



*Consolidated Financial Statements of*

**Route1 Inc.**

*December 31, 2007 and 2006*



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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, 2007 and 2006 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, 2007 and 2006 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 18, 2008

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## CONSOLIDATED BALANCE SHEETS

### Route1 Inc.

As at December 31

	2007	2006
<b>ASSETS</b>		
Current		
Cash and cash equivalents (note 5)	\$ 6,303,351	\$ 1,486,364
Accounts receivable	585,545	546,244
Other receivables	19,399	18,324
Notes receivables (note 6)	163,833	86,457
Inventory	607,796	508,047
Prepaid expenses	174,633	117,542
	<b>7,854,557</b>	<b>2,762,978</b>
Investments (note 7)	4	75,003
Capital assets (note 8)	470,761	751,482
	<b>\$ 8,325,322</b>	<b>\$ 3,589,463</b>
<b>LIABILITIES</b>		
Current		
Accounts payable and accrued liabilities	\$ 1,193,872	\$ 1,331,690
Deferred revenue	376,239	165,995
Current portion of obligations under capital lease (note 9)	88,169	218,447
	<b>1,658,280</b>	<b>1,716,132</b>
Non current		
Deferred revenue	12,098	14,236
Obligations under capital lease (note 9)	2,700	90,869
	<b>1,673,078</b>	<b>1,821,237</b>
Commitments and Contingencies (note 15)		
<b>SHAREHOLDERS' EQUITY</b>		
Common shares (note 10)	23,905,243	13,065,386
Warrants (note 10)	6,527,888	5,277,983
Contributed surplus (note 10)	1,572,409	1,313,732
Deficit	(25,353,296)	(17,888,875)
	<b>6,652,244</b>	<b>1,768,226</b>
	<b>\$ 8,325,322</b>	<b>\$ 3,589,463</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

	2007	2006
<b>Revenues</b>		
Devices	\$ 633,329	\$ 383,874
Services	373,871	151,579
	<b>1,007,200</b>	535,453
<b>Cost of revenues</b>	<b>1,292,587</b>	1,382,557
<b>Gross margin (loss)</b>	<b>(285,387)</b>	(847,104)
<b>Expenses</b>		
General administration	2,334,188	2,989,720
Research and development	2,244,611	2,254,881
Selling and marketing	2,308,331	3,016,155
Amortization	284,592	284,507
	<b>7,171,722</b>	8,545,263
<b>Loss before the following items</b>	<b>(7,457,109)</b>	(9,392,367)
<b>Interest income</b>	<b>67,687</b>	61,156
<b>Loss from continuing operations</b>	<b>(7,389,422)</b>	(9,331,211)
<b>Write-down of Hypernet (note 7)</b>	<b>(74,999)</b>	-
<b>Income from discontinued operations (note 11)</b>	<b>-</b>	457,000
<b>Net loss and comprehensive loss for the period (note 3)</b>	<b>(7,464,421)</b>	(8,874,211)
<b>Deficit, beginning of period</b>	<b>(17,888,875)</b>	(9,014,664)
<b>Deficit, end of period</b>	<b>\$(25,353,296)</b>	\$(17,888,875)
<b>Loss per share from continuing operations (note 14)</b>	<b>\$ (0.03)</b>	\$ (0.05)
<b>Loss per share (note 14)</b>	<b>\$ (0.03)</b>	\$ (0.05)
<b>Weighted average number of common shares outstanding</b>	<b>286,651,757</b>	186,886,349

## CONSOLIDATED STATEMENTS OF CASH FLOW

### Route1 Inc.

#### Years ended December 31

	2007	2006
<b>Net cash inflow (outflow) related to the following activities</b>		
<b>Continued operating activities</b>		
Loss from continuing operations	\$(7,389,422)	\$(9,331,211)
Items not affecting cash		
Amortization	538,138	625,016
Stock based compensation	258,677	158,794
	<b>(6,592,607)</b>	<b>(8,547,401)</b>
Net changes in working capital balances		
Accounts receivable	(39,301)	(437,748)
Other receivables	(1,075)	3,793
Inventory	(99,749)	(357,752)
Prepaid expenses	(57,091)	(44,370)
Accounts payable and accrued liabilities	(137,818)	990,986
Deferred revenue	208,106	163,530
	<b>(6,719,535)</b>	<b>(8,228,962)</b>
<b>Discontinued operations</b>		
Net change in working capital balances	-	(457,000)
Income (loss) from discontinued operations	-	457,000
	-	-
<b>Investing activities</b>		
Acquisition of capital assets	(257,417)	(250,998)
Note receivables	(77,376)	83,644
	<b>(334,793)</b>	<b>(167,354)</b>
<b>Financing activities</b>		
Issuance of obligations under capital lease	-	51,676
Repayment of obligations under capital lease	(218,447)	(238,478)
Issuance of share capital – net	12,089,762	9,231,120
	<b>11,871,315</b>	<b>9,044,318</b>
<b>Net cash inflow</b>	<b>4,816,987</b>	<b>648,002</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>1,486,364</b>	<b>838,362</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 6,303,351</b>	<b>\$ 1,486,364</b>
<b>Supplementary information</b>		
Capital assets financed under capital lease	\$ -	\$ 55,560
Interest paid	\$ 10,864	\$ 10,136

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2007 and 2006

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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 is the trusted provider of security and identity management network solutions that are redefining today’s digital landscape. 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. Leveraging the power of MobiNET is the award-winning MobiKEY, an ultra-portable computing device that securely connects users to the myriad of MobiNET services from any Internet-enabled Windows-based PC. This patent-pending computing solution is embedded on a smart-card enabled, cryptographic USB device, making it one of the most powerful and easy-to-use secure computing solutions available today. MobiKEY provides secure remote access to data, applications, network resources, and web content with services such as TruOFFICE and PurLINK. Route1’s patent-pending solutions, based on FIPS-140-2 cryptographic modules, meet the stringent security needs and high standards mandated by all levels of government. They have been evaluated by ICSA Labs and certified by the CSE. As a Company with high regard for intellectual property, Route1 continues to encourage and nurture innovation across its talented team.

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, 2007 and 2006, the Company incurred losses of \$7,464,421 and \$9,331,211 respectively, and has an accumulated deficit of \$25,353,296 as at December 31, 2007. 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, 2007 and 2006

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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 at into Canadian dollars 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 statement of operations in the period in which they occur.

#### *Cash and cash equivalents*

Cash and cash equivalents consist of cash balances with banks and investments in term deposits and money market instruments that are readily convertible into cash.

#### *Allowance for Doubtful Accounts*

The allowance for doubtful accounts receivable is determined based on management’s assessment of the collectibility 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 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, 2007 and 2006

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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 collectibility 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.

##### *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.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2007 and 2006

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

##### *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; and
- the recoverability of investments.

##### *Stock 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 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.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2007 and 2006

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### 3. CHANGES IN ACCOUNTING POLICIES INCLUDING INITIAL ADOPTION

In April 2005, the Accounting Standards Board (“AcSB”) issued new accounting standards; CICA Handbook Section 1530 “Comprehensive Income”, Section 3251 “Equity”, Section 3855 “Financial Instruments – Recognition and Measurement” and Section 3861 “Financial Instruments Disclosures”. On January 1, 2007, the Company adopted these new accounting standards, these standards have been adopted prospectively and comparative amounts for the prior year have not been restated. These sections require certain financial instruments to be recorded at their fair value.

They also introduce the concept of comprehensive income and accumulated other comprehensive income.

#### *Comprehensive Income*

Section 1530 establishes standards for reporting and presenting comprehensive income, which is defined as the change in shareholders’ equity from transactions and other events from non-owner sources. This standard requires certain gains and losses to be presented in other comprehensive income until it is considered appropriate to recognize into net income. Major components for this category include unrealized gains and losses on financial assets classified as available-for-sale and unrealized foreign currency translation amounts.

Accordingly, the Company now reports combined statements of operations and comprehensive loss. The comparative statements did not require restatement to reflect the application of this section.

#### *Equity*

Section 3241 replaces Section 3250 “Surplus”. This section describes the presentation of equity and changes in equity for a reporting period as a result of the application of Section 1530 “Comprehensive Income.”

#### *Financial Instruments – Recognition and Measurement*

Section 3855 establishes standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. All financial instruments are required to be measured at fair value on initial recognition. Measurement in subsequent periods depends on whether the financial instrument has been classified as loans and receivables, held-for-trading, held-to-maturity, available-for-sale, or other liabilities. The classification depends on the purpose for which the financial instruments were acquired, their characteristics and/or management’s intent. Management determines the classification of financial assets and financial liabilities at initial recognition and, except in very limited circumstances, the classification is not changed subsequent to initial recognition.

At present, the Company’s financial instruments comprise of the following:

a. Loans and receivables

Loans and receivables are initially recognized at fair value including the direct and incremental transaction costs and are subsequently measured at amortized cost, using the effective interest method. The classification of the Company’s accounts receivable, other receivable, notes receivable into loans and receivables did not have any material impact on the consolidation financial statements.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2007 and 2006

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#### 3. CHANGES IN ACCOUNTING POLICIES INCLUDING INITIAL ADOPTION (continued)

b. Held-for-trading

Financial assets and financial liabilities that are purchased and incurred with the intention of generating income in the near term are classified as held-for-trading. Financial instruments included in this category are initially recognized at fair value and transaction costs are taken directly to earnings along with gains and losses arising from changes in fair value. The Company has classified cash and cash equivalents, as held-for-trading, which did not have any material impact on the consolidated financial statements.

c. Held- to-maturity

Held-to-maturity investments are financial assets with fixed or determinable payments that the Company has the intention and ability to hold to maturity. These are initially recognized at fair value including direct and incremental transaction costs and are subsequently valued at amortized costs using the effective interest rate method. No financial assets were classified as held-to-maturity on January 1, 2007.

d. Available-for-sale

Available for sale assets are financial assets that are designated as available for sale and are not categorized into any other categories described above. These are initially recognized at fair value including direct and incremental transaction costs and are subsequently held at fair value, with gains and losses arising from changes in fair value included in other comprehensive income until the sale when the cumulative gain or loss is transferred to earnings, except for investments in equity instruments which do not have a quoted price in an active market, which are recorded at cost. The Company classified its investment in Hypernet as available for sale and, subject to review for impairment at each reporting date.

e. Other liabilities

Accounts payable and accrued liabilities were classified as "other liabilities". After their initial fair value measurement, they are measured at amortized cost using the effective interest rate method. No financial liabilities were classified as other liabilities on January 1, 2007.

#### *Fair Value*

As at December 31, 2007, the carrying values of accounts receivable, other receivables, notes receivable, accounts payable and accrued liabilities approximate their fair values due to their immediate or short-terms to maturity. The carrying amount of cash and cash equivalents, classified as held-for-trading, approximates cost, due to the short term nature of these instruments. The fair value of the investments in equity instruments classified as available for sale, specifically the Company's investment in Hypernet Inc, is estimated based on discounted revenue analysis to be \$1. Due to the use of judgment and uncertainties in the determination of estimated fair values, these values should not be interpreted as being realizable in the immediate term.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2007 and 2006

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#### 3. CHANGES IN ACCOUNTING POLICIES INCLUDING INITIAL ADOPTION (continued)

##### *Hedge*

Section 3865 establishes standards that specifies the circumstances under which hedge accounting is permissible, how hedge accounting may be performed, and where the impacts should be recorded. The provisions of this standard introduce three specific types of hedging relationships: fair value hedges, cash flow hedges and hedges of a net investment in self-sustaining foreign operations. This standard did not affect the Company's financial position or results of operations.

##### *Accounting Changes*

On January 1, 2007, the Company adopted CICA Handbook section 1506 "Accounting Changes" which prescribes the criteria for changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors. This standard did not affect the Company's financial position or results of operations. The adoption of this standard requires that the Company disclose new primary sources of GAAP that have been issued, but not yet effective nor adopted by the Company.

#### 4. FUTURE ACCOUNTING PRONOUNCEMENTS

##### *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 is not expected to have a material effect on the Company's financial statements.

##### *Inventory*

In June 2007, the Canadian Institute of Chartered Accountants ("CICA") issued the new handbook Section 3031 "Inventories" replacing Section 3030 "Inventories". The new Section will be applicable to financial statements relating to fiscal years beginning on or after January 1, 2008. Accordingly, the Company will adopt the new standard for its fiscal year beginning January 1, 2008. It provides more guidance on the measurement and disclosure requirements for inventories. This new standard is not expected to have a material effect on the Company's financial statements.

##### *Financial Instruments*

Effective January 1, 2008, the Company will be required to adopt two new standards issued by the Canadian Institute of Chartered Accountants ("CICA"), Section 3862 "Financial Instruments – Disclosure," and Section 3863 "Financial Instruments - Presentation," which will replace Section 3861 "Financial Instruments – Disclosures and Presentation". This new presentation standard carry forward the former presentation requirements and increase the emphasis on the disclosure of risks associated with both recognized and unrecognized financial instruments and how those risks are managed. This new standard is not expected to have a material effect on the Company's financial statements.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2007 and 2006

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#### 5. CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of the following:

	<u>2007</u>	<u>2006</u>
Cash (bank indebtedness)	<b>\$6,303,351</b>	\$(19,506)
Cash equivalents	-	1,505,870
	<u><b>\$6,303,351</b></u>	<u>\$1,486,364</u>

Investments held, which mature in less than ninety days from the original maturity are classified as cash equivalents on the consolidated balance sheet. Generally, cash equivalents are comprised of banker acceptances, term deposits and treasury bills.

#### 6. NOTES RECEIVABLES

Notes receivable consist of the following:

	<u>2007</u>	<u>2006</u>
Due from an officer of the Company, unsecured and due on demand with interest at 6%	<b>\$60,000</b>	\$50,000
Due from an officer of the Company, secured and repayable no later than June 2, 2008 with interest at 6%	<b>52,000</b>	-
Due from an employee of the Company, secured and repayable no later December 28, 2008 with interest at 6%.	<b>50,000</b>	-
Due from an employee of the Company, secured, due on demand and non-interest bearing	<b>1,000</b>	-
Due from an employee of the Company, secured and repayable no later January 15, 2008 with interest at 6%.	<b>833</b>	-
Due from employees of the Company, unsecured, due on demand and non-interest bearing	-	36,457
	<u><b>\$163,883</b></u>	<u>\$ 86,457</u>

Subsequent to year end, \$61,833 of these notes receivable has been repaid.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

#### December 31, 2007 and 2006

#### 7. INVESTMENTS

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

	<u>2007</u>	<u>2006</u>
Hypernet Inc.	\$ 1	\$ 75,000
Other	3	3
	<u>\$ 4</u>	<u>\$ 75,003</u>

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

#### 8. CAPITAL ASSETS

	<b>December 31, 2007</b>		
	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>

	December 31, 2006		
	Cost	Accumulated Amortization	Net Book Value
Furniture and equipment	\$ 227,417	\$ 119,260	\$ 108,157
Computer equipment	1,052,272	510,104	542,168
Computer software	576,403	522,312	54,091
Leasehold improvements	69,769	22,703	47,066
	<u>\$ 1,925,861</u>	<u>\$ 1,174,379</u>	<u>\$ 751,482</u>

Included in computer equipment are assets held under finance leases with a cost of \$657,847 (2006 - \$657,847), accumulated amortization of \$548,671 (2006 - \$329,389) and net book value of \$109,176 (2006 - \$328,458).

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

#### December 31, 2007 and 2006

#### 9. OBLIGATIONS UNDER CAPITAL LEASE

The Company has obligations under capital lease as follows:

	<u>2007</u>	<u>2006</u>
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	<b>\$7,094</b>	\$35,471
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	<b>32,250</b>	128,999
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	<b>36,492</b>	109,476
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	<b>5,137</b>	15,413
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	<b>13,500</b>	24,300
Computer equipment lease agreement in the amount of \$22,564, repayable in monthly instalments of \$2,199 including interest calculated at 5.4%, with a bargain purchase option at maturity on April 30, 2007	-	8,798
	<hr/>	<hr/>
Total amount of future minimum lease payments	<b>94,473</b>	322,457
Executory costs and interest included in instalments	<b>3,604</b>	13,141
	<hr/>	<hr/>
	<b>90,869</b>	309,316
Current portion	<b>88,169</b>	218,447
	<hr/>	<hr/>
	<b>\$2,700</b>	<b>\$90,869</b>

Future minimum lease payments under the capital leases in each of the next two years are as follows:

2008	\$88,169
2009	2,700
	<hr/>
	<b>\$90,869</b>

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

#### December 31, 2007 and 2006

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#### 10. 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:

	<b>Number of Shares</b>	<b>Share Capital</b>
Balance, January 1, 2006	134,731,332	\$ 9,112,249
Shares issued on private placement (a, b)	106,976,285	3,953,137
Balance, December 31, 2006	241,707,617	13,065,386
Shares issued on exercise of warrants (c)	42,959,832	7,086,064
Shares issued on private placement (d)	64,720,666	3,781,593
Other	-	(27,800)
Balance, December 31, 2007	<u>349,388,115</u>	<u>\$ 23,905,243</u>

During the year ended December 31, 2006, the following share transactions took place:

- a. On March 9, 2006, the Company issued through a private placement 41,666,667 units at a price of \$0.12 per unit for total net proceeds of \$4,538,415. Each unit consisted of one common share and one common share warrant which is exercisable into one common share at a price of \$0.155 per share for a period of 2 years. \$2,155,082 of these proceeds has been recorded as common shares and \$2,383,333 has been recorded as warrants. In addition, 2,916,667 warrants have been issued as Broker Warrants. The value of the warrants was derived under the Black-Scholes pricing model using the following assumptions: a risk free interest rate of 4%, an expected life of 2.0 years, an expected volatility of 100% and a dividend yield of nil.
- b. On September 21, 2006, the Company issued through a private placement 65,309,618 units at a price of \$0.08 per unit for total net proceeds of \$4,692,705. Each unit consists of one common share and one common share warrant which is exercisable into one common share at a price of \$0.10 per share for a period of 2 years. \$1,798,055 of these proceeds has been recorded as common shares and \$2,894,650 has been recorded as warrants. In addition, 4,517,673 warrants have been issued as Broker Warrants. The value of the warrants was derived under the Black-Scholes pricing model using the following assumptions: a risk free interest rate of 4%, 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, 2007 and 2006

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

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

- c. 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.
- d. 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.

#### *Escrow requirements*

As at December 31, 2007, approximately 33,825,000 (2006 - 45,100,000) common shares of the Company were held in an Exchange escrow. 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, 2007 and 2006

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

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

	2007		2006	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Options Outstanding				
Balance, beginning of the period	9,201,500	\$ 0.30	7,194,000	\$ 0.44
Options granted during the period	5,390,160	0.17	6,346,500	0.23
Options cancelled during the period	(3,993,000)	0.23	(4,339,000)	0.43
Balance, end of the period	<u>10,598,660</u>	<u>\$ 0.26</u>	<u>9,201,500</u>	<u>\$ 0.30</u>

Exercise Price	Options Outstanding 2007		Options Exercisable 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>2,387,001</u>	<u>1.1</u>

Exercise Price	Options Outstanding 2006		Options Exercisable 2006	
	Number of Options	Weighted Average Life (Years)	Number of Options	Weighted Average Life (Years)
\$ 0.20	4,545,000	3.0	-	-
\$ 0.30	1,474,500	4.3	-	-
\$ 0.40	1,891,000	1.3	1,103,084	1.3
\$ 0.50	1,291,000	1.3	753,084	1.3
	<u>9,201,500</u>	<u>2.7</u>	<u>1,856,168</u>	<u>1.3</u>

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

#### December 31, 2007 and 2006

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

During 2007, the Company recorded stock-based compensation expense of \$258,677 (2006 - \$158,794), 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:

	<u>2007</u>	<u>2006</u>
Risk free interest rate	4.5% - 4.75%	4% to 4.5%
Expected life (years)	3 to 5	3.75 to 5
Expected volatility	100%	100%
Dividend yield	Nil	nil
Weighted average fair value of options granted	<u>\$ 0.11</u>	<u>\$ 0.08</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-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 is determined using the Black-Scholes Option Pricing Model and is amortized to income on a straight-line basis over the vesting period and also 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 also credit to share capital.

#### *Warrants*

At December 31, 2007 there were 107,748,365 warrants outstanding with the following terms:

	<u>2007</u>		<u>2006</u>	
	Number of warrants	Weighted average exercise price	Number of warrants	Weighted average exercise price
Balance, January 1	114,464,624	\$0.121	14,170,240	\$0.499
Issued	36,243,573	\$0.155	114,464,624	\$0.121
Exercised	(42,959,832)	\$0.120	-	-
Cancelled	-	-	(14,170,240)	\$0.499
Balance, December 31	<u>107,748,365</u>	<u>\$0.134</u>	<u>114,464,624</u>	<u>\$0.121</u>

- (a) 29,369,174 warrants expiring March 9, 2008 with an exercise price of \$0.155 per share.
- (b) 42,135,618 warrants expiring September 20, 2008 with an exercise price of \$0.10 per share.
- (c) 36,243,573 warrants expiring November 6, 2009 with an exercise price of \$0.155 per share

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

#### December 31, 2007 and 2006

#### 11. DISCONTINUED OPERATIONS

On April 26, 2005, the Company announced the discontinuance of operations of The Clones Society Inc. ("Clones"), a subsidiary company. As a result of its inability to continue as a going concern, Clones declared itself to be insolvent and has, as a result, voluntarily made an assignment in bankruptcy. During 2006, the bankruptcy was finalized with all debts and liabilities outstanding being satisfied.

Summarized below is the selected financial information pertaining to these discontinued operations:

	<u>2007</u>	<u>2006</u>
Current assets	\$ -	\$ -
Current liabilities	\$ -	\$ -
Capital deficiency	-	-
	<u>\$ -</u>	<u>\$ -</u>
Sales	\$ -	\$ -
Cost of sales	-	-
Gross margin	-	-
Expenses	-	-
Gain on finalization of bankruptcy assignment	-	457,000
(Loss) Income from discontinued operations	<u>\$ -</u>	<u>\$457,000</u>

#### 12. INCOME TAXES

The tax effect of significant temporary differences is as follows:

	<u>2007</u>	<u>2006</u>
Future income tax assets (liabilities)		
Capital assets	\$ 554,046	\$ 424,186
Unamortized financing fees	504,060	230,236
Reserve for unearned revenue	11,625	-
Tax losses carryforwards	8,138,430	6,824,152
	<u>9,208,161</u>	<u>7,478,574</u>
Valuation allowance	<u>(9,208,161)</u>	<u>(7,478,574)</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.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

#### December 31, 2007 and 2006

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#### 12. INCOME TAXES (continued)

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

	<u>2007</u>	<u>2006</u>
Tax recovery at statutory rate	35.0 %	36.1 %
Permanent differences	2.9%	3.1 %
Temporary difference due to non-recognition of tax loss carryforwards	(37.9) %	(39.2) %
Effective tax rate	<u>0.0 %</u>	<u>0.0 %</u>

The Company has non-capital losses for tax purposes of approximately \$26,253,000 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:

2008	\$423,000
2009	550,000
2010	2,573,000
2014	989,000
2015	5,912,000
2026	9,109,000
2027	6,697,000
	<u>\$ 26,253,000</u>

#### 13. RELATED PARTY TRANSACTIONS

At the end of 2007, the Company had notes receivable from officers and employees in the amount of \$191,633 (2006- \$86,457). Some of these notes are secured and unsecured, and some with interest at 6% and others being non-interesting bearing (see note 6).

#### 14. 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 2007 and 2006, the loss per share was \$0.03 and \$0.05 respectively.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2007 and 2006

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#### 15. 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:

2008	\$105,000
2009	120,000
2010	12,000
	<u>\$ 237,000</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, managements believe 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.

#### 16. 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.

#### 17. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

The carrying amount of financial instruments including cash and cash equivalents, accounts receivable, other receivables, notes receivable and accounts payable and accrued liabilities approximates fair value because of the limited term 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 Company is exposed to the following risks related to its financial assets and liabilities:

*Credit risk*

Credit risk arises from the possibility that the Company's customers may experience financial difficulty and be unable to fulfill their financial obligations. The Company, in the normal course of business, monitors the financial condition of its customers and reviews the credit history of each new customer. The Company establishes an allowance for doubtful accounts that corresponds to

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### Route1 Inc.

December 31, 2007 and 2006

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

specific credit risk of its customers, historical trends, and economic circumstances. The Company's two largest customers accounted for approximately 32% of revenues in 2007 and approximately 55% of accounts receivable at December 31, 2007.

##### *Interest rate risk*

The Company interest rate risk is due to volatility in interest rates. This risk has been mitigated by borrowing at fixed rates.

##### *Foreign exchange*

A portion of our revenues and cost of sales has a functional currency other than the Canadian dollar; accordingly we are exposed to foreign exchange rate risk inherent in our revenues and cost of sales. Fluctuations in exchange rates may harm our operations and could result in exchange losses. The impact of future exchange rate fluctuations cannot be predicted with certainty; however our exposure to foreign currency rate risk is primarily associated with fluctuations in the Euro, and the United States dollar.

Although the Company has the ability to address these risks through the use of options, futures and forward contracts, it currently has not entered into such arrangements to reduce these risks.

#### 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 or 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, 2007 the Company had \$388,337 (2006-\$180,231) of deferred revenues. Prior year's figures for revenue have been reclassified to conform to the current years' presentation for segmentation as follows:

	2007	2006
<b>Revenues</b>		
Devices	\$ 633,329	\$ 383,874
Services	373,871	151,579
	<u>\$ 1,007,200</u>	<u>\$ 535,453</u>

#### 19. SUBSEQUENT EVENTS

On February 21, 2008, the Company issued to directors 1,125,000 options to purchase common shares of the Company with an exercise price of \$0.08 per share.