



Consolidated Financial Statements of

Route1 Inc.

December 31, 2009 and 2008

Auditors' Report

To the Shareholders of
Route1 Inc.

We have audited the consolidated balance sheets of Route1 Inc. as at December 31, 2009 and 2008 and the consolidated statements of operations, comprehensive loss and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material 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, 2009 and 2008 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Deloitte & Touche LLP

Chartered Accountants
Licensed Public Accountants
Toronto, Ontario
April 5, 2010

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December 31, 2009 and 2008.

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CONSOLIDATED BALANCE SHEETS

Route1 Inc.

As at December 31

	2009	2008
Assets		
Current		
Cash	\$ 640,045	\$ 2,120,333
Accounts receivable	88,583	115,620
Other receivables	34,954	18,873
Notes receivable (note 6)	173,000	198,220
Inventory (note 18)	900,775	1,333,427
Prepaid expenses	128,630	228,473
Total current assets	1,965,987	4,014,946
Capital assets (note 7)	74,571	206,464
Total assets	\$ 2,040,558	\$ 4,221,410
Liabilities		
Current		
Bank indebtedness (note 5)	\$ 854,717	\$ -
Accounts payable and accrued liabilities	1,197,258	920,541
Current portion of deferred revenue	1,535,823	1,658,691
Current portion of obligations under capital lease (note 8)	-	2,700
Total current liabilities	3,587,798	2,581,932
Deferred revenue	32,861	48,302
Total liabilities	3,620,659	2,630,234
Commitments and contingencies (note 13)		
Shareholders' equity (deficiency)		
Common shares (note 9)	23,977,296	24,038,562
Warrants (note 9)	2,949,072	3,203,207
Contributed surplus (note 9)	5,702,410	5,149,384
Deficit	(34,208,879)	(30,799,977)
Total shareholders' equity (deficiency)	(1,580,101)	1,591,176
	\$ 2,040,558	\$ 4,221,410

Approved by the Board of Directors:

Director:

● “signed”

Michael F. Doolan

Director:

● “signed”

Tony Busseri

The accompanying notes are an integral part of these consolidated statements

CONSOLIDATED STATEMENTS OF OPERATIONS, COMPREHENSIVE LOSS AND DEFICIT

Route1 Inc.

Years ended December 31

	2009	2008
Revenues		
Devices	\$ 2,572,148	\$ 444,110
Services	2,637,307	725,352
	5,209,455	1,169,462
Cost of revenues (note 18)	1,793,134	801,558
Gross margin	3,416,321	367,904
Expenses		
General administration	2,417,449	2,518,763
Research and development	1,831,780	1,836,116
Selling and marketing	1,492,868	1,311,858
Stock-based compensation	209,825	291,329
Amortization	121,311	213,796
	6,073,233	6,171,862
Loss before the following items	(2,656,912)	(5,803,958)
Interest income	12,229	81,220
Foreign exchange (loss) gain	(249,525)	276,057
Proxy contest charges (note 20)	(514,694)	-
Net loss and comprehensive loss for the period	(3,408,902)	(5,446,681)
Deficit, beginning of year	(30,799,977)	(25,353,296)
Deficit, end of year	\$ (34,208,879)	\$ (30,799,977)
Basic and diluted loss per share (note 12)	\$ (0.01)	\$ (0.02)
Weighted average number of common shares outstanding	350,388,115	349,864,827

The accompanying notes are an integral part of these consolidated statements

CONSOLIDATED STATEMENTS OF CASH FLOW

Route1 Inc.

Years ended December 31

	2009	2008
Net cash inflow (outflow) related to the following activities		
Operating activities		
Loss from operations	\$ (3,408,902)	\$ (5,446,681)
Items not affecting cash		
Amortization	148,315	329,583
Stock based compensation (note 9)	209,825	291,329
	(3,050,762)	(4,825,769)
Net changes in working capital balances		
Accounts receivable	27,037	469,925
Other receivables	(16,081)	526
Inventory	432,652	(725,631)
Prepaid expenses	99,843	(53,836)
Accounts payable and accrued liabilities	276,717	(273,331)
Deferred revenue	(138,309)	1,318,656
	(2,368,903)	(4,089,460)
Investing activities		
Acquisition of capital assets	(16,422)	(65,286)
Notes receivable	53,020	(34,387)
Bank indebtedness	854,717	-
	891,315	(99,673)
Financing activities		
Repayment of obligations under capital lease	(2,700)	(88,169)
Issuance of share capital – net	-	94,284
	(2,700)	6,115
Net cash outflow for the year	(1,480,288)	(4,183,018)
Cash, beginning of year	2,120,333	6,303,351
Cash, end of year	\$ 640,045	\$ 2,120,333
Supplementary information		
Interest paid	\$ 8,833	\$ 4,077
Reclass from share capital to notes receivable (note 6)	\$ 27,800	\$ -

The accompanying notes are an integral part of these consolidated statements

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Route1 Inc.

December 31, 2009

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.

Going concern assumption

While the accompanying audited 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, 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 year ended December 31, 2009 and 2008, the Company incurred losses of \$3,408,902 and \$5,446,681 respectively, and has an accumulated deficit of \$34,208,879 as at December 31, 2009. The Company’s continued operation 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.

2. SIGNIFICANT ACCOUNTING POLICIES

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”) applied on a basis consistent with the prior year with the exception of the changes in accounting policies noted in Note 3.

The significant accounting policies of the company are as follows:

Principles of consolidation

These audited 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.

For the year ended December 31, 2009, the Company incurred foreign currency losses of \$249,525 compared to a gain of \$276,057 for the year ended December 31, 2008.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Route1 Inc.

December 31, 2009

Cash

Cash consists of cash balances with chartered banks both in Canada and the United States of America.

Financial instruments

Financial assets and financial liabilities are initially recognized at fair value and their subsequent measurement is dependent on their classification as described below. Their classification depends on the purpose, for which the financial instruments were acquired or issued, their characteristics and the Company's designation of such instruments. Settlement date accounting is used.

Classification

Cash	Held for trading
Accounts receivable	Loans and receivables
Other receivables	Loans and receivables
Notes receivable	Loans and receivables
Bank Indebtedness	Other liabilities
Accounts payable and accrued liabilities	Other liabilities

Held for trading

Held for trading financial assets are financial assets typically acquired for resale prior to maturity or that are designated as held for trading. They are measured at fair value at the balance sheet date.

Fair value fluctuations including interest earned, interest accrued, gains and losses realized on disposal and unrealized gains and losses are included in other income.

Financial liabilities designated as held for trading are those non-derivative financial liabilities that the Company elects to designate on initial recognition as instruments that it will measure at fair value through other interest expense. These are accounted for in the same manner as held for trading assets. The Company has not designated any non-derivative financial liabilities as held for trading.

Loans and receivables

Loans and receivables are accounted for at amortized cost using the effective interest method.

Other liabilities

Other liabilities are recorded at amortized cost using the effective interest method and include all financial liabilities, other than derivative instruments.

Effective interest method

The Company uses the effective interest method to recognize interest income or expense which includes transaction costs or fees, premiums or discounts earned or incurred for financial instruments.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Route1 Inc.

December 31, 2009

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.

Investments

Investments not subject to significant influence are recorded at cost less any impairment to their value.

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. The following paragraphs describe the specific revenue recognition policies for each major category of revenue.

Devices

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

Appliances

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Route1 Inc.

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Service

Revenue from TruOFFICE subscription-based services, DEFIMNET and other appliance maintenance, are recognized rateably over the term of the contract 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 the residual method which allocates each undelivered component its fair value and the remaining amount is allocated to the undelivered element. 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.

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 amortized when the criteria for capitalization and amortization are met; otherwise they are expensed as incurred. To date, no development expenditures have been capitalized.

Earnings (loss) per share

Basic earnings (loss) per share are 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Route1 Inc.

December 31, 2009

Use of estimates

In preparation of 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 impairment of assets
- the valuation of future tax assets; and
- the calculation of stock option compensation expense.

Stock-based compensation

The Company has a stock-based compensation plan, which is described in note 10. 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

Goodwill and intangible assets

In February 2008, the CICA issued Handbook Section 3064, Goodwill and Intangible Assets which supersedes Sections 3062 *Goodwill and Other Intangible Assets*. Section 3064 provides additional guidance on when expenditures qualify for recognition as intangible assets and requires that costs be deferred only when relating to an item meeting the asset definition. CICA Handbook Section 1000, Financial Statement Concepts, was also amended to provide consistency with this new standard. The Company adopted this standard for the fiscal year commencing January 1, 2009. The adoption of this standard has had no material impact on the Company's financial statements or disclosures.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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Financial instruments

The Company also adopted the changes made by CICA to Section 3862, *Financial Instruments – Disclosures* whereby an entity shall classify and disclose fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy shall have the following levels:

Level 1 - valuation based on quoted prices (unadjusted) in active markets for identical assets or liabilities;

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

Level 3 - valuation techniques using inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The fair value hierarchy requires the use of observable market inputs whenever such inputs exist. A financial instrument is classified to the lowest level of the hierarchy for which a significant input has been considered in measuring fair value.

The required disclosures are included in note 15.

Credit risk and the fair value of financial assets and liabilities

In January 2009, the Company adopted Emerging Issues Committee (“EIC”) 173, Credit risk and the fair value of financial assets and financial liabilities issued by the Emerging Issues Committee. This abstract requires that an entity's own credit risk (for financial liabilities) and the credit risk of the counterparty (for financial assets) should be taken into account in determining the fair value of financial assets and financial liabilities, including derivative instruments. The adoption of this abstract did not have a material impact on the consolidated financial statements.

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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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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 evolving as it approaches implementation. The Company anticipates that it will not adopt IFRS for annual and interim reporting periods before the fiscal year beginning January 1, 2011. In 2010 the Company will complete an analysis of the impact of IFRS on accounting policies, information systems and internal controls over financial reporting. The analysis will include those policies the Company will be required to use, as well as those the Company would expect to apply where choices are permitted in preparing IFRS financial statements. To facilitate this transition in January 1, 2011, the Company will internally apply IFRS to the 2010 quarterly results ensuring that comparative results for fiscal year 2010 will be available when preparing the 2011 financial reports.

Business combinations, consolidated financial statements and non-controlling interests

In January 2009, the CICA issued the following new Handbook sections: Section 1582, Business Combinations, Section 1601, Consolidated Financial Statements and Section 1602, Non-Controlling Interests which replace Section 1581, Business Combinations and Section 1600, Consolidated Financial Statements. These new Sections will be applicable to financial statements relating to fiscal years beginning on or after January 1, 2011. Early adoption is permitted to the extent the three new Sections are adopted simultaneously. Together, the new Sections establish standards for the accounting for a business combination, the preparation of consolidated financial statements and the accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. The Company is currently evaluating the impact of the adoption of these new Sections on its consolidated financial statements. The Company does not expect that the adoption of these new Sections will have a material impact on its consolidated financial statements.

Multiple deliverable revenue arrangements

In December 2009, the CICA issued EIC 175, Multiple Deliverable Revenue Arrangements, replacing EIC 142, Revenue Arrangements with Multiple Deliverables. This abstract provides updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated and the consideration allocated; require, in situations where a vendor does not have vendor-specific objective evidence (VSOE) or third party evidence of selling price, that the entity allocate revenue in an arrangement using estimated selling prices of deliverables; eliminate the use of residual method and require an entity to allocate revenue using the relative selling price method; and require expanded qualitative and quantitative disclosures regarding significant judgments made in applying this guidance. This EIC is effective for future years beginning on or after January 1, 2011. The Company is currently evaluating the impact of the adoption of these new standards on its consolidated financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Route1 Inc.

December 31, 2009

5. BANK INDEBTEDNESS

The Company has a \$2,500,000 (Dec. 31, 2008 - \$nil) non-revolving senior credit facility that bears interest at bank prime plus 2.5% per annum. As of December 31, 2009, the Company had utilized \$854,717 (2008 - \$nil) of this credit facility. The credit facility's term was to have expired and the amount fully repaid on February 28, 2010.

On February 23, 2010, the Company was granted an extension on the repayment of its obligation from February 28, 2010 to May 31, 2010. At the same time the non-revolving senior credit facility was reduced from \$2,500,000 to \$1,000,000. Based on the extension being granted, at the request of the lender, the Company agreed to pay an extension fee of \$10,000 and initiate monthly principal payments of \$10,000 per month commencing February 28, 2010 until the outstanding balance is fully repaid on May 31, 2010.

As at December 31, 2009, the Company was in violation of a financial covenant, specifically its minimum current ratio (current assets divided by current liabilities). The lender has provided the Company with a waiver for the covenant breach. The waiver covers the period up to May 31, 2010. Interest expense related to this credit facility for the year ended December 31, 2009 was \$8,003 (2008 - \$nil).

6. NOTES RECEIVABLE

Notes receivable consist of the following:

	<u>December 31, 2009</u>	<u>December 31, 2008</u>
Due from the Vice-Chairman of the Company, secured and on demand with interest at 6%	\$ 95,200	\$ 90,100
Due from the former Executive Vice President and COO of the Company, secured and due on demand with interest at 6%	-	55,120
Due from the Executive Vice-President and CTO of the Company, secured and due on demand with interest at 6%	50,000	53,000
Due from the Executive Vice-President and CTO of the Company, non-secured and due on demand with interest at 6% (a)	27,800	-
	<u>\$ 173,000</u>	<u>\$ 198,220</u>

- (a) This note receivable was reclassified from equity in the prior year in accordance with EIC 132, Share Purchase Financing as an interest component and security was attached to the Note receivable during the fourth quarter of 2009.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Route1 Inc.

December 31, 2009

7. CAPITAL ASSETS

	December 31, 2009		
	Cost	Accumulated Amortization	Net Book Value
Furniture and equipment	\$ 235,950	\$ 234,178	\$ 1,772
Computer equipment	1,351,576	1,283,982	67,594
Computer software	607,691	607,691	-
Leasehold improvements	69,769	64,564	5,205
	<u>\$ 2,264,986</u>	<u>\$ 2,190,415</u>	<u>\$ 74,571</u>

	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>

Included in computer equipment are assets held under capital leases with a cost of \$657,847 (December 31, 2008 - \$657,847), accumulated amortization of \$657,847 (December 31, 2008 - \$652,995) and net book value of \$nil (December 31, 2008 - \$4,852).

8. OBLIGATIONS UNDER CAPITAL LEASE

The Company has obligations under capital lease as follows:

	December 31, 2009	December 31, 2008
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
Total amount of future minimum lease payments	-	2,700
Executory costs and interest included in instalments	-	-
	-	2,700
Current portion	-	2,700
	<u>\$ -</u>	<u>\$ -</u>

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Route1 Inc.

December 31, 2009

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, 2008	350,388,115	\$ 24,038,562
Revaluation of Warrants on extension to May 7, 2010	-	(89,066)
Other – note 6	-	27,800
Balance, December 31, 2008 and December 31, 2009	<u>350,388,115</u>	<u>\$ 23,977,296</u>

Escrow requirements

As at December 31, 2009, approximately 11,285,000 (December 31, 2008 – 22,570,000) 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.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Route1 Inc.

December 31, 2009

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

	December 31, 2009		December 31, 2008	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Options Outstanding				
Balance, beginning of the year	5,949,660	\$ 0.18	10,598,660	\$ 0.26
Options granted during the year	17,135,716	0.08	1,125,000	0.08
Options expired during the year	-	-	(2,837,000)	0.44
Options cancelled during the year	(7,501,786)	0.06	-	-
Options forfeited during the year	(3,563,230)	0.11	(2,937,000)	0.18
Balance, end of the year	12,020,360	\$ 0.11	5,949,660	\$ 0.18

The cancelled stock options represent those options that were granted below the allowable TSX Venture Exchange exercise price of \$0.10.

Exercise Price	Options Outstanding December 31, 2009		Options Exercisable December 31, 2009	
	Number of Options	Weighted Average Life (Years)	Number of Options	Weighted Average Life (Years)
\$ 0.10	8,000,000	4.8	-	-
\$ 0.125	950,000	1.0	633,333	1.0
\$ 0.20	1,185,000	0.1	1,185,000	0.1
\$ 0.205	1,298,360	0.1	1,298,360	0.1
\$ 0.30	587,000	1.3	587,000	1.3
	12,020,360	3.7	3,703,693	0.5

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
	5,949,660	2.8	1,196,386	2.9

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Route1 Inc.

December 31, 2009

The Company cancelled 7,501,786 stock options which included all options granted in the current year. The aforementioned stock options were cancelled as the grants were not in compliance with the policies of the Exchange.

Ninety days following the termination of his relationship with the Company on October 27, 2009, the 1,200,000 stock options held by the former Executive Vice President, Chief Financial Officer and Treasurer expired. These options expired on January 27, 2010.

During the year ended December 31, 2009, the Company recorded stock-based compensation expense of \$209,825 (December 31, 2008 - \$291,329), as derived using the Black-Scholes option valuation model. As a result of the cancelled stock option grants the compensation expense of \$77,987 for the 2009 year on the 7,501,786 stock option grants was reversed in December. The table below shows the assumptions used in determining stock based compensation expense, as derived under the Black-Scholes option pricing model:

The table below shows the assumptions used in determining stock based compensation expense, as derived under the Black-Scholes option pricing model:

	<u>2009</u>	<u>2008</u>
Risk free interest rate	2.62%	4.25%
Expected life (years)	5	5
Expected volatility	129%	100%
Dividend yield	Nil	Nil
Weighted average fair value of options granted	\$ 0.06	\$ 0.09

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-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.

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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. On November 7, 2009, 3,883,240 warrants issued as part of a private placement on November 7, 2007 expired with a value of \$343,201 which was reallocated to contributed surplus from warrants.

Warrants

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

	<u>Number of Warrants</u>	<u>Weighted Average Exercise Price</u>
Balance, January 1, 2009	36,243,573	\$ 0.155
Warrants exercised	-	-
Warrants expired	<u>3,883,240</u>	-
Balance, December 31, 2009 (a)	<u>32,360,333</u>	<u>\$ 0.155</u>

- (a) 36,243,573 warrants were expiring on November 7, 2009 with an exercise price of \$0.155 per share and value of \$3,203,207. Subsequent to September 30, 2009, the TSX Venture Exchange approved an extension to the expiry date of 32,360,333 warrants, from November 7, 2009 to May 7, 2010. The extension of the warrants resulted in a revaluation of their value to \$2,949,072. The Company used the Black Scholes model to fair value the modification of the warrants resulting in an additional warrant valuation of \$89,066 being bifurcated from share capital to warrants.

10. INCOME TAXES

The tax effect of significant temporary differences is as follows:

	<u>2009</u>	<u>2008</u>
Future income tax assets (liabilities)		
Capital assets	\$ 187,325	\$ 296,237
Unamortized financing fees	127,850	258,448
Eligible capital property	90,794	-
Tax losses carry-forwards	<u>9,075,500</u>	<u>9,407,310</u>
	<u>9,481,469</u>	<u>9,961,995</u>
Valuation allowance	<u>(9,481,469)</u>	<u>(9,961,995)</u>
Future income tax asset	<u>\$ -</u>	<u>\$ -</u>

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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>2009</u>	<u>2008</u>
Tax recovery at statutory rate	33.0 %	33.5 %
Permanent differences	(2.1)%	(1.9)%
Temporary difference due to non-recognition of tax loss carry forwards	(30.9) %	(31.6) %
Effective tax rate	<u>0.0 %</u>	<u>0.0 %</u>

The Company has non-capital losses for tax purposes of approximately \$36,302,000 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:

2010	550,000
2011	2,574,000
2014	990,000
2015	5,912,000
2026	9,109,000
2027	7,309,000
2028	6,498,000
2029	3,360,000
	<u>\$ 36,302,000</u>

11. RELATED PARTY TRANSACTIONS

On December 31, 2009, the Company had notes receivable from officers in the amount of \$173,000 (2008 - \$198,220) inclusive of accrued interest. As well, as of December 31, 2009, the Company made payments of \$33,750 (2008 - \$ nil) to the numbered company of 1220764 Ontario Inc. for management services provided by Mr. Tony Busseri, a director of the Company. In the fourth quarter the Company reimbursed the former President and CEO of the Company proxy contest amounts related to the Annual and Special Shareholders Meeting held on September 24, 2009 for costs incurred for third party service providers, including but not limited to consulting, printing, mailing, and transfer agent services, in the amount of \$514,694 (2008 - \$ nil) in the year ended December 31, 2009. These charges are one-time charges in nature not expected to recur.

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12. 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.

	<u>December 31, 2009</u>	<u>December 31, 2008</u>
Net loss	\$ (3,408,902)	\$ (5,446,681)
Weighted average number of common shares outstanding	<u>350,388,115</u>	<u>349,864,827</u>
Basic and diluted loss per share	<u>\$ (0.01)</u>	<u>\$ (0.02)</u>

The diluted loss per share is equal to the basic loss per share as the effects of the options and warrants are anti-dilutive.

13. 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:

2010	\$ 120,000
2011	12,000
	<u>\$ 132,000</u>

(ii) *Legal matters*

In the normal course of operations, the Company may be 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.

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14. 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 obligation.

15. FINANCIAL INSTRUMENTS

a) Establishing fair value

The carrying amount of financial instruments including cash, accounts receivable, other receivables, notes receivable, bank indebtedness and accounts payable and accrued liabilities approximates fair value because of the short-term nature of these instruments.

The following table sets out the classification, carrying amount, and fair value of the Company's financial assets and liabilities as at December 31, 2009 and December 31, 2008:

	December 31, 2009		December 31, 2008	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
FINANCIAL ASSET				
Held for trading				
Cash (i)	\$ 640,045	\$ 640,045	\$ 2,120,333	\$ 2,120,333
Loans and receivables				
Accounts receivable (i)	\$ 88,583	\$ 88,583	\$ 115,620	\$ 115,620
Other receivables (i)	\$ 34,954	\$ 34,954	\$ 18,873	\$ 18,873
Notes receivable (i)	\$ 173,000	\$ 173,000	\$ 198,220	\$ 198,220
FINANCIAL LIABILITIES				
Other liabilities				
Accounts payable and accrued liabilities (i)	\$ 1,197,258	\$ 1,197,258	\$ 920,541	\$ 920,541
Bank indebtedness(i)	\$ 854,717	\$ 854,717	\$ -	\$ -

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

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b) Fair value hierarchy

Financial instruments recorded at fair value on the Consolidated Balance Sheet are classified using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy has the following levels:

- a. Level 1 - valuation based on quoted prices (unadjusted) in active markets for identical assets or liabilities;
- b. Level 2 - valuation techniques based on inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (ie as prices) or indirectly (ie derived from prices);
- c. Level 3 - valuation techniques using inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The fair value hierarchy requires the use of observable market inputs whenever such inputs exist. A financial instrument is classified to the lowest level of the hierarchy for which a significant input has been considered in measuring fair value.

Fair value of cash is measured based on Level 1 inputs referred to in the three levels of hierarchy noted above. No other financial assets or financial liabilities are measured at fair value on the balance sheet.

16. CAPITAL MANAGEMENT

The Company's objectives when managing capital are:

- To maintain a flexible capital structure which optimized the cost of capital at acceptable risk;

The Company manages its capital structure and makes adjustments due to changes in economic conditions and the risk characteristics of the underlying assets. In order to maintain or adjust the capital structure, the Company may issue new shares, issue new debt, and/or issue new debt to replace existing debt with different characteristics.

Capital management objectives, policies and procedures are unchanged since the preceding year.

Under its borrowing agreement, the Company must satisfy certain restrictive covenants as to minimum financial ratios such as current ratio, debt to equity ratio, the purchase of property, plant and equipment and the payment of dividends.

As at December 31, 2009, the Company was in violation of a financial covenant, specifically its minimum current ratio (current assets divided by current liabilities) as a result of recording the severance obligation for certain past executives. The lender has provided the Company with a waiver for the covenant breach. The waiver covers the period up to May 31, 2010.

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17. FINANCIAL INSTRUMENTS - 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	
Bank indebtedness	Yes	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, 2009, the largest single customer represented approximately 37 % 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. At December 31, 2009, the Company had cash consisting of cash on hand and deposits with banks of \$640,045 (December 31, 2008 - \$2,120,333). During the year ended December 30, 2009, the Company did not hold any investments in asset-backed commercial paper.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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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, 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, 2009, the largest single customer represented approximately 6.2% of accounts receivable.

The following table outlines the details of the aging of the Company's receivables as at December 31, 2009 and December 31, 2008:

	December 31, 2009	December 31, 2008
Current	\$ 31,427	\$ 19,882
Past due		
1 – 60 days	47,873	15,244
Greater than 60 days	27,743	180,554
Less: Allowance for doubtful accounts	(18,460)	(100,060)
Total accounts receivable, net	\$ 88,583	\$ 115,620

The following table outlines the details of the Allowance for Doubtful Accounts of the Company's receivables as at December 31, 2009 and December 31, 2008:

	December 31, 2009	December 31, 2008
Opening balance as of January 1, 2009	\$ (99,672)	\$ (122,612)
Collected in period	1,297	-
Increase in reserve in period	(2,769)	(52,064)
Write-off in period	82,684	75,004
Closing balance as of December 31, 2009	\$ (18,460)	\$ (99,672)

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(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, 2009:

	<u>2010</u>	<u>2011</u>	<u>Total</u>
Accounts payable and accrued liabilities	\$1,197,258	\$ -	\$ 1,197,258
Bank indebtedness	854,717		854,717
Operating lease commitments	120,000	12,000	132,000
	<u>\$ 2,171,975</u>	<u>\$ 12,000</u>	<u>\$ 2,183,975</u>

(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, 2009, the Company's had non Canadian dollar net monetary liabilities of approximately US\$271,400 and €136,700 (December 31, 2008 - approximately US\$26,300 and €34,000). Any changes in the respective exchange rates as at December 31, 2009 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 and bank indebtedness which are exposed to interest rate fluctuations. At December 31, 2009, cash totalled \$640,045 (2008 - \$2,120,333) and bank indebtedness \$854,717 (2008 - \$nil). An increase of 100 basis points in the market interest rate would have decreased net loss by approximately \$6,400 (a 100 basis point decrease would have had the equal but opposite effect) for the year ended December 31, 2009.

18. INVENTORY

For the year ended December 31, 2009, the cost of inventories recognized as an expense was \$1,271,060 (\$214,003 in 2008) including write-downs of inventory to net realizable value of \$172,441.

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19. 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, 2009, the Company had \$1,568,684 (2008 - \$1,706,993) of deferred revenues. The Company recognized during the year ended December 31, 2009 \$1,162,948 (2008 - \$nil) in device revenue for the DEFIMNET hardware.

	<u>2009</u>	<u>2008</u>
Revenues		
Devices	\$ 2,572,148	\$ 444,110
Services	2,637,307	725,352
	<u>\$ 5,209,455</u>	<u>\$ 1,169,462</u>

20. PROXY CONTEST CHARGES

The proxy contest charges of \$514,694 include legal fees, proxy solicitation fees and expenses, and other professional consulting fees relating to the September 24, 2009 Annual and Special Shareholders Meeting, which was a contested meeting. These charges are expected to be one time in nature and not to recur, see note 11.

21. COMPARITIVE FIGURES

Prior year comparative figures have been reclassified to conform to current year presentation.

22. SUBSEQUENT EVENTS

On January 11, 2010, Route1 announced that the Reseller informed the Company that it would not be respecting its contractual obligations under the Agreement in regards to their purchase of the remaining Minimum Amount of approximately 25,000 MobiKEY® devices. The Reseller also informed the Company that it wished to continue to market and sell Route1 security and identity management solutions to the U.S. Federal Government in 2010, but on a non-exclusive basis. The Company has communicated to the Reseller that it will continue to fulfill its obligations under the Agreement and work with the Reseller to continue to service the U.S. Federal Government through the end of the Agreement's term. The Company also informed the Reseller that in no way should the Company's actions be construed as a waiver of any of its rights under the Agreement based on the Reseller's action to not purchase the remaining Minimum Amount.

On February 26, 2010 the Company announced the closing of a non-brokered private placement of 38,000,000 units ("Units") at \$0.05 per Unit for aggregate net proceeds of \$1,900,000. Each Unit is comprised of one common share and one common share purchase warrant of the Company. Each Warrant entitles the holder to purchase one additional common share of the Company at a price of \$0.15 per common share for a period of 60 months following the closing date.

On March 1, 2010, the Company announced that a total of 9,500,000 stock options to purchase common shares of Route1 were granted to an officer and a consultant of Route1 on February 26,

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2010 and expiring on February 26, 2015. 5,250,000 of the stock options are exercisable at \$0.10 per share and 4,250,000 are exercisable at \$0.15 per share. The grant is subject to regulatory approval.

On March 25, 2010 the Company announced that a total of 12,525,000 stock options to purchase common shares of Route1 were granted to employees, officers and a director of Route1 on March 24, 2010 at an exercise price of \$0.13 per share, expiring on March 24, 2015. The grant is subject to regulatory approval.