	0.120
Balance, December 31, 2007	107,748,365	0.134
Warrants exercised	(1,000,000)	0.100
Warrants expired	(70,504,792)	0.120
Balance, December 31, 2008	36,243,573	\$0.155

- (a) 36,243,573 warrants expiring November 6, 2009 with an exercise price of \$0.155 per share and value of \$3,203,207.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

#### December 31, 2008 and 2007

#### 10. INCOME TAXES

The tax effect of significant temporary differences is as follows:

	<u>2008</u>	<u>2007</u>
Future income tax assets (liabilities)		
Capital assets	\$ 296,237	\$ 554,046
Unamortized financing fees	258,448	504,060
Reserve for unearned revenue	-	11,625
Tax losses carryforwards	<u>9,407,310</u>	<u>8,138,430</u>
	<u>9,961,995</u>	<u>9,208,161</u>
Valuation allowance	<u>(9,961,995)</u>	<u>(9,208,161)</u>
Future income tax asset	<u>\$ -</u>	<u>\$ -</u>

A valuation allowance of 100% has been established in respect of the net future income tax assets due to the uncertainty of the Company's utilization of such future income tax assets.

A reconciliation between the Company's statutory and effective tax rates is as follows:

	<u>2008</u>	<u>2007</u>
Tax recovery at statutory rate	33.5 %	35.0 %
Permanent differences	(6.5)%	2.9%
Temporary difference due to non-recognition of tax loss carryforwards	<u>(27.0) %</u>	<u>(37.9) %</u>
Effective tax rate	<u>0.0 %</u>	<u>0.0 %</u>

The Company has non-capital losses for tax purposes of approximately \$32,439,000 that may be used to reduce Canadian taxable income in the future. The potential tax benefits pertaining to these tax losses have not been recognized in the financial statements. If not utilized, these losses will expire as follows:

2009	\$ 550,000
2010	2,574,000
2014	989,000
2015	5,912,000
2026	9,109,000
2027	6,697,000
2028	<u>6,608,000</u>
	<u>\$ 32,439,000</u>

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2008 and 2007

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#### 11. CAPITAL MANAGEMENT

The Company's capital currently consists of shareholders' equity. The Company's capital management objectives are to safeguard its ability to continue as a going concern, in order to provide future returns for shareholders. Management intends to accomplish this objective with the least dilution to our shareholders. The Company manages its capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. There were no changes in the Company's approach to capital management during the year ended December 31, 2008. The Company is not subject to externally imposed capital requirements.

#### 12. RELATED PARTY TRANSACTIONS

On December 31, 2008, the Company had notes receivable from officers and employees in the amount of \$198,220 (December 31, 2007- \$163,833) inclusive of accrued interest. These notes are secured and bear interest at six percent (6%) (see note 5).

#### 13. LOSS PER SHARE

The Company uses the treasury stock method to calculate basic and diluted earnings (loss) per share. Basic earnings (loss) per share have been calculated based on the weighted average number of common shares without the inclusion of dilutive effects. Diluted earnings (loss) per share are calculated based on the weighted average number of common shares plus dilutive common share equivalents outstanding which consist of options and warrants to purchase common shares. For the years ended December 31, 2008 and 2007, the loss per share was \$0.02 and \$0.03 respectively.

#### 14. COMMITMENTS AND CONTINGENCIES

(i) *Operating leases*

The Company is committed under operating lease agreements for the rental of real property and certain equipment. Minimum annual future lease payments are approximately as follows:

2009	\$ 120,000
2010	120,000
2011	12,000
	<u>\$ 252,000</u>

(ii) *Legal matters*

In the normal course of operations, the Company maybe subject to litigation and claims from customers, suppliers and former employees. Management believes that adequate provisions have been recorded in the accounts, where required. Although it is not possible to estimate the extent of potential costs, if any, management believes that the ultimate resolution of such contingencies would not have a material adverse effect on the results of operations, financial position or liquidity of the Company.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2008 and 2007

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#### 15. INDEMNIFICATIONS

Under certain agreements and the bylaws of the Company, the Company is obligated to indemnify persons who serve as directors or officers (or both) of the Company, against certain costs, charges and expenses suffered or incurred by such person as a result of their service. Claims for indemnity pursuant to such agreements or the bylaws of the Company are subject to certain statutory and other legal limitations. Having regard to the nature of the indemnification obligations and the broad range of circumstances under which the Company may become obligated to make indemnification payments, the Company is unable to make a reasonable estimate of the maximum potential amount that it could be required to pay to persons entitled to indemnification from the Company. The Company has purchased insurance coverage to reduce the risks associated with its indemnification obligations.

#### 16. FINANCIAL INSTRUMENTS

The carrying amount of financial instruments including cash, accounts receivable, other receivables, notes receivable and accounts payable and accrued liabilities approximates fair value because of the short-term nature of these instruments. The carrying amount of obligations under capital lease approximates fair value due to the market rate of interest associated with the instrument.

The following table sets out the classification, carrying amount, and fair value of the Company's financial assets and liabilities as at December 31, 2008 and 2007:

	2008		2007	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
FINANCIAL ASSET				
Held for trading				
Cash (i)	\$2,120,333	\$2,120,333	\$6,303,351	\$6,303,351
Loans and receivables				
Accounts receivable (i)	\$115,620	\$115,620	\$585,545	\$585,545
Other receivables (i)	\$18,873	\$18,873	\$19,399	\$19,399
Notes receivable (i)	\$198,220	\$198,220	\$163,833	\$163,833
FINANCIAL LIABILITIES				
Other liabilities				
Accounts payable and accrued liabilities (i)	\$920,541	\$920,541	\$1,193,872	\$1,193,872

- (i) The fair value of these instruments approximates their carrying amount due to their short-term nature.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2008 and 2007

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#### 17. FINANCIAL RISK MANAGEMENT

The Company has exposure to credit risk, liquidity risk and market risk associated with its financial assets and liabilities. The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Board of Directors has established the Audit Committee which is responsible for monitoring the Company's compliance with risk management policies. The Audit Committee regularly reports to the Board of Directors on its activities.

The Company's risk management program seeks to minimize potential adverse effects on the Company's financial performance and ultimately shareholder value. The Company manages its risks and risk exposures through a system of internal controls and sound business practices.

The Company's financial instruments and the nature of the risks which they may be subject to are set out in the following table.

	Risks			
	Credit	Liquidity	Foreign Exchange	Interest Rate
Cash	Yes		Yes	Yes
Accounts receivable	Yes		Yes	
Other receivables	Yes			
Notes receivable	Yes			
Accounts payable and accrued liabilities		Yes	Yes	

##### (a) Credit Risk

Credit risk arises from cash held with banks and credit exposure to customers, including outstanding accounts receivable. The maximum exposure to credit risk is equal to the carrying value (net of allowances) of the financial assets. The objective of managing credit risk is to prevent losses on financial assets. The Company assesses the credit quality of counterparties, taking into account their financial position, past experience and other factors. During the year ended December 31, 2008, the largest single customer represented approximately 27% of recorded revenues.

##### *Cash*

Cash consists of bank balances. Credit risk associated with cash is minimized substantially by ensuring that these financial assets are invested in debt instruments of highly rated financial institutions. As at December 31, 2008, the Company had cash consisting of cash on hand and deposits with banks of \$2,120,333 (2007 - \$6,303,351). During the year ended December 31, 2008, the Company did not hold any investments in asset-backed commercial paper.

##### *Accounts receivable*

Accounts receivable consists primarily of accounts receivable from invoicing of devices and services. The Company's credit risk arises from the possibility that a customer which owes the Company money is unable or unwilling to meet its obligations in accordance with the terms and conditions in the contracts with the Company, which would result in a financial loss for the Company. This risk is mitigated through established credit management techniques,

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2008 and 2007

#### 17. FINANCIAL RISK MANAGEMENT (continued)

including monitoring customer's creditworthiness, setting exposure limits and monitoring exposure against these customer credit limits.

The carrying amount of accounts receivable are reduced through the use of an allowance for doubtful accounts and the amount of the loss is recognized in the statement of operations. When a receivable balance is considered uncollectible, it is written off against the allowance for accounts receivable. Subsequent recoveries of amounts previously written off reduce other expenses in the statement of operations. At December 31, 2008, the largest single customer represented approximately 74% of accounts receivable.

The following table outlines the details of the aging of the Company's receivables as at December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Current	<b>\$19,882</b>	\$58,500
Past due		
1 – 60 days	<b>15,244</b>	48,750
Greater than 60 days	<b>180,554</b>	601,295
Less: Allowance for doubtful accounts	<b>(100,060)</b>	(123,000)
Total accounts receivable, net	<b><u>\$115,620</u></b>	<u>\$585,545</u>

#### (b) Liquidity Risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's objective in managing liquidity risk is to maintain sufficient readily available reserves in order to meet its liquidity requirements at any point in time. In order to meet its financial liabilities, the Company has recently relied on collecting its accounts receivable.

The Company's ability to manage its liquidity risk going forward will require some or all of the following: the ability to secure capital and/or credit facilities on reasonable terms in the current market place and its ability to generate positive cash flows from operations.

The following table details the Company's contractual maturities for its financial liabilities, including interest payments and operating lease commitments, as at December 31, 2008:

	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>Total</u>
Accounts payable and accrued liabilities	\$920,541	\$-	\$-	\$920,541
Obligations under capital lease	2,700	-	-	\$2,700
Operating lease commitments	120,000	120,000	12,000	\$252,000
	<u>\$1,043,241</u>	<u>\$120,000</u>	<u>\$12,000</u>	<u>\$1,175,241</u>

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2008 and 2007

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#### 17. FINANCIAL RISK MANAGEMENT (continued)

(c) *Market Risk*

Market risk is the risk that changes in market prices, such as foreign exchange rates and interest rates will affect the fair value of recognized assets and liabilities or future cash flows or the Company's results of operation.

*Foreign exchange*

The functional currency of the parent company is Canadian dollars and the reporting currency is Canadian dollars. As at December 31, 2008, the Company's non Canadian dollar net monetary liabilities totalled approximately US\$26,300 and €34,000 and accordingly any changes in the respective exchange rates as at December 31, 2008 would have resulted in an exchange gain or loss which would have been included in the determination of net income.

*Interest rate*

The Company has cash balances which are exposed to interest rate fluctuations. As at December 31, 2008, cash totalled \$2,120,333 (2007 - \$6,303,351). An increase of 100 basis points in the market interest rate would have decreased net loss by approximately \$42,100 (a 100 basis point decrease would have had the equal but opposite effect) for the year ended December 31, 2008.

#### 18. SEGMENTED INFORMATION

The Company is organized and managed as a single reportable business entity with two distinct revenue segments, being devices and services. The Company considers revenue realizable and earned when the product has been delivered or the services have been provided to the customer and collectability is reasonably assured. For sale of devices, revenue is recognized at the time of shipment of the device which constitutes transfer of ownership of the device. Revenue for the services component is reported as deferred revenue on the balance sheet and is recognized as earned revenue in the period which the service is provided. At December 31, 2008, the Company had \$1,706,993 (December 31, 2007 - \$388,337) of deferred revenues. Prior year's figures for revenue have been reclassified to conform to the current years' presentation for segmentation as follows:

	2008	2007
<b>Revenues</b>		
Devices	\$ 444,110	\$ 633,329
Services	725,352	373,871
	<u>1,169,462</u>	<u>1,007,200</u>

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

**December 31, 2008 and 2007**

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#### **19. SUBSEQUENT EVENTS**

In January 2009, the Company signed an agreement granting Qwest Government Services, Inc., the exclusive rights to resell the Company's solution to the U.S. Federal Government for 2009. As part of the agreement, Qwest has committed to purchase a minimum of 30,000 Route1 MobiNET devices along with TruOFFICE subscription-based services, which is valued at approximately US\$8.0 million for 2009. The potential reoccurring annual revenue stream to Route1 from this commitment is valued at approximately US\$5.5 million. In addition to the purchase commitment for 2009, Qwest will provide advertising and marketing support to promote Route1's solutions to various U.S. Federal departments and agencies. Qwest will also provide network-hosting services to Route1 from their facilities.