

ESI Entertainment Systems Inc.
Consolidated Financial Statements

(expressed in Canadian dollars)

For the Six Months Ended August 31, 2010 and 2009

Notice to Reader:

These unaudited financial statements have not been reviewed by the Company's auditors.

ESI Entertainment Systems Inc.

Consolidated Balance Sheets

(expressed in Canadian dollars)
(unaudited)

	August 31, 2010 (unaudited)	February 28, 2010 (audited)
Assets		
Cash and cash equivalents	\$ 94,794	\$ 89,208
Accounts receivable	1,274,650	1,073,580
Citadel processing accounts (Note 3)	4,648,617	4,937,401
Prepays	<u>103,990</u>	<u>65,658</u>
	6,122,051	6,165,847
Capitalized development costs	119,333	47,532
Property and equipment (Note 4)	147,372	170,499
Deferred contract costs	<u>466,915</u>	<u>550,362</u>
	<u>\$ 6,855,671</u>	<u>\$ 6,934,240</u>
Liabilities		
Accounts payable and accrued liabilities (Note 8)	\$ 2,928,692	\$ 2,227,935
Loan Payable (Note 9)	2,247,948	2,174,733
Citadel processing liabilities (Note 3)	5,720,798	5,649,239
Deferred revenue	<u>495,288</u>	<u>582,230</u>
	11,392,726	10,634,137
Deferred revenue	<u>774,681</u>	<u>913,605</u>
	<u>12,167,407</u>	<u>11,547,742</u>
Shareholders' Equity		
Capital stock (Note 5)	9,957,959	9,957,959
Contributed surplus	4,467,539	4,467,539
Deficit	<u>(19,737,234)</u>	<u>(19,039,010)</u>
	<u>(5,311,736)</u>	<u>(4,613,502)</u>
	<u>\$ 6,855,671</u>	<u>\$ 6,934,240</u>

On behalf of the Board

"Tony Greening" Director
Tony Greening

"Michael Meeks" Director
Michael Meeks

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ESI Entertainment Systems Inc.

Consolidated Statements of Operations and Comprehensive Income (Deficit) and Retained Earnings

(expressed in Canadian dollars)

(unaudited)	Three Months Ended August 31,		Six Months Ended August 31,	
	2010	2009	2010	2009
Revenues (Note 4)	\$ 822,029	\$ 952,271	\$ 1,565,294	\$ 1,786,262
Direct costs	<u>482,599</u>	<u>597,289</u>	<u>980,012</u>	<u>1,271,526</u>
Gross profit	<u>339,430</u>	<u>354,982</u>	<u>585,282</u>	<u>514,736</u>
Operating expenses				
Product development	-	59,580	-	122,888
Sales, marketing and customer service	29,035	37,954	60,419	78,279
General and administrative	687,397	594,803	1,346,436	1,270,538
Amortization of property and equipment	12,370	59,276	26,345	131,502
	<u>728,802</u>	<u>751,613</u>	<u>1,433,200</u>	<u>1,603,207</u>
(Loss) Earnings before under noted items	(389,372)	(396,631)	(847,918)	(1,088,471)
Other expenses (income)				
Foreign exchange loss (gain)	(158,526)	118,671	(250,935)	(96,674)
Interest income	(645)	(19,510)	(689)	(20,200)
Interest expense	53,223	39,885	101,930	86,203
Net (Loss) Earnings	<u>\$ (283,424)</u>	<u>\$ (535,677)</u>	<u>\$ (698,224)</u>	<u>\$ (1,057,800)</u>
(Loss) Earnings per share				
Basic	\$ (0.02)	\$ (0.04)	\$ (0.05)	\$ (0.07)
Retained earnings (deficit), beginning of period	\$ (19,453,810)	\$ (17,220,834)	\$ (19,039,010)	\$ (16,698,711)
Net (Loss) Earnings	<u>(283,424)</u>	<u>(535,677)</u>	<u>(698,224)</u>	<u>(1,057,800)</u>
Retained earnings (deficit), end of period	<u>\$ (19,737,234)</u>	<u>\$ (17,756,511)</u>	<u>\$ (19,737,234)</u>	<u>\$ (17,756,511)</u>

These unaudited financial statements have not been reviewed by the Company's auditors.

See accompanying notes to the consolidated financial statements.

ESI Entertainment Systems Inc.

Consolidated Statements of Cash Flows

(expressed in Canadian dollars)

(unaudited)	Three Months Ended August 31,		Six Months Ended August 31,	
	2010	2009	2010	2009
Cash flows provided by (used in)				
Operating activities				
Net (Loss) Earnings	\$ (283,424)	\$ (535,677)	\$ (698,224)	\$ (1,057,800)
Items not affecting cash:				
Amortization of property and equipment	12,370	59,276	26,345	131,502
Net changes in non-cash operating items:				
Accounts receivable	(149,495)	852,300	(201,069)	563,803
Prepays	(6,114)	(89,828)	(38,332)	(65,280)
Accounts payable and accrued liabilities	546,693	(194,807)	1,061,088	29,462
Deferred revenue	(251,903)	(80,058)	(225,866)	(63,399)
Deferred contract costs	53,663	55,636	83,448	63,444
	<u>(78,210)</u>	<u>66,842</u>	<u>7,390</u>	<u>(398,268)</u>
Investing activities				
Capitalized development costs	(71,801)	-	(71,801)	-
Acquisition of property and equipment	(3,218)	12,854	(3,218)	5,202
	<u>(75,019)</u>	<u>12,854</u>	<u>(75,019)</u>	<u>5,202</u>
Financing activities				
Loan payable	72,247	(24,992)	73,215	(355,596)
Capital lease payments	-	(13,279)	-	(26,169)
	<u>72,247</u>	<u>(38,271)</u>	<u>73,215</u>	<u>(381,765)</u>
Increase (decrease) in cash and cash equivalents	(80,982)	41,425	5,586	(774,831)
Cash and cash equivalents, beginning of period	<u>175,776</u>	<u>93,529</u>	<u>89,208</u>	<u>909,785</u>
Cash and cash equivalents, end of period	<u>\$ 94,794</u>	<u>\$ 134,954</u>	<u>\$ 94,794</u>	<u>\$ 134,954</u>
Supplemental information				
Interest received	\$ 645	\$ 19,510	\$ 689	\$ 20,200
Interest paid	53,223	39,885	101,930	86,203

These unaudited financial statements have not been reviewed by the Company's auditors.

See accompanying notes to the consolidated financial statements.

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ESI Entertainment Systems Inc.

Notes to the Consolidated Financial Statements

(unaudited, expressed in Canadian dollars)
Three and Six Months Ended August 31, 2010 and 2009

1. Nature and continuance of operations

ESI Entertainment Systems Inc. ("the Company") was incorporated as e-Success Inc. on December 9, 1999 under the *Canada Business Corporations Act*. On February 27, 2006, the Company was continued as a British Columbia corporation and changed its name to ESI Entertainment Systems Inc.

ESI Corporate

ESI Entertainment Systems Inc. is a software development company with two main independently operated and controlled subsidiaries: ESI Integrity Inc. and Citadel Commerce Corp. The two active subsidiaries are located in separate physical locations and operate autonomously with completely separate management, personnel and infrastructure. ESI has 14 Citadel employees and 12 Integrity employees located in Burnaby, British Columbia, Canada from where each company markets its products and services globally.

ESI Integrity

ESI Integrity provides software solutions for real-time auditing of transaction processing systems, fraud control and risk management systems to businesses requiring high levels of security, integrity, and trust, including government lotteries and pari-mutuel (horse tracks) organizations. Integrity enters into long term customer license and support contracts where it charges a fixed license fee for the use of its audit and risk management software, as well as an annual support fee. The license contracts can be perpetual or renewable. The support contracts are renewable. Revenue is typically earned over a two to five year period, depending on a contract's respective term.

Citadel

Citadel provides on-line payment processing services to and from end-users and e-commerce merchants. The payment processing services include Bank Transfers, Instant Bank Transfers, electronic cheques and paper cheques. Transactions are processed with concurrent transactional fraud detection services including full identity pre-authorization via in-house and third party databases and validation of previous transaction history. All of Citadel's services are based on a fee per transaction charged to its merchants and end-users.

Going Concern

These financial statements have been prepared on a going concern basis which includes the assumption that the Company will be able to realize its assets and settle its liabilities in the normal course of business. For the three month period ended August 31, 2010 the Company incurred a loss from operations of \$283,424 and a decrease in operating cash flow of \$80,982. In addition, the Company has incurred significant operating losses and net utilization of cash in operations in prior periods. Accordingly, the Company will require continued financial support from its shareholders and creditors and/or new debt or equity financing until it is able to generate sufficient cash flow from operations on a sustained basis. There can be no guarantee that adequate funds will be available on acceptable terms as and when required by the Company. Failure to obtain ongoing support of its shareholders and creditors may make the going concern basis of accounting inappropriate, in which case the Company's assets and liabilities would need to be recognized at their liquidation values. These financial statements do not include any adjustment due to this going concern uncertainty.

ESI Entertainment Systems Inc.

Notes to the Consolidated Financial Statements

(unaudited, expressed in Canadian dollars)
Three and Six Months Ended August 31, 2010 and 2009

2. Basis of consolidation and financial statement preparation

These unaudited interim Consolidated Financial Statements have been prepared in accordance with Canadian Generally Accepted Accounting Principles (GAAP) on a basis consistent with those followed in the most recent audited annual financial statements for the year ended February 28, 2010. These unaudited interim Consolidated Financial Statements do not include all note disclosures required by GAAP for annual consolidated financial statements. Accordingly, these statements should be read in conjunction with the Company's annual audited financial statements for the year ended February 28, 2010.

3. Citadel processing

Citadel Processing Accounts represent the bank accounts maintained by the Company for the purpose of payment processing for Citadel merchants and clients. These accounts are recorded separately from the Company's operating bank accounts.

Citadel Processing Liabilities represent balances due to myCitadel clients, merchants and their clients from funds held in trust, pending transaction cancellation periods and processing times. These amounts consist of:

	<u>August 31,</u> <u>2010</u>	<u>February 28,</u> <u>2010</u>
Merchant processing funds	\$ 5,695,476	\$ 5,581,442
Merchant reserves	11,020	58,101
myCitadel consumer funds	<u>14,302</u>	<u>9,696</u>
	<u>\$ 5,720,798</u>	<u>\$ 5,659,239</u>

Merchant processing funds are funds held with Citadel for its merchants, these are available on demand.

Merchant reserves represent 10% of certain processed transactions accumulated on a six month rolling period for certain merchants.

myCitadel consumer funds represent the funds held by clients to be used in e-commerce activities.

4. Segmented information

The Company operates two main operating segments – ESI Integrity and Citadel.

The ESI Integrity segment provides software solutions for real-time auditing of transaction processing systems to businesses requiring high levels of security, integrity and trust including government regulated lotteries and pari-mutuel (horse tracks) betting.

Citadel provides on-line payment processing services including internet bank transfers, electronic cheque and paper cheques. Transactions are processed with concurrent transactional fraud detection services including full identity pre-authorization via in-house and third party databases and validation of previous transaction history.

ESI Entertainment Systems Inc.

Notes to the Consolidated Financial Statements

(unaudited, expressed in Canadian dollars)
Three and Six Months Ended August 31, 2010 and 2009

4. Segmented information (Continued)

Gross Profit:

Three months ended, August 31, 2010

	ESI Integrity	Citadel	Total
Segment gross profit			
Revenue	\$ 440,076	\$ 381,953	\$ 822,029
Cost of goods sold	<u>226,970</u>	<u>255,629</u>	<u>482,599</u>
Gross profit	<u>213,106</u>	<u>126,324</u>	<u>339,430</u>
Acquisition of property and equipment	\$ <u>3,218</u>	\$ <u>-</u>	\$ <u>3,218</u>

Three months ended, August 31, 2009

	ESI Integrity	Citadel	Total
Segment gross profit			
Revenue	\$ 706,095	\$ 246,176	\$ 952,271
Cost of goods sold	<u>311,004</u>	<u>286,285</u>	<u>597,289</u>
Gross profit	<u>395,091</u>	<u>(40,109)</u>	<u>354,982</u>
Acquisition of property and equipment	\$ <u>12,854</u>	\$ <u>-</u>	\$ <u>12,854</u>

Six months ended, August 31, 2010

	ESI Integrity	Citadel	Total
Segment gross profit			
Revenue	\$ 873,929	\$ 691,365	\$ 1,565,294
Cost of goods sold	<u>455,369</u>	<u>524,643</u>	<u>980,012</u>
Gross profit	<u>418,560</u>	<u>166,722</u>	<u>585,282</u>
Acquisition of property and equipment	\$ <u>3,218</u>	\$ <u>-</u>	\$ <u>3,218</u>

Six months ended, August 31, 2009

	ESI Integrity	Citadel	Total
Segment gross profit			
Revenue	\$ 1,286,602	\$ 499,660	\$ 1,786,262
Cost of goods sold	<u>697,299</u>	<u>574,227</u>	<u>1,271,526</u>
Gross profit	<u>589,303</u>	<u>(74,567)</u>	<u>514,736</u>
Acquisition of property and equipment	\$ <u>5,202</u>	\$ <u>-</u>	\$ <u>5,202</u>

ESI Entertainment Systems Inc.

Notes to the Consolidated Financial Statements

(unaudited, expressed in Canadian dollars)
Three and Six Months Ended August 31, 2010 and 2009

4. Segmented information (Continued)

Property and Equipment:

As at August 31, 2010

	ESI Integrity	Citadel	ESI Corp	Total
Segment assets				
Property and equipment, net	\$ <u>64,420</u>	\$ <u>53,054</u>	\$ <u>29,898</u>	\$ <u>147,372</u>

As at February 28, 2010

	ESI Integrity	Citadel	ESI Corp	Total
Segment assets				
Property and equipment, net	\$ <u>72,596</u>	\$ <u>61,784</u>	\$ <u>36,119</u>	\$ <u>170,499</u>

Net Loss:

	<u>Three months ended, August 31</u>		<u>Six months ended, August 31</u>	
	2010	2009	2010	2009
Segment gross profit	\$ 339,430	\$ 354,982	\$ 585,282	\$ 514,736
Product development	-	59,580	-	122,888
Sales, marketing and customer service	29,035	37,954	60,419	78,279
General and administrative	687,397	594,803	1,346,436	1,270,538
Amortization of property and equipment	12,370	59,276	26,345	131,502
Foreign exchange loss (gain)	(158,526)	118,671	(250,935)	(96,674)
Interest income	(645)	(19,510)	(689)	(20,200)
Interest expense	53,223	39,885	101,930	86,203
Net Loss	\$ <u>(283,424)</u>	\$ <u>(535,677)</u>	\$ <u>(698,224)</u>	\$ <u>(1,057,800)</u>

Total Assets:

	August 31, <u>2010</u>	February 28, <u>2010</u>
Property and Equipment	\$ 147,372	\$ 170,499
Cash and cash equivalents	94,794	89,208
Capitalized development costs	119,333	47,532
Accounts receivable	1,274,650	1,073,580
Prepays	103,990	65,658
Citadel processing accounts	4,648,617	4,937,401
Deferred contract costs	466,915	550,362
	\$ <u>6,855,671</u>	\$ <u>6,934,240</u>

ESI Entertainment Systems Inc.

Notes to the Consolidated Financial Statements

(unaudited, expressed in Canadian dollars)
Three and Six Months Ended August 31, 2010 and 2009

4. Segmented information (Continued)

Revenues earned by geographic location:

	<u>Three months ended August 31</u>		<u>Six months ended August 31</u>	
	2010	2009	2010	2009
United States	\$ 166,074	\$ 277,023	\$ 248,437	\$ 498,651
Canada	89,780	75,324	167,674	156,259
International	<u>566,175</u>	<u>599,942</u>	<u>1,149,183</u>	<u>1,131,352</u>
	<u>\$ 822,029</u>	<u>\$ 952,289</u>	<u>\$ 1,565,294</u>	<u>\$ 1,786,262</u>

As at August 31, 2010, 79% of the Company's fixed assets were situated in Canada and 21% were located internationally.

5. Capital stock

Authorized:

Unlimited voting common shares without par value

	<u>Number of Common Shares</u>	<u>Amount</u>
Issued and outstanding - common shares		
Balance, February 28, 2010	14,234,726	\$ 9,957,959
Balance, August 31, 2010	<u>14,234,726</u>	<u>\$ 9,957,959</u>

6. Stock-based compensation plans

Under the company stock option plan and at the discretion of the board of directors, the Company may grant options to purchase up to 2,850,000 common shares of the Company to its directors, officers, employees and consultants. No one person is to be granted options equal to more than 5% of the total issued and outstanding common shares of the Company on a non-diluted basis. The maximum term of the options under this plan is ten years and the exercise price and vesting period will be determined by the board of directors at the time of granting.

During the three months ended August 31, 2010, no stock options were granted and 1,751,000 were surrendered (without compensation), forfeited or expired unexercised; (August 31, 2009 – 50,000, nil and 29,000 respectively). As at August 31, 2010, there were 145,000 options outstanding, (August 31, 2009 – 1,937,000) exercisable at a Weighted Average Price of \$0.05. (August 31, 2009 - \$0.62). As at the date of these Interim Financial Statements there are 1,559,000 options outstanding.

All options are exercisable at a price equal to the current trading price of common shares at the date of grant. When stock options are granted, the Company records a stock based compensation expense in the statement of operations. This amount is included in General and Administrative operating expenses. The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option pricing model. During the three and six month periods ending August 31, 2010, no stock based compensation expense was recorded (August 31, 2009 – nil).

ESI Entertainment Systems Inc.

Notes to the Consolidated Financial Statements

(unaudited, expressed in Canadian dollars)
Three and Six Months Ended August 31, 2010 and 2009

7. Earnings (loss) per share

The following table sets the number of weighted average shares used in the computation of basic and diluted earnings per share:

	<u>Three Months Ended,</u> <u>August 31</u>		<u>Six Months Ended,</u> <u>August 31</u>	
	2010	2009	2010	2009
Weighted average shares used in computation of basic earnings per share	14,234,726	14,234,726	14,234,726	14,234,726
Fully diluted weighted average number of common shares	14,234,726	14,234,726	14,234,726	14,234,726

The fully diluted loss per share has not been computed, as the effect would be anti-dilutive.

8. Accounts Payable and accrued liabilities

As at August 31, 2010, of the \$2,928,692 balance in Accounts payable and accrued liabilities, \$1,158,502 is comprised of deferred salaries. Certain employees have voluntarily deferred part of their compensation. The unpaid deferred amounts are being accrued with interest and are payable upon termination or when the Company's economic conditions have strengthened to accommodate for the repayment.

9. Loan Payable

In June 2008, the Company secured a US\$ 2 million loan bearing interest at the rate of 6% per annum. The loan is secured by first ranking fixed charges on the entire issued share capital of the Company's principal subsidiaries, ESI Integrity Inc., Citadel Commerce Corp and Citadel Commerce UK Limited. On January 28, 2010, the Company renegotiated the terms of the loan facility so that the loan is no longer repayable on a fixed date and is now repayable on demand. All other terms of the loan are unchanged.

10. International Financial Reporting Standards ("IFRS")

In February 2008, the Canadian Accounting Standards Board ("AcSB") announced that 2011 is the changeover date for publicly-listed companies to use International Financial Reporting Standards ("IFRS"), replacing Canada's own GAAP. The date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. The transition date of March 1, 2011 will require the restatement for comparative purposes of amounts reported by the Company for the year ended February 28, 2011. The Company is currently working to analyze the standards and while the Company has begun assessing the adoption of IFRS for 2011, the financial reporting impact of the transition to IFRS cannot be reasonably estimated at this time.

ESI Entertainment Systems Inc.

Notes to the Consolidated Financial Statements

(unaudited, expressed in Canadian dollars)

Three and Six Months Ended August 31, 2010 and 2009

11. Commitments and contingencies

The Company files separate tax returns for its Canadian subsidiaries. Management has recorded their best estimate of the Company's income tax obligation in the consolidated financial statements. The ultimate liability however is subject to final approval by taxation authorities. It is possible that the tax authorities may reassess the Company's filing position which could result in a material increase in the Company's liability for current and prior financial periods; however any such adjustment is indeterminate at this time.

The Company is subject to anti-money laundering ("AML") legislation in jurisdictions in which it operates or has operated in. Management has implemented controls and procedures that it believes put the Company in compliance with all applicable AML rules and regulations.

12. Financial instruments and concentration of risk

Fair values

The Company's financial instruments include cash and cash equivalents, accounts receivable, Citadel processing accounts, accounts payable and accrued liabilities, Citadel processing liabilities and capital lease. The fair values of these financial instruments approximate their carrying values.

Credit risk

The Company maintains substantially all of its cash and cash equivalents with major financial institutions internationally. Financial instruments that potentially subject the Company to concentration of credit risk are primarily accounts receivable. Management is of the opinion that any risk of loss is significantly reduced due to the financial strength of the Company's major customers.

Foreign currency risk

A significant component of the Company's transactions, particularly revenues, is undertaken in US dollars, Euros, and other foreign currencies. The Company maintains significant deposits in foreign currencies denominated accounts. Fluctuations in exchange rates between those foreign currencies could have a material effect on the business, results of operations and financial condition of the Company. The Company does not use hedging instruments to manage its exposure to foreign currency exchange risk.

These unaudited financial statements have not been reviewed by the Company's auditors.

Dated October 29, 2010